Analysis of Key Policy Areas of Reform in the Existing Framework Governing Debt Restructuring in Latvia

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Tieslietu ministrija

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for Reconstruction and Development

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Glossary

Term	Definition
APR	The absolute priority rule, as defined by Directive 2019/1023, whereby a dissenting class must be paid in full if a more junior class receives any distribution or keeps any interest under the Restructuring Plan
Debt Restructuring	A common term encompassing OCW, LPP and ELPP, which means a formal or informal process that allows a business entity facing cash flow problems and financial distress to reduce and renegotiate its debts to improve or restore liquidity so that it can continue its operations
Directive 2013/34	Directive (EU) 2013/34 of the European Parliament and of the Council of 26 June 2013 on annual financial statements, consolidated financial statements and related reports for certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC Text with EEA relevance
Directive 2019/1023	Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EDS	Electronic declaration system
ELPP	Extrajudicial legal protection proceedings within the meaning of the Insolvency Law
EU	European Union
EWI	Early warning indicators
EWS	Early warning system
FICIL	Foreign Investors' Council in Latvia
Formal Restructuring	A term encompassing either LPP or ELPP, which means a formal process under the supervision of the court that allows a business entity facing cash flow problems and financial distress to reduce and renegotiate its debts to improve or restore liquidity so that it can continue its operations
FY	Financial year
ICS	Insolvency Control Service
IMF	International Monetary Fund
Insolvency Law	Latvian Insolvency Law in force since 1 November 2010, as amended, last modified on 5 December 2019
Insolvency Practitioner	A natural person appointed by the court for the managing of liquidation as defined by Article 9 of the Insolvency Law
KPI	Key performance indicator

Latvia	The Republic of Latvia
LCCI	The Latvian Chamber of Commerce and Industry
LLC	Limited liability company
LPP	Legal protection proceedings within the meaning of the Insolvency Law
Ministry of Justice	Ministry of Justice of the Republic of Latvia
MS	Member State of the EU
N/A	Not applicable
NPL	Non-performing loans
OCW	Out-of-court workouts
OECD	Organisation of Economic Co-operation and Development
Project	Support for Debt Restructuring in Latvia
PwC	PricewaterhouseCoopers SIA, registration number: 40003142793, address: Krišjāņa Valdemāra iela 21–21, Riga, LV-1010, Latvia
Register of Enterprises	The Register of Enterprises of the Republic of Latvia
RPR	The relative priority rule, as defined by Article 11 of Directive 2019/1023, whereby a dissenting voting class of affected creditors is treated at least as favourably as any other class of the same rank and more favourably than any junior class
Restructuring Plan	Plan of measures of LPP and ELPP as defined by Article 40 of the Insolvency Law
Rules	Regulations of the Cabinet of Ministers
SME	Small (micro) and medium-sized enterprises
SRS	State Revenue Service
Supervisor	A natural person appointed by the court for the supervision of LLP or ELPP as defined by Article 8.1 of the Insolvency Law
UK	United Kingdom
VAT	Value Added Tax

Restrictions and Limitations

This report has been prepared by PricewaterhouseCoopers SIA ("PwC") for the EBRD and Ministry of Justice as a beneficiary under the terms of the contract dated 30 August 2019 (the "Contract").

This Project and report are funded by the European Union through the Structural Reform Support Programme and is implemented by the EBRD, in cooperation with the European Commission, and with the support of a consortium of financial and legal experts led by PwC Latvia.

This report has been prepared for the purposes of identifying legislative or implementation issues hindering Debt Restructuring in Latvia with an in-depth review of existing practices. Please note that the insolvency of natural persons who are not entrepreneurs does not fall within the scope of the report.

The assignment was carried out during the period from 20 September 2019 to 5 June 2020. The work of PwC included interviewing stakeholders and experts as well as analysing documentation, Latvian legislation, EU legislation, case law, research materials, online resources, national databases, international best practice, statutory instruments in force at the time of drafting this report and legislative benchmarking.

This report contains information obtained or derived from a variety of sources. PwC has not sought to establish the reliability of those sources or verified the information so provided. Accordingly, no representation or warranty, whether express or implied, is given by PwC to any person (other than the EBRD under the Contract) as to the accuracy or completeness of the report.

This report does not incorporate the effects of any events or circumstances which may have occurred or any information which may have come to light after 5 June 2020. We make no representation as to whether there would have been a material effect on the report had we carried out such work or made such enquiries.

We have, without independent investigation or verification, assumed the following:

- All facts set forth in official documents are complete, truthful and accurate;
- All the information provided to us is complete, truthful and accurate;
- All the factual representations contained in the documents produced to us are complete and accurate, and we have therefore made no independent investigation thereof unless expressly provided herein otherwise;

This report provides our opinion only on the general legal aspects contained herein. Moreover, this report is based on the information provided to us by the stakeholders as well as on publicly available information, binding laws of Latvia, and the case law of Latvian courts.

PwC accepts no duty of care to any person (other than the EBRD under the Contract) for preparing this report. Accordingly, regardless of the form of action, whether in contract, tort or otherwise, and to the extent permitted by applicable law, PwC accepts no liability whatsoever and disclaims all responsibility for the consequences to any person (other than the EBRD under the Contract) or for any decisions made or not made on the basis of this report.

On March 2020, the Latvian government announced new measures designed to contain the spread of COVID-19 within Latvia following the World Health Organisation's declaration of a global pandemic. Please note that statistics and most of the recommendations in this report were produced prior to this decision, and the present political and economic conditions may change dramatically.

Preface

This report has been drafted by PwC in coordination with the EBRD within the framework of the Project "Support for Debt Restructuring in Latvia." The Project and this report are funded by the EU and implemented with the support of the EC Directorate-General for Structural Reform Support (DG REFORM) in cooperation with the EBRD's Legal Transition Team.

The findings of this report will benefit Latvia's overall objective to improve its current Debt Restructuring and insolvency framework and thus improve the overall business environment in Latvia according to the policy guidelines already in place. The report will also advance the overall goals of the Project, which are to provide technical support to the Latvian authorities in order to strengthen the framework for Debt Restructuring and enhance the use of OCW for enterprises and improve the understanding and skills of key stakeholders.

The suggestions and recommendations of the report are intended to assist the legislators in implementing Directive 2019/1023 and drafting general reforms within the existing Debt Restructuring and insolvency framework in Latvia.

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Executive Summary

Objectives of the Report

This report is created within the larger scope of activities of the Project scheduled to take place from September 2019 to March 2021. The main objectives of the Project are to improve access to Debt Restructuring for enterprises in Latvia and to strengthen the capacity of judges, Insolvency Practitioners and Supervisors in Formal Restructuring and cross-border insolvency in line with international best practice.

The **specific objectives** of the Project are to support the Latvian authorities in –

- identifying legislative or implementation issues hindering Debt Restructuring in Latvia with an in-depth review of existing practices;
- developing strategies and mechanisms to strengthen and encourage the use of Debt Restructuring at an early stage;
- training key stakeholders, namely judges, Insolvency Practitioners and Supervisors, in Formal Restructuring and cross-border insolvency; and
- raising awareness across the public and private sectors of the benefits of Debt Restructuring.

Greater awareness and better use of Debt Restructuring, and any related improvements in the legal framework, if necessary, are expected to have a positive effect on the wider economy, investment climate and employment in Latvia. This is also expected to improve the financial sector's resilience and to help Latvia reduce the level of NPL in the banking system.

The expected outcome of the Analysis of Key Policy Areas of Reform in the Existing Framework Governing Debt Restructuring in Latvia is to provide support for the Latvian authorities in addressing any shortcomings identified in Debt Restructuring (from an implementation perspective and, to the necessary extent, from a legislative perspective), in particular obstacles to the use of Debt Restructuring tools.

Scope of the Report

This engagement includes benchmarking the Latvian Debt Restructuring regime against the EU's new Directive 2019/1023 on preventive restructuring frameworks. Directive 2019/1023 seeks to establish a stronger, more harmonised restructuring regime for enterprises across the EU and to improve the efficiency of insolvency, Debt Restructuring and debt discharge procedures for entrepreneurs. As the Latvian authorities are required to transpose Directive 2019/1023 by 17 July 2021, this report aims to indicate which mandatory provisions of Directive 2019/1023 would require changes to Latvian laws and practices, and which optional provisions of Directive 2019/1023 should be considered by the Latvian authorities for implementation. With its focus on restructuring, Directive 2019/1023 inevitably interacts with most areas of this report.

Directive 2019/1023 requires MS to develop a framework for supporting preventive restructuring. The reference to "framework" is an acknowledgement that Formal Restructuring cannot be achieved by a court-led or -supervised procedure alone, and that a number of different procedures may often be involved. In certain cases the goal of Debt Restructuring may be achieved through contract negotiations subject to an appropriate level of creditor support. Indeed, creditors and debtors often seek to avoid formal insolvent liquidation proceedings, as they can be value-destructive for the business. Yet having a properly functioning legal framework for Formal Restructuring can act as a catalyst for contract-based Debt Restructuring. Restructuring Plans approved by the majority of creditors are binding on all creditors and thus ensure an effective solution to the requirement for the consent of all creditors, which would otherwise be nearly impossible to meet. The Project therefore includes an assessment of Formal Restructuring and OCW to provide a complete picture of the existing Debt Restructuring environment.

Directive 2019/1023 is focused on developing a debtor-in-possession preventive restructuring framework across the EU, as insolvency systems in many MS have traditionally focused on liquidation. However, similar to insolvency, Debt Restructuring needs to carefully balance the interests of the various parties, in particular the debtor, its owners or shareholders, private creditors, and public creditors (especially the tax authorities). The system needs to create the right checks and balances to ensure that debtors have some breathing space to reach an agreement with their creditors, while the interests of creditors are not unduly harmed by a stay that restricts their ability to take enforcement action.

Supporting Debt Restructuring and Formal Restructuring does not necessarily mean increasing the number of Formal Restructuring cases, since a low case count may suggest wider use of private solutions and OCW, which is to be encouraged. Evidence of some critical-level use of Formal Restructuring procedures is nonetheless important, as very low or no usage may mean that there is resistance to Debt Restructuring and there is not enough practice to build a culture and expertise of Debt Restructuring and turnaround of financially distressed enterprises.

Consultations with public stakeholders clearly indicate an urgent need to improve the formal practices of Formal Restructuring, to build public confidence and trust, and to ensure that the Formal Restructuring tools are properly used by enterprises in financial difficulty and for their intended purpose of restoring solvency. Accordingly, any vision of Debt Restructuring should primarily focus on increasing –

(i) the information available to debtors and creditors about Debt Restructuring to ensure timely preventive action and proper use;

(ii) the quality of Restructuring Plans submitted to the courts in Formal Restructuring; and

(iii) the number of successfully completed Restructuring Plans.

As LPP offer the possibility of a stay of creditor enforcement actions, the screening of enterprises accessing LPP should also become more effective to ensure that any stay is used for the intended objective of reaching an agreement between the debtor and its majority creditors.

In summary, there are five preconditions for Debt Restructuring to succeed:

> **The Right Companies**
>
> **For the Right Reason**
>
> **In the Right Way**
>
> **At the Right Time**
>
> **And**
>
> **For the Right Outcome**

More specifically, in order to achieve this goal and have the highest impact:

(i) **further development of and proactive communication about the existing EWS** operated by the SRS, supported by online information and guidance, should help **alert debtors in financial distress** to the need for acting quickly and appropriately;

(ii) **development of guidance and state-subsidised advice** may assist smaller enterprises to access the procedure;

(iii) **strengthening and expanding the Supervisor's role** in Formal Restructuring should increase the quality of Restructuring Plans, and mandating the appointment of a Supervisor where there is a stay should provide an important level of supervision of the debtor's business necessary to prevent misuse;

(iv) **further improvement of the existing sanctions system**, where appropriate, including administrative penalties for certain cases of misuse or misbehaviour, should deter misuse of Formal Restructuring;[1]

(v) **further specialisation of judges** and a focus on increasing their judicial capacity to tackle ever more complex insolvency and Formal Restructuring cases should ensure the effectiveness and efficiency of procedures as envisaged by Directive 2019/1023; and

(vi) **granting access to LPP only to viable enterprises** by requiring a prior business viability assessment should reduce the burden on the judicial system. Given the out-of-court nature of the first phase of ELPP and lack of a stay period, such a viability test should not apply to ELPP.

[1] While various statutory sanctions are available, ways of applying them more actively should be discussed to limit abuse of Formal Restructuring.

Overview

Latvian Economy and Statistical Data

The Latvian economy is dominated by SMEs[2] and micro enterprises in particular. According to the EC overarching framework for the EU policy on SMEs – Small Business Act data for 2018, SMEs represent 99.8% of all enterprises in Latvia (92.1% micro, 6.5% small, and 1.2% medium). The remaining 0.2% are classified as large enterprises.[3]

In making any recommendations, this report will focus on the characteristics of the Latvian business environment and on the large number of micro and small enterprises to maximise the potential benefits of Debt Restructuring in Latvia.

Legal Framework of Formal Restructuring

In Latvia, Formal Restructuring was first introduced by the Law on Insolvency of Enterprises and Companies and reiterated in the Insolvency Law of 1 January 2008. Subsequent reforms gradually added more tools for restoring solvency and increasing the speed and effectiveness of Formal Restructuring.

Overall, the stakeholders consulted by PwC consider the Latvian framework to be satisfactory and suited to the specifics of the business environment. LPP and ELPP can be used as a basis for the preventive restructuring framework envisaged by Directive 2019/1023. While the Latvian legal framework is largely consistent with internationally accepted standards, Latvia must adopt certain mandatory provisions to increase the flexibility of Debt Restructuring and may include certain optional provisions of Directive 2019/1023.

Transposing Directive 2019/1023 will not eliminate all the existing differences between MS preventive restructuring frameworks. Some of the provisions of Directive 2019/1023 allow significant room for interpretation by the national legislature. While Directive 2019/1023 is an opportunity for Latvia to further enable preventive restructuring as a viable alternative to insolvent liquidation, legislation alone will not facilitate its effective use. Focus should therefore be on strengthening the practical application of LPP and ELPP in parallel with transposing Directive 2019/1023.

Practice of Debt Restructuring in Latvia

The latest statistics for Latvia show a total of 428 LPP cases initiated over the period from 2017 to 2019 (149 in 2017, 150 in 2018, and 129 in 2019) (see Figure 1 and Annex 11). A Restructuring Plan was approved by the court only in one out of five initiated LPP cases. The Restructuring Plan success rate was even lower than the number of completed LPP cases. The Restructuring Plan was carried out by the debtor according to its provisions in only one out of about 15 completed cases. These trends are generally consistent with earlier years going back to 2008.

The overall number of ELPP is relatively small (see Figure 1) and comprises initiated, court-approved and completed cases. The last three years saw only three new initiated ELPP cases. Most of the ELPP cases involved Restructuring Plans approved by the court during the period under review (19 in total). This number is quite close to the number of ELPP cases completed (18 in total). Most of the ELPP cases relate to 2017, with lower activity in 2018.[4]

Approved Restructuring Plans are substantially outnumbered by liquidation cases: close to 600 annually (591 in 2017, 590 in 2018, and 566 in 2019). Similarly, in other countries such as the UK, cases of administration, a procedure that may result in restructuring the debtor's business, are significantly outnumbered by the number of liquidation cases.[5]

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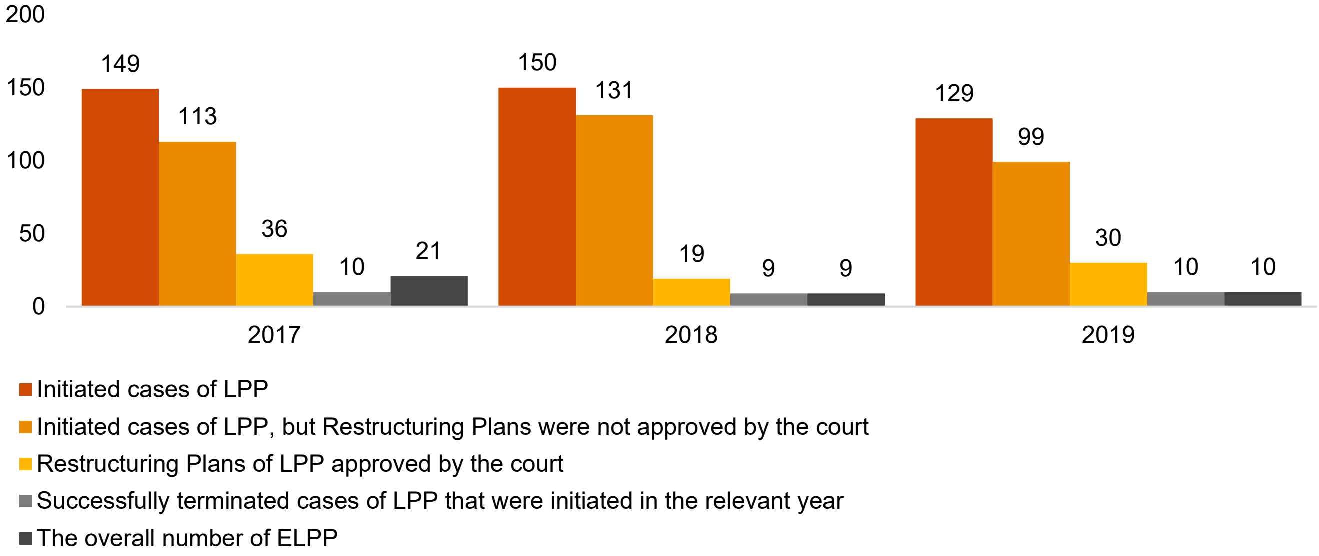
[2] The term "SME" in this report is used in line with Rules No. 776 of 16 December 2014, *Procedures for Declaring Enterprise Compliance with the Status of Small (Micro) and Medium-Sized Enterprises and* falls within the scope of the Commercial Activity Support Control Act. For the purposes of these rules, an SME is defined in accordance with Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty ("Commission Regulation No 651/2014").

[3] See statistics in Annex 2. A statistical overview of viability of enterprises in Latvia by count.

[4] Registered ELPP cases. Available at: https://www.lursoft.lv/exec?act=MNR_LSTAT&stat_id=553&lang=EN. [Accessed February 13, 2020].

[5] In England and Wales, administration, which is an insolvency procedure, may be combined with a scheme of arrangement, a company law procedure, to achieve a restructuring of the debtor's business. For data on the different types of UK insolvency procedures, see consolidated data from 2015 to 2017. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/780091/Commentary_domain_update.pdf. [Accessed February 11, 2020].

Figure 1 Cases of Formal Restructuring in the relevant year, source: Insolvency Register[6]



As detailed in section IV below, OCW in Latvia mainly involves various agreements between the debtor and its financial creditors or the SRS. The stakeholders have cited bilateral OCW agreements between private enterprises, with no evidence of widespread multilateral or multi-creditor OCW.

I. Key Findings

This section summarises the main issues raised in the Project team's interviews with the stakeholders listed in Annex 5 to this report and found in the analysis of relevant legislation and practices related to Debt Restructuring.

a. Overall Business Environment

1) Latvian enterprises are overwhelmingly SMEs. The low maturity level and lack of financial expertise in most Latvian enterprises results in their failure to address financial problems early or in their unwillingness or inability to spend money on external professional advice. This situation is aggravated by a lack of available and affordable advisory support for enterprises. Consequently, the behaviour of many enterprises does not support any turnaround or rescue.

2) The progressive concept of preventive restructuring for financially distressed enterprises is overshadowed by numerous cases of deliberate misuse of the stay period and consequently failed LPPs. According to the stakeholder interviews, many cases of misuse did not lead to a company director or other officer being sanctioned or prosecuted, even though criminal liability for breaching Formal Restructuring rules is prescribed by Article 215^1 of the Criminal Law. The image of Formal Restructuring has suffered significant damage and contributed to a culture where public and private partners avoid entering into new contractual relationships with such enterprises even though some of them are legitimately pursuing Debt Restructuring.

3) Debt Restructuring is also hindered by the existing shadow economy and the availability of "easier" and more lucrative alternatives. Instead of restructuring its debts, a company's shareholders and/or directors tend to form a new company and shift the presumably struggling business and its assets to the new company, leaving the old one as a defunct insolvent entity encumbered by its old liabilities.

[6] See data on registered LPP cases in the relevant year. Available at: https://ws.ur.gov.lv/urpubl?act=MNR_STAT&stat_id=539&tableorder=yes&tableorder=1&tablesequence=D, and https://www.lursoft.lv/exec?act=MNR_LSTAT&l=LV. [Accessed February 11, 2020].

b. OCW

4) Interviewees confirmed that OCW plans are based on private agreements and are independent of judicial intervention. This is the case in most countries, with exceptions such as Ukraine and Serbia,[7] which have experienced high NPL levels in their banking systems. In those countries, the legislature has sought to formalise OCW in a legal framework, while retaining its voluntary nature by providing tax and other incentives to banks and enterprises. In Slovenia, during a period of high NPL levels, the Central Bank took on a monitoring role for OCW and required the parties to notify any OCW they had entered into. As Latvia is not experiencing a financial crisis or high NPL levels, the authors of this report believe that the authorities should follow the standard practice of not interfering in the parties' autonomy with respect to OCW.

5) The majority of stakeholders (e.g. credit institutions, major suppliers and the SRS) consider OCW[8] to be more economically reasonable in terms of value preservation (i.e. less disruptive and more effective) than Formal Restructuring. It is not clear, however, to what extent OCW really addresses business reorganisation needs and promotes economic performance (operational restructuring) and financial restructuring.

6) Credit institutions (banks) use in-house and external tools to closely monitor their borrowers and minimise the risk of loans becoming NPL, and prefer to deal with enterprises in financial distress on a bilateral basis outside court proceedings, without receiving approval for their activities from other creditors and the SRS.

7) The SRS has adopted rigorous control procedures and a risk analysis approach that allows early detection of misuse and tax evasion. The Law on Taxes and Duties expressly recognises the option of negotiating an extension of the time limit for a tax payment within OCW, and the SRS generally accepts it.

8) The SRS does not have the power to reduce the amount of overdue tax charges within OCW unless a settlement is signed or a tax amnesty declared. Interest continues to accrue on tax debts, increasing the risk of unsuccessful execution of the Restructuring Plan if a formal procedure such as LPP is subsequently initiated.

9) Employees are typically not informed about OCW, and their representatives do not generally take part in the decision-making process or influence the negotiations. This is the case in most OCW negotiations since the objective of OCW is to keep the business as stable as possible.

c. Directive 2019/1023

10) Directive 2019/1023 is expected to bring substantial changes to the MS national legal frameworks. As stated above, the Latvian legal framework is largely consistent with internationally accepted standards but will require modifications nevertheless.

11) Article 3 of Directive 2019/1023 requires MS to ensure that debtors have access to one or more clear and transparent early warning tools for detecting financial problems with the assistance of IT for notification and communication. With its SRS Taxpayer Rating System, Latvia appears to meet the minimum EWS criteria prescribed by Directive 2019/1023. However, additional measures should be considered to achieve one of its main objectives – encouraging debtors to take early preventive action in restructuring their enterprises. These measures may include, for example, proactive communication to explain the workings of the Taxpayer Rating System, educating entrepreneurs on Debt Restructuring topics and ensuring that all information on Debt Restructuring tools is easily accessible to enterprises.

12) Certain concepts in Directive 2019/1023 are new to the Latvian legal system, including these:

    (i) Provisions relating to creditor voting rights, approval of Restructuring Plans, protections for debtor enterprises such as invalidity of *ipso facto* clauses and maintenance of essential executory contracts, and the potential for an enhanced role of the Supervisor in certain circumstances.

[7] Serbia introduced the Consensual Financial Restructuring Law and a mediation-based OCW framework in 2013. Ukraine adopted the Financial Restructuring Law in 2016 to support OCW, which has been used in particular for state-owned banks.

[8] OCW are carried out before the initiation of proceedings in court (Formal Restructuring). The party conducting business that has run into financial difficulties (the "debtor") and the creditor may enter into an agreement on Informal Restructuring, which results in both parties attempting to reach an agreement and change their debt repayment terms, using informal restructuring techniques in a way that allows the debtor to continue in business.

(ii) The concept of a “cross-class cram-down” (the court may confirm a Restructuring Plan even if it has not been approved by all creditor classes, subject to certain conditions) is not included in Latvian legislation. Directive 2019/1023 requires MS to ensure that for voting purposes the affected parties are treated in separate classes reflecting “sufficient commonality of interest” and that the national legislation recognises a minimum of two creditor classes: secured and unsecured. Directive 2019/1023 further requires that MS must adopt “appropriate measures” to ensure that classes are formed with a particular view to protecting vulnerable creditors such as small suppliers.

(iii) Under Article 9(4) of Directive 2019/1023, MS may allow SMEs to opt not to treat affected creditors in separate classes. Because of the inherent risk of misuse and Latvia’s experience with similar provisions in past iterations of the Insolvency Law, the authors of this report advise against permitting SMEs to opt out of separating their creditors into classes. Instead, SMEs should be subject to the same creditor class structuring rules as larger enterprises (i.e. an SME is either competent to separate creditors into classes of its choice or liable to follow the creditor class structure prescribed by the Insolvency Law).

(iv) The Insolvency Law treats all creditors as affected. Directive 2019/1023, however, introduces the concept of affected and unaffected creditors and provides that parties that are not affected by a Restructuring Plan should not have voting rights in adopting it. Introducing affected and unaffected creditor groups envisaged by Directive 2019/1023 would have a systemic impact on the Latvian insolvency framework and would need to be assessed in the light of the existing insolvent liquidation processes. However, introducing such groups could contribute to the effectiveness of Formal Restructuring by offering more flexibility to Formal Restructuring procedures and limiting their unnecessary application to creditors whose claims do not require restructuring, such as trade creditors, which the debtor must pay in full to continue trading.

(v) Directive 2019/1023 requires MS to prevent obstruction by equity holders, while at the same time offering certain safeguards for equity holder interests where they are affected. Directive 2019/1023 does not expressly regulate the conversion of debt into equity in satisfaction of financial liabilities, a tool that has been used by Latvia and other legal systems to enable banks and other creditors in Formal Restructuring to benefit from a potential future upside in the business in return for giving up a portion of the debt owed to them. Furthermore, Directive 2019/1023 does not prescribe how MS should approach the role of the tax authorities when designing an effective preventive restructuring framework.

d. Access to Formal Restructuring

13) The Insolvency Law makes Formal Restructuring relatively accessible to enterprises by setting very few entry requirements. With no viability test required at the outset of Formal Restructuring, LPP and its stay period are potentially accessible to unviable enterprises with no prospect of survival. There are no minimum eligibility criteria for LPP, and LPP has been open to misuse by persons using the procedure without good reason to believe the business will avoid foreseen financial difficulties or recover from a serious risk of insolvency. This is exacerbated by weaknesses in the law enforcement system and the judiciary, which usually does not prosecute perpetrators for misusing LPP or the company’s legal prerogatives. The number of ELPP cases is at least ten times as low as LPP, but ELPP boast a much higher rate of success. The statistics for the last three years show that a Restructuring Plan was completed in almost half of the ELPP cases initiated.

14) As the Latvian business environment mainly consists of SMEs with limited access to professional financial advice, a properly executed Formal Restructuring process may be so costly as to make it prohibitive for debtors.

15) While creditors are generally responsive to a sound Restructuring Plan, they are frequently reluctant to keep up supplies to the debtor, and their position may involve stopping supplies or requiring upfront payment with a potentially devastating effect on the viability of the debtor’s business. Directive 2019/1023 addresses this issue by limiting the ability of suppliers to trigger *ipso facto* termination clauses in their supply contracts (i.e. clauses that permit termination on an insolvency or near-insolvency event) and protecting essential executory contracts necessary for the continuation of the debtor’s business such as supplies. It still provides some level of protection also for suppliers, which are considered to be vulnerable creditors and potentially at risk of knock-on financial difficulties.

16) New suppliers and customers are reluctant to enter into agreements with debtors pursuing Formal Restructuring unless they provide additional guarantees or make advance payments. A debtor restructuring its tax debt within Formal Restructuring is prevented from participating in public procurements.

e. Restructuring Plan

17) Restructuring Plans tend to be underdeveloped because the legislation does not allow the Supervisor to take part in drafting the Restructuring Plan, and creditors rarely object to it. Thus, certified auditors or other experts are not often engaged to assess the Restructuring Plan. The Supervisor's duties are mostly confined to monitoring implementation of the Restructuring Plan. It is also common for the court to refrain from assessing the viability of the Restructuring Plan.

