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The Growing Business
phenomenon of “Fraudulent
Bankruptcy”

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Following the recent global economic recession, there has been a huge increase in the number of businesses seeking to declare themselves Insolvent. Logically, no business or individual would like to go bankrupt, or would they?

The Lithuanian economy, lawyers use the new term "phoenix" for this type of business behaviour. 'Why 'phoenix'? In Ancient Egyptian mythology, the 'phoenix' is a symbol of rebirth, a saintly mythological bird. According to the legend, the bird used to make self-immolation, after which it was reborn from the ashes every five hundred years. The link by analogy between the original meaning of the symbol, its use in common everyday speech and our recently developed usage of it as an informal legal term can be readily observed.

The concept of 'Fraudulent Bankruptcy' (also known as the 'Phoenix syndrome') became common practice from the time of Lithuania's independence in 1991 and became very popular for businesses after the Russian economic crunch in 1998. Fraudulent bankruptcy has become an increasingly evident problem during the economic downturn. Increasingly, this is of concern to the public who are outraged when a company, post-bankruptcy, effectively continues its operations in the names of other companies. Also where irresponsible management has led a company to be run by other companies and creditors of bankrupt companies, companies are simply crossed out and written off.

This practice is undoubtedly to the detriment of the state and its citizens. It spreads legal nihilism in society. Some business association leaders even publicly say that the 'Phoenixism' is the only option for business continuity. It is true that for some the 'Phoenix' is a good option, but for others that continuing business entity can be a very heavy burden.

Who can stop such a 'Phoenix syndrome'? The main features of fraudulent bankruptcy can be identified in instances of artificial corporate arrangements, which include agreements to pay unreasonably large liquidated damages. The 'tax administration law fraud model' of Lithuania defines the offence, where the company has a self-serving desire to go out of business, reduce its activity, and prior to terminating to transfer its marketable assets to others, usually to individual company owners or shareholders of the newly founded company, thus avoiding the obligations to creditors and government taxes. Meanwhile, the company that acquires the property applies to the State Tax Inspectorate under the Ministry of the Republic of Lithuania for the value added tax (VAT) reimbursement, even though it knows that the assets were sold by the company claiming to be insolvent, and which did not pay VAT on the sale of assets.

Another similar scam can be found where the company asks the court to declare its insolvency and commence bankruptcy proceedings and to appoint a trustee. This is a situation where after a very short period of time or a change in the company shareholders, the company transfers its shares to a fictitious person (eg. an anti-social person) leaving creditors unpaid. Another option is where, before the bankruptcy or insolvency proceedings, the company's brand is sold and a new company with a very similar name created (often where the name is changed by one or two letters).

Often, this model is related to unfair practices by the debtor intentionally causing the company to become insolvent, or significantly reduce their volume of business, moving the company's resources to another entity, which is usually associated with a debtor's shareholders, managers, either in a direct or an indirect way. A debtor transferring the debt to the whole of its business or a significant part of it to another company, and thus preventing the implementation of its obligations to creditors as a 'Phoenix syndrome' can also be used as a getaway from the various requirements established by law. The decision to go out and continue in the other company may be one way to avoid these requirements.

The illegal use of such models affects the economic situation negatively (compounding the global

financial crisis), encouraging the worsening financial situation of companies, the dishonesty of business managers or owners, and the desire to get rid of the financial responsibility.

When the head of a company consciously decides to keep the bankrupt company to the detriment of its creditors, what happens next? Answer – ‘fraudulent bankruptcy’, fraudulent conduct or creditors who seek to transfer the assets. Of course, there is unlimited liability of unincorporated individual enterprises, where the owner is responsible for the debts of the enterprise with all of their personal property due to the fact that the business owner takes a risk not only for the company but also for his personal property. Therefore, the individual business owner has no incentive to waste or sell assets, because its creditors may pursue their claims in reference to the owner's personal assets.

Deliberate bankruptcy, 'Phoenix syndrome' is an inevitable consequence of the limited liability company. As long as it is considered that a limited liability company is required (eg, for entrepreneurship reasons), then corporate executives will have an incentive to indulge in illegal activities. An analogous situation is the concept of personal bankruptcy. The imposition of conditions under which a natural person could go bankrupt, allows individuals to deliberately worsen their financial position to meet the necessary conditions for bankruptcy.