18) While Directive 2019/1023 does not prescribe a time frame for executing Restructuring Plans, the national legislation prevents them from exceeding two years. Limiting the time frame for executing a Restructuring Plan, without considering the specific circumstances of the restructuring case, is an unduly restrictive requirement that is not part of other leading European insolvency regimes such as the UK or Germany. This limitation is contrary to business sense, as some enterprises may need a longer period to implement the Restructuring Plan. On expiry of the two-year period, the Insolvency Law permits a two-year extension, so in practice the execution of a Restructuring Plan often lasts four years.

f. Stay Period

19) The lack of safeguards for creditor interests during the stay period creates opportunities for misuse. For example, the debtor may use the stay to transfer assets to another company or to delay the enforcement of creditor claims before the onset of liquidation.

20) The Insolvency Law does not confer the power to lift the stay of individual enforcement actions on judicial authorities, whether on their own initiative or at the request of the Supervisor or any interested party (such as a creditor). In contrast, Directive 2019/1023 expressly requires the power of judicial authorities to lift the stay in a number of cases, including where the stay no longer serves the purpose of supporting the development of a Restructuring Plan. However, Directive 2019/1023 permits MS to provide for a minimum period during which the stay cannot be lifted.

21) Under the Insolvency Law, a stay of individual enforcement actions initially lasts for two months, with the possibility of extending it for a third month. In practice, however, there are cases where the initial stay period exceeds four months. The authors of this report note that the maximum period in many MS is substantially longer than this, and Directive 2019/1023 initially limits the stay to four months, extendable for up to 12 months.

22) Under the Insolvency Law, no independent person is required to monitor the debtor's activities during the stay period in order to prevent him from hiding assets, amending documents, or exploiting the stay period under LPP simply to delay progress without attempting to prepare a Restructuring Plan for negotiation with creditors. Creditors alone (even if they have approved the Restructuring Plan) are unable to ensure adequate supervision of the debtor's activities during the stay period.

23) The stay period and the following period of (ultimately unsuccessful) execution of the Restructuring Plan sometimes eliminate all opportunity to challenge the debtor's previous transactions during the insolvent liquidation procedure, as the Insolvency Law limits the time frame for challenging the debtor's transactions to three years before the declaration of the insolvent liquidation procedure.

g. Supervisors

24) Supervisors often lack sufficient financial and economic expertise and are unable to ensure that the Formal Restructuring process can restore the debtor's business to financial health, or at least save some parts of the business that are still economically viable. There are no requirements for the Supervisor's economic or financial expertise, and in practice more than 90% of Supervisors are lawyers.

25) Since the law does not prescribe any qualification requirements for Supervisors, it is possible for a person without the necessary expertise to become a Supervisor, which leads to poor quality of Formal Restructuring from a business perspective.

26) The Supervisor's main role is to check that the Restructuring Plan meets the formal requirements and to formally monitor its execution (in practice this mainly involves verifying that the debtor has made a monthly payment to creditors according to the Restructuring Plan).

27) In appointing a Supervisor for a particular case, the judicial authority often fails to give due consideration to the Supervisor's experience or skills, including his financial skills, or to the specific features of the case or business, as required by Directive 2019/1023.

h. Employees

28) Workers' rights are generally protected under Latvian law but could benefit from further codification in the Insolvency Law. New obligations imposed on employers could ensure that existing protections work in practice. Consultations with the Latvian Confederation of Free Trade Unions suggest that LPP have adversely affected individual workers' social security entitlements in a number of cases.

29) Although employees' representatives have the right to access or request information about the employer's financial position under Article 11 of the Labour Law, in practice workers might remain unaware of the employer's financial difficulties. Workers have no other legal rights as creditors in the process of Formal Restructuring unless they are affected by the Restructuring Plan.

i. Directors' and Shareholders' Role

30) There are no specific restrictions on equity holders under Latvian legislation to ensure that they do not prevent or hinder the adoption, confirmation or implementation of a Restructuring Plan as required by Directive 2019/1023, apart from certain restrictions on shareholders with decisive influence over the debtor and on companies incorporated in one group with the debtor to vote on the Restructuring Plan. The existing restrictions are mostly confined to the general principles of the Insolvency Law that regulate the conduct of all stakeholders, such as a general prohibition on acting in a manner that is detrimental to the collective interests of creditors.

31) According to the interviews, where there is a likelihood of insolvent liquidation, directors sometimes take deliberate or negligent steps that harm creditors (by increasing their loss) and threaten the viability of the business.

32) Directors (or directors and shareholders, or only shareholders) sometimes hamper the company's financial performance during LPP by continuing the same course of actions that led to the financial distress before the execution of LPP, thus hindering Formal Restructuring efforts.

33) The stakeholders have indicated that directors are not often prosecuted for their failure to file for insolvent liquidation and do not face liability for misrepresentation leading to insolvent liquidation or a transfer of assets *in absentia*, or abuse of LPP. As a result, directors have no incentive to fulfil their obligations, and creditors and third parties (including shareholders) are unable to properly review the company's financial position and are unaware of its financial difficulties. This may also occur at a time when such creditors or third parties enter into agreements leading to their further exposure to the debtor.

II. Recommendations

A summary of recommendations relating to the key findings is provided below in Table 1. To understand the full analysis behind the recommendations, please refer to the sections of the report identified next to each recommendation. Please note that recommendations that do not require an immediate legislative initiative are highlighted in orange.

The impact assessment levels are based on an expert evaluation of how a given activity affects achievement of the objective:

- **Very High** impact – a top priority recommendation with broad effects on the urgent needs of the majority of parties;
- **High** impact – an important recommendation for solving topical problems and addressing serious shortcomings;
- **Medium** impact – could potentially provide certain benefits in particular areas; and
- **Low** impact – quite a formal requirement with a potentially positive effect on isolated issues.

Table 1 Executive summary of recommendations contained in the report.

No.	Recommendation	Impact on the current legal and economic system	Mandatory or optional provision under Directive 2019/1023	Reference page to the report
General recommendations				
1)	The restructuring framework should consider the specifics of the Latvian business environment. Thus, future reforms should aim to improve the application of rules related to Formal Restructuring and insolvent liquidation e.g. the role of Supervisors should be strengthened and the Restructuring Plans should be made more effective. Personal liability for breaches of the Commercial Law and the Insolvency Law should be more effectively enforced in regard to directors and owners of companies.	**Very High**	N/A	N/A
a.	**Out-of-court workouts**			
2)	A legal framework should be incorporated into Article 24(1)(3) of the Law on Taxes and Duties to authorise the SRS to apply similar measures to those prescribed by Article 41 of this law in order to reduce or cancel penalties on overdue tax payments when implementing tax restructuring measures for viable enterprises that demonstrate their ability to restore solvency in OCW.	**Medium**	N/A	38
b.	**Enterprise profile**			
3)	The Register of Enterprises, potentially in collaboration with the SRS, should act to dissolve and remove the large number of enterprises registered in the Commercial Register that have not performed any commercial activities for more than two years and fail to carry out their statutory obligations.	**Medium**	N/A	55
4)	Enterprises with reported negative equity and/or other clear signs of financial distress should be subject to a special supervisory regime. Accordingly, clear rules on shareholder and director duties should be established.	**Very High**	N/A	55
c.	**EWS**			
5)	Given the size of the Latvian economy, debtors would benefit from a centralised data point. The credit registry should be expanded by requiring the inclusion of data on a debtor's indebtedness to entities such as utility and transportation providers. Alongside the current request-based system, to initiate proactivity from the state, the credit registry could send full profile data to the debtor annually.	**Medium**	N/A	65
6)	The SRS should aim to obtain real-time data on SMEs by either improving the existing data integration mechanisms between the SRS and its private	**Medium**	N/A	**Error! Bookmar**

	partners, or by introducing and facilitating an online accounting platform designed for SMEs.			**k not defined.**5
7)	Overall company rating thresholds should be established and trigger electronic notifications (enabled by the SRS system) emailed by the single authority (SRS) directly to company directors and owners, along with links to affiliated educational online tools.	**Very High**	Optional	62
8)	Latvia should seek ways of providing state-subsidised advisory services to enterprises in financial difficulties (potentially based on the comprehensive guidelines for enterprises in financial distress to be developed as part of the Project). A web-based financial health checklist would be useful for encouraging entrepreneurs to act without delay.	**Medium**	Optional	65
d.	**Availability of preventive restructuring frameworks**			
9)	The Insolvency Law should be amended to restrict persons who have committed serious breaches of statutory rules from accessing Formal Restructuring.	**Very High**	Optional	73
10)	Latvia needs to ensure that Formal Restructuring is used by economically viable debtors. A business viability (minimum criteria) assessment for access to LPP should be implemented to ensure that only enterprises with the ability to survive may access LPP. Given the out-of-court nature of the first phase of ELPP and the lack of a stay period, such a viability test should not apply in ELPP.	**Very High**	Optional	73
11)	When applying for LPP, debtors should prove their viability at their own expense and with proper evidence.	**Very High**	Optional	73
e.	**Role of Supervisor**			
12)	To promote Formal Restructuring and distinguish it from insolvent liquidation, Supervisors as a professional body should be separated from Insolvency Practitioners, while not preventing the latter from acting as Supervisors.	**High**	N/A	82
13)	The Insolvency Law should be amended to include specific requirements for a Supervisor's (1) education, (2) background, and (3) experience. The Supervisor should either have expertise in business, and potentially in economics, or should be able to engage professional advisors having the necessary expertise.	**Very High**	Mandatory	82
14)	The Insolvency Law should be amended to permit Supervisors to assist debtors in drafting and negotiating Restructuring Plans with creditors and in executing Restructuring Plans in Formal Restructuring processes.	**Very High**	Mandatory	82
15)	Supervisors should be appointed only in a limited number of scenarios: (i) in LPP during the stay of individual enforcement actions; (ii) in Formal Restructuring when the debtor, creditors or the court request the appointment of Supervisor; and (iii) in Formal Restructuring when the Restructuring Plan has been confirmed through a cross-class cram-down.	**Very High**	Mandatory	82
16)	The ICS should maintain a public list of Supervisors to help a debtor choose a Supervisor suitable for the debtor's needs, the size of business, and the case.	**Medium**	N/A	82
17)	The Insolvency Law should be amended to require civil liability insurance for Supervisors depending on the scale of each Formal Restructuring case.	**Medium**	N/A	82
18)	The Insolvency Law should be amended to permit the Supervisor to enlist the assistance of qualified experts in complex Formal Restructuring cases and/or where the Supervisor lacks a particular skill set.	**Medium**	N/A	82
f.	**Stay of individual enforcement actions**			
19)	To deter misuse of Formal Restructuring, including a stay of individual enforcement actions, the Insolvency Law should define liability and sanctions for any misuse of the stay in LPP by the debtor's management board, including personal liability for losses so caused.	**Very High**	N/A	86

20)	The appointment of a Supervisor on the day that LPP are initiated should be implemented to supervise the debtor during the stay of individual enforcement actions, and if necessary, to advise on and assist in negotiations with creditors and in drafting the Restructuring Plan.	**Very High**	N/A	86
21)	The Insolvency Law should be amended to provide that the initial stay period may exceed two months only where a Supervisor is involved in the process of negotiating or drafting the Restructuring Plan.[9] An extension of the stay should be justified by appropriate proof of progress but should not exceed 12 months.[10]	**Medium**	Optional	86
22)	The Insolvency Law should be amended to enable the court to lift the extended stay period in certain circumstances, including those set out in Article 6(9), as required by Directive 2019/1023.	**Medium**	Mandatory	86
23)	A minimum period should be set, during which the stay of individual enforcement actions cannot be lifted, to give the parties time to assess the situation. The period should not exceed the initial stay period (two months in Latvia) unless there is evidence of misuse or negligence by the debtor.	**Medium**	Optional	86
g.	**Consequences of stay of individual enforcement actions**			
24)	Restrictions should be introduced in the Insolvency Law to prevent withholding of performance or termination, acceleration or some other way of modifying executory contracts to the detriment of the debtor by virtue of a contractual clause relating to Formal Restructuring and any related stay, and to render any purported reliance on such a clause null and void, requiring the contracting party to continue performing its obligations under the contract as if the clause had no effect. Protection for essential executory contracts should also be introduced.	**High**	Mandatory	89
25)	Protecting the debtor from contracting parties who purport to terminate executory contracts or fail to perform their obligations under contracts in breach of the amended Insolvency Law, could be assigned to the Supervisor, acting on the debtor's behalf, who would have extended rights.	**High**	N/A	89
26)	Since Latvian legislation has not fully introduced netting arrangements, including close-out netting, and may not fully exempt such arrangements from the effects of a stay of individual enforcement actions in all cases, the issue should be further evaluated in consultation with representatives of the regulated industries to ensure sufficient protection of financial markets.	**Low**	Optional	89
27)	If Formal Restructuring has been initiated for the second time in a year but is not declared, the court should be required to establish at least one other feature of insolvency apart from subsequent failures to declare Formal Restructuring. The creditors' right to file for liquidation should be reinstated immediately after such subsequent rejection by the court.	**High**	Mandatory	89
h.	**Content of the Restructuring Plan**			
28)	The Insolvency Law should be amended to provide that a Restructuring Plan must include a statement of reasons why the Restructuring Plan has a reasonable prospect of preventing the debtor's insolvency and securing the viability of the business, including the necessary preconditions for the success of the Restructuring Plan.	**High**	Mandatory	95
29)	A comprehensive checklist for Restructuring Plans should be created.	**Medium**	Mandatory	95
30)	An online platform should be introduced to make various tools for handling information about Debt Restructuring available to debtors.	**Very High**	Optional	95

[9] The requirement for appointing a Supervisor appears to be more equitable than restricting the extension of a stay to larger enterprises that have engaged professional advisers.

[10] Directive 2019/1023 prescribes an initial stay period of up to four months, extendable up to 12 months in total, and provides that the scope of the stay may be determined by the judge. However, the proposed approach is not to change the initial stay period under the Insolvency Law but to provide for the possibility of extending it in particular cases.

31)	Further amendments to the Insolvency Law should be considered with a view to introducing the concept of unaffected creditors, who should be neither included in the Restructuring Plan nor allowed to vote on it. The debtor should be required to state the reason for excluding certain creditors.	**Very High**	Mandatory	95
i.	**Adoption of the Restructuring Plan**			
32)	It is advisable to evaluate the procedures for seeking and receiving approval for a Restructuring Plan from the SRS and other institutions whose review process is too lengthy and cumbersome. State creditors should accelerate their decision-making on Formal Restructuring.	**Medium**	N/A	99
33)	To help the court form an opinion on granting a cross-class cram-down, the court should be authorised to invite dissenting creditors to state their reasons in writing, or at a court hearing, for dissenting from approval of the Restructuring Plan.	**Medium**	N/A	99
34)	The Insolvency Law should not limit the time frame for the initial execution of a Restructuring Plan, and the existing two-year cap should be lifted.	**Medium**	N/A	99
35)	According to Recommendation 32, the Insolvency Law should provide that any parties that are not affected by a Restructuring Plan should not have voting rights in adopting it.	**High**	Mandatory	99
36)	SMEs should not be exempted from the requirement for treating creditors in separate classes.	**Low**	Optional	99
j.	**Confirmation of the Restructuring Plan**			
37)	The Insolvency Law should be amended to provide that the courts may reject any Restructuring Plans that have a high chance of failure.	**Medium**	Mandatory	102
38)	The Insolvency Law should clarify the application of the best-interest-of-creditors test required by Directive 2019/1023 and provide that the courts will only examine compliance with the test if the Restructuring Plan has been challenged by a dissenting creditor on failure to satisfy the test.	**Medium**	Mandatory	102
k.	**Cross-class cram-down**			
39)	The Insolvency Law should be amended to permit the courts to approve, at the debtor's request, a Restructuring Plan that is not approved by one of the creditor classes (secured or unsecured) if it conforms with other provisions of Directive 2019/1023 and has been approved by at least one of the creditor classes, with adequate protection for the dissenting class.	**High**	Mandatory	114
40)	In addition to introducing Article 11(1)(c) of Directive 2019/1023, the Insolvency Law should offer more safeguards for creditor interests. The RPR is preferable by virtue of being more appropriate for the Latvian business environment, which is dominated by SMEs and has only two distinct creditor classes.	**High**	Mandatory test with two options	114
41)	The Insolvency Law should be amended to permit the courts to apply a cross-class cram-down to the tax authority's claims, despite the tax authority's current right of veto pursuant to Article 38(5) of the Insolvency Law.	**High**	Optional	114
42)	The Insolvency Law could be amended to introduce the concept of more than two creditor classes (currently secured and unsecured) for voting purposes. Such amendments could regulate how creditors are separated into classes by specifying a larger number of potential classes, or it could be left up to the debtor to group the creditors into classes according to their commonality of interest. The formation of classes can later be approved by the court, or a mixture of both mechanisms could be introduced.	**High**	Optional	114
l.	**Equity holders**			

43)	Amendments to the Insolvency Law should (i) separate equity holders in their own class and provide voting rights to all equity holders, or (ii) exclude equity holders from the effects of Articles 9–11 and expand the restrictions and liability on any equity holders seeking to obstruct the development and initiation of Formal Restructuring, for example: a) further codifications of equity holder liability; b) further obligations on equity holders with voting rights to state their reasons for voting against the adoption and confirmation of a Restructuring Plan.	Medium	N/A	116
m.	**Workers and their rights**			
44)	The Insolvency Law should be amended to regulate the types of information available to workers and the frequency of providing such information, with assurances that certain rights will not be affected by Formal Restructuring (LPP or ELPP). There should also be rules to ensure that workers receive fair treatment.	Medium	Optional	118
45)	Workers' claims arising from an employment contract or relationship should be guaranteed by the workers' guarantee fund on the initiation of Formal Restructuring. Alternatively, the stay of individual enforcement actions should not affect workers' claims.	Medium	Optional	118
n.	**Valuation by judicial or administrative authority**			
46)	The existing mechanism in the Latvian Civil Procedure Law should be further developed to permit the courts to summon and consult a Supervisor or other qualified expert when deciding on issues arising in Formal Restructuring. As a minimum, the courts should be able to appoint or hear a Supervisor or other qualified expert when assessing a valuation in disputes over confirmation of a Restructuring Plan, as required by Directive 2019/1023.	High	Mandatory	124
o.	**Effects of Restructuring Plans**			
47)	The Insolvency Law should be amended to introduce the definition of unaffected creditors and the criteria and principles relevant to Formal Restructuring.	Very High	Mandatory	125
p.	**Appeals**			
48)	The Civil Procedure Law should be amended to make the decision confirming a Restructuring Plan appealable.	High	Mandatory	127
49)	The Civil Procedure Law should specify a deadline for lodging an appeal against the decision confirming a Restructuring Plan.	High	Mandatory	127
50)	The appeal procedure should be dealt with under an "expedited appeal" procedure of the Civil Procedure Law.	High	Mandatory	127
51)	An appeal against the decision confirming a Restructuring Plan should have no suspensive effects on the execution of that Restructuring Plan.	High	Mandatory	127
52)	Further research and/or debate should be conducted on the question of implementing a compensation mechanism for an injured party if its appeal against the Restructuring Plan is upheld.	Medium	Optional	127
q.	**Protection of new financing and interim financing**			
53)	An additional article on new and interim financing should be inserted in the Insolvency Law to (i) define the two types of financing, to (ii) protect them from voidance actions, and to (iii) expressly limit the liability of grantors of new and interim financing.	Medium	Optional	130

54)	Article 17(3) of Directive 2019/1023, which permits MS to exclude from the protection interim financing granted after the debtor has become unable to pay its debts as they come due, should not be transposed nationally since doing so would possibly limit the flexibility of Formal Restructuring and limit availability of interim financing.	Medium	Optional	130
55)	Grantors of new and interim financing should not receive payments with higher priority than secured creditors in the context of subsequent insolvent liquidation of the debtor. Grantors of new and interim financing should continue to enjoy higher payment priority than unsecured creditors.	Medium	Optional	130
r.	**Protection for other restructuring related transactions**			
56)	The Insolvency Law should be amended to provide that certain transactions that are reasonable and necessary should not be declared void, voidable or unenforceable in the process of (1) negotiating a Restructuring Plan and (2) when they are carried out in accordance with a Restructuring Plan confirmed by the court.	Medium	Mandatory	131
57)	It would be beneficial to amend the Insolvency Law in order to include definitions of transactions that are reasonable and immediately necessary for negotiating a Restructuring Plan.	Medium	Optional	131
58)	To mitigate the risk that transactions protected by negotiation of the Restructuring Plan will be used in bad faith, the optional provisions of Article 18 (2) and (3) of Directive 2019/1023, which require court control or confirmation of the Restructuring Plan and exclude any transactions made after the debtor became unable to pay its debts as they fall due, should be implemented in Latvian law.	Medium	Optional	131
s.	**Duties of directors**			
59)	Obstacles to the successful criminal prosecution of directors should be removed and/or criminal sanctions should be converted into administrative fines imposed by the ICS or the SRS to enable their wider application as a deterrent.	Medium	N/A	134
60)	Although the State Police has recently undertaken serious structural reforms and more resources have been made available for increasing its capabilities, the policy makers should continue strengthening the operational capacity of the State Police in order to further increase its ability to enforce obligations of directors and to prevent fraud in Formal Restructuring and insolvent liquidation.	Medium	N/A	134
61)	Latvia should continue strengthening the existing obligations in the Latvian legal framework to ensure that company directors (i) have due regard to the interests of all stakeholders, particularly creditors, and (ii) take steps to avoid insolvent liquidation.	High	Optional	134
t.	**Insolvency proceedings for entrepreneurs**			
62)	Since in most cases an individual merchant, a general partner in a partnership, or a founder or shareholder in a farm or fishery operation, need to go through two separate insolvency proceedings to obtain the full discharge of debts, Directive 2019/1023 should be transposed to enable the authorities to – (i) combine entrepreneur insolvency cases into one proceeding after which they are fully discharged from their debts; or (ii) at least synchronise the two proceedings to ensure that the natural person's insolvency proceedings can afterwards be declared automatically at the debtor's request; and (iii) ensure that the period after which all insolvent entrepreneurs can be fully discharged from their professional and personal debts does not exceed three years.	Medium	Mandatory	137
63)	When merging the two proceedings, the information on the natural person's and legal entity's insolvency should be available in the insolvency register.	High	N/A	137

64)	When merging or synchronising the two proceedings, the Insolvency Practitioner should be required to remove the special status of entrepreneur from the Register of Enterprises on completion of the sale of assets and other obligations within the legal entity's insolvent liquidation.	**High**	N/A	137
u.	**Judicial and administrative authorities**			
65)	Judges within the existing court framework should pursue further specialisation and focus on increasing their judicial expertise to be able to tackle ever more complex Formal Restructuring and insolvent liquidation cases.	**High**	Optional	139
66)	Given the proposal for introducing a specialised economic court in Latvia, it is advisable to discuss the possibility of including Formal Restructuring and insolvent liquidation procedures within its jurisdiction.	**High**	Optional	139
v.	**Supervision and remuneration of practitioners**			
67)	To improve the quality and image of Formal Restructuring, secondary legislation or guidelines should be adopted to ensure that Supervisor remuneration is comprehensively regulated as required by Directive 2019/1023 and there are mechanisms for settling disputes over Supervisor remuneration.	**Medium**	Mandatory	140
68)	The professional code of ethics for Insolvency Practitioners and Supervisors should be updated in accordance with Directive 2019/1023 to (i) describe the purpose of a Supervisor and the goals to be achieved by Supervisors; to (ii) lay down economic principles that should guide Supervisors in overseeing Formal Restructuring proceedings; and to (iii) promote the development of skills necessary to perform Supervisor duties.	**Medium**	Optional	140
w.	**Data collection**			
69)	Latvian governmental institutions should expand their data gathering efforts on Formal Restructuring and insolvent liquidation matters and systematically structure and publish such data to monitor the effectiveness of procedures, including time, cost, and creditor recoveries.	**Medium**	Mandatory and some Optional	143
Recommendations for further analysis				
70)	Further research and/or discussions should be conducted in order to find the most effective measures for prevention of misuse by debtors and their shareholders and/or management, in particular: (i) Research on the practice of "asset stripping" i.e. transfer of assets into a new business; (ii) Research on the practice of prosecuting directors for any misconduct impacting the financial condition of the company and the recovery of creditors within liquidation; (iii) Additional discussions should be held and further research conducted concerning amendments to the Commercial Law to consider the possibility of expanding liability and to also include former management of debtor into the list of sanctionable subjects.	**High**	N/A	N/A

1 Introduction

The report has been drafted for the purpose of identifying issues in Latvia's Debt Restructuring and insolvency framework and to assist the Ministry of Justice in transposing Directive 2019/1023 into the Latvian legal system, which has to be completed by 17 July 2021.

1.1 Goals and Background of the Report

The report has three main goals:

1) to identify shortcomings in Debt Restructuring (from an implementation perspective and, to the necessary extent, from a legislative perspective;
2) to detect obstacles to the use of Debt Restructuring tools; and
3) to establish workable mechanisms for restoring distressed enterprises to financial health.

The core of any insolvency law is the most efficient use of resources used by a distressed company and the allocation of potential costs. This primary objective of economic efficiency is complemented by the specific redistributive goals that result from the cultural and social value patterns of a given society and may vary between countries. An effective insolvency regime should not only ensure a fair and timely distribution of assets among creditors through liquidation proceedings but should also allow viable debtors to restructure at an early stage and thus avoid liquidation and the related loss of value, jobs and know-how.[11] Thus, Debt Restructuring has both an economic and a social purpose.

The objective defined by the Insolvency Law is to promote the honouring of the obligations of a debtor in financial difficulties and, where possible, the renewal of solvency (see Article 1 of the Insolvency Law).

The sub-objective of the Latvian policy on LPP 2016–2020 is to facilitate the return of viable enterprises to the economy, thus providing creditor protection and gaining more in the long run than in the event of liquidation.[12]

Several recent studies conclude that corporate restructuring is weakly developed in Latvia.[13] For example, the IMF expert team finds that reorganisation (rehabilitation) of insolvent or financially distressed legal entities is exceptional in Latvia. In practice, most Formal Restructurings end up as asset liquidations because Formal Restructurings are not workable mechanisms to restore financial health to distressed enterprises.[14] With "insolvency cases" apparently meaning "insolvent liquidation proceedings," the insolvency proceedings in the Latvian system are meant to be liquidation. However, the conclusion is clear that there are more insolvent liquidation proceedings than Formal Restructurings, and LPP are often used merely as a delaying tactic against creditor action.

The number of initiated reorganisation proceedings of this kind is 140–160 a year. However, only about 25% of those proceedings are "announced" or "declared" (i.e. a Restructuring Plan is proposed in a timely manner and accepted by the creditors).[15] According to an overview of Formal Restructuring statistics in Latvia for the period from 2008 to 2018, the LPP cases totalled 1,180[16] but their total success rate ranged from 4% to 8% annually (2008–2018).[17]

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[11] Commission Staff Working Document. Impact Assessment. Accompanying the document Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52016SC0358. [Accessed November 4, 2019].

[12] Insolvency Policy Development Guidelines 2016–2020. Available at: https://likumi.lv/ta/id/284925-par-maksatnespejas-politikas-attistibas-pamatnostadnem-2016-2020-gadam-un-to-istenosanas-planu. [Accessed November 4, 2019].

[13] Jauja, H., Zandersons, A., Par tiesiskās aizsardzības procesa regulējuma efektivitāti, 2018. Available at: http://petijumi.mk.gov.lv/sites/default/files/title_file/Zinojums_Par_tiesiskas_aizsardzibas_procesa_efektivitati.pdf. [Accessed 4 November 2019]. Garrido, J. M., Rasekh, A., Rouillon, A., Republic of Latvia: Evaluation of the Insolvency Framework, International Monetary Fund, January 2019, page 28. Available at: https://www.ta.gov.lv/UserFiles/Faili/Latvia_-_Technical_Assistance_Report_on_Evaluation_of_the_Insolvency_Framework-FINAL_ENG.pdf. [Accessed November 4, 2019].

[14] Garrido, Rasekh, Rouillon, loc. cit.

[15] Garrido, Rasekh, Rouillon, op. cit., page 28.

[16] Jauja, Zandersons, op. cit., page 31.

[17] Jauja, Zandersons, op. cit., page 37.

Directive 2019/1023 introduces a debtor-in-possession restructuring procedure for MS, including mandatory provisions and optional provisions. Latvia has a significant level of alignment with international standards in its existing legislation but should adopt more safeguards to ensure compliance with the mandatory provisions. The optional provisions allow Latvia to further enable preventative restructuring as a viable and preferable alternative to insolvent liquidation, but legislation alone will not lead to its effective use.

Latvia has Formal Restructuring aimed at providing a viable and preferable alternative to insolvent liquidation for debtor enterprises. In this regard, it is very similar to the objectives of preventative restructuring but often fails to deliver on its purpose. In some cases, a stay of individual enforcement actions is used to shift assets away from the creditors into a new company, leaving an insolvent shell entity to enter liquidation. In about 75% of cases,[18] the debtor does not present a Restructuring Plan to the court, despite enjoying a stay of individual enforcement actions.

The ease with which shareholders and/or directors can create a new company and shift an existing, presumably, struggling business and its assets to the new company, leaving the old one as a "defunct" insolvent entity, most often with its old liabilities and with "new" or non-resident directors of the old company, does not help motivate entrepreneurs to put efforts into restructuring and to use Formal Restructuring. Misuse of the latter is particularly the case with SMEs, which may lack the structural sophistication and/or complexity to "transact" the new enterprise structure. It is also necessary to make it more difficult to move the business to a new company, leaving an empty shell with debts to creditors.

Either way, the original shareholders and directors currently avoid prosecution and/or public censure in all but a handful of cases, making both of these alternatives to LPP (or a new preventative restructuring process) attractive.

While it is laudable that the EU is seeking new and enlightened legislation across the EU, in Latvia's case the success of the preventative restructuring legislation on a large scale will be defined by stopping the "easier" and more lucrative debtor-friendly alternatives above, not by the legislation being successfully adopted in-country.

The scope of our work was defined and agreed with the EBRD, the EC and the Ministry of Justice, and is focused on a legislative gap analysis, EWS, assessing Restructuring Plans and training and embedding preventive restructuring methodology and best practice into the Latvian setting. It does not cover addressing the misuse of insolvency.

1.2 Structure of the Report

The report consists of an Executive Summary and 12 chapters. The Executive Summary is a synopsis of Key Findings and Recommendations.

The introductory part – **Introduction** (Chapter 1) and **Description of the Legal Framework** (Chapter 2*)* – provides information on the goals of the report and the methodology applied, giving a description of the national and EU legal framework and phases of company Debt Restructuring. **Chapters 3–12 provide a comparative analysis of Directive 2019/1023** with the national legal framework and benchmarking of the national legal framework against international best practice.

Phases of Company Debt Restructuring provide a description of the legal framework for the phases of company Debt Restructuring (Chapter 3), describing phases such as OCW and Formal Restructuring procedures.

The next two chapters provide an overview of the characteristics of the business environment, enterprises that could be subject to Formal Restructuring (Chapter 4 **Profile of Latvian Enterprises and Other Entities**) and an assessment of **EWI and Stakeholder Access to Information** (Chapter 5).

Availability of preventive restructuring frameworks (Chapter 6) provides an in-depth analysis of opportunities for enterprises in distress to access assistance with Formal Restructuring proceedings.

Chapter 7 **Formal Restructuring procedures** covers topics such as the role, competence, rights and duties of a Supervisor, and the specifics and consequences of a stay of individual enforcement actions.

Chapter 8 **Restructuring Plans** covers the content, adoption and confirmation of Restructuring Plans, cross-class cram-down, equity holders, workers, valuation by judicial or administrative authority, effects, and appeals.

Chapters 9–12 cover **protection for new financing** and **interim financing**, and **duties of directors**, while the chapter on **measures to increase the efficiency of procedures** assesses the judicial and administrative authorities, supervision and remuneration of practitioners, monitoring procedures, and data collection.

[18] Jauja, Zandersons, op. cit., page 37.

Each chapter of the report offers a substantive sub-analysis of particular areas, covering the existing legal framework, a gap analysis to meet the requirements of Directive 2019/1023 and best international standards, and shortcomings identified in implementation and stakeholder analysis. All of these chapters contain references to the conducted benchmarking, while also making specific recommendations for solving the issues identified.

The recommendations are structured according to their priority from the perspective of an expert opinion on urgency, feasibility, and availability of resources.

Annexes 1–11 provide background information and data.

1.3 Methodology

The report was created by the following stages of research: (i) a literature review and information gathering relevant to subsequent research; (ii) an analysis of the national legal environment and of auxiliary matters; (iii) a comparative analysis of Directive 2019/1023 with the national legal framework; (iv) benchmarking of the national framework with international best practice; (v) the development of recommendations for implementing Directive 2019/1023 and mitigating issues detected in the national legal framework; (vi) data collection and data analysis to see the latest developments; (vii) interviews with stakeholders. These phases of research are hereinafter described in more detail.

The development of the report has followed a previously refined and coordinated plan for information gathering and analysis.

The literature review and information gathering was conducted for two primary purposes.

Firstly, this phase of research was carried out to obtain substantial data and facts that could be useful for developing recommendations and suggestions in later chapters, but also to confidently arrive at conclusions on the national legal framework. This element was also crucial for the later comparative analysis, as it delivered substance from a national perspective to be subsequently analysed in the light of Directive 2019/1023 and international best practice.

Secondly, the information gathered on national insolvency and Debt Restructuring would notably assist readers who do not take an active part in Latvian insolvency and Debt Restructuring practice, as it gives an overview of the general national legal framework, while also delivering insights into national peculiarities.

Information gathering in a practical sense refers to the collection of macroeconomic data relevant to insolvency and Debt Restructuring processes, a roundup of the legislation, case law and other legal sources that regulate and govern Debt Restructuring and insolvency in Latvia, and the gathering of data and conclusions from previous relevant studies and recommendations developed by other experts on issues analysed in this report. Furthermore, the introductory chapter contains a list of identified problems in the national insolvency and Debt Restructuring framework.

An analysis of the national legal environment was carried out to develop a broader understanding of the context in which the national framework has been developed and operates. As with the previous element of the research, the inclusion of such information will also familiarise readers with the broader context of the Latvian national framework.

A comparative analysis of Directive 2019/1023 with the national legal framework is highly topical for the stakeholders and therefore forms an integral part of the report. First and foremost, this chapter includes an analysis of Directive 2019/1023 itself: the classification of mandatory and optional provisions, the application of legal interpretation methods to the provisions of Directive 2019/1023, and an analysis of its supplementary sources.

Directive 2019/1023 will subsequently be compared to the national legal framework with the purpose of locating any existent and analogous provisions in the national legal framework so as to determine which provisions of Directive 2019/1023 do not need to be implemented. Similarly, this allows still implementable provisions of Directive 2019/1023 to be targeted for more in-depth analysis in later chapters. The chapter also covers an analysis of the need to introduce certain optional provisions of Directive 2019/1023 and a justification of the optional provisions of Directive 2019/1023 that should not be included in the national legal framework.

Benchmarking will be extensively used for two main purposes: to develop the best mechanisms for introducing mandatory and optional provisions of Directive 2019/1023, and to offer possible solutions to issues identified during the development of the report.

Benchmarking efforts include a comparison of the Latvian legal framework with those of other European countries (mainly Spain, Portugal, and France). International expertise gathered through questionnaires and interviews with foreign experts gives insights into the most successful mechanisms and practices used in other countries, which can further help in developing solutions for the introduction of Directive 2019/1023 in Latvia.

The report also includes a chapter dedicated to recommendations for implementing Directive 2019/1023 and mitigating issues identified in the national legal framework. This chapter serves as a source for conclusions and is developed for the purpose of offering practical advice to the Latvian authorities on implementing Directive 2019/1023. The report aims to provide practitioners and stakeholders with tools for developing a national legal framework that meets the requirements of Directive 2019/1023, while at the same time respecting the characteristics of the Latvian environment and using the best available international tools and mechanisms aligned with the goals of Directive 2019/1023.

The previous chapter has described the various methods of research employed within this report and has roughly outlined the contents to follow. The next chapter will offer insights into the fundamental legal research methods used in drafting the analysis for this report.

The analysis in the report will utilise doctrinal, historical, comparative and empirical legal research methods.

The doctrinal method will be used for the analysis of applicable legal norms and existing regulations. Furthermore, the information gathered through the use of other methods of analysis will be backed by extensive analysis of primary and secondary law sources, i.e. legislation, case law, doctrinal texts by legal scholars, and previous reports from professional institutions.

The comparative method will be the principal method used for research purposes. This will be most relevant when comparing Directive 2019/1023 with the national legal framework and when analysing best international practice as a source for making decisions about implementing the suggested provisions of Directive 2019/1023. Further comparisons will be drawn between the laws and regulations of Latvia and other European countries that have extensive experience in insolvency and Debt Restructuring matters.

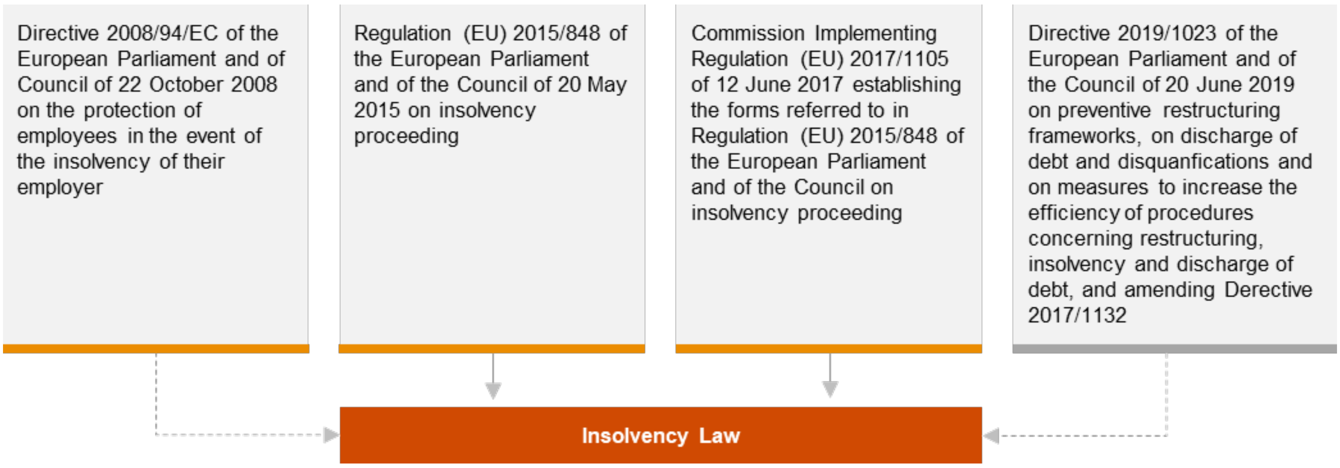
The historical method will be used where appropriate background information is necessary on the legislation currently in force. Further research into case law will include an analysis of the historical development of judicial involvement in the interpretation of laws and rules that regulate insolvency and Debt Restructuring.

The analysis of the available data on insolvency and Debt Restructuring will require the use of **empirical legal research methods**. Further interviews with relevant stakeholders, which include public administration bodies, representatives and associations of enterprises, representatives of the judiciary and supervisory authorities, will have empirical elements. The study will also include the most relevant statistics on insolvency and Debt Restructuring as a means to stimulate certain decisions on the recommended changes to the current legislation and practice. The research will also strive to develop certain indicators to be used for benchmarking the effectiveness of current and historical practice.

2 Description of the Legal Framework

2.1 EU Enactments

Figure 2 Location of EU enactments in the hierarchy of the Latvian legal framework



Latvia is an MS, and thus EU legislation is directly (through Regulations) and indirectly (through Directives) applicable to the national legal framework (see Figure 2 above). These EU enactments are:

- **Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings which regulates the applicable jurisdiction** and national law in cross-border insolvency. It also deals with the recognition of decisions made by the courts in insolvency and is especially relevant when the company has business activities in multiple MS;
- **Directive 2008/94/EC of the European Parliament and of the Council of 22 October 2008 on the protection of employees in the event of the insolvency of their employer** is transposed into multiple national laws and Rules, most notably the Law on Protection of Employees in the Event of Employer Insolvency. This directive sets out guarantees for employees for receiving remuneration when their employer becomes insolvent;
- **Commission Implementing Regulation (EU) 2017/1105 of 12 June 2017 establishing the forms referred to in Regulation (EU) 2015/848 of the European Parliament and of the Council on insolvency proceedings** governs the content of forms that are governed by Regulation 2015/848; and
- **Directive (EU) 2019/1023** to be implemented under Article 34 of Directive 2019/1023. The vast majority of provisions need to be transposed into national legislation by 17 July 2021.

2.2 Insolvency Law

The applicable law currently in force in Latvia on Formal Restructuring and insolvent liquidation is the Insolvency Law, first adopted on 26 July 2010 and in force from 1 November 2010. In 2010, the Insolvency Law replaced the older Insolvency Law, which was adopted on 1 November 2007 and was in force in Latvia from 1 January 2008. Previous laws on Formal Restructuring and insolvent liquidation in Latvia have included the Law on Insolvency of Enterprises and Companies (in force from 1996 to 2007), the Law on Insolvency and Bankruptcy of Enterprises and Companies (in force from 1992 to 1996), and other laws that previously included provisions comparable to modern Formal Restructuring and liquidation proceedings.

The current Insolvency Law was initially drafted to fulfil Latvia’s obligations arising from Article 36 of the Letter of Intent signed between the IMF and Latvia on 27 June 2009, Article 57 of the Action Plan for the Implementation of Latvia’s Economic Stabilisation and Growth Recovery Programme, and the loan agreement between the government of Latvia and the EBRD for a loan of EUR 200,000,000 to improve the national financial sector.

The Insolvency Law has since been amended on 15 occasions and contains 217 articles as of 5 June 2020. The latest amendments were made on 5 June 2020.

The Insolvency Law is structured in accordance with the different phases of Formal Restructuring and liquidation available in Latvia. The Insolvency Law contains chapters on (i) general provisions; (ii) LPP (with a section dedicated to ELPP); (iii) the legal entity's insolvency proceedings; (iv) the natural person's insolvency proceedings; (v) costs of LPP and liquidation; and (vi) supervision of LPP and liquidation.

The Insolvency Law has been amended on three occasions by the Constitutional Court of Latvia through judgments which found that certain provisions of the Insolvency Law contradicted the applicable higher legal norms. These judgments were mainly concerned with the education of Insolvency Practitioners,[19] the deposit pay-out by an employee for the initiation of liquidation,[20] and the status of public officials[21] as Insolvency Practitioners.

Because the laws and regulations governing Formal Restructuring and liquidation have been changed on multiple occasions, practitioners have at times been burdened with applying different laws for enterprises that have begun their Formal Restructuring or insolvent liquidation at different times. The Insolvency Law contains extensive transitional provisions that regulate the applicability of the different historical versions of the law to the particular circumstances of cases.

2.3 Other National Laws

Other Latvian laws regulate auxiliary matters of Debt Restructuring and liquidation. As *lex specialis*, the following legal enactments regulate specific aspects of Debt Restructuring and liquidation:

Table 2 Overview of laws in Latvia which regulate auxiliary matters of Debt Restructuring and liquidation.

Title of the Law	Description of the Law
Law on Enforcement of Coercive Measures	Regulates enforcement procedures in criminal proceedings, including the forced liquidation of enterprises and other similar penalties
Latvian Administrative Violations Code	Regulates administrative violations in the field of insolvency
Law on Protection of Employees in the Event of Employer Insolvency	Regulates the procedure for satisfying workers' claims against the employer
Land Register Law	Regulates the form of entries made on the Land Register concerning the debtor's property in cases of liquidation and prescribes the rights of Insolvency Practitioners to make, change or extinguish such entries
Civil Procedure Law	Extensively regulates all aspects of court procedure relating to insolvency proceedings. This includes rules for filing applications in Formal Restructuring and liquidation, the procedure for involving the judiciary, and the termination of such proceedings, among other auxiliary matters connected with the proceedings
Commercial Law	Determines the information about the initiated Formal Restructuring and liquidation that must be included in the Commercial Register and in the debtor's documents and website. The law authorises Insolvency Practitioners to submit notices for removing enterprises from the Commercial Register and other matters connected with registering information and publicity of the company's liquidation. Liquidation can affect the possibility of shareholders taking certain actions normally included in the Commercial Law and can have limiting consequences for enterprises
Law on Taxes and Duties	Foresees the possibility of restructuring debts of persons who are at risk of insolvency. The law also lays down the administrative

[19] Judgment of the Constitutional Court of the Republic of Latvia of 22 November 2011 on Case No.2011-04-01.
[20] Judgment of the Constitutional Court of the Republic of Latvia of 20 April 2012 on Case No.2011-16-01.
[21] Judgment of the Constitutional Court of the Republic of Latvia of 21 December 2015 on Case No.2015-03-01.

	procedure for taxing persons who have initiated Formal Restructuring or are subject to liquidation
Criminal Law	Prescribes criminal liability for persons who have driven enterprises into insolvency due to neglect or intentionally if this has caused substantial harm to other persons

2.4 Rules

Liquidation and Formal Restructuring in Latvia are also regulated by Rules that oversee specific aspects of liquidation and Formal Restructuring. Currently 12 Rules are based on the Insolvency Law.

Table 3 Overview of Rules in Latvia which regulate Formal Restructuring and liquidation.

Title of the Rules	Description of the Rules
Rules No.88 "Procedure for payment and pay-out of deposits in insolvency proceedings of legal entities and natural persons"	Regulates how natural persons and legal entities pay their deposits into the ICS treasury deposit account and how these persons may receive the deposit back if certain conditions are met
Rules No.89 "Procedure for the deposition and pay-out of funds if the debtor's assets which have served as collateral for a secured creditor whose rights of claim rely on the occurrence of the condition have been sold"	Regulates the procedure for the deposition and pay-out of funds in the ICS State Treasury account if the debtor's assets which have served as collateral for a secured creditor whose rights of claim rely on the occurrence of the condition have been sold
Rules No.169 "Rules on the service cards of officials and employees of the Insolvency Control Service"	Governs the content and form of service cards of ICS officials and employees
Rules No.233 "Regulations on disciplinary matters of Insolvency Practitioners of insolvency proceedings and persons supervising LPP"	Prescribes the procedures for initiating a disciplinary matter against an Insolvency Practitioner and the person supervising Formal Restructuring and the procedures for the operation of the Disciplinary Matters Commission
Rules No.246 "Procedure for the maintenance of records of Insolvency Practitioners and Insolvency Practitioners in LPP"	Regulates the procedures for keeping records and processing of documentation in liquidation
Rules No.287 "Price list and payment procedure of the Insolvency Control Service"	Regulates the price list for ICS services and the procedure by which persons pay for these services
Rules No.288 "Procedures for training applicants for the office of Insolvency Practitioner of insolvency proceedings, for examining them, procedures for the operation of the examination commission and procedures for appointing, releasing, removing and discharging from office and the suspension of professional activity of the Insolvency Practitioners in insolvency proceedings"	Governs the minimal content and volume of training courses for applicants for the position of Insolvency Practitioner, and the information to be included in the certification for the attendance of such training courses, the agenda of the examination commission, the Insolvency Practitioner examination agenda and the minimum scope of necessary expertise, and evaluation procedure, the procedure for the appointment of Insolvency Practitioners, the form and substance and the issuing procedure for the certificates of Insolvency Practitioners, the procedure for the qualification exam of Insolvency Practitioners and the fields in which the knowledge and skills of Insolvency Practitioners are tested, and the evaluation procedure and the procedure for the dismissal, suspension and termination of service of Insolvency Practitioners
Rules No.346 "Rules on the activity reports of Insolvency Practitioners"	Determines the information to be included in reports of Insolvency Practitioners and the procedure for how these activity reports are prepared and submitted

Rules No.484 “Rules for news posting on the Insolvency Control Service’s website”	Regulates how and which news must be published on the ICS website and the procedure for correcting errors in the news
Rules No.761 “Rules of the electronic insolvency registration system”	Regulates the use and maintenance of the national electronic insolvency registration system, and the procedure by which documents and information are included and extracted from it
Rules No.837 “Procedure for sorting the list of applicants for the position of Insolvency Practitioner and selecting the candidate for the Insolvency Practitioner”	Regulates the procedure by which Insolvency Practitioners are appointed to a specific liquidation
Rules No.1005 “Rules on the civil liability insurance procedure of the Insolvency Practitioner and the minimum insurable sum”	Regulates the procedure by which civil liability of Insolvency Practitioners is insured and determines the minimum insurance amount of their liability

The overview suggests that the national Formal Restructuring and insolvency framework consists of many different laws and regulations in addition to the Insolvency Law. Every other law in the Latvian legal system, which might include provisions relating to Formal Restructuring and insolvency, regulates only aspects that are relevant to the events and procedures with which the particular law is mainly concerned. See the Civil Procedure Law, for example, which, as stated before, regulates court procedures in Latvia. It is evident that the Formal Restructuring and insolvency aspects that require the involvement of courts would also be subject to this particular law, which therefore precludes a total centralisation of the Debt Restructuring and insolvency framework into a single, unified law.

It can be presumed that the complexities of the modern Debt Restructuring and insolvency framework might be confusing and discourage enterprises from understanding and pursuing the mechanisms and tools contained therein. However, there is no direct evidence that the structure of the current system is ineffective or flawed, or that the structure of the framework could somehow be the source of the systemic issues identified and analysed in this report.

3 Phases of Company Debt Restructuring

The Insolvency Law and subsequent legislation, including guidelines for OCW in Latvia,[22] distinguish between three solutions available to enterprises in financial distress:

- OCW;
- Formal Restructuring; and
- Liquidation (with a further distinction between the legal entity's liquidation and the natural person's insolvency).

Of these three legal solutions, only OCW does not require the formal involvement of courts, while judicial assistance is paramount to both Formal Restructuring and liquidation. It should also be noted that there are no formal criteria other than procedural criteria that must be met before an enterprise can access LPP.

3.1 OCW

In order to confirm our hypothesis of higher cost-effectiveness of OCW, this section provides findings based on available data, information received from interviews with the SRS representatives, credit institutions, the Bank of Latvia and utility providers, as well as from analysis of practices of credit registers and previous research.[23] Separately this section examines the interaction between tax settlement and OCW.

Concept of OCW

OCW is based on non-judicial consensual negotiations and private contractual arrangements between the debtor and some or all of its creditors. In the literature, it is possible to find different definitions of OCW, but most references are to a World Bank report:[24]

> "OCW involves changing the composition and/or structure of assets and liabilities of debtors in financial difficulty, without resorting to the involvement of court, and with the objective of promoting efficiency, restoring growth, and minimising the costs associated with the debtor's financial difficulties."[25]

In the literature, the term "informal workouts" or "private restructuring" is used as a synonym for OCW. OCW can be categorised into two distinct types:

1) Mutual negotiations between the debtor and a creditor in order to reach an agreement on renegotiating the repayment schedule and/or forgiving debt;
2) Multi-party negotiations between the debtor and the main creditors in order to agree on a repayment schedule or debt forgiveness.

OCW can be carried out before Formal Restructuring or insolvent liquidation proceedings are initiated. OCW may even overlap with ELPP, as it may result in a plan prepared in OCW being presented to the court for approval in ELPP where it is not possible to obtain unanimous creditor approval for the plan in OCW.

[22] OCW Guidelines, (ICS, August 6, 2009). Available at: https://www.tm.gov.lv/en/news/guidelines-out-of-court-debt-restructuring-in-latvia. [Accessed November 4, 2019].
[23] Jauja, H., Zandersons, A., Par tiesiskās aizsardzības procesa regulējuma efektivitāti, 2018. Available at: http://petijumi.mk.gov.lv/sites/default/files/title_file/Zinojums_Par_tiesiskas_aizsardzibas_procesa_efektivitati.pdf. [Accessed November 4, 2019].
[24] Out-of-Court Debt Restructuring. Maria Garrido J.M., *the World Bank*, 2011. Available at: https://siteresources.worldbank.org/INTLAWJUSTICE/Resources/OutOfCourtDebtRestructuringBeforeTypesetting.pdf. [Accessed November 4, 2019].
[25] Ibid.

A financially distressed company (the debtor) and all the creditors have the opportunity to carry out mutually agreed OCW, whereby all the parties try to reach an agreement for changing the debt repayment terms and allowing the debtor to stay in business. This mainly involves negotiations between the debtor and one or more or all of the creditors. **No legislation in Latvia can be directly applied to this legal solution, except for the treatment of tax debts in OCW, which is governed by the Law on Taxes and Duties.** Any obligations, commitments and rights arising from agreements reached in negotiations on the restructuring of debts are governed by the Civil Law and the Commercial Law, which regulate most legal relationships between private parties in Latvia.

Despite the Ministry of Justice's efforts in raising awareness of OCW, the stakeholders have indicated that the concept of OCW is not familiar to the Latvian public. In collaboration with the ICS, Finance Latvia Association, Insolvency Practitioners, the Latvian Employers Confederation, FICIL, LCCI and the Latvian Borrowers Association, the Ministry of Justice has drafted guidelines for OCW in Latvia. The guidelines offer practical suggestions for enterprises and other stakeholders on how to carry out Debt Restructuring negotiations, with a condensed overview of the best international OCW practices.[26] Like most guidelines, these guidelines are considered soft law.

The guidelines cite 12 principles to be considered in Debt Restructuring, similar to those contained in the INSOL Guidelines for Multi-Creditor Restructurings[27] and the Vienna Rules,[28] which are really also principles. These principles are good faith, creditor honesty, priority of new funds, confidentiality etc. It should be noted that the guidelines offer a list of principles only, not procedures to be followed in OCW, and the stakeholders find that awareness of the existence of these guidelines is very low.

OCW Statistics

OCW is usually public and not tracked officially in any public registers, making it impossible to obtain precise empirical data on OCW success compared to Formal Restructuring. However, clear indications of the prevalence of OCW activities can be obtained from indirect data, such as tax payment timescale extension statistics and non-bank client forborne loan portfolio details.

The statistics provided by the SRS on bilateral measures to settle tax debts (see **Figure 3**) demonstrate the prevalence of out-of-court arrangements compared to Formal Restructuring proceedings.

In the interviews, the SRS and banks stated that in many cases creditors communicate and exchange information, or even agree on possible options for debt settlement. In Latvia, tax debt data is public if a debt exceeds EUR 150. Thus, the credit institutions and other creditors can closely monitor the debtors. It can be concluded that the cases of deferred tax debt also include a number of cases of multilateral debt settlements.

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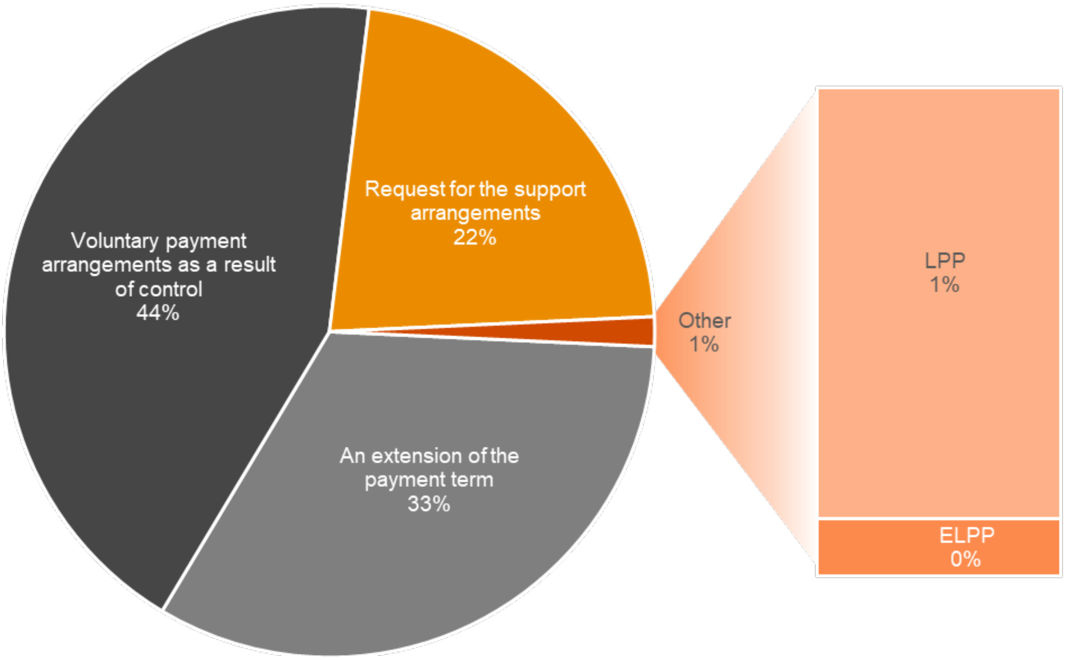
[26] OCW Guidelines. Available at: https://www.fktk.lv/wp-content/uploads/2019/05/Arpustiesas_Vadlinijas_precizetas.pdf. [Accessed November 4, 2019].

[27] INSOL Guidelines for Multi-Creditor Restructurings. Available at: https://www.insol.org/_files/Publications/StatementOfPrinciples/Statement%20of%20Principles%20II%2018%20April%202017%20BML.pdf. [Accessed November 4, 2019].

[28] Vienna Rules. Available at: https://www.viac.eu/en/arbitration-rules. [Accessed November 4, 2019].