This kind of syndrome is an old and current business issue, not only for legal persons, but also among individuals. The validation of an individual bankruptcy only encourages abuse of the bankruptcy model. Validation of complex bankruptcy appears in financial situations, where individuals reduce the incentives to improve the financial situation, because of work or earnings due to the consequences of a less painful exit from demanding business opportunities. Bankruptcy allows the opportunity to repeat the risky economic activities for persons who have been declared bankrupt. It also enables validation of the bankruptcy into debt, acquiring the assets transferred or otherwise concealing them, and then initiating a bankruptcy to get rid of liabilities while keeping all the debtors assets. Such an approach to bankruptcy of natural persons would amount to a 'Phoenix' in the future not only for legal entities, but also as individuals.

Lithuania does not yet have a legally regulated bankruptcy institute, but the perception is that an individual bankruptcy validation only encourages an abuse of the bankruptcy concept. However, we must not necessarily divide the 'Phoenix Syndrome' into natural and legal persons. As in all cases, the companies continue to be owned by natural persons – i.e. business executives, whose abilities to organize the work governs the success of business.

Competition between the different activities should be maintained. Not only because limited liability of legal persons is caused by bankruptcy with various possibilities for abuse, but also because the company's creditors should be able to confidently choose to lend to these legal persons who are not entitled (whether intentionally or due to business failure) to go bankrupt and thus eliminate their obligations. It may be that at the end of the economic downturn, on corporate bankruptcies with fingers burned, creditors will pay more attention to lending to limited or unlimited liability companies. This could become an additional motive for doing business in the choice of unlimited liability status.

Fraudulent bankruptcy diminishes the honesty of a company's working position, reducing the mutual trust of business partners. The biggest problem is the determination of fraudulent bankruptcy cases - prolonged pre-trial investigations gathering evidence of the determination of the absence of fraudulent bankruptcy. Dishonest players, selecting and applying the order of the 'Phoenix syndrome' model, not only to avoid tax obligations to the state, but also seeking to benefit its business partners. Usually the intention to place the company into bankruptcy is planned in advance by business managers or owners to avoid responsibility.

In the case of an intentional bankruptcy, the bankruptcy administrator is required to investigate and verify the bankrupt company transactions concluded within 5 years prior to bankruptcy, and actions contrary to the company's objectives, or which could have an impact on the company such that it cannot pay its creditors, are deemed to be invalid. Normally during the bankruptcy process, the

transactions concluded within not less than 3 years prior to bankruptcy are checked. The right to apply to court for a declaration of fraudulent bankruptcy or creditor claims in bankruptcy proceedings both require to be approved by the court. The fraudulent bankruptcy offence of the Republic of Lithuania Criminal Code provides for civil and criminal offences. The most common criminal offenses relate to fraudulent bankruptcy of the institution, which is classified as a serious crime. The criminal liability of proof in such cases is complicated, requiring considerable intellectual input. Suspects in the alleged offenses such as crimes of property misappropriation are punishable by a maximum prison sentence of up to 10 years; in fraud, the maximum prison sentence is up to 8 years; property embezzlement (imprisonment for up to 7 years) and less severe forms of financial crime: fraudulent record keeping, incorrect data on income and property presentation and so on.

Often, state proposals to combat officially unaccounted 'Phoenix syndrome' identify it as one of the violations that pose the greatest threat to the country's economy.

From the legislation you can find that there should be an obvious position on the Lithuanian state's 'Fraudulent Bankruptcy' problem, but it doesn't work in practice. The State Tax Inspectorate under the Ministry of the Republic of Lithuania is quite active in fighting for the interests of the state budget. In order to authenticate the company's insolvency, it is necessary to have provided financial balance sheets, information on the nature of trading, (debt trading partners, the state budget, the wages paid to employees) and public advertising of jobs. The concept of obliging companies to report large transactions concluded needs to be considered as well. If this requirement for reporting is increased, the personal liability of company shareholders is highlighted, thus ensuring that no 'Fraudulent Bankruptcy', or 'phoenix' will appear. The State Tax Inspectorate has provided tools to determine the pattern of tax evasion and attempts to bankrupt otherwise solvent companies. Their dealings in property or relocation of assets is carefully analysed. The media highlights this area by discussing the fraudulent bankruptcy cases and their decisions. For society, it is no longer enough to permit such matters to be dealt with in just a few lines of public notices relating to a company which has filed for bankruptcy. Of course, it is good to have an effective judicial practice in Lithuania. The bankruptcy of some of the personal assets of company managers relating to the recovery of damages is clearly prejudicial to the creditors and constitutes a transaction in the knowledge of expected bankruptcy proceedings. However, the fact that the company was led by a number of management indulging in financial irregularities does not in itself prove deliberate, targeted and consistent action.