Figure 3. Types of extension of tax payment deadline, 2018 (Source: SRS)



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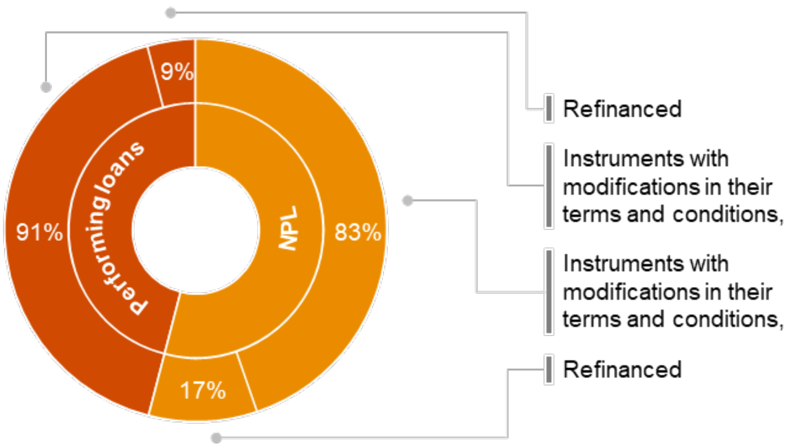
The information on the non-bank client forborne loan portfolio balance available from the Financial and Capital Market Commission[29] reveals that a large portion of the loan portfolio with forbearance measures[30] as at 31 December 2018 consists of instruments with modifications in their terms and conditions: 83% of NPL and 91% of performing loans as shown in Figure 4.

Figure 4. Balance of non-bank client forborne loan portfolio as at 31 December 2018 (gross carrying amount in thousands of euro)



Items	Sub-item	Value, EUR
Performing loans	Total	379,178,918
	Instruments with modifications in their terms and conditions	345,133,774
	Refinanced	34,045,144
NPL	Total	444,635,387
	Instruments with modifications in their terms and conditions	369,211,736
	Refinanced	75,423,651

The statistics indirectly show that OCW is used outside Formal Restructuring.

[29] Consolidated financial and performance indicators for banks, Financial and Capital Market Commission. Available at: https://www.fktk.lv/en/statistics/credit-institutions/quarterly-reports/banking-activities-in-2018/ [Accessed January 6, 2020].
[30] Excluding loans to households.

The stakeholders recognise that OCW solutions are typically realised in a case-by-case manner and are tailor-made for each debtor's situation. Thus, there is no single practice to be used in all cases.

The stakeholders have also indicated that OCW are largely based on experience gathered when dealing with distressed businesses and the broadest experience with OCW is accumulated in commercial banks, in particular the restructuring units specialising in legal and economic restructuring matters. Even though commercial banks' priority is to secure repayment of debt, in many cases the restructuring must include broader actions such as business operational restructuring to ensure sustainable business continuity. Commercial banks usually perform OCW on a bilateral basis, but sometimes multilateral OCW is also performed.

The interviews also show that other common creditors such as suppliers and the SRS often focus only on modifications of debt repayment terms by prolonging the repayment schedule, providing a grace period, dividing the debt into instalments etc.

Moreover, the SRS and credit institutions in Latvia are using an assessment of viability of entrepreneurs in order to make decisions on activities related to OCW and potential formal proceedings, if applicable. Thus, OCW practices can vary from rating of debtor to type of debt and are not always performed according to the guidelines for OCW.

3.2 Tax Settlement

As tax settlements usually take place out of court, together with the SRS and the debtor, a tax settlement could be considered a type of OCW.

Late payers may be seen as a serious problem for the SRS with a negative effect on the national budget totalling 600 million euros. Currently, there are enterprises that tend to have a negative cash flow over multiple years. To tackle this problem, the **SRS has introduced rigorous control procedures and a risk-analysis-based approach that allows early detection of malpractice and tax evasion.**

As of 1 November 2019, the SRS had arrangements with 1,517 legal entities and individual merchants who had applied for an extension of their payment deadline; 2,002 legal entities and individual merchants who had applied for voluntary payment; and 1,030 legal entities and individual merchants who had applied for support. LLCs represent the majority (more than 95%) of the undertakings having applied. At the same time, the number of Formal Restructuring proceedings is much lower: as of 1 November 2019, the SRS was a creditor in 68 court proceedings, out of which 60 had been initiated or were in the process of LPP, and 8 were in the process of ELPP.

Under Article 24 of the Law on Taxes and Duties, the tax authority (in most cases the SRS) has the power to divide the payment of taxes, interest and penalties into instalments or to defer the payment of overdue taxes under different conditions of up to one or five years based on the nature of debt formation.

In response to a taxpayer's reasoned application in writing, the SRS has the power to divide the payment of taxes into instalments over a period of up to one year as of the date of submission of the application.

Figure 5 illustrates how the tax settlement procedure is regulated by Article 24(1) of the Law on Taxes and Duties.

1) The first step is filing an application at least **three days before** the statutory payment deadline;
2) In the second step, the taxpayer should submit a reasoned application to the SRS **within 15 days** after the payment fell due;
3) In the third step, if it is voluntary tax debt restructuring, the SRS has the power to divide the payment of taxes into instalments over a period of up to one year;
4) As a result of control activities, the SRS has the power to divide the payment of taxes, interest and penalties resulting from SRS controls (inspections, audits) into instalments over a period of **up to five years**, and to divide the payment of taxes, interest and penalties resulting from an SRS data compliance check over a period of up to **five years**. In this case, the taxpayer should submit a reasoned application to the SRS three days before the statutory payment deadline. Taxpayers that draw up an annual report should attach the balance sheet and income statement prepared on the first day of the month in which the application is filed.

In reviewing an application, the SRS will evaluate the taxpayer's financial position and assess whether he –

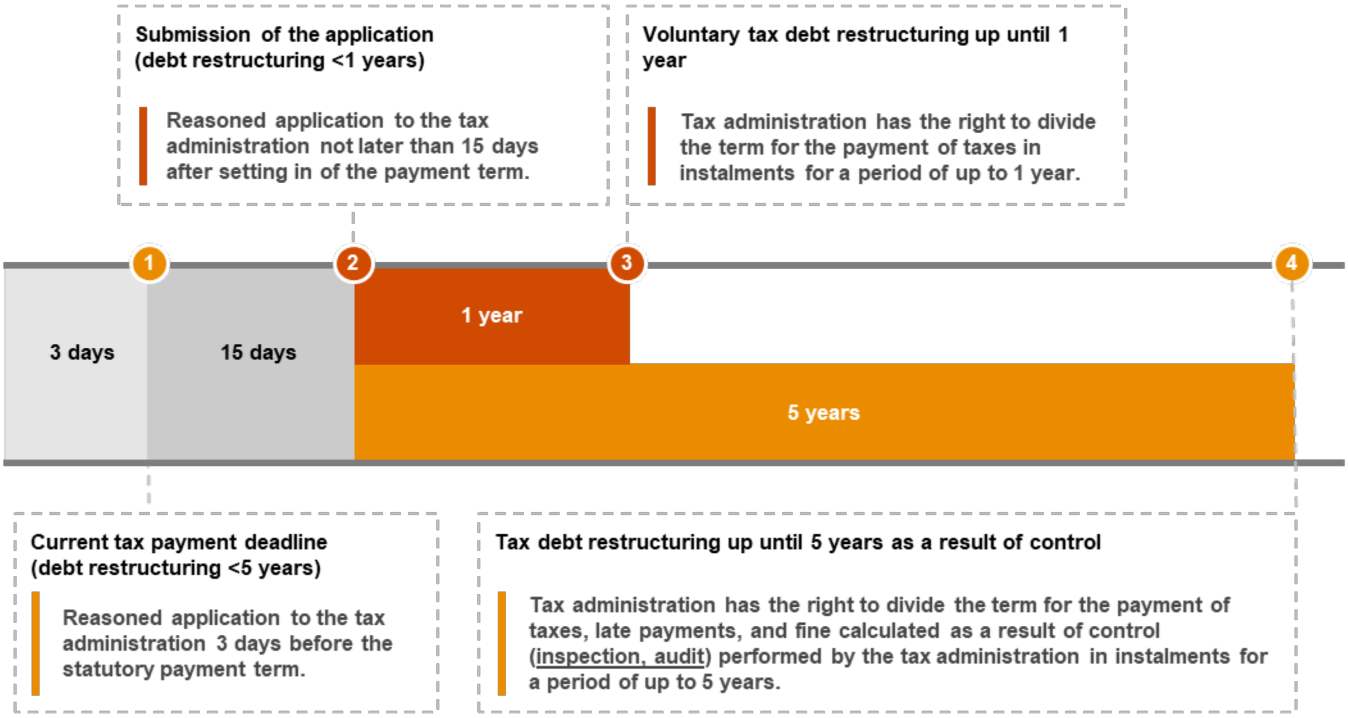
- meets the statutory deadlines for current tax payments;
- has been previously granted extensions of tax payment deadlines and whether the taxpayer has complied with the tax payment procedure;
- meets the statutory deadlines for filing tax returns and informative declarations;

- cooperates with the SRS; and
- whether any infringements by the taxpayer have been identified during the most recent tax review (audit).

If the taxpayer fails to comply with the time limits set in a decision extending the tax payment deadline, the SRS may cancel the decision.

It is not legally possible to reduce or waive penalties.

Figure 5 Tax settlement procedure in Article 24(1) of the Law on Taxes and Duties.



Tax penalties increase proportionally as the process of tax debt restructuring outside Formal Restructuring lengthens, thus increasing the risk of accrued charges significantly reducing a successful execution of the Restructuring Plan. To address this problem, the authors of this report suggest that the SRS could be granted the power to reduce or extinguish overdue tax payment charges if the enterprise has requested an extension of the tax payment deadline, including the relevant statement in Article 25 of the Law on Taxes and Duties (Extinguishment of Tax Debt).

The SRS assesses the taxpayer's actual financial position and considers the factors characteristic of debt restructuring:

(a) The taxpayer supplies evidence that a repeated division of tax payments into instalments for a period of up to six months will stabilise its financial position and the overdue taxes will be paid within the time limits set for the payment of the tax payments, divided repeatedly into instalments, for a period of up to six months;

(b) The performance of obligations in respect of payment of the overdue taxes may lead to the taxpayer's insolvency;

(c) Up to the date of submitting the application, the taxpayer, except for persons engaged in consumer lending activities, has not issued any outstanding loans to individuals, including the company's shareholders and directors;

(d) The tax debt is related to one of the following circumstances:

  - The net book value of the taxpayer's trade receivables equals or exceeds the amount of outstanding payments in respect of which an application has been submitted;
  - The net book value of the taxpayer's inventory equals or exceeds the amount of outstanding payments in respect of which an application has been submitted, and the inventory arises from a decline in the taxpayer's sales;
  - The taxpayer has not received consideration for the performance of public and local government orders, in whole or in part, within the due period;
  - For state-funded institutions as well as central and local government enterprises providing services funded by the state, the amount of financing or the reduction in services funded from the budget in the reporting year in which a tax debt arose exceeds 30% compared to the previous reporting year.

As a general rule, the SRS can extend the tax payment deadline within OCW at the debtor's request under Article 24 of the Law on Taxes and Duties. Article 24(1)(3) prescribes certain conditions for dividing the payment of taxes, interest and penalties into instalments over a period of up to five years, but it is not possible to reduce at least the accrued interest, which could be quite substantial. Applying for court proceedings (i.e. Formal Restructuring) makes it possible for the SRS to cancel the overdue taxes, interest and penalties under Article 25.[2] of the Law on Taxes and Duties. This rule delays early restructuring, creates an artificial need to apply to the courts and increases the burden on court proceedings, yet it could be regulated similarly to the procedure of Article 41 of the Law on Taxes and Duties.

This finding is confirmed by entrepreneurs who claim that a major disadvantage of extending taxes beyond LPP is interest on arrears of taxes and duties. If the state wants to promote OCW restructuring, then it needs to introduce more debt-friendly tax restructuring tools and give the SRS the power to use them during informal procedures.

According to an interview with the SRS, the extension (deferral or division into instalments) of late tax payments does not release the taxpayer from the duty to fully pay his current taxes on the due dates for payment laid down by tax laws. The SRS may grant an extension of the time limit for paying a particular type of tax and other payments to the same taxpayer up to four times per calendar year. In the process of collecting tax debts, there is the dilemma of whether to come to a Formal Restructuring agreement, because at first it is not possible to recover the full sum, but where the entity lives on, full recovery is possible.

The SRS analyses the overall condition and history of the entity, including the financial position, cooperation with other enterprises etc. Entities which receive an extension for tax debts have to submit interim financial statements (including income statement) and a financial analysis is performed. If there are already debt extensions for other taxes, and they have not been paid off yet, or the SRS sees that the entity is paying other debts, for example, to suppliers, but is not paying off its tax debts, then, of course, the SRS would not grant more extensions.

In 2012, there were cases where entities could apply for and obtain a total tax debt amnesty, but there are no plans currently to bring this procedure back.

> Some stakeholders have noted that debtors with tax debts already have adequate opportunities to cooperate with the SRS on a relieved regime for paying their taxes, i.e. those unable to duly pay taxes in full can reach a deferral agreement with the SRS. It is also said that debtors and the SRS have successfully concluded such agreements in practice.
>
> One of the indicated risks for expanding the methods of tax restructuring is that debtors may be more reluctant to pay taxes and motivated to act fraudulently in relation to the accounting information provided.
>
> This position is nevertheless opposed by a number of other stakeholders, who express frustration with the lack of flexibility in applying the tax restructuring rules, which can lead to the failure of otherwise viable OCW.

a. Recommendations

- A legal framework should be incorporated into Article 24(1)(3) of the Law on Taxes and Duties to authorise the SRS to apply similar measures to those prescribed by Article 41 of this law in order to reduce or cancel penalties on overdue tax payments when implementing tax restructuring measures for viable enterprises that demonstrate their ability to restore solvency in OCW.

3.2.1 Credit information offices

The study "Bankruptcy and Second Chance for Honest Bankrupt Entrepreneurs"[31] identifies the positive and negative effects of private credit scoring bureaus (PCSBs) and credit databases:

- Honest entrepreneurs' negative credit scorings should be cancelled on discharge or almost immediately thereafter. The length of time that negative information is kept on honest bankrupt entrepreneurs by PCSBs and credit databases should be monitored and limited;
- Minimum standards and quality control (along the lines of the ECAI system) are recommended for PCSBs to increase their legitimacy;
- Monitoring and/or limits;

[31] Bankruptcy and Second Chance for Honest Bankrupt Entrepreneurs. Corporate author(s): Directorate-General Enterprise and Industry (European Commission, 2014). Available at: https://ec.europa.eu/growth/content/study-bankruptcy-and-second-chance-honest-bankrupt-entrepreneurs-0_en. [Accessed November 20, 2019].

- Credit databases should be made available in all MS to increase their usage and usefulness; and
- Financial information from PCSBs and credit databases should be accessible across the EU.

In Latvia, credit scoring is only vaguely developed, while other countries have developed insightful and easy-to-use credit databases. Sweden and Portugal have been cited as good examples by interviewees from the banking sector.

The first licensed credit information bureau in Latvia was established in 2013 under the name "Credit Information Bureau" (KIB[32]). KIB is part of the Creditinfo Group, which is known worldwide and operates with the goal of diminishing the financial risks taken by any natural person or legal entity. KIB's shareholders are banks present in Latvia such as Swedbank AS, SEB banka AS, Luminor bank AS, Citadele Banka AS, and Creditinfo Group. KIB gathers information from various institutions: credit institutions (including banks which are shareholders and other banks present in Latvia), micro financial institutions (other credit institutions), utility companies, fuel retailers, insurance companies, and public information sources.

KIB's clients can access a secured database, which contains financial data of Latvian enterprises and natural persons. The bureau also performs payment-history, credit-rating and insolvency evaluations for enterprises. For no extra fee, natural persons may acquire their own credit history reports once a year. These reports contain information about all of the person's liabilities and late payment history, and a list of enterprises that have requested the person's credit history.

Another institution which gathers information in Latvia is Creditreform, and the Crediweb portal[33] offers the possibility of accessing the information gathered. Information about legal entities includes the registration number, contact details, credit history, taxpayer status, information on insolvency, liquidation and LPP proceedings, shares in other companies, and balance and profit-and-loss calculations. As to information on natural persons, there is access to the person's status on any company's management board, insolvency, and pledges or prohibitions placed on the person by any institution.

Overall, the publicly available information in Latvia (lursoft.lv,[34] crediweb.lv,[35] and SRS public data on registered debtors[36]) on the financial health of enterprises offers limited opportunities to make sound conclusions about the financial health of a given enterprise. Some of the reasons include the late submission of annual reports (e.g. as of 2019 only 70% of enterprises have filed their annual reports for 2017[37]).

[32] See further information on the credit database, (Credit Information Bureau, 2019). Available at: http://www.kib.lv/about-us/ [Accessed November 26, 2019].

[33] See further information on the register, (Crediweb 2019). Available at: https://www.crediweb.lv/. [Accessed November 26, 2019].

[34] Lursoft register of company annual reports, (Lursoft, 2019). Available at: https://www.lursoft.lv/en/register-of-companies-annual-reports. [Accessed November 26, 2019].

[35] See further information on the register, (Crediweb 2019). Available at: https://www.crediweb.lv/. [Accessed November 26, 2019].

[36] Tax debtors, (SRS, 2019). Available at: https://www6.vid.gov.lv/NPAR. [Accessed November 26, 2019].

[37] Changes in customer status are monitored, but no comprehensive customer due diligence is performed before a transaction is concluded, (Lursoft, 2019). Available at: https://blog.lursoft.lv/2019/05/09/klientu-statusu-izmainu-monitore-tacu-pirms-darijumu-slegsanas-neveic-vispusigu-klientu-izpeti/. [Accessed November 26, 2019].

Sweden

UC, Sweden's leading business and credit reference agency, provides information on enterprises and is more precisely connected to credit information by comparison. It was established in 1997 with the purpose of providing information to individuals, enterprises, and the public sector. The credit register contains information on every individual over the age of 15 and all companies registered in Sweden. UC is gathering and processing data for several purposes, for example, to be able to conduct market analysis, gather statistics, monitor enterprises, and provide lenders and borrowers with statistics on the current market situation, which helps them address potential risks. UC gathers information from various institutions and does calculations. The information and statistics about other persons that a user can obtain is prepared so that no one can be identified. Only the persons themselves can check their credit file with all information identifying them.

UC gathers, stores and analyses information such as names and addresses, income, property data, LLC board members and auditors, annual reports, various ratios, licences and certificates, details of unsecured creditors' claims, credit information, details of missed payments, debt reconstruction etc. UC cooperates with the Business Information Group Network (BIGNet), which enables it to provide its users with corporate information from nine European countries. UC is part of the Nordic Credit Alliance, together with Finland, Denmark and Norway, which also expands the list of companies and individuals on which information can be found. There are various sources of this information, such as the Swedish Population Registry, Tax Agency, District Court, Companies Registration Office, bankruptcy supervising authority, banks and other financial institutions, and many more.

Equifax[38] has been listed by the World Bank[39] as a private credit bureau in Portugal similar to UC in Sweden. Equifax operates in many countries, including Portugal, as a credit reference agency collecting information about individuals and entities, who can receive a credit report on request. Equifax carries out analyses and creates models and visual representations of trends and other industry data.

3.3 Formal Restructuring

In contrast to OCW, Formal Restructuring involves the court to some extent, with the aim for the debtor to obtain a breathing space and creditor support for a Restructuring Plan. A more detailed description of these processes is available in the following sections.

Both ELPP and LPP were implemented in the national legal system in 2008. Until then, there were several other tools in place. All insolvent enterprises were required to file for insolvency, which could have three different outcomes: liquidation, settlement, or amicable settlement. The latter two were restructuring tools, but neither was often applied in practice or considered fully successful. To bring Latvia into line with international best practice, its legislature has adopted Formal Restructuring to provide legal protection for the debtor by involving the courts.

Article 34 of the Insolvency Law imposes three common restrictions on the initiation of Formal Restructuring:

1) The debtor has initiated and is still in its own liquidation process;
2) In the preceding four months, the court has initiated and interrupted the debtor's Formal Restructuring because the Restructuring Plan was not supported by the majority of creditors or did not meet requirements of the Insolvency Law;
3) The debtor has successfully implemented a Restructuring Plan in the preceding five years. The provision is not applicable if the debtor has had the legal entity's insolvent liquidation proceedings proclaimed, and an application for ELPP has been submitted.

Thus, the Insolvency Law imposes restrictions, not requirements, that must be met before an enterprise can access Formal Restructuring.

The most notable differences between ELPP and LPP are:

[38] See further information on the register, (Equifax, 2019). Available at: https://www.equifax.com/personal/education/credit/report/what-is-a-credit-report-and-what-does-it-include/. [Accessed November 22, 2019].

[39] See listing of the World Bank, (World Bank, 2010). Available at: http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/Private_Credit_Bureau_LIST_July_2010.pdf. [Accessed November 22, 2019].

1) The development, adoption and approval by creditors of the Restructuring Plan. In ELPP, the Restructuring Plan is developed and approved before the application is submitted to the court. In LPP, the Restructuring Plan is usually developed and approved by creditors after the application has been submitted to the court;
2) There is no stay period in ELPP;
3) Timing of the initiation of proceedings. In LPP, proceedings are initiated when the debtor is already facing or able to foresee financial difficulties and is most likely unable to reach an agreement with the creditors, and is therefore willing to receive court protection immediately and use a stay period. ELPP are used as a tool for drawing up a Restructuring Plan and seeking approval from the majority of creditors before the application is submitted to the court, and consequently there is no stay period in this process.

3.3.1 ELPP

ELPP are regulated by Chapter VIII “Extrajudicial Legal Protection Proceedings” of the Insolvency Law and can be used by legal entities, partnerships, individual merchants, persons registered in a foreign country who perform permanent economic activity in Latvia, and by makers of agricultural products that have good prospects of reaching an agreement with the majority of creditors, and there is no risk that an individual creditor will take individual action against the debtor that could seriously endanger the development, approval and implementation of the Restructuring Plan.

It should be noted that entrepreneurs (persons performing economic activity) without individual merchant status are not subject to ELPP.

Once a negotiated agreement with the majority of creditors has been reached, the court’s approval of the Restructuring Plan in ELPP allows it to bind minority creditors and to obtain other legal protections pursuant to the Insolvency Law.

After the Restructuring Plan has been drafted and the Supervisor of the potential ELPP has given his opinion on the Restructuring Plan, it must be submitted to all minority creditors and to the court, who will decide to approve or reject the Restructuring Plan and the Supervisor, and so allows or disallows the implementation of the ELPP.

If the court confirms the Restructuring Plan in ELPP, the debtor has two years to implement the Restructuring Plan, unless the majority of creditors agree to extend this period for another two years. Implementation of the Restructuring Plan offers various benefits that ensure uninterrupted operation of the business and may include postponement of due debts, alienation of property, increase of the debtor’s capital etc.

Although the Insolvency Law does not enforce direct obstacles for the debtor to execute its day-to-day activities and, for example, participate in public procurement, in practice the debtor might find it difficult to continue operating during the Formal Restructuring process. For example, under the Public Procurement Law, the procuring entity is allowed to exclude a bidder from participation in the tender if the debtor has tax debts of more than EUR 150. Thus, even though the law does not directly impose obstacles, the debtor might face obstacles to continuous operation.

If Formal Restructuring is not declared, or is declared but interrupted, which can happen for various reasons, after four months the debtor can try to re-initiate Formal Restructuring or may pursue insolvent liquidation.

Insolvent liquidation proceedings can also be transformed into LPP by using the ELPP rules. ELPP are public proceedings and information on them is included in the insolvency register (see Annex 4 a Schematic Overview of ELPP in Latvia).

3.3.2 LPP

LPP are regulated by Division B “Legal Protection Proceedings” of the Insolvency Law and Chapter V “General Provisions of Legal Protection Proceedings,” Chapter VI “Effects of Initiating a Case of Legal Protection Proceedings,” and Chapter VII “Implementation of Legal Protection Proceedings.” **LPP are a legal solution used by the same subjects as mentioned in the ELPP section, foreseeing financial distress in the near future or already facing financial distress** (see Annex 4 a Schematic Overview of LPP in Latvia).

It should be noted that entrepreneurs without individual merchant status cannot access LPP.

There are no formal criteria for an enterprise to access LPP and ELPP other than the formal procedural requirements under the Civil Procedure Law. By initiating LPP, the debtor automatically benefits from a two-month stay of individual enforcement actions, with the possibility of extending it for a third month if certain criteria under the Insolvency Law are met. The stay of individual enforcement actions aims to support negotiations on the Restructuring Plan and to prevent the debtor from losing assets through the creditors’ individual recovery actions.

During the stay period, the debtor drafts the Restructuring Plan and seeks approval from the creditors. A Supervisor is suggested to the court by the majority of creditors (if they agree on a candidate) subject to the debtor’s approval.

Once the court receives the approved Restructuring Plan, it must decide on the appointment of Supervisor and on the deadline for submission to the court of the Supervisor's opinion on the Restructuring Plan. If the court confirms the Restructuring Plan for the measures of LPP, the debtor has two years to implement it, unless the majority of creditors agree to amend the Restructuring Plan and to extend the period for another two years.

Implementation of the Restructuring Plan offers various benefits that ensure uninterrupted operation of the business and may include postponement of due debts, alienation of property, increase of the debtor's capital etc. If LPP are not declared, or are declared but interrupted, which can happen for various reasons, after a certain period the debtor can try to re-initiate LPP or pursue liquidation.

Insolvent liquidation proceedings can also be transformed into Formal Restructuring by using the ELPP rules. LPP are public proceedings and information on them is made public in the insolvency register.

Similar practical obstacles exist for enterprises pursuing Formal Restructuring through LPP. As with ELPP, enterprises may be barred from participating in a public tender if a certain threshold of tax debts is reached.

3.4 Liquidation

According to the current legal framework, if Formal Restructuring efforts are unsuccessful, the debtor must pursue liquidation instead.

There are two types of liquidation in Latvia:

- The natural person's insolvency proceedings (a non-entrepreneur or an entrepreneur without individual merchant status) regulated under Division D of the Insolvency Law;
- The legal entity's liquidation regulated under Division C of the Insolvency Law. It should be noted that the liquidation of credit institutions is governed by the Credit Institutions Law.

The natural person's insolvency proceedings (a non-entrepreneur or an entrepreneur without individual merchant status) are an aggregate of legal measures aimed at satisfying creditor claims as much as possible out of the debtor's property and providing a debtor whose property and income is insufficient to cover the entire obligations with an opportunity to be released from any obligations that have not been honoured, and to restore solvency. The natural person's insolvency proceedings are a way for a person to restore solvency under the supervision of an Insolvency Practitioner and in accordance with the procedure prescribed by the laws and regulations governing insolvency proceedings, and to be released from debt after the discharge of liabilities. The natural person's insolvency proceedings are purely voluntary and can be initiated only by the debtor. Please see the analysis of compliance of the natural person's insolvency proceedings with Directive 2019/1023 in the section "Insolvency Proceedings for Entrepreneurs" below.

The legal entity's liquidation, which includes natural persons/entrepreneurs with individual merchant status, is an aggregation of legal actions aimed at satisfying creditor claims out of the insolvent debtor's assets.

If Formal Restructuring is irrelevant, or if the debtor fails to or is unwilling to agree with creditors on Formal Restructuring, which is a voluntary option, and the debtor has signs of the legal entity's insolvency defined by Article 57 of the Insolvency Law, the debtor will be declared insolvent. The legal entity's liquidation is applicable to a legal entity, a partnership, an individual merchant, or a person registered in a foreign country who performs permanent economic activities in Latvia and in the special areas listed by the Insolvency Law.

Article 57 of the Insolvency Law lists features of the legal entity's insolvency. The legal entity's liquidation may be initiated when certain signs of insolvency under Article 57 have been identified by –

- the debtor;
- a creditor or a class of creditors, including the debtor's employees; or
- the court after a repeated failure of Formal Restructuring in a certain period.

As to the legal entity's liquidation initiated by the debtor, the Insolvency Law prescribes liability of the debtor's management board if the debtor has failed to declare its own insolvency in a timely manner.

In summary, the legal entity's insolvent liquidation proceedings are initiated by an application submitted to the court by creditors or the debtor. After the initiation of liquidation and the appointment of an Insolvency Practitioner (an accredited professional) by the court, the debtor's bankruptcy proceedings are carried out. Following the declaration of the legal entity's insolvent liquidation proceedings, the debtor's assets are protected from increased interest charges and other penalties for late payment, and generally the Insolvency Practitioner takes control over the debtor's assets and operations, with the previous management having lost all control of the assets and day-to-day operations.

The main task of an Insolvency Practitioner during insolvent liquidation proceedings is to sell all of the debtor's assets and recover the debtor's claims and any other assets that may be recoverable through litigation, with the aim of settling as many creditor claims as possible and, if possible, renewing the debtor's solvency.