Perhaps the solution is greater corporate responsibility in such a way that the arrangements ensure that no fraudulent bankruptcy, 'phoenix' and so on occurs. Corporate bankruptcy would then no longer have such a big impact on the economy. Are there clear cases of 'Fraudulent Bankruptcy' in Lithuania? According to official data, in the 1998 - 2009 years, there have been 30 fraudulent bankruptcy cases. Bankruptcy courts generally do not recognize a deliberate arguing that a lack of evidence, wrongly stated facts, or the management's actions, aim to bring a company to a bankruptcy declared legally. Meanwhile, the number of apparently 'non-fraudulent' bankruptcies amounts to hundreds of thousands.

On a closer examination of fraudulent bankruptcy causes, it is clear that a large number of managers and owners are charged for transactions that have been deliberately arranged so as to increase losses and debts of the company that could not be settled with their creditors: loss-free sale or transfer of immovable property or shares, giving the owners interest-free loans the company itself owes to banks and creditors are not accountable to, the use of company funds without a reasonable record, setting up a subsidiary in which the property transferred, leaving debts of a failing firm.

Due to improper unprofessional management behaviour, and an inability to properly and responsibly organize the company in achieving the company goals, companies go bankrupt. Nevertheless, even a perfect organization of the procedure will not help those companies whose managers simply do not wish to continue their business, as they must show the greatest interest in the company's future performance.

However, in order to deliberately be declared bankrupt, strong evidence is required, which, as experience shows, is rare. Officials investigating a case of possible fraudulent bankruptcy are hampered by lack of resources and professionals. Trying to determine what were the goals of bankruptcy and to identify bad faith, or an attempt to use a failing firm with the rights conferred by law, is not an easy exercise.

Maybe one company director sees the 'phoenix' as a good opportunity to preserve a business, but for another business entity it may be a rope around their neck. Banks are demanding their own redress, but then the companies have to try to conceal their assets or go out and get rid of all the obligations while rescuing the financially viable part. In fact, there are often good reasons why the transfer of a business should be permitted, as long as it is handled fairly and at arms length. Not all legitimate businesses succeed at the first attempt. According to data from the financial institutions, one in three businesses closes within three years. Businesses can fail for any number of reasons and there are many occasions when honest individuals find they can no longer trade their way out of their difficulties. In these cases, the 'phoenix company arrangement' allows a business to start again, and for the profitable elements of the failed business to survive, offering some continuity for both suppliers and employees.

It may be that at the end of the economic downturn on corporate bankruptcies, creditors will pay more attention to whom they lend their money. Nevertheless, it is clear that one of the forms of tax avoidance – 'phoenix syndrome' – intensified because tax evasion increases during the economic crisis. Once a company has achieved its financial commitments, they dissolve the bankruptcy, but economic activity continues with the newly established company. In this case, the state budget for delinquent and non-repayment of the VAT-based is a victim several times.

We would like to add that none of the failures are protected. There is many parties to blame - too high expectations, the period of their decisions. In each case the facts should be considered in relation to the activities of the company, the corporate bodies of decisions that are consistent and targeted "phoenix syndrome" symptoms. After all, business strategy, rather uniformly over life, is consciously created and selected.

At this point, each of us needs to respond to the following question: 'If a company went bankrupt, and found the strength to start all over again – it is bad? The answer is 'Not necessarily!' Everything just depends on the approach. Apparently, all efforts are not in vain. This is a viable expression of the fact that if you cannot change the situation, you must change one's attitude towards it to achieve victory.