The legal entity's insolvent liquidation proceedings lead to the debtor's liquidation and removal from the Register of Enterprises, unless there is an opportunity to restore the debtor's solvency using the ELPP rules.

As stated before, according to Chapter XIX "Transition from the Legal Entity's Insolvency Proceedings to Legal Protection Proceedings" of the Insolvency Law, insolvent liquidation proceedings can be transformed into Formal Restructuring by using the ELPP rules if the Restructuring Plan in ELPP is approved by the majority of creditors and restoration of the debtor's business may be attempted. The following persons have the initiative to restore the debtor to solvency: the debtor's representative (owners and previous members of governing bodies), the Insolvency Practitioner, the liquidator involved in the insolvent liquidation proceedings specified by Article 3(1) of European Parliament and Council Regulation No 2015/848 initiated against the debtor in another MS, and a creditor or a class of creditors.

In practice, there are cases where, although there was no initial plan to restore solvency, after the sale of the property and the recovery of other assets, the recoveries can fully satisfy all recognised creditor claims, or a solvent enterprise has been declared insolvent by mistake but is able to meet creditor claims and continue operating.

In this case, the law provides for paying out the remaining funds to the debtor's shareholders and liquidating the enterprise, but the owners are sometimes willing to continue operating an entity whose solvency has been restored *de facto*.

Despite the will of the shareholders and the purpose of the Insolvency Law to promote the honouring of the obligations of a debtor in financial difficulties and, where possible, the renewal of solvency, the Insolvency Law does not prescribe the recovery of solvency when the creditors have been satisfied in full during liquidation, as there are no creditors left to approve the Restructuring Plan, and so Formal Restructuring cannot be initiated, and the debtor will be liquidated.

It should be noted that liquidations are public proceedings, and information on them is made public in the insolvency register. Thus, the sooner the creditor notices a potential problem and the enterprise receives attention, the more options are available for successful restructuring. For an enterprise at a crisis stage, there is a very limited set of options left, such as forced sale of assets, changes to the shareholder structure, Formal Restructuring, or insolvent liquidation.

4 Profile of Latvian Enterprises and Other Entities

The legal framework for Debt Restructuring should accommodate the characteristics of the Latvian business environment in order to figure out what kinds of safeguards should be created to promote effective Debt Restructuring. In order to understand the characteristics of the business environment and enterprises that could be subject to Debt Restructuring proceedings, the authors of this report analyse (1) the profile of Latvian legal entities subject to Formal Restructuring, (2) the business environment in general and how it affects Formal Restructuring proceedings, and (3) access to Formal Restructuring.

4.1 Types of Enterprises in Latvia

The Latvian business environment mainly consists of micro enterprises, which have a limited access to professional financial advice. A large number of enterprises have no shareholder equity to cover all outstanding debts in the event of a business downturn.

The Commercial Law establishes five different types of undertakings: an LLC (*sabiedrība ar ierobežotu atbildību*), a joint stock company (*akciju sabiedrība*), a general partnership (*pilnsabiedrība*), a limited partnership (*komandītsabiedrība*), and an individual merchant (*individuālais komersants*). Associations and foundations are also recognised as legal entities (see Article 3 of the Associations and Foundations Law).

The Law on Individual (Family) Undertakings and Farm or Fishery Operations defines an individual undertaking (*individuālais uzņēmums*), a family undertaking (*ģimenes uzņēmums*), a farm operation (*zemnieka saimniecība*), a fishery operation (*zvejnieka saimniecība*), and a rural craft undertaking (*lauku amatnieka uzņēmums*).

The Latvian legal system regulates two types of natural persons/economic operators: persons performing economic activity (entrepreneurs without individual merchant status) and individual merchants.

There are also associations and foundations, including political parties and their associations.

Persons (entrepreneurs without individual merchant status) performing economic activity are not entered on the Register of Enterprises but are only registered with the SRS for tax purposes.[40] Their economic activity consists of regular transactions and substantial earnings and is organised for the purpose of gaining financial benefit. Persons performing economic activity are liable with all of their assets, yet the requirement for being entered on the Register of Enterprises becomes mandatory only when specific criteria are met.

Another group of economic operators are **individual merchants** – natural persons who are registered as merchants in the Register of Enterprises and as taxpayers with the SRS. Natural persons are required to register as individual merchants if their economic activities reach a certain turnover, if they perform the activities of commercial agents or brokers, or if they employ at least five persons.

Natural persons can voluntarily register as individual merchants even if their economic activity does not meet the above criteria. Individual merchants are liable with all of their assets, and their activities are regulated by Division VIII of the Commercial Law.

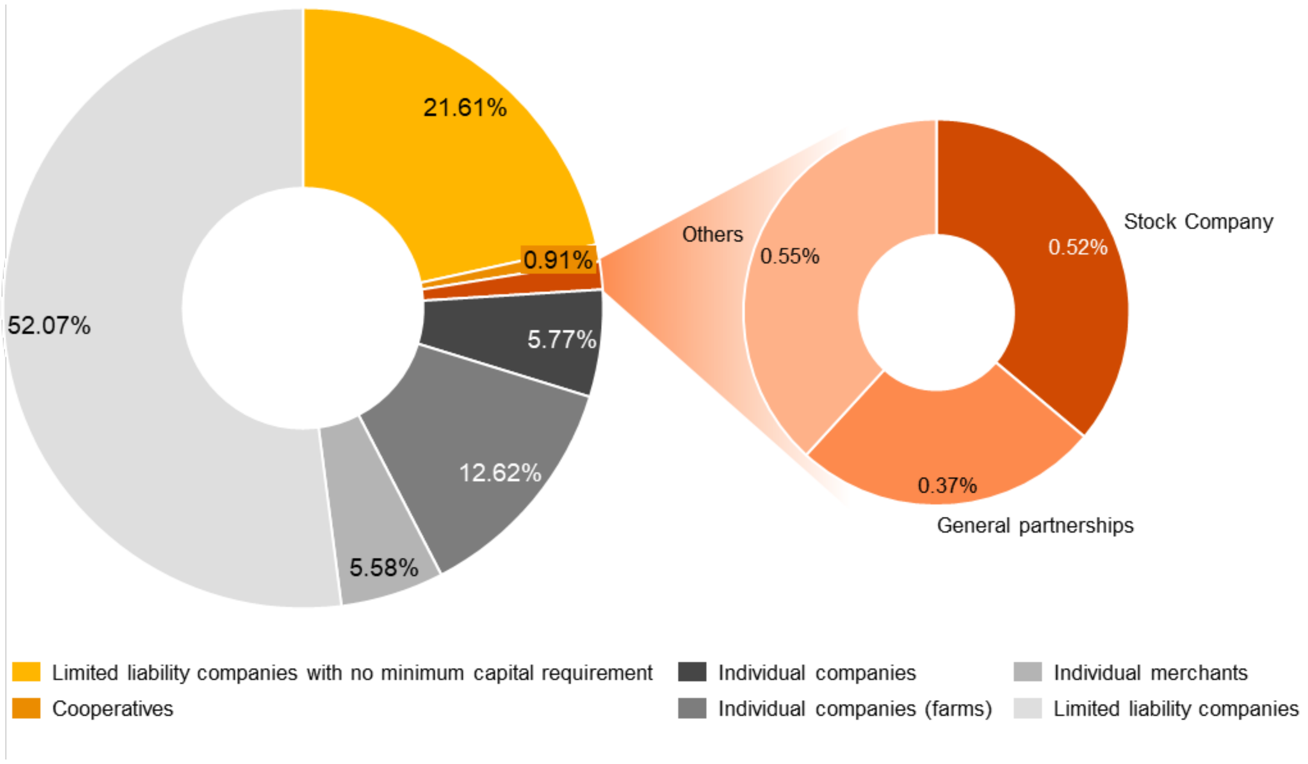
As at 31 December 2018, there were 203,856 registered commercial enterprises, individual merchants and individual undertakings (205,034 as at 31 October 2019[41]) according to the Register of Enterprises. There has been a steady growth in the number of registered enterprises from 1991 through 2019.

[40] Law on Taxes and Duties. Available at: https://likumi.lv/ta/en/en/id/33946-on-taxes-and-duties. [Accessed November 30, 2019].

[41] Statistics. The Register of Enterprises of the Republic of Latvia. Available at: https://www.ur.gov.lv/lv/jaunumi/statistika/ [Accessed November 30, 2019].

Of the 203,856 enterprises registered as at 31 December 2018, 52% (106,137) were LLCs, 22% (44,068) LLCs with no minimum capital requirement, 19% (37,485) individual undertakings, 6% (11,375) individual merchants, and 1% other legal forms of business (see Figure 6).

Figure 6 Registered businesses by legal form as at 31 December 2018, the Register of Enterprises of the Republic of Latvia, 2019



A record number of LLCs (126,677) were registered as at December 2015. In the case of individual merchants, the peak was observed in September 2011 with 13,792 individual merchants registered. There has since been a downward tendency in both cases.[42] A new type of LLC – one with no minimum capital requirement – gained traction in 2010, when the first considerable number of such LLCs were registered. This type of company was introduced by amendments to the Commercial Law passed on 1 May 2010, with the aim of spurring the business environment and increasing share capital.

Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty, Annex I, Article 2 classifies SMEs into micro, small and medium-sized enterprises. According to the EC overarching framework for the EU policy on SMEs – Small Business Act data for 2018, SMEs in Latvia break down as follows: 92.1% micro, 6.5% small, and 1.2% medium. The remaining 0.2% are classified as large enterprises.[43]

[42] Ibid.

[43] SBA Fact Sheets 2018, EC. Available at: https://ec.europa.eu/docsroom/documents/32581/. [Accessed November 4, 2019].

Figure 7 Latvian company classification according to Commission Regulation No 651/2014, Annex I, Article 2.

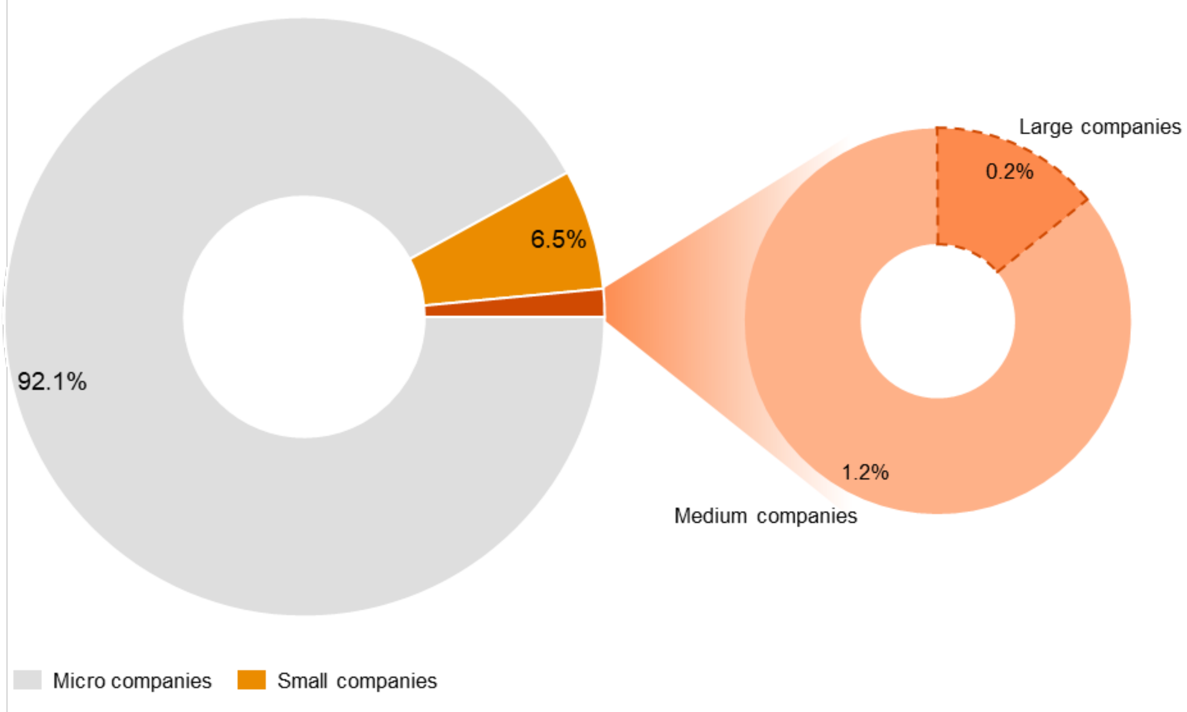


Figure 7 above makes it clear that the Latvian economy mainly consists of SMEs. Accordingly, when further analysing the various issues and opportunities for access to Formal Restructuring contained in the legislation, one would benefit from keeping this in mind and developing solutions tailored for the Latvian business environment.

4.2 Tax Discipline and Proportion of Shadow Economy

The size of the shadow economy in Latvia and the possibility of "easier" and more lucrative alternatives to Formal Restructuring for debtors are due to the following circumstances:

- The ease with which shareholders and/or directors can form a new company and shift their existing, presumably struggling business and its assets to the new company, leaving the old one as a "defunct" insolvent entity, most often with its old liabilities and with "new" or non-resident directors of the old company;
- The lack of safeguards against abuse, in particular with SMEs, which may lack the structural sophistication and/or complexity to seek a moratorium to "transact" the new legal structure;
- The lack of prosecution against the original shareholders and directors and/or public censure in all but a handful of cases, making alternatives to Formal Restructuring attractive;
- The very small number of enterprises successfully completing Formal Restructuring precludes general conclusions about success factors other than the impossibility of Formal Restructuring because of hidden insolvency or management failure from the beginning.

The low tax discipline and the size of the shadow economy in Latvia cause the SRS and other creditors to treat debtors as potentially dishonest and not acting in good faith. This attitude could decrease the possibility of honest debtors receiving a restructuring discharge of tax debt out of court.

The SRS regularly assesses the size of the gap for different taxes.[44] **The proportion of workers at risk of cash-in-hand wage payments was 28% in 2018.**[45]

[44] The size of the tax gap, SRS. Available at: https://www.vid.gov.lv/lv/statistika/nodoklu-plaisu-apmeri. [Accessed November 4, 2019].

[45] Wage tax gap for general tax wage earners (cash-in-hand wage payments). (SRS, 2019, p.19). Available at: https://www.vid.gov.lv/sites/default/files/aploksnu_algu_plaisa_komersantiem_kas_strada_vispareja_rezima_2018.gada_publikacijai.pdf. [Accessed November 4, 2019].

The largest share of the shadow economy at 50.6% last year is represented by individual merchants – natural persons who are registered as performing economic activity. In 2018, the share of undeclared operating income had increased by 2.6 percentage points compared to 2017.[46]

> **Representatives of Insolvency Practitioners** pointed out in the interviews that LPP should be viewed in a broader context of options for enterprises in financial difficulties. Other options and "solutions" such as the insolvent liquidation procedure are not as easily accessible as LPP because they introduce extra fees, responsibility etc. If it were not so easy to circumvent proper procedures, people would pay more attention to the successful execution of LPP. An entity applying for LPP knows that if the proceedings are unsuccessful, then liquidation is available. Insolvency can influence the company's reputation, but this is not a major factor nowadays, even for large enterprises, because according to the stakeholders, the perception by business in general is that everybody has had their problems. The regulation of LPP is considered quite lax, and this has partly led to the LPP moratorium period being used to delay time. This is because in reality the time from the application for LPP to the end of the stay period sometimes exceeds three months, during which the enterprise has a free hand to act.

> **Bailiffs in the interviews confirmed** that asset transfers/shifts are mostly carried out by small enterprises with no real estate. They acquire debt, do not pay wages, and then just shift the assets through restructuring or re-registration. A company with several real estate assets reorganises its business and transfers/sells, for example, a warehouse building that is its most profitable asset, to another business entity, which may be newly registered. The register accepts the form of reorganisation and completes the required processes. It is then impossible to recover the debts from the first entity, and the creditor cannot recover from the new entity to which the building has been transferred/sold. In conclusion, the problem lies also in the fact that the State Land Service is disorganised, especially the process of entering buildings on the Land Register.

To recognise classes of taxpayers by tax discipline and to develop tax administration tactics accordingly, the SRS has created a system of taxpayer segmentation. The segmentation is revised according to the taxpayer's track record. There are seven segments of taxpayers according to their compliance with tax requirements:

1. Trustworthy taxpayers (fully compliant), members of the Advanced Cooperation Programme, taxpayers with excellent tax discipline and no identified risks, with good tax paying record and rare occurrence of minor risks in one area;
2. Taxpayers to be promoted (compliant), with satisfactory tax discipline, rare occurrence of risks in several areas;
3. Taxpayers to be monitored (partially compliant), with risks of VAT evasion, high and medium risks of cash-in-hand wage payments, other taxpayers with significant tax compliance problems and significant risks at least in one area;
4. Non-registered taxpayers (non-compliant), a specific group of taxpayers which according to third-party information are subject to registration on the taxpayer register and have a significant risk profile;
5. Low-sustainability taxpayers are with insufficient economic activity to meet tax liabilities and have a significant risk profile;
6. Taxpayers to be restricted are whose future economic activity is undesirable and subject to a full set of restrictive measures, with a significant risk profile; and
7. Economically inactive taxpayers with a significant risk profile.

Figure 8 illustrates the relationship between tax debt and headcount in various entities. According to the SRS, the most critical amount of tax debt (see Figure 8) is concentrated in entities segmented as "Low-sustainability taxpayers" and "Taxpayers to be restricted." A significant amount of tax debt is also accrued by economically inactive taxpayers (58,725 enterprises) employing only 406 persons in total.

In contrast, entities that are considered the most probably viable business segment thanks to their regular tax payments employ over 200,000 persons per segment. In total, there are 69,566 such entities with a low level of tax debt.

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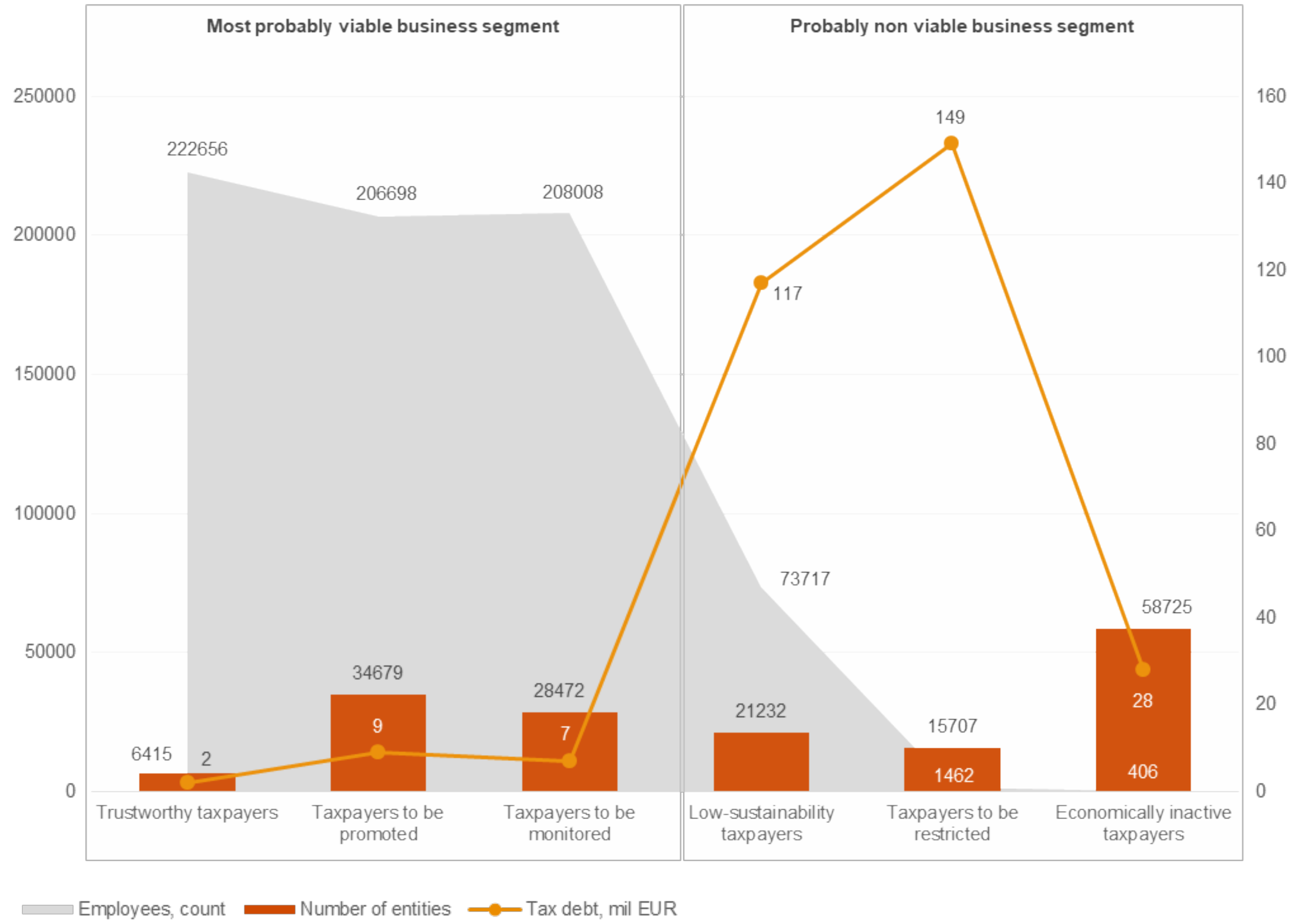
[46] Tax gap on performers of economic activity, (SRS, November 2019, p.7). Available at: https://www.vid.gov.lv/sites/default/files/sd_veiceju_nodoklu_plaisa_2019.pdf. [Accessed November 4, 2019].

Figure 8 Tax debt and number of employees per different taxpayer segments, SRS data, September 2019



4.3 Viability of Enterprises Registered in Latvia

The large number of registered enterprises is inflated and does not correspond to the actual number of economically active business entities. This finding is supported by a general assessment of annual accounts submitted and an analysis of available annual accounts.

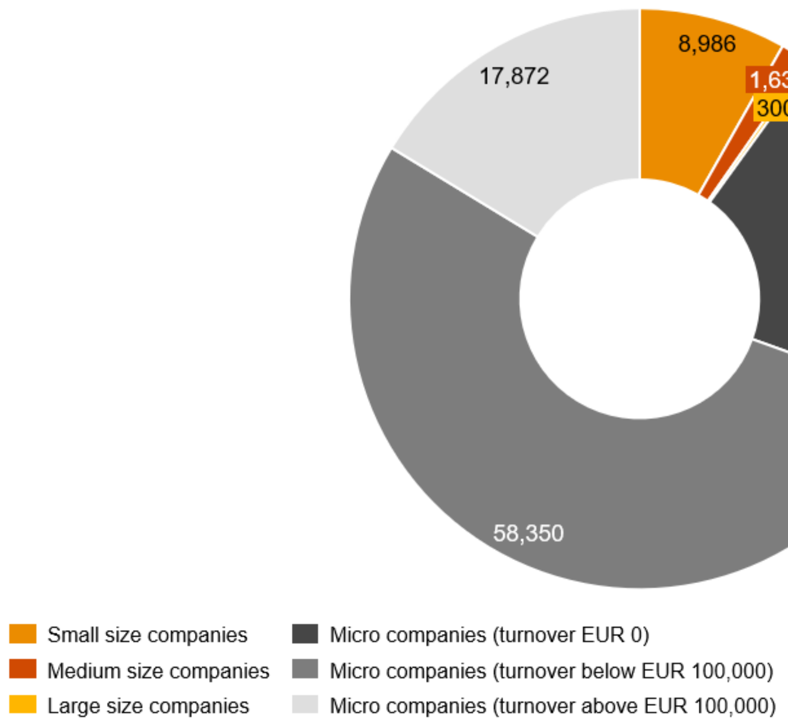
The easy terms offered by the Register of Enterprises and the weak supervision by the regulatory authorities allow “defunct” enterprises to avoid liquidation. To determine which enterprises are potentially subject to Formal Restructuring, it is necessary to distinguish economically active business units from the total number of enterprises on the Register of Enterprises. There are several criteria to be assessed to recognise enterprise viability: (1) submission of annual accounts; (2) facing financial distress; (3) access to business advice; and (4) shareholder oversight.

4.3.1 Failure to submit of annual accounts to the SRS

The main criterion of economic activity, as well as being an indication of whether there is a justified intention to continue business operations, is regular submission of annual accounts to the SRS. **The number of companies that have submitted their annual accounts for 2018 by 11 November 2019 and have not been liquidated or whose business activity has been since suspended is 109,635.** As at 31 December 2018, there were 203,856 registered commercial enterprises, and considering that 2,740 enterprises have since been liquidated, the **proportion of annual accounts for 2018 submitted is around 55%,** which reveals an enormous blind spot in terms of available financial information that is representative and up to date.

Thus, defining unsubmitted annual accounts (see Figure 9 below) as a stage-one filter to deflate the population of enterprises and highlight the potential subjects of Formal Restructuring proceedings results in a “trimmed” population of 109,635 companies that have submitted their annual accounts for 2018. Graph 4 shows that micro enterprises represent 90% of the population, small enterprises 8.2%, medium-sized enterprises 1.5%, and large enterprises 0.3%.

Figure 9 Number of enterprises classified by Commission Regulation (EC) No 800/2008 that have submitted annual accounts for the FY ended 31 December 2018, source: *Lursoft data, https://www.lursoft.lv/.*



There have been some recent steps towards “cleansing” the Register of Enterprises of defunct enterprises. The “cleansing” was initiated by the Register of Enterprises as a response to the Moneyval Fifth Round Mutual Evaluation Report on anti-money laundering and counter-terrorist financing measures in Latvia, dated 23 August 2018.[47]

According to our analysis, there is a large portfolio of registered enterprises that are largely non-compliant, have accumulated substantial tax debts and risk being involved in fraudulent activities, which should not have access to Formal Restructuring for the benefit of society.

Under Article 314.1 of the Latvian Commercial Law, a company’s activities may be terminated by decision of the Register of Enterprises (see Figure 10) if the company’s management board has no members for a certain period or if the company cannot be reached at its registered office for a certain period. A company’s activities may also be terminated by decision of the SRS if –

a. the company has not duly submitted an annual report, and six months have passed since the breach was committed;

b. the company has not filed tax returns for six months, and one month has passed since an administrative penalty was imposed;

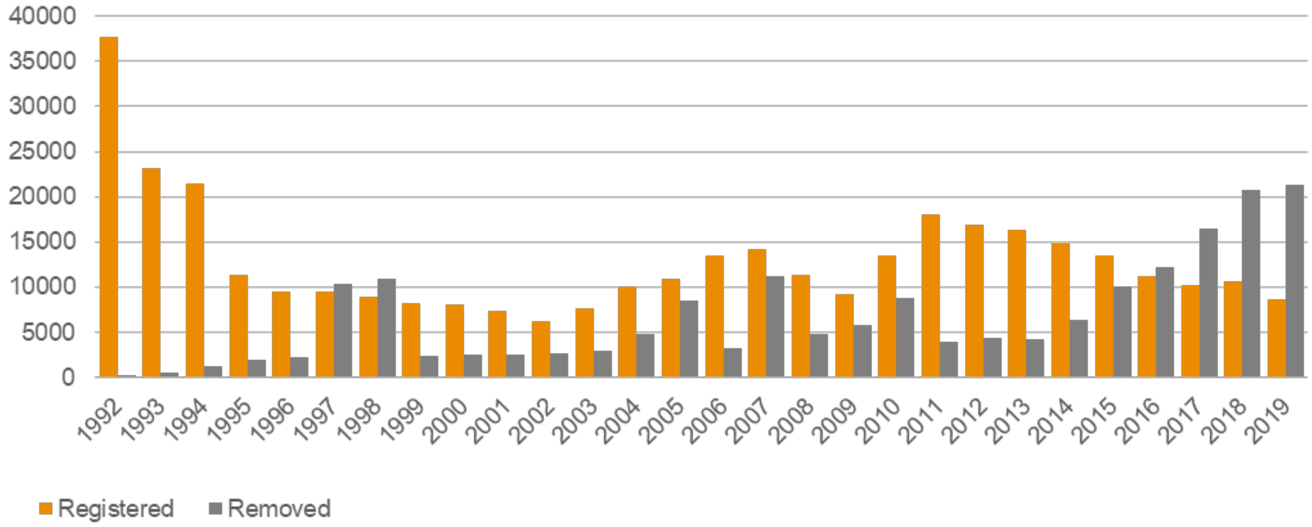
c. the company’s activities have been suspended by decision of the tax authority, but the company has not rectified the deficiency within three months after its activities were suspended.

Figure 10 proves the “cleansing” efforts made by the Register of Enterprises in 1992–2019. The number of enterprises removed has been on the increase since 2011. According to the latest data, 22,735 enterprises were removed from the Register of Enterprises over the period from 1 January to 31 October 2019. As at 14 January 2019, the Register of Enterprises had “cleansed” itself of 6,645 enterprises (see **Figure 10**).[48]

[47] Anti-money laundering and counter-terrorist financing measures, Moneyval. Available at: https://rm.coe.int/moneyval-2018-8-5th-round-mer-latvia/16808ce61b. [Accessed November 26, 2019].

[48] Statistics. Enterprises and Merchants, (Register of Enterprises, 2019). Available at: https://www.ur.gov.lv/lv/jaunumi/statistika/. [Accessed November 26, 2019].

Figure 10 Number of registered and removed enterprises and commercial entities* 1992–2019, based on data from the Register of Enterprises, 2019



In 2018, the OECD stated similarly that an issue where certain progress has been achieved, but which continues to plague the Register of Enterprises, is the relatively large number of inactive enterprises on it. While there is nothing to be said against using shelf companies that are created in order to be immediately ready if needed, stakeholder comments suggest that the inactive enterprises on the Register of Enterprises go far beyond the legitimate use of registering companies that are not immediately trading. In particular, such companies create a risk of being abused to the detriment of outsiders such as creditors. If this problem persists, it is advisable to consider using a combination of mixed measures to distinguish legitimate inactive companies from illegitimate ones. In dealing with inactive companies, English law uses a mix of filing duties, penalties and the threat to strike companies off the register.[49]

SRS opinion

The SRS have provided information that according to their estimates, **58,725**[50] enterprises (excluding farmers and individual merchants) are economically inactive.

Thus, the SRS directly confirms our hypothesis: **by excluding registered farmers and individual merchants (37,485 as at 31 December 2018) from the population of registered enterprises, even if we attribute the proportion of unsubmitted annual accounts (60%) to the rest of the population, the result is about 54,000 economically inactive enterprises based on a single criterion: unsubmitted annual accounts.**

To further minimise the potential abuse of LPP by unviable enterprises, we should look into the 22,495 micro enterprises that submitted annual accounts but recorded no turnover. Considering that these kinds of enterprises could be operating as asset managers with a decent amount of fixed assets on their balance sheet, we should refrain from automatic removal of such enterprises from the Register of Enterprises and give this issue further consideration.

Stakeholders have suggested holding further discussions on the issue of liquidation of unviable enterprises and especially on substantive property issues, i.e. the assets of those unviable enterprises. For example, a simplified procedure could be created under which the financial assets of liquidated enterprises left in credit institutions are transferred to the state.

[49] Access to Justice for Business and Inclusive Growth in Latvia, (OECD Publishing, Paris, p.79.). Available at: https://doi.org/10.1787/9789264303416-en. [Accessed November 26, 2019].
[50] Data provided by SRS, September 2019.

Another issue raised in the stakeholder discussions is the current use of evaluation methodology, which is applied to determine whether an enterprise is indeed unviable. It has been suggested that the current method ignores any intangible value (intellectual property, customer base etc) and considers only the value of the enterprise's tangible assets.

4.3.2 Best practice of other countries in ensuring financial viability

The UK

Under section 1000 of the Companies Act, the registrar has the power to strike off a defunct company provided certain steps are followed. If the registrar has reasonable cause to believe that a company is not trading, the registrar may send them a letter asking whether the company is trading. If no answer is received within 14 days, the registrar sends a second enquiry. If there is still no response within an extra 14 days, a notice is published in the Gazette (an official journal) stating that the registrar will strike the company's name off the register at the expiry of two months from the date of the notice unless cause is shown to the contrary. The registrar is required to then publish a further notice of the company's name being struck off the register at which point the company is dissolved.

However, the liability (if any) of every director, managing officer and member of the company continues and may be enforced as if the company had not been dissolved, and the court retains the power to wind up a company whose name has been struck off the register.

Under section 1012(1) of the Companies Act, when a company is dissolved, all of its property and rights pass to the Crown. This is known as *bona vacantia*.

4.3.3 High proportion of micro enterprises facing financial distress indicators

Financial difficulties of SMEs are apparent through both the analysis of annual accounts and the assessment by the bank sector.

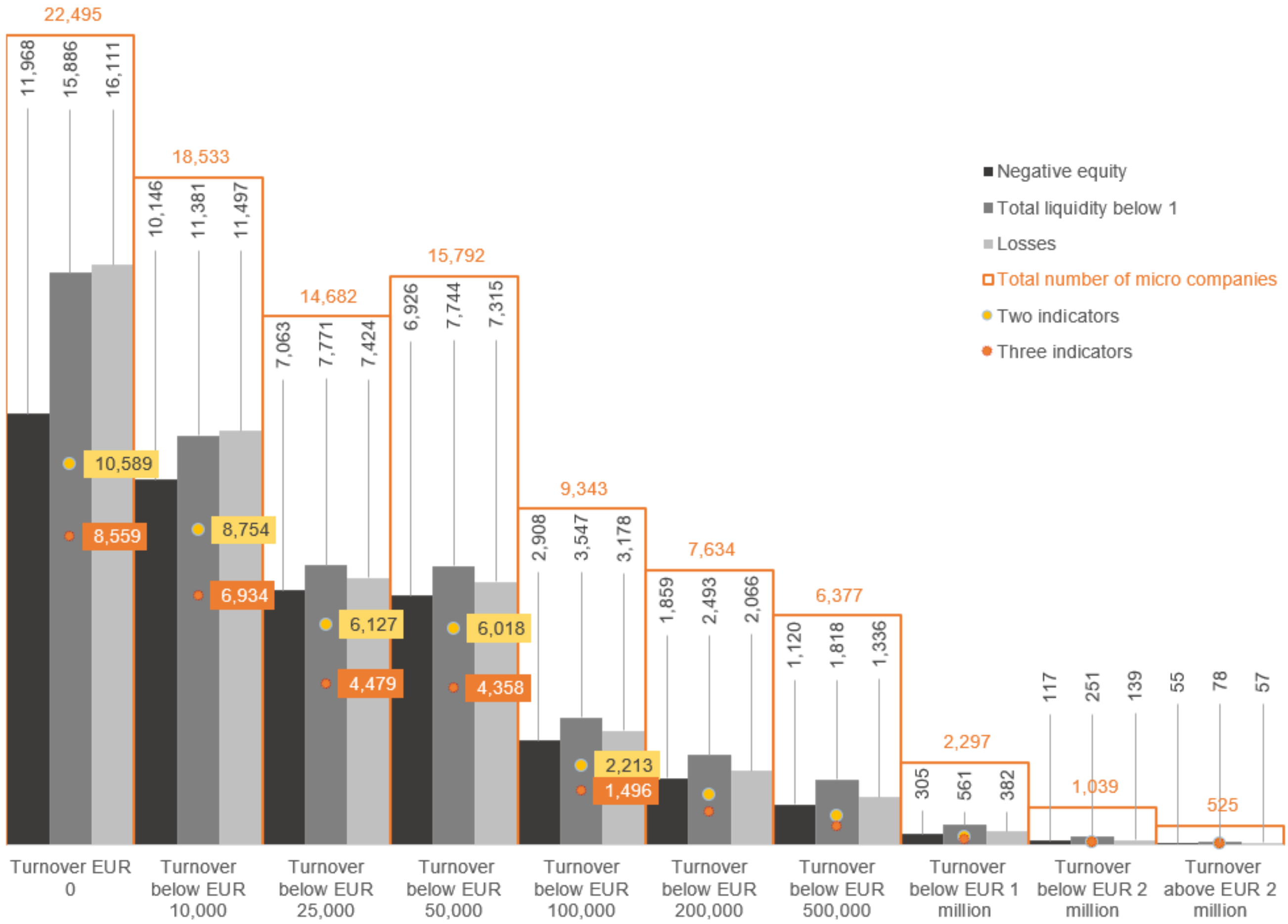
Figure 11 below, which analyses the annual accounts of micro enterprises with a turnover of EUR 0 in 2018, shows that 16,000 are subject to at least one of the financial distress indicators, accounting for 72% of all enterprises in this group.

At least two indicators (negative equity and total liquidity below 1) are met by 47% of enterprises in this group, while all three indicators (adding losses in 2018) are met by 39% of enterprises in this group. For micro enterprises with a turnover between EUR 0 and 100,000 in 2018, at least one of the indicators is met in 57% of cases. For this group of enterprises, two indicators (negative equity and total liquidity below 1) are met in 40% of cases, while all three indicators (adding losses in 2018) are met by 30% of enterprises. For all micro enterprises, two indicators are met by 37% and all three indicators by 28% or 27,506.

The assessment by the credit institutions is even more critical. According to the commercial bank interviews, less than half of the registered LLCs are estimated to be capable of maintaining such a business model to have access to bank loans.

The information provided by the Credit Register shows that around 35,000 enterprises have access to different types of bank loans.

Figure 11. Total number of micro enterprises that have submitted annual accounts for 2018 facing distress indicators – negative equity, total liquidity below 1 and losses, classified by turnover (as at 31 December 2018 or for the entire FY 2018, source: *Lursoft data, https://www.lursoft.lv*.

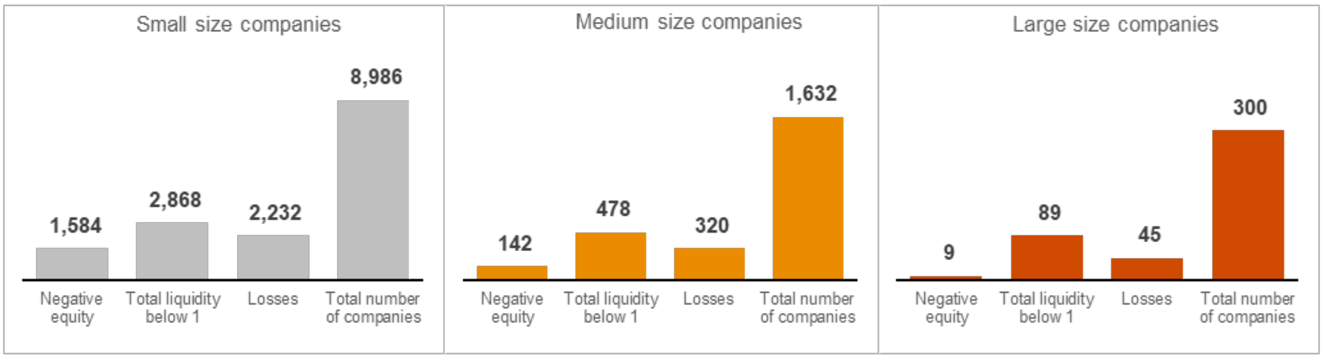


Averaging out all the non-viability indicators, the micro enterprises within the EUR 100,000 turnover range comprise 86% of all potentially unviable enterprises.

According to the stakeholders, in most cases micro enterprises have no grounds for applying for LPP because of lack of available funds that could be redirected to advisory services and their financial illiteracy as such, rather than abuse of the moratorium period. According to the experts, the probability of such enterprises restoring business viability is extremely low.

By looking at small, medium-sized and large enterprises in Figure 12 below, the concentration of all unviable enterprises is only about 5%. It should be noted that nearly 30% of enterprises per size group have issues with liquidity. **An indicator such as negative equity** is not in fact an absolute indicator, but it is essential to assess whether a company has the necessary cash flow and viability to initiate Formal Restructuring procedures.

Figure 12. Small, medium-sized and large enterprises that have submitted annual accounts for 2018 facing distress indicators (as at 31 December 2018 or for the entire FY 2018), classified by turnover, source: *Lursoft data,* https://www.lursoft.lv/)



An analysis of the overall condition, financial position and historical trends of enterprises by public agencies should be purposeful and should therefore be performed only for enterprises that carry on business. Warning notifications sent to company management (analysed in Chapter 5) based on the analysis of critical business viability indicators, along with affiliated educational online tools and solutions, should also cover only functioning enterprises. Thus, a precondition for monitoring and warning is establishing a trustworthy commercial registrar that only keeps a record of enterprises that carry on business.

4.3.4 Access to financial advice and professional audit services

Micro enterprises again run the highest risk because only a limited number of enterprises in Latvia receive financial advice or at least some kind of independent financial insight from the outside.

Under Article 91 of the Law on Annual Financial Statements and Consolidated Financial Statements, the annual accounts prepared by medium-sized or large enterprises or enterprises whose transferable securities are included in the regulated market, as well as the consolidated annual accounts prepared by the parent of a group of companies, are audited by a sworn auditor, who prepares a report on the audit results.

The annual accounts prepared by a small company are audited if its indicators exceed two of three thresholds for two years in succession (in the current and previous reporting years), but for a newly established company – on the balance sheet date of the first reporting year. The thresholds are:

- Balance sheet total – EUR 800,000;
- Net turnover – EUR 1,600,000;
- Average number of employees in the reporting year – 50.

Only a tiny proportion of the small enterprises that have prepared and submitted annual accounts are audited, causing concern about the quality of information about the company's financial standing. The Law on Annual Financial Statements and Consolidated Financial Statements[51] requires auditing by a sworn auditor, but only 3.6% of all registered enterprises are subject to this requirement.[52]

The SRS does not pay significant attention to sworn auditors' opinions on annual accounts, as they have experienced a number of situations where the data is not reliable. From the SRS standpoint, however, this could be improved, since the auditor's opinion includes notes of details that could not be fully assessed in a superficial analysis of the financials, thus revealing possible early seeds of distress.

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[51] Article 91 of the Law on the Annual Financial Statements and Consolidated Financial Statements. Enactments of the Republic of Latvia. Available at: https://likumi.lv/ta/en/en/id/277779-law-on-the-annual-financial-statements-and-consolidated-financial-statements. [Accessed November 21, 2019].

[52] Yearbook of Auditors. 25th anniversary edition. (The Latvian Association of Certified Auditors, loc. cit., page 70.). [Accessed November 21, 2019].

Estonia's experience

The Estonian Commercial Code grants the company register the opportunity to approach this problem using legal measures. Article 60 of the Estonian Commercial Code addresses actions the company register can take where a private limited company or commercial association does not submit an annual report. Where the entity has not submitted an annual report within six months after the final submission date, the company register issues a warning about deregistering the entity, with an extension of the period for at least six months, within which the annual report must be submitted. If the annual report or an explanation is not submitted within the time limit, the company register can publish a statement asking creditors to state their claims against the entity within a month following the published statement. If no claims are filed, the entity can be removed from the company register without a liquidation process. And if six months after publication of the statement, the annual report or an explanation is not submitted and no creditor has requested the entity's liquidation, the company register can remove the entity from the Commercial Register. The decision to remove the entity from the company register is ruled on by the court and can be appealed in the following thirty days. This article of the Commercial Code provides a basis for the company register to act on and decrease the number of possibly economically inactive enterprises.

Chapter 3 of the Estonian Accounting Act[53] provides that the annual report is mandatory for all undertakings operating in Estonia and must take the form established in legislation. The annual report consists of the annual accounts and the management report (§ 24.(4)). If shareholders' equity falls short of the Commercial Code requirements (meaning it is negative) as at the end of a FY, the management report must include a description of activities that have been or will be performed to be sustainable in the future, or must state whether a different decision has been adopted.

It merits considering that for a large number of micro enterprises the capacity to pursue LPP in terms of availability of data and ability to pay for advice to produce a Restructuring Plan is questionable. This strengthens the demand for variable Formal Restructuring rules for enterprises of different sizes and turnover results.

4.3.5 Combined role of Board Member and Shareholder

The stakeholder interviews, previous studies and expert opinions support the conclusion that **in many SMEs a single person fulfils the roles of owner and director and lacks specific expertise in economics or finance, which can lead to financial distress or even liquidation. There is no external oversight in the case of a combined role of board member and shareholder. Especially when facing financial difficulties, many SMEs have limited access to legal advice and many are burdened by financial illiteracy.**

Introducing a simple SRS notification of these enterprises based on the EDS and the Taxpayer Rating System to warn the directors that their company has been showing a pattern of financial distress could directly alert members of the management board.

The Ministry of Justice has provided information on the results of the ongoing implementation of Moneyval recommendations,[54] including the removal of shell companies from the Register of Enterprises, and has carried out other risk mitigation measures relating to legal entities and arrangements in Latvia, such as removing enterprises with no economic activity from the Register of Enterprises (32,846 enterprises liquidated in 2018 and 2019) and verifying the credibility of data on the beneficial ownership of all registered entities. The authors of this report are pleased that Latvia is making necessary efforts to ensure transparency of beneficial ownership of legal entities and is disactivating dormant entities. However, light needs to be shed on the most popular methods, trends and scale of asset and business transfer, on the one hand, and on legislative, practical and institutional obstacles to the successful prevention of this practice, on the other hand.

Further research and discussions are needed to make the company's directors and in certain cases the owners personally liable for abuse of the procedure causing loss to the company and/or to its creditors. The authors of this report note that because of its potential for piercing the corporate veil, this approach is a very complex one and needs additional assessment to mitigate risks. This issue was raised by local stakeholders. Theoretically, the shareholders should be sanctioned if they have caused the management board to misbehave or have appointed fake directors while in fact running the company themselves. The basis for the sanction would be the shareholder's role in misbehaviour, rather than shareholder status *per se*. And from a practical point of view, SME shareholders are usually the main decision-makers regardless of who the director is.

[53] Accounting Act. Available at: https://www.riigiteataja.ee/en/eli/517012017005/consolide. [Accessed November 26, 2019].

[54] Fifth Round Mutual Evaluation Report on Latvia, Moneyval. Available at: https://www.coe.int/en/web/moneyval/-/moneyval-publishes-a-report-on-latvia. [Accessed November 26, 2019].

b. Recommendations

- To ensure that the business environment is fit for the purpose of receiving the advantages of Formal Restructuring, the cleansing of the Commercial Register is critical. A large number of entrepreneurs on the Register of Enterprises must be dissolved by the state and disqualified from LPP because they have been commercially inactive for more than two years, do not file annual statements, have no creditors, or for other reasons. The authors of this report encourage the Register of Enterprises to continue its efforts in ensuring the simplified liquidation of companies and the SRS to impose fines on enterprises that avoid filing for insolvency.
- Enterprises with reported negative equity and/or other clear signs of financial distress should be subject to a special supervisory regime. Clear rules for shareholder and director duties should be established and monitored, preferably by an institution that has the necessary competence. To grasp the magnitude of potential financial difficulties as well as the actions planned to resolve them, the management report provided for the purposes of the company's annual report must offer an appropriate and structured explanation confirming that the situation will not lead to insolvent liquidation.
- Formal Restructuring could work efficiently and actually help enterprises if there are no easy alternatives like illicit transfer of assets to choose instead. The legal framework for Formal Restructuring should accommodate the specifics of the Latvian business environment, and necessary safeguards should therefore be created, e.g. professionally supervised access to the LPP stay period and verification of the debtor's viability by professionally trained judges. Since abusive transfer of assets and business is used in many areas to avoid state-imposed sanctions, an in-depth research into the practice of abusive transfer of assets and business should be conducted.

5 EWI and Stakeholder Access to Information

The state provides enterprises in Latvia with a number of digital tools to serve as an early warning of financial difficulties and ensure a high level of transparency of tax debts. Credit institutions closely monitor the financial position of borrowers, but providing alerts is a supervisory tool for protecting the interests of creditors. There is a lack of requests from debtors for accessing those digital tools and a lack of affordable advisory support for enterprises.

Under Directive 2019/1023, early warning tools should be put in place to warn debtors of the urgent need to act, considering the limited resources of SMEs for hiring experts. Article 3 of Directive 2019/1023 guides enterprises towards several tools that can be used as part of the EWS, for example, alert mechanisms. The debtor could be alerted by public or private organisations providing services to it, or by a third party (accountant, tax and social security authorities) that has acquired information about a missed payment or a general negative business trend. The purpose is to identify enterprises facing financial difficulties so that they can be given relevant advice in the early stages of their crisis, reducing the personal, business-related and socio-economic consequences of the distress. By abstracting from other ways of detecting financial problems caused by, e.g. financial illiteracy or external factors, the authors of this report conclude that Latvia has no EWS as a centralised, purposeful and targeted aid for debtors. Some of the mechanism's gears could be found scattered around creditors' *post factum* (*ad hoc*) core credit control functions, triggered by tax indebtedness, overdue supplier invoices, overdue interest payments etc.

Article 3 of Directive 2019/1023 vaguely describes compliance with it, leaving room for debate on whether an MS is compliant or not. The term "early" is also quite subjective. One can maintain that this term should address the issue even before the stage of vulnerability, yet it all depends on the system implemented, accessibility of data, and the perception and profile of the debtor. One can conclude that larger enterprises are more tolerant of belated EWI. Since micro enterprises are highly dependent on early detection of distress, a *post factum* warning could turn out to be too late.

Currently, a handful of separate early warning tools are present:

1. SRS information on tax indebtedness and taxpayer rating

The SRS confirmed during the interview that the following early warning tools are available to a taxpayer (debtor) facing late tax payments:

a. A warning is displayed via the EDS, thus providing the taxpayer with information on the amount of current tax debts administered by the SRS in line with the Law on Taxes and Duties.[55] To continue work in the EDS, the taxpayer is required to confirm that he acknowledges the information on his tax debt. The taxpayer's EDS home page always displays a short notice about tax indebtedness and a reminder wizard, which displays information on both tax return filing deadlines and current tax debt, as well as the option to request an extension of the time limit for a tax payment. Together with tax debt information, the EDS offers a calculation wizard that calculates the projected future amount of tax liabilities.

b. Information on taxpayers whose tax debt administered by the SRS exceeds EUR 150 is publicly available. A complete list of current unpaid taxes is accessible via the SRS website.[56]

c. Essentially the only genuine EWS is by nature accessible via EDS – the taxpayer rating (illustrated in Annex 10 SRS Taxpayer Rating System indicators and interface via EDS).[57] The taxpayer rating is a passively built widget that obtains financial data from the EDS database and provides five dimensions of analysis described by 12 indicators (see Annex 10). To provide an objective assessment of different aspects of taxpayer activities, the individual dimensions include more than one indicator.

[55] Articles 18 and 31 of the Law on Taxes and Duties. Available at: https://likumi.lv/ta/id/33946-par-nodokliem-un-nodevam [Accessed November 4, 2019].

[56] Tax debtors, SRS. Available at: https://www6.vid.gov.lv/NPAR [Accessed November 13, 2019].

[57] Taxpayer Rating System, SRS. Available at: https://www.vid.gov.lv/lv/nodoklu-maksataju-reitinga-sistema [Accessed November 15, 2019].

Aiming to assess tax discipline and future policy formulation (see Annex 10), the Taxpayer Rating System gives two positive ratings: “4” indicating that the economic activity is in line with industry trends or good tax discipline, and “5” indicating successful business or complete fulfilment of all tax obligation points; one neutral rating: “3” indicating episodic or periodic problems with tax compliance discipline or economic activity; and two negative ratings: “2” indicating poor tax compliance or significant business risk, and “1” indicating poor tax compliance or high business risk.

To allow the taxpayer to assess the relevance of his indicators to the general economic situation of the country, industry or region he operates in, most rating indicators provide statistical information on the average value of the indicator in the country, industry and region.

The data of the specific economic operator should be linked to the data of the sector and region corresponding to the principal activity and registered office declared by the taxpayer at the time of analysis.

According to the interview, the SRS Taxpayer Rating System has three main objectives:

- To inform the taxpayer of the correlation between the characteristics of his business and general economic trends;
- To motivate the taxpayer to follow and improve tax discipline; and
- To provide taxpayers with a tool for informing their partners of their reputation, tax discipline and performance against general economic trends.

In Latvia, data on management changes held by the Register of Enterprises and data processing companies such as Lursoft and Firmas.lv could be used as a red flag for the debtor’s counterparties.

The Register of Enterprises provides information on all registered entities and legal facts. It is an institution of public administration that acts under the supervision of the Ministry of Justice. The Register’s activity is regulated by the Law on the Register of Enterprises, Rules on the Register of Enterprises, and other regulatory enactments.

From 7 January 2020, information on legal entities (including company officers, shareholders and beneficial owners) stored on 14 Registers of the Register of Enterprises is publicly accessible online and free of charge on the Register’s information website. These new features are possible as a result of amendments to the Law on the Register of Enterprises adopted by the Latvian parliament on 14 November 2019.

Under Article 4.15 of the Law on the Register of Enterprises, Lursoft IT SIA (“Lursoft”) is a re-user of information of the Register of Enterprises. Lursoft has entered into an agreement with the Register of Enterprises on information services, meaning that Lursoft as a re-user can provide information to third parties. These information systems provide the recording, processing, storage, transmission and availability of big data, as well as automating the preparation of various statistics and data exchange with other state information systems.[58]

The main task of Firmas.lv is to facilitate and improve the data user’s daily activities in research, planning, management and other business processes in all sectors of the Latvian economy with the help of information available in the database and portal technology options.[59]

2. Information of the Central Credit Register on NPL

The credit register is a national information system managed by the Bank of Latvia. In the credit register, the Bank of Latvia collects, accumulates and stores data on customers and customers’ guarantors of the credit register participants. Under the regulation from the Bank of Latvia,[60] information (amount of capital liabilities, overdue interest, days past due) on late payments of customers (both natural persons and legal entities) should be reported by the credit register participants at the end of each month if payments are due 60 days and exceed EUR 150. The rules also limit information flow as data available to customers’ guarantors are limited by requiring consent to the use of data issued by the customer. These rules allow the banking institution to have an insight into the customer’s payment dossier in any other financial institution as long as the contract is active. Debtors have access to the Central Credit Register’s data on their loans under Article 14 of the Credit Registry Law.

3. Individual notices by specific creditors (individually sent notifications to the debtor on overdue payments)

[58] See further information on the database. Available at: https://www.lursoft.lv/en/about-lursoft. [Accessed November 13, 2019].

[59] Please see further information on the database. Available at: https://www.firmas.lv/about [Accessed November 13, 2019].

[60] Regulation of the Bank of Latvia No. 160, from 18 January 2018. Available at: https://likumi.lv/ta/id/296597-kreditu-registra-noteikumi. [Accessed November 13, 2019].

4. **The SRS provides a digital consolidated analysis** of the overall financial condition (score) of enterprises, including their present financial position and historical results, and their Commercial Register compliance. The data is consolidated monthly from the SRS system, the Credit Register, the Commercial Register and other sources.

To illustrate the circulation of financial information in the business environment, Table 4 offers plausible indicators that could describe a company facing certain stages of financial problems, where only notices from the SRS on tax debts, the SRS Taxpayer Rating System and overdue payments could be regarded as existing early warning tools for debtors. However, only the SRS Taxpayer Rating System is able to warn debtors *ex ante* in line with Article 3(1) of Directive 2019/1023 and give them access to one or more clear and transparent early warning tools that can detect circumstances indicating a likelihood of insolvency and alert the debtors to the necessity of acting without delay.

According to Table 4, an enterprise's financial health should be considered individually as a combination of specific indicators dependent on a specific industry. The authors of this report conclude that even though all the up-to-date financial information is under the debtor's nose, the greatest challenge is data consolidation and interpretation by the debtor.

Table 4 Characteristics and segregation of enterprises facing financial difficulties

Financial health of enterprise	Possible indicators	Source of data	Surfacing frequency	Final overseer of data[61]	Availability of data
Vulnerable	Unreported annual accounts for the last year (delayed after due date)	SRS register	Yearly	SRS	Public (free)
Likely OCW	Unreported interim financials	Creditor registers	Ad hoc, Quarterly	CF	Limited to creditor
	Short-term cash flow problems	Accounting system	Ad hoc	DO, DAD	Limited to debtor
	Short-term tax debt	SRS register	Monthly	SRS	Public (free)
	Constant losses	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
	Liquidity ratio ~1.0	Accounting system, Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)

[61] DO – Debtor (Owner), DAD – Debtor (Accountancy, Finance Department), CF – Creditor (Finance), CS – Creditor (Supplier), FCMC – Financial and Capital Market Commission, BoL – Bank of Latvia, SA – Sworn Auditor, RE – Register of Enterprises.

	Payments up to 30 days past due	Financial statements Supplier registers, Creditors registers, Credit register	Yearly Monthly Monthly Ad hoc	CF, CS	Public (paid) Limited to supplier Limited Limited to CFs
	Lower EBITDA (than industry)	Accounting system Financial statements	Ad hoc Yearly	DO, DAD	Limited to debtor Public (paid)
	High level of debts	Accounting system Financial statements	Ad hoc Yearly	DO, DAD	Limited to debtor Public (paid)
	Breach of bank covenants	Creditors registers	Yearly	CF	Limited to creditor
	Equity ratio below 10% or negative equity	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
Imminent insolvency (decline)	Increased shareholder lending	Accounting system Financial statements	Ad hoc Yearly	DO, DAD	Limited to debtor Public (paid)
Likely ELPP **Likely LPP**	Liquidity ratio slightly <1.0	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
	Historically stable income decline	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
	Unexplainable increase in inventories, slow stock turnover	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
	Decline in cash levels	Accounting system Financial statements	Ad hoc Yearly	DO, DA	Limited to debtor Public (paid)
	Historically steady decrease in margins	Accounting system Financial statements	Ad hoc Yearly	DO, DAD	Limited to debtor Public (paid)
	Changes in management	ER register***	Ad hoc	ER	Public (free)

	Payments 30+ days past due	Financial statements, Supplier registers, Creditors registers, Credit register***	Yearly Monthly Monthly Ad hoc	CF, CS	Public (paid) Limited to supplier Limited Limited to CFs
	Decline in working capital	Accounting system Financial statements	Ad hoc Yearly	DO, DA, SA	Limited to debtor Public (paid)
	Tax debt	SRS register***	Monthly	SRS	Public (free)
Over-indebtedness (distress, crisis)	Significant cash flow and liquidity problems	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
Viability evaluation for gaining access to LPP	Significant working capital problems, further losses	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
	Delayed submission of annual accounts for the last year, qualified auditor statements (with remarks), restatement of prior-year profit to loss	SRS register	Yearly	SRS	Public (free)
	Increasing exposure to related parties	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
	Selective asset sales	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
	Change in management	Accounting system Financial statements	Ad hoc Yearly	DO, DAD, SA	Limited to debtor Public (paid)
	Payments 60+ days past due	Financial statements, Supplier registers, Creditors registers, Credit register***	Yearly Monthly Monthly Ad hoc	CF, CS	Public (paid) Limited to supplier Limited Limited to CFs
	Significant tax debt	SRS register***	Monthly	SRS	Public (free)

The effectiveness of EWS is highly dependent on the frequency and availability of financial data, its consolidation, and skills of interpretation. Enterprises with bank debts are more likely to trigger more early warning tools because of keeping within monthly payment schedules. As to tax debts, indications are month-based. However, the indicator is specific and thus bound to one trigger. Both triggers are already present in the Latvian business environment and considered some of the preferable mechanism gears, serving a specific purpose as creditor safeguards.

To help the Latvian authorities respond more quickly and appropriately to the enterprise's financial difficulties, it is necessary to increase the frequency of submission of analysable financial data covering as many enterprises as possible.

Lithuania

Lithuania is completing implementation of the Standard Audit File for Tax (SAF-T), which started in 2016. It should be completed for most enterprises by early 2020.

The tax practice of the Lithuanian tax authority has changed rapidly in recent years, with improved control and data processing methods being introduced. An important step forward is the development and implementation of a procedure for submitting accounting records in a standard accounting data file.

SAF-T is an electronic system developed for the efficient exchange of information between tax authorities and enterprises. It was created by the OECD in 2005 as a standard for global use to ensure consistency from country to country and facilitate exchange of data between tax authorities. The file requirements are expressed using XML, although the EU does not specify the exact file format.

The SAF-T file consists of 18 sections with more than 500 elements, so its creation poses serious problems for the company's accounting and finance staff.[62]

There are generally five reporting requirements:

1. General ledger and supporting journals
2. Accounts payable, including supplier master data and invoices
3. Accounts receivable, with customer master data and invoices
4. Warehouse inventories and master data
5. Fixed assets ledger, including amortisation

The Lithuanian SAF-T implementation schedule:

- From 1 January 2017 for enterprises with revenue above EUR 8,000,000 per FY
- From 1 January 2018 for enterprises with revenue above EUR 700,000 per FY
- From 1 January 2019 for enterprises with revenue above EUR 45,000 per FY
- From 1 January 2020 for all enterprises

The SAF-T file should be submitted at the request of the State Tax Inspectorate, the Customs of Lithuania, the Financial Crime Investigation Service under the Ministry of the Interior, or the administrative institutions of the State Social Insurance Fund.[63]

The SAF-T file must be prepared in advance, as it must be submitted within a relatively short time frame: ten days after receiving a request from the State Tax Inspectorate.

Failure to submit the SAF-T file will result in administrative liability for non-submission of data.[64]

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[62] See further information on SAF-T. Available at: https://www.vz.lt/vedlys2020/2019/11/29/kaip-saf-t-reikalavimus-is-nastos-paversti-nauda. [Accessed November 26, 2019].

[63] Resolution No. 699 on the approval of the procedure for submitting accounting data in the standard accounting data file (1 July 2015). Available at: https://e-seimas.lrs.lt/portal/legalAct/lt/TAD/573a9621219111e58a4198cd62929b7a. [Accessed November 19, 2019].

[64] See further information on SAF-T. Available at: https://www.vmi.lt/cms/duk-apie-saf-t. [Accessed November 26, 2019].

For a comprehensive analysis of data, the most comprehensive financial data surfaces on submission of the company's annual accounts to the SRS. Currently, on submission, companies have to file annual accounts in the structured form on the EDS. However, this applies only to basic information (balance sheet, income statement, cash flow statement and statement of changes in equity) as well as some information chosen by the company. The rest of the data is submitted in a scanned manner, thus rendering it invalid for automated processing. The digitisation of public accounting data is becoming increasingly widespread in Europe, as Directive 2013/34 has standardised the requirements for data across the EU. This gives both public authorities and private parties new opportunities to analyse business economic patterns and trends using advanced calculation methods for a wide range of purposes. In principle, therefore, a methodological and data-related basis needed to identify enterprises facing financial difficulties solely on the basis of public data on them is in place.

The authors of this report conclude that Latvia ensures that debtors have access to one or more clear and transparent early warning tools that can detect circumstances triggering a likelihood of insolvency and alert them to the necessity of acting without delay.

The Taxpayer Rating System meets the minimum criteria established by Article 3(3–4) of Directive 2019/1023. The SRS ensures that information on access to the Taxpayer Rating System as an early warning tool is publicly available online[65] for everyone, including SMEs and employees' representatives. This information is easily accessible and presented in a user-friendly manner by a video clip and a description of the principles for compiling the data. Each EDS user as a taxpayer can easily access its rating on the front page of its profile. Information about the legal framework of procedures and measures involved in restructuring and discharge of debt is available.

Accordingly, to unburden the EWS, preparative activities such as detection and liquidation of defunct enterprises should be considered. This could be done by clearly defining red flags, e.g. the inability to regularly submit an annual report or permanent negative equity coupled with unresponsiveness to enquiries from the SRS, indicating that the company has no further business drive and potential.

At the same time, the Latvian business environment would clearly benefit if a warning about financial difficulties from the creditor would be accompanied by advisory services or even voluntary mentoring provided by some public institution not directly related to the creditor (e.g. the Ministry of Economics or the Latvian Investment and Development Agency) or private organisations (e.g. LCCI, *Lursoft, firmas.lv*). Given that cash-flow problems and accrued bills are the first sign of financial hardship and the debtor is aware of it long before one of the creditors realises it, positive support, incentives and even encouragement to stay in business and not give up in the face of the first financial difficulties are much more important than warnings.

A notable technicality indicated by the stakeholders is that the governmental institutions that could be tasked with providing early warnings to enterprises lack the necessary contact details of potential recipients of such information. Further discussions should be held to arrive at a solution to this significant technical obstacle.

This requires a cross-government plan and the authors of this report would be pleased to provide insights into the potential sources of data gained from this report to assist, but attention is also drawn to the enabler of the Register clean-up discussed below.

In our view, the EWS set up by the SRS meets the minimum criteria of Directive 2019/1023 for the type of early warning tools but is not sufficient to trigger a positive development in enabling debtors to restructure effectively at an early stage and to avoid insolvency without the following elements:

1. **Overall company rating thresholds** should be established and **trigger electronic notifications** (enabled by the SRS system) emailed by the single authority (SRS) directly to company directors, and in certain cases to owners, along with links to affiliated educational online tools, advisory services, mentoring options and solutions (this may be based on the comprehensive guidelines for enterprises in financial distress to be developed as part of the Project).

[65] See further information on the taxpayer database. Available at: https://www.vid.gov.lv/lv/nodoklu-maksataju-reitinga-sistema [Accessed November 23, 2019].

2. **Provision of incentives** for the management to seek early Debt Restructuring rather than delay or take abusive actions. A critical first step is visible prosecution of insolvency abuse and a professional judiciary, including personal liability and active disqualification of directors from managing, forming or promoting companies for meaningful periods for a) those responsible for transferring assets and leaving defunct insolvent shells behind and b) abusing Formal Restructuring and/or liquidation. However, this could be combined with providing a presumption of “doing the right thing” and hence a potential relief from potential personal liability and disqualification for directors who actively initiate Formal Restructuring instead of simply applying for liquidation or leaving a defunct company behind.

5.1 EWS Europe

There is a concept of a completely automated EWS – a model offered by Early Warning Europe has been launched for testing by the Danish Business Authority to gain insight into whether it is possible to develop a model that distinguishes enterprises facing financial difficulties from financially well-functioning enterprises through machine learning, using publicly available accounting data (annual accounts).

The Early Warning Europe project was launched in December 2016. It aims to help enterprises avoid bankruptcy by identifying enterprises facing difficulties and providing them with relevant and timely advice and support. Support is delivered by volunteer mentors who have personal experience and are trained on how to approach entrepreneurs in difficulties and find solutions to financial problems and other difficulties and are remunerated by the debtor. The project is co-funded by the EU programme for the Competitiveness of Enterprises and SMEs, thus bringing together organisations providing services to SMEs in Belgium, Denmark, Germany, Greece, Italy, Poland, and Spain. The Early Warning Europe project is directly relevant to the implementation of Directive 2019/1023.[66]

[66] Early Warning Europe. Available at: https://ec.europa.eu/easme/en/tags/early-warning-europe. [Accessed November 23, 2019].

Denmark

The Danish Business Authority sought to confirm the hypothesis that by using public accounting figures contained in company annual accounts, they can train a machine to distinguish between and identify companies facing financial difficulties and companies that are not, all by using machine learning. To test the hypothesis, they need access to a large population of companies facing financial difficulties and to a large population of companies that are not. In this way, they can develop a model that, through training, learns to recognise the accounting conditions characteristic of companies facing financial difficulties. The two data sets must be structured in a uniform manner, either on submission or by subsequent processing, so that the accounting patterns of the two company classes can be compared across enterprises and industries.

To increase the relevance of the experiment to the entire consortium behind Early Warning Europe, the Danish Business Authority has first developed a base model based on Danish data and then further developed four derived models for the four target countries in the overall project, i.e. Greece, Spain, Poland, and Italy.

Output from the model is a so-called confidence score that expresses how accurate the model is in predicting whether a company is facing financial difficulties based on the available data.

The list of input data contains gross profit or loss, profit (loss) from ordinary operating activities, profit (loss), distributions, assets, non-current assets, intangible assets, property, plant and equipment, investments, inventories, current assets, receivables, short-term investments, cash and cash equivalents, equity, provisions and liabilities other than provisions.

The list of calculated features contains the gross profit to ordinary operating activities ratio, the ordinary operating activities to profit loss ratio, return on equity, profit loss distributions ratio, assets delta, non-current assets delta, non-current assets ratio, intangible assets delta, intangible assets ratio, property, plant and equipment delta, property, plant and equipment ratio, long-term investments and receivables delta, long-term investments and receivables ratio, current assets delta, current asset ratio, inventories delta, inventories ratio, short-term receivables delta, short-term receivables ratio, short-term investments delta, short-term investments ratio, cash and cash equivalents delta, cash and cash equivalents ratio, equity delta, solvency ratio, provisions delta, provisions ratio, liabilities other than provisions delta, and liabilities other than provisions ratio.

Overall, the test is considered to have proved that publicly available annual accounts can be meaningfully modelled for use in automated identification of companies facing financial difficulties.

Early Warning Europe names five best-practice volunteer institutions supporting enterprises in distress:[67] Early Warning Denmark, Team U (Germany), 60,000 Rebounds (France), MKB Doorstart (Netherlands), and Dyzo (Belgium).

5.2 Advisory Services Provided by Public or Private Organisations

Advisory services for enterprises in financial difficulties in Latvia comprise mainly audit services by sworn auditors who provide an annual opinion on the company's financial position, bank lending consultants and outsourced consultants who are only involved on a case-by-case basis, and accountants who carry out day-to-day bookkeeping services. Given the nomenclature of enterprises in distress, there is a clear tendency for those enterprises, on the one hand, not to be subject to a mandatory annual audit and, on the other hand, to have limited additional resources for outsourced consultancy assistance.

The number of enterprises who hire financial service providers on their own initiative is not available, but there is data on various seminars for enterprises provided by the LCCI. From the interview with LCCI and data provided by them, the authors of this report conclude that in 2019 alone, LCCI in cooperation with the SRS held nine seminars on various topics. However, none of the topics has covered business viability processes yet. Lack of tools such as a viability test or review of the debtor by financial or economic experts has damaged the reputation of LPP as a result of being used in bad faith. PwC experts strongly recommend that the application of LPP to all enterprises (large or small) should be possible only after the diagnostic of their economic standpoint has been passed. The case law clearly shows that the creditors' vote on the Restructuring Plan cannot replace a third-party economic viability assessment, and the debtors are not sufficiently qualified or motivated to hire experts.

[67] Early Warning Europe. Five best practices. Available at: https://www.earlywarningeurope.eu/about/best-practices: https://www.earlywarningeurope.eu/about/best-practices. [Accessed November 23, 2019].

c. Recommendations

- Given the size of the Latvian economy, debtors would benefit from a centralised data point. The credit registry should be expanded by requiring the inclusion of data on a debtor's indebtedness to entities such as utility and transportation providers. Alongside the current request-based system, to initiate proactivity from the state, the credit registry could send full profile data to the debtor annually.

- The SRS should aim to obtain real-time data on SMEs by either improving the existing data integration mechanisms between the SRS and its private partners, or by introducing and facilitating an online accounting platform designed for SMEs.
- Overall company rating thresholds should be established and trigger electronic notifications (enabled by the SRS system) emailed by the single authority (SRS) directly to company directors and owners, along with links to affiliated educational online tools.
- Latvia should seek ways of providing state-subsidised advisory services to enterprises in financial difficulties (potentially based on the comprehensive guidelines for enterprises in financial distress to be developed as part of the Project). A web-based financial health checklist would be useful for encouraging entrepreneurs to act without delay.

The SRS should look for ways of obtaining real-time data and processing information on a large population of micro enterprises by improving the data integration between the SRS and business partners or introducing a facilitated accounting platform for smaller enterprises. This could provide the SRS with up-to-date financial information (journal entries or Standard Audit File for Tax) that is crucial for financial vulnerability detection and would be economically beneficial for the company cost-wise. The platform could be used as a tool for tackling shadow economy issues but would take substantial time and investment. The proposed solution exists in certain countries (e.g. Lithuania) yet it should be carefully analysed before implementation.

6 Availability of Preventive Restructuring Frameworks

Directive 2019/1023 sets a goal to make preventive restructuring frameworks available to enterprises but also provides that unviable enterprises with no prospect of survival should be liquidated as quickly as possible.[68] Thus, while Directive 2019/1023 provides for a second chance, the focus is on viable enterprises. Currently Latvia has no requirements for debtors accessing Formal Restructuring other than the formal requirements in the Insolvency Law and the Civil Procedure Law.

Nevertheless, the authors of this report believe that the Formal Restructuring access system should be slightly changed to satisfy the aim of Directive 2019/1023 and to ensure that only viable enterprises can access Formal Restructuring.

6.1 Access to Preventive Restructuring

Article 4(1) of Directive 2019/1023 requires MS to ensure that where there is a likelihood of insolvency, debtors have access to a preventive restructuring framework that enables them to restructure, with a view to preventing insolvency and ensuring their viability, without prejudice to other solutions for avoiding insolvency, thereby protecting jobs and maintaining business activity.

Recital 2 of Directive 2019/1023 provides that preventive restructuring frameworks should, above all, enable debtors to restructure effectively at an early stage and to avoid insolvency, thus limiting the unnecessary liquidation of viable enterprises. By the same token, unviable enterprises with no prospect of survival should be liquidated as quickly as possible. Where a debtor in financial difficulties is economically unviable or cannot be readily restored to economic viability, restructuring efforts could result in the acceleration and accumulation of losses to the detriment of creditors, workers and other stakeholders, as well as the economy as a whole.[69] It can be concluded that the main goal of the provision is to give a “second chance” to debtors who have the prospect of restoring their economic viability.

There are various debt restructuring possibilities under Latvian law: (1) OCW based on agreement of the parties (the party autonomy principle); (2) ELPP, and (3) LPP, both of which provide for court involvement. **The authors of this report believe that Article 4(1) of Directive 2019/1023 has been introduced into the Latvian legal system**.

It should be noted, however, that almost everyone who satisfies formal criteria under Latvian law can apply for Formal Restructuring. Many studies have shown[70] that Formal Restructuring is **used in bad faith** by debtors who have no willingness to repay the debts and to maintain the business. Thus, an approach where almost everyone can access Formal Restructuring may not achieve the overall goal of Article 4, i.e. ensuring that only viable debtors with a good chance of restoring business can access Formal Restructuring.

To avoid creating obstacles, the authors of this report believe that all debtors (subject to restrictions under Article 4(2) of Directive 2019/1023) should have access to ELPP, as there is no stay period. Statistics and findings show that this procedure is not popular with the debtors and abuse of the system is slightly lower (with most debtors exploiting the stay period to abuse the system).[71] The authors of this report note that Article 4 of Directive 2019/1023 refers to general access to preventive restructuring by debtors, however given the findings on abuse of the stay period, it is advisable to go further and limit access only to LPP.

6.1.1 Access to Formal Restructuring for debtors with a record of serious breaches

To minimise the use of Formal Restructuring in bad faith by debtors, Article 4(2) of Directive 2019/1023 permits MS to provide that debtors sentenced for serious breaches of accounting or bookkeeping obligations under national law are allowed to access a preventive restructuring framework only after those debtors have taken adequate measures to remedy the issues that gave rise to the sentence, with a view to providing creditors with the necessary information to enable them to take a decision during restructuring negotiations.

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[68] Recital 3 of Directive 2019/1023.

[69] Recital 2 of Directive 2019/1023.

[70] For example, see International Monetary Fund, Evaluation of the Latvian Insolvency Framework (2019). [Accessed November 4, 2019].

The current limitations on participation in Formal Restructuring are described in Articles 34 and 51 of the Insolvency Law and do not include limitations on debtors charged with previously breaching the law as described by Article 4(2) of Directive 2019/1023.

As to safeguards and remedies for checking abuse by an unscrupulous debtor, the national legislation provides for various sanctions and types of liability, including administrative fines, civil and criminal liability, restriction to automated liquidation, denying the right to engage in a specific type or all types of entrepreneurial activity or the right to take up a specific office for a certain period (see Annex 9). It can be concluded from the stakeholder interviews that sanctions are applied rarely, with a strong emphasis on Insolvency Practitioners exposing illicit behaviour.

Practice shows that there are very few cases where serious breaches are considered. The breaches are usually subject to the Criminal Law and therefore investigated by the police. Since most debtors seeking LPP are legal entities, it should be noted that liability for violation of law (including accounting and bookkeeping rules) in the Latvian legal system is often imposed on natural persons representing legal entities, not the legal entities themselves. Moreover, the question of adopting the optional provision of Article 4(2) of Directive 2019/1023 and finding the balance to enhance the effectiveness and positive image of Debt Restructuring is a highly debatable one.

First and foremost, adopting this provision is unlikely to make a significant impact on the Latvian Debt Restructuring and insolvency environment for two reasons:

(i) Formal Restructuring proceedings are rarely used; and

(ii) very few enterprises are charged with accounting and bookkeeping offences.

Accordingly, if the penalty system becomes more effective in the future and imposes sanctions for breaching the relevant laws, this provision could potentially be introduced. Practice shows, however, that debtors that are subject to serious breaches tend to apply for liquidation instead of Formal Restructuring, and implementing the optional provision in this way is unlikely to achieve the goal. To mitigate the risk of Formal Restructuring being used in bad faith, **the restrictions on application of LPP could be expanded and linked to track records of natural persons (directors, equity holders, beneficial owners) related to the debtor**. However, to avoid restricting Formal Restructuring unreasonably and to balance interests of the parties, it is advisable to discuss this recommendation with stakeholders.

6.1.2 Initiation of preventive restructuring

Article 4(7) of Directive 2019/1023 requires MS to ensure that preventive restructuring is available on application by debtors. Since Article 33(1) of the Insolvency Law similarly provides that an application for LPP should be submitted to the court by the debtor, **it can be concluded that the Latvian law is consistent with Article 4(7) Directive 2019/1023.**

Article 4(8) Directive 2019/1023 permits MS to provide that preventive restructuring frameworks are available at the request of creditors and employees' representatives, subject to the debtor's consent.

Czech Republic

Can creditors initiate debt restructuring?

Under Czech insolvency law, a Restructuring Plan can be prepared and submitted by creditors, but it does not automatically bind the debtor whose consent is not requested.

Consequently, the debtor's employees having creditor status can also prepare and submit a Restructuring Plan.

Article 107 of the Insolvency Law permits a creditor to initiate Formal Restructuring. However, it can be initiated only after the insolvent liquidation proceedings have been initiated, and consequently it is a possible way of stepping back from insolvent liquidation. As debtors are frequently late in initiating Formal Restructuring, implementation of the optional provision in order to enable creditors to initiate Formal Restructuring could possibly encourage early action. Introducing this provision could bring information about available Formal Restructuring opportunities to the attention of the debtor's management and thus create positive consequences, but there is still the question of who pays for the Restructuring Plan to be prepared unless the creditors can draft it themselves or pay for external financial support. The ability of creditors and employees to suggest the initiation of restructuring should also be introduced. However, as stipulated by Directive 2019/1023, this should be subject to the debtor's consent and should not automatically bind the debtor. Introducing a new mechanism could contribute to a more active use of Formal Restructuring. Legislation could be amended to introduce additional obligations on debtors when the initiation of Formal Restructuring is suggested by creditors or employees. In such cases, creditors would be required to either initiate Formal Restructuring through statutory proceedings or submit an economically reasoned opinion on why this is not vital for the company's future. As a result, the management of enterprises in distress would be more actively engaged and also "pulled" to Formal Restructuring where they would normally lack the necessary expertise or motivation. **Accordingly, implementing the optional provision of Article 4(8) could possibly mitigate the risk of late initiations of Formal Restructuring (LPP).**

Article 4(4) of Directive 2019/1023 permits MS to limit the number of times within a certain period that a debtor can access a preventive restructuring framework. Under Article 34(1)(2–3) of the Insolvency Law, a debtor is restricted in accessing Formal Restructuring if he has initiated a finalised Formal Restructuring in the last five years or initiated and terminated Formal Restructuring proceedings in the last four months (see Articles 34(2), 34(1)(2–3) and 51(1–5) of the Insolvency Law). **Accordingly, the Latvian law is consistent with Article 4(4) of Directive 2019/1023.**

Article 4(6) Directive 2019/1023 permits MS to limit the involvement of judicial authorities where necessary. Under Latvian law, the courts can decide on the initiation of Formal Restructuring. The authors of this report believe, therefore, that court involvement in the process is sufficient.

However, regulation should focus more on the early and continued involvement of Supervisors with requisite financial and economic skills and certain obligations. Under Rules No.407 of 22 August 2019,[72] the concentration of court jurisdiction is an appropriate solution if the total number of cases per year is relatively small, but their handling is related to specific legal issues. With the probability that such a case could possibly be received by a judge every five years, it would not be effective to train all the Latvian judges. In such cases, the solution is therefore to concentrate jurisdiction in one court. A judge specialising in certain kinds of cases is able to work faster and more accurately. Scattered jurisdiction over disputes of a specific economic nature is unable to create a complex and effective (without conflict) system for resolving economic disputes. **The national legal framework is consistent with Article 4(6) Directive 2019/1023.**

6.1.3 Proposed approach to Formal Restructuring access

Article 4(3) of Directive 2019/1023 permits MS to introduce a viability test provided that it has the purpose of excluding debtors who do not have a prospect of viability and that it can be carried out without detriment to the debtors' assets, which could take the form of, inter alia, the granting of an interim stay or the conduct of the test without undue delay.[73] Although Directive 2019/1023 reflects general access to preventive restructuring, the authors of this report believe that all debtors should have access to ELPP, and some viability assessment criteria should be imposed on access to LPP. Latvia needs to ensure that Formal Restructuring is accessible to economically viable debtors, but at the same time it should be kept in mind that tools such as a sophisticated viability test could place too heavy an administrative burden on SMEs and thus hinder access to Formal Restructuring.

Currently there are no minimum criteria that would provide solvent enterprises and entrepreneurs (viable debtors in financial difficulties) with access to the advantages of Formal Restructuring. Thus, almost everyone who is willing to access Formal Restructuring can do so, as long as certain procedural requirements under the Insolvency Law and the Civil Procedure Law are met.

The economic viability of a business can be measured by implementing the provision that the preventive restructuring mechanism can be accessed only by –

- **the right companies** (viable debtors in financial difficulties);
- **for the right reason** (using Debt Restructuring as a second chance);

[72] See Rules No.407. Available at: https://likumi.lv/ta/id/308908-par-konceptualo-zinojumu-par-ekonomisko-lietu-tiesas-izveidi. [Accessed February 25, 2020].
[73] Recital 26 of Directive 2019/1023.

- **in the right way** (with the assistance of restructuring experts and addressing the core issues);
- **at the right time** (an early stage of financial difficulties); and
- **for the right outcome** (i.e. to stay in business and secure the prospect of returning from Formal Restructuring to a sustainable business).

Viability is often defined as the ability to survive and is linked to the debtor's financial performance and market position. An enterprise is viable where the recent and probable development of its activities and the economic situation demonstrate potential for returning a profit that is sufficient to provide a return to the business owner while also meeting its commitments to creditors and/or to have sufficient cash resources to sustain itself through a period when it is not returning a profit.

In ELPP, the debtor draws up a Restructuring Plan and must receive approval from the majority of creditors if the Restructuring Plan is to bind all creditors. If the debtor is able to do that, no additional obstacles to the debtor should be implemented.

On the other hand, access to LPP and the stay period should be limited, and additional requirements should be imposed to safeguard the interests of creditors and ensure that only viable creditors can access the stay period and use it in good faith.

Although Directive 2019/1023 is new and MS may have to adjust their national laws to comply with it, other jurisdictions currently have some criteria for debtors to access Formal Restructuring, for example:

Germany

Overview and accessibility of debt restructuring procedures

German law prescribes very limited options for debt restructuring outside the formal main insolvency procedure, which acts as a gateway for enterprises to either reorganisation or liquidation. Enterprises may opt for the protective umbrella procedure to prepare for submitting a reorganisation plan (*Insolvenzplan*) in the main insolvency procedure.

In the latter scenario, an insolvency plan is drawn up, subject to a creditor vote on the opening of proceedings. To access this procedure, the company must demonstrate in writing by a statement prepared by a person having experience in insolvency matters that only imminent illiquidity and over-indebtedness exist, while the debtor is not cash-flow-insolvent, and that restructuring can lead to a successful outcome.

Spain

Overview and accessibility of debt restructuring procedures

Under Article 6.2.2 LC, Spanish debtors filing for insolvency must submit their viability plans, which are later subject to judicial review.

The Spanish debt restructuring and insolvency framework contains two distinct procedures accessible to different subjects. Debtors with a total debt of up to EUR 5,000,000 have access to one kind of debt restructuring procedure intended for SMEs and natural persons (extrajudicial payment agreement). **At the same time, all debtors** have access to a different debt restructuring procedure which is intended and more appropriate for larger enterprises (restructuring agreement).

Spanish insolvency law gives access to an extrajudicial payment agreement procedure to debtors who may be natural persons or legal entities or even corporations if they meet the following criteria: (i) the debtor has not been sentenced for crimes (against the heritage, against the socio-economic order, of false documents, against the Public Treasury, the Social Security or against workers' rights in the last ten years; (ii) the debtor has not reached an extrajudicial payment agreement or a restructuring agreement, nor has been under an insolvent liquidation procedure in the last five years; (iii) the debtor has initiated negotiations on the restructuring agreement, or a judge has accepted the initiation of insolvent liquidation proceedings.

Access to a restructuring agreement procedure is not available to debtors who have had a restructuring agreement approved in the last year.

The Spanish courts and appointed debt restructuring practitioners consider the potential outcome of debt restructuring and can request external advice to assess its usefulness.

France

Overview and accessibility of debt restructuring procedures

French law prescribes restructuring proceedings for enterprises in eminent or existing financial distress. Initial debt restructuring proceedings are separated into *mandat at hoc* and conciliation proceedings. The two procedures differ in their applicability to an enterprise's financial standing. *Mandat ad hoc* proceedings apply to solvent enterprises, while conciliation is suited for those already facing insolvency where the following conditions can be identified: (i) the enterprise has been insolvent for less than 45 days; and (ii) the debtor has proper evidence to prove financial distress.

If *mandat ad hoc* or conciliation is unsuccessful, the debtor may opt for the safeguard or accelerated financial safeguard proceedings (for financial creditors only). The debtor may otherwise be required to go into judicial reorganisation. If this is unsuccessful, the debtor will go into liquidation.

Advisory services provided by public or private organisations include, among others:

- Commercial Courts;
- CIP ("Centre d'Information sur la Prévention des difficultés des entreprises");
- Credit Mediation (public) (linked to Banque de France) for banking difficulties;
- La médiation des entreprises;
- CODEFI ("Comité départemental d'examen des problèmes de financement des entreprises");
- CIRI ("Comité Interministériel de Restructuration Industrielle") (only for large and medium-sized enterprises – often with headcounts exceeding 400);
- URSSAF (social tax administration) and CCSF ("Commission départementale des Chefs des Services Financiers").

France facilitates the financial literacy of enterprises and the quality of restructuring in terms of economic viability at various levels:

- Where applicable, the tax and social security authorities (CCSF/ URSSAF) can agree to a payment schedule of social and tax debt;
- CODEFI (for SMEs < 400 workers) or CIRI (for larger enterprises > 400 employees) assists the enterprise in negotiations with (i) public tax and/or social security authorities, and (ii) banks and other creditors;
- The Commercial Court (or its chair), the "Administrateurs judiciaires" and "Mandataires judiciaires" play a significant role in determining the quality of restructuring (protection of the debtor and creditors).

Czech Republic

Overview and accessibility of debt restructuring procedures

Formal restructuring is separated into reorganisation proceedings (applicable to commercial entities) and debt relief proceedings (applicable to non-commercial entities). Both procedures ensure that the debtor's economic activity continues while the creditor claims are restructured.

Debtors are denied the ability to access debt restructuring where they or members of their governing bodies –

(i) have initiated insolvent liquidation proceedings in the last five years which have failed to reach a successful conclusion; and

(ii) have been convicted of offences and crimes related to property in the last five years.

The Czech Republic has no viability test as understood by Article 4 of Directive 2019/1023, yet there are different procedures available. Compulsory reorganisation procedures are available only to debtors whose annual revenue for the period preceding insolvency exceeds EUR 2,000,000 and who employ at least 50 persons.

Portugal

Overview and accessibility of debt restructuring procedures

Two debt restructuring procedures are available to Portuguese enterprises: (i) an out-of-court regime for business recovery and (ii) a special revitalisation process.

Enterprises experiencing financial difficulties or facing imminent insolvency with a chance of avoiding it can file for both procedures. Financial distress is defined as a serious inability to comply with obligations on time through a lack of liquidity or inability to obtain more credit, and must be certified by an accountant or auditor. No formal tests exist for identifying this condition in court.

Enterprises are prevented from entering into a special revitalisation process if they have ended negotiations on their own initiative in the last two years.

Foreign practice shows that different types of Debt Restructuring tools are available to enterprises of different sizes, with different creditor sizes/structures and different levels of financial distress.

Currently, the prospect of viability under Latvian law is formally measured in the Restructuring Plan. Latvian law does not prevent the stakeholders and the court from assessing the Restructuring Plan from a business perspective. However, there is an emphasis on checking the formal/legal preconditions in order to confirm the Restructuring Plan in court. The court usually pays attention to the viability of the Restructuring Plan only if there are objections from the stakeholders. **Thus, even though it is possible to assess the Restructuring Plan from a business perspective (and check its viability), this is not done properly in practice.** This may be due to the fact that Latvian law mainly imposes only formal requirements that have to be fulfilled in order for the court to approve the Restructuring Plan. In Germany, for instance, a debtor applying for Formal Restructuring should enclose certification of the debtor's viability.

Germany

Debt restructuring viability requirements

Under the German Insolvency Statute, a reorganisation must not manifestly lack the prospect of success. Also, debtors must prove to the court that they are not already cash-flow-insolvent and that the proposed restructuring does not manifestly lack the prospect of success.

This has to be proved by enclosing with the request for opening insolvency proceedings the opinion of a tax advisor, an accountant or a lawyer with experience in insolvency matters, or a person with comparable qualifications.

A similar provision is optional under the Insolvency Law. Some institutions have commented that, while making this provision mandatory might contribute to the quality of LPP, this could impose too high an administrative and financial burden on the debtor.

Representatives of the judiciary in the interviews have expressed their support for introducing minimum viability criteria for enterprises wishing to pursue Formal Restructuring. These criteria **should be objective and easily verifiable** by judges who lack specialisation in Formal Restructuring or lack extensive financial expertise.

The proposed criteria include requirements that (i) the company should have a proven track record of filing all required annual reports; (ii) it should not have been deregistered for Latvian VAT purposes; and (iii) the SRS should not have initiated debt recovery against the company.

Nevertheless, a company should be allowed to participate in Formal Restructuring even if these objective criteria are not met but the company can present an authoritative and financially sound opinion from a qualified expert refuting the assumption that Formal Restructuring cannot produce a successful outcome and confirming that it will not be used for fraudulent purposes.

The general assumption behind this system is that the stakeholders (mainly creditors) are able to figure out whether a Restructuring Plan is viable or not, and that their vote in favour of the Restructuring Plan is evidence that they believe it is viable. However, this assumption does not work in practice, leads to situations of abuse, and should be reviewed to facilitate better Debt Restructuring.

Accordingly, there should be (1) criteria to distinguish which enterprises can access LPP and (2) means of measuring the viability of business. As stated before, all debtors should have access to ELPP by virtue of no stay period, which is used for the wrong purposes in many cases. The viability test is not practical in ELPP because of the out-of-court nature of the first part of the procedure. Instead, reliance is placed on the fact that debtors in ELPP are negotiating on the basis of strong support from the majority of creditors and are presumably comfortable that they have a higher level of majority support, so they do not need a stay period.

Given Latvia's specific issues, the authors of this report suggest evaluating the scope for introducing different kinds of evidence of business economic viability to access LPP depending on the size of debtors: (1) SMEs and (2) large enterprises starting from the SRS taxpayer rating results in all cases, complemented by the Supervisor's opinion, when the stay period is applied and an opportunity for the judge to request some other type of viability evidence in the case of Formal Restructuring for larger enterprises.

If micro enterprises with relatively low experience, which prevail in Latvia, are unable to meet the minimum criteria, they should be either undergoing insolvent liquidation or normal liquidation in an (1) easy and (2) inexpensive way or (3) depending on their previous misconduct, certain debtors could be excluded from the list of persons with access to LPP.

d. Recommendations

- The Insolvency Law should be amended to restrict persons who have committed serious breaches of statutory rules from accessing Formal Restructuring.
- Latvia needs to ensure that Formal Restructuring is used by economically viable debtors. A business viability (minimum criteria) assessment for access to LPP should be implemented to ensure that only enterprises with the ability to survive may access LPP. Given the out-of-court nature of the first phase of ELPP and the lack of a stay period, such a viability test should not apply in ELPP.
- When applying for LPP, debtors should prove their viability at their own expense and with proper evidence.

7 Formal Restructuring procedures

7.1 Supervisors

Directive 2019/1023 aims to avoid unnecessary costs and to facilitate acting at an early stage when debtors face financial difficulties. Article 5 of Directive 2019/1023 provides that debtors should have control over their assets and the day-to-day operation of their business, and practitioners in the field of restructuring should only be appointed on a case-by-case basis depending on the circumstances or on the debtor's specific needs.[74] This section will analyse the current and historical approach to the role of Supervisor[75] and will benchmark the provisions of Directive 2019/1023 to Latvian law.

Before the reform of 1 July 2017, the Insolvency Law provided that a court-appointed Supervisor may only be a certified Insolvency Practitioner (a person who has passed appropriate exams and is authorised to practice as Insolvency Practitioner). The Supervisor was chosen and financed by the debtor, was allowed to be involved in the Formal Restructuring process from the beginning of negotiations with creditors, and had the power to draft a Restructuring Plan. **Appointing a Supervisor was mandatory for all Formal Restructuring proceedings, and the court appointed one after the initiation of Formal Restructuring proceedings for the entire period, including execution of the Restructuring Plan.**

Several scandalous insolvent liquidation proceedings and Formal Restructuring proceedings used in bad faith (i.e. delaying the debtor's recovery from financial difficulties and "preparing" the company for liquidation, including "moving" its business to another company, divesting individual assets or adjusting accounting documents) and contrary to the purpose of Formal Restructuring caused the stakeholders and the public to distrust the profession of Insolvency Practitioners and the Supervisor's role in Formal Restructuring proceedings.

For these and other reasons, the Insolvency Law was amended on 1 July 2017, and it has so far been possible to appoint any natural person as Supervisor. Although Chapter I1 of the Insolvency Law imposes certain limitations on a Supervisor, those are mainly aimed at limiting conflicts of interest and misuse of authority.

Supervisors are still appointed by the court in all Formal Restructuring proceedings, but their selection procedure has been changed. A Supervisor is chosen and financed by the majority of creditors unless another agreement has been reached. Where the creditors are unable to agree on a Supervisor, the court will appoint one from a list of Supervisors submitted by the creditors, or the ICS will propose a Supervisor to the court if the creditors are even unable to agree on a list of Supervisor candidates.

Currently Supervisors are not allowed to draft Restructuring Plans. The main aims of these amendments to the Insolvency Law were to reduce the Supervisor's conflicts of interest and the financial burden on debtors, to strengthen the Supervisor's monitoring function, and to attract a wider range of legal and financial professionals instead of Insolvency Practitioners, most of whom are persons with a legal education.

Despite these efforts to improve the system, entrepreneurs tend to lack financial literacy in their day-to-day operations and in dealing with financial difficulties. Also, the cost of Formal Restructuring can still be a significant burden on some small enterprises, which puts their restructuring at risk.

Practice shows that the existing funding model for Supervisors does not fully work in practice and results in extra time and resources being spent by the debtor and creditors. The rule that prohibits a Supervisor from negotiating with creditors and drafting the Restructuring Plan is only partially effective in practice, and overall it still creates more difficulties than benefits in terms of the effectiveness of Formal Restructuring. Practice also shows that due to financial distress, most small enterprises would rather not voluntarily hire a high-quality expert for drafting the Restructuring Plan and receiving approval from the creditors. This results in impracticable and unrealistic Restructuring Plans being prepared and unsuccessful or inadequate communication taking place between the debtor and creditors, which in turn leads to difficulties in receiving approval for the Restructuring Plan from the creditors.

[74] Recitals 30 and 31 of Directive 2019/1023

[75] To avoid misusing the terms under Directive 2019/1023 and Latvian law, please note that the Supervisor as defined in the glossary of this report is a "practitioner in the field of restructuring" under Article 2(1)(12) of Directive 2019/1023.

It has been noted that some of these problems are being addressed by Directive 2019/1023, which introduces an approach that the Supervisor may help in drafting the Restructuring Plan and receiving approval from the creditors, however the court appointment of a Supervisor should be determined on a case-by-case basis, except in certain circumstances where it is mandatory. Under Recital 30 and Article 5 of Directive 2019/1023, the appointment of a practitioner should be mandatory where a judicial or administrative authority grants the debtor a general stay of individual enforcement actions, provided a practitioner is needed to safeguard the interests of the parties; the Restructuring Plan needs to be confirmed by a judicial or administrative authority through a cross-class cram-down; it was requested by the debtor; or it is requested by the majority of creditors provided that the creditors cover the costs and fees of the practitioner.

Directive 2019/1023 also provides that practitioners and consequently Supervisors should have relevant training, qualifications and expertise, and they should perform their tasks with integrity, avoid conflicts of interest etc.

To achieve these objectives and to introduce the requirements of Directive 2019/1023, Latvia should introduce the minimum mandatory provisions of Directive 2019/1023. However, because of the history and current issues identified in the Formal Restructuring framework, Latvia should go further than the minimum and should strengthen and expand the role of Supervisor, bearing in mind that supplementary supervision of the Supervisor makes additional gridlock for the stakeholders, so the oversight of Formal Restructuring proceedings or part of it should take place and be effective only in certain cases where –

1) it is critically needed considering the Latvian business environment and past experience of abusive insolvent liquidation and restructuring cases; and
2) it is mandated by Directive 2019/1023.

Also, considering the mandatory and optional provisions of Directive 2019/1023, Latvia should modify the role of Supervisor. Strengthening this role and focusing on Supervisor involvement periods and tasks they are to carry out during their involvement would reduce their conflict of interest, which is partly due to their current potential interest in the outcome of the process. This approach should improve the overall quality of Formal Restructuring and increase Supervisor objectivity, since their involvement would mostly depend on the assistance provided to the debtor and on the quality of their supervision service, not their opinion on the Restructuring Plan.

7.1.1 Debtor in possession

Directive 2019/1023 contains multiple requirements for MS to ensure that debtors retain control over their business in preventive restructuring procedures. Directive 2019/1023 also provides for appointing a practitioner in the field of restructuring to assist the debtor in negotiating with creditors and drafting the Restructuring Plan in certain circumstances.

Latvian law provides that the debtor's governing bodies should continue to function and conduct usual business operations during Formal Restructuring proceedings to the extent of this freedom and according to the types of transactions the debtor is permitted to conclude without the prior authorisation of the person supervising the restructuring proceedings (see Article 49 of the Insolvency Law). Accordingly, the **existing law is consistent with Article 5(1) of Directive 2019/1023**.

7.1.2 Role of the Supervisor

There are notable differences between the provisions of Directive 2019/1023 and Latvian law relating to the Supervisor's duties. Under Article 2(1)(12) of Directive 2019/1023, a "practitioner in the field of restructuring" means any person or body appointed by a judicial or administrative authority to carry out, in particular, one or more of the following tasks:

a. assisting the debtor or creditors in drafting or negotiating a Restructuring Plan;
b. supervising the debtor's activity during negotiations on the Restructuring Plan, and reporting to a judicial or administrative authority;
c. taking partial control over the debtor's assets or affairs during negotiations.

While Directive 2019/1023 provides that Supervisors (practitioners in the field of restructuring) may assist the debtor or creditors in drafting and negotiating the Restructuring Plan, the Insolvency Law contains a clear limitation that forbids Supervisors from assisting the debtor in drafting the Restructuring Plan (see Article 12.3(3)(1) of the Insolvency Law). **This discrepancy means that the Insolvency Law needs amending and that the previous model with the Supervisor assisting the debtor in drafting the Restructuring Plan could be reinstated.**

7.1.3 Appointment of the Supervisor

As stated before, Latvian law makes no distinction between circumstances under which a Supervisor is appointed, and consequently one is appointed in each and every Formal Restructuring. Under Latvian law, a Supervisor must be chosen by creditors and appointed through subsequent approval by the court. Article 5(2) of Directive 2019/1023 provides that the appointment by a judicial or administrative authority of a practitioner in the field of restructuring should be decided on a case-by-case basis, except in certain circumstances where MS may require the mandatory appointment of such a practitioner in every case. Article 5(3) of Directive 2019/1023 provides that a practitioner (Supervisor) should be appointed at least in the following cases:

a. where a general stay of individual enforcement actions is granted by a judicial or administrative authority who decides that such a practitioner is necessary to safeguard the interests of the parties;

b. where the Restructuring Plan needs to be confirmed by a judicial or administrative authority through a cross-class cram-down; or

c. where this is requested by the debtor or the majority of creditors, provided that, in the latter case, the cost of the practitioner is borne by the creditors.

Because Formal Restructuring proceedings are often inaccessible to SMEs and profoundly burdensome for larger enterprises, partly due to the expenses incurred in remunerating the Supervisor and drafting the Restructuring Plan, the **legislators should consider implementing amendments to the Insolvency Law that in certain cases allow the judges not to appoint a Supervisor, and give the debtor's management a chance to independently carry out Formal Restructuring if particular criteria are met.** This would save resources of the debtor and the state, which would otherwise be spent selecting and appointing a Supervisor, due to avoidable additional administrative procedures for the state and financial expenses for the debtor arising from the Supervisor's remuneration. This could also have the added benefit of advancing the literacy and abilities of the debtor's management if the required assistance is granted.

Such exceptions to Supervisor appointment could, subject to the requirements of Directive 2019/1023, be applicable to enterprises –

(i) which are facing financial difficulties for the first time;

(ii) which have a good working relationship with creditors (confirmed by creditor acceptance);

(iii) which have an impeccable reputation in terms of timely submission of annual reports and other necessary documents;

(iv) where the debt structure is not so complex as to require the appointment of an outside expert and where the financial expertise of the management should be sufficient for managing the financial distress;

(v) where the causes of financial difficulties are short-term economic troubles or any other identifiable and relatively simple deficiencies, rather than systemic issues within the debtor's business or operations, and which can be mitigated through elementary postponement of payment of debts until a normal cash flow is restored; and

(vi) where the debtor is an SME with an annual turnover of less than EUR 250,000 and has up to 20 creditors.

Considering the above analysis and the requirements of Directive 2019/1023, a Supervisor should be appointed where one of the following circumstances is present:

(i) For the stay period on the day that LPP are initiated, since the debtor can benefit from a stay of individual enforcement actions to support negotiations on the Restructuring Plan, and the stay period should be supervised to prevent abuse. The cost of Supervisor is borne by the debtor;

(ii) On the day that Formal Restructuring is initiated where the Restructuring Plan is confirmed through a cross-class cram-down. The cost of Supervisor is borne by the debtor.

Apart from the above cases, the parties should have the autonomy to appoint a Supervisor also –

(i) where it is requested by the majority of creditors or by one creditor, with the cost of Supervisor borne by the creditor/s;

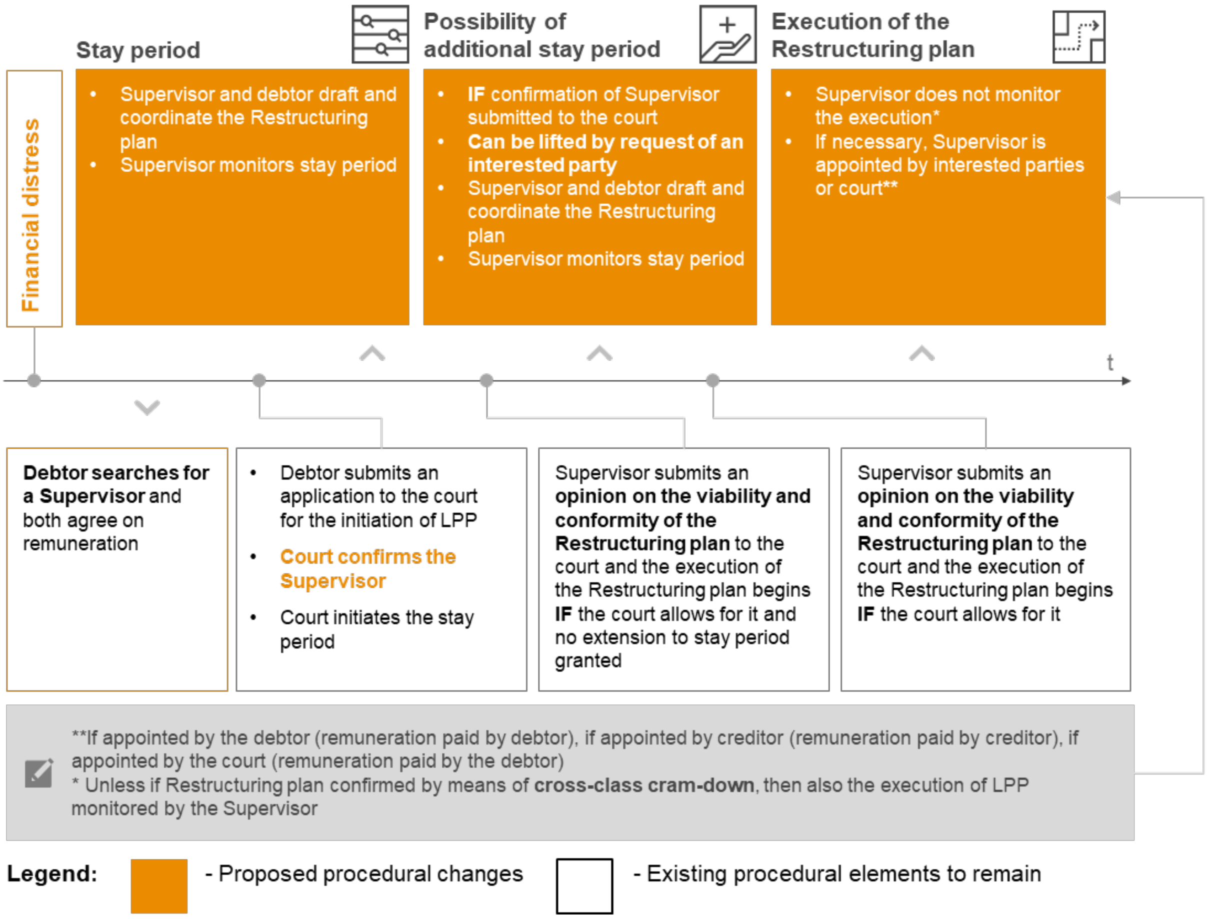
(ii) in any case and at any time where it is requested by the debtor or the court to safeguard the interests of the parties, or where the court requires a Supervisor's opinion on the Restructuring Plan, or where the Restructuring Plan needs amending. In such cases the cost of Supervisor is borne by the debtor.

This would achieve the objective of Directive 2019/1023 and minimise the Supervisor's conflict of interest and the cost of proceedings, as the Supervisor would only be remunerated for specific tasks and duties and in most cases for a short period.

Stakeholders have expressed concerns that Supervisor appointment creates an additional financial burden on creditors, who, as it currently stands, can expect little in terms of having their claims satisfied.

An earlier suggestion that Supervisor remuneration and appointment might be delegated to the state has been noted. However, it has also been noted that it would then be unclear to whom the Supervisor is accountable.

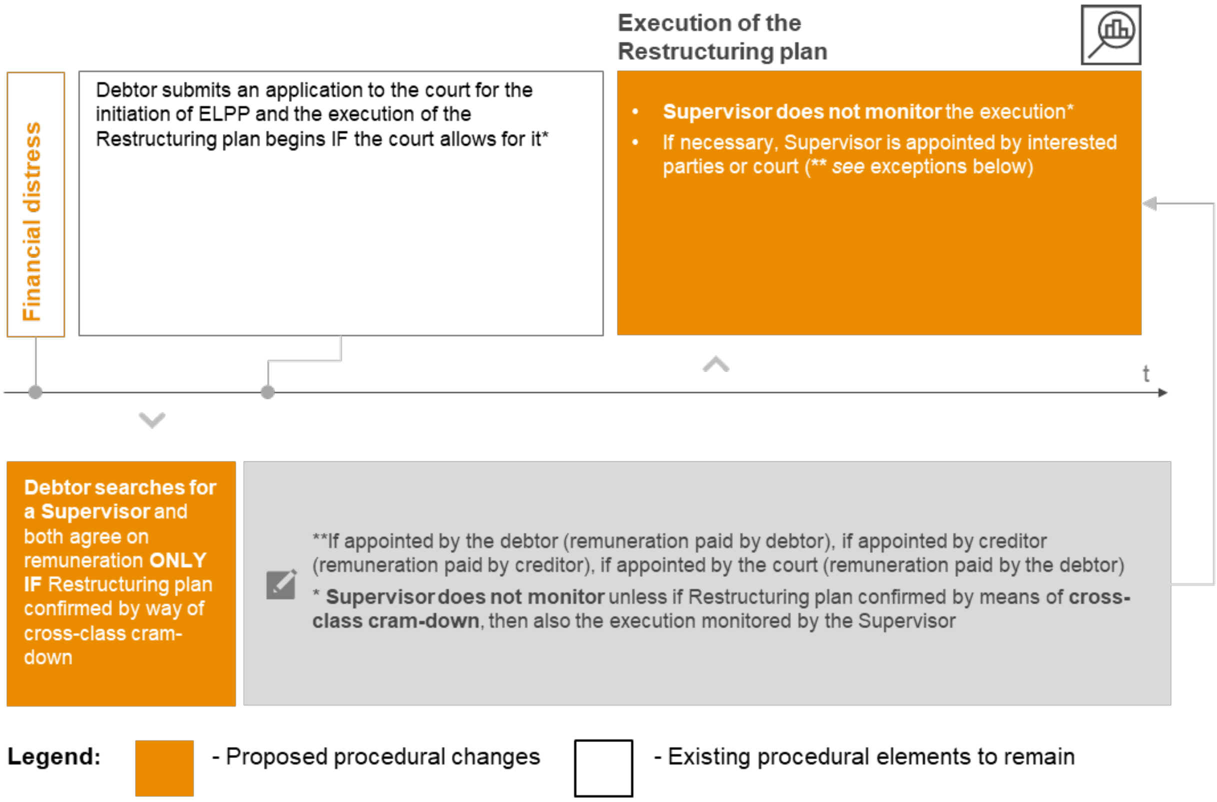
Figure 13 Involvement of the Supervisor in LPP



Figures 13 and 14 show that under the proposed Formal Restructuring proceedings, the appointment of a Supervisor is requested by the debtor or creditors, or on the initiative of the court where there is no such initiative from the parties and the court wishes to hear an expert opinion on the Formal Restructuring proceedings before taking substantial decisions on the procedure (see below section “8.7.2 Appointment of experts”).

It should be noted that these selection procedures should be possible only outside the mandatory Supervisor appointment periods. A Supervisor will nevertheless be appointed during a stay of individual enforcement actions in LPP when a Restructuring Plan is confirmed through a cross-class cram-down, when the stay period is extended, or when a Supervisor is necessary to review amendments to the Restructuring Plan.

Figure 14 Involvement of the Supervisor in ELPP



7.1.4 Qualifications of the Supervisor

Article 26(1) of Directive 2019/1023 requires MS to ensure that practitioners appointed by a judicial or administrative authority in restructuring, insolvency and debt discharge procedures ("practitioners") receive suitable training and have the necessary expertise for their responsibilities. In appointing a practitioner for a particular case, including cases with cross-border elements, due consideration should be given to the practitioner's experience and expertise and to the specific features of the case.

The main goal of this provision according to Recital 87 of Directive 2019/1023 is to ensure that practitioners are suitably trained, transparently appointed with due regard to the necessity of setting up efficient procedures, and supervised when carrying out their tasks, and they should perform their tasks with integrity.

Currently such practitioners in Formal Restructuring and liquidation in Latvia are (1) the Insolvency Practitioner and (2) the Supervisor.

Historically, only certified Insolvency Practitioners could perform these duties, but the current rules permit any natural person appointed by the debtor to conduct these duties. This can create issues in both theory and practice where an unqualified lawyer or Insolvency Practitioner or other person without the necessary business and financial education and experience is tasked with evaluating a Restructuring Plan, which is in fact a business plan for the debtor's future operation.

The Insolvency Law lists requirements that must be met in order to become a Supervisor in debt restructuring proceedings, e.g. legal capacity, no criminal record, no conflict of interest (see Article 12.3 of the Insolvency Law). The requirements that are set for Supervisors under Latvian law are currently regulated under Chapter 1.1 of the Insolvency Law, namely Articles 12.3, 12.4, 12.5, 12.6, 12.7, and 12.8, which lay down a number of requirements and limitations for Supervisors and their activities. There are no formal requirements for Supervisors to have a business education or experience in the field of Formal Restructuring. In fact, the **Insolvency Law imposes no requirements for a Supervisor's experience**, education or training. It is therefore possible for a person without the necessary expertise to become a Supervisor. **Accordingly, in terms of Supervisor qualification, the Latvian law is not fully consistent with Article 26(1)(a) of Directive 2019/1023.**

None of these provisions are fully implemented in the Latvian legal system. Practice shows that creditors who can afford it tend to choose Insolvency Practitioners, attorneys at law, or representatives of some other regulated profession. **Many stakeholders have pointed out that around 90% of Supervisors in Latvia are lawyers, not economists or businesspersons**. Even though lawyers are able to check formal compliance with the law, most Supervisors do not have financial expertise and are unable to assess, for example, the viability of a Restructuring Plan and the overall business.

In the absence of experience requirements and tests of the Supervisor's suitability for specific cases, the courts, **in appointing a practitioner for a particular case, are not giving due consideration to the Supervisor's experience and expertise or to the specific features of the case.**

Under Article 41(1), a Supervisor must provide an opinion on the Restructuring Plan before it is approved by the court. The Supervisor's opinion has to contain an assessment of the Restructuring Plan for compliance with the Insolvency Law. In his opinion, the Supervisor has to evaluate whether the Restructuring Plan will achieve the statutory purpose of the legal protection process. Thus, **the main role of a Supervisor comes down to checking whether the Restructuring Plan meets the formal requirements and monitoring its execution from a formal point of view.** As this process is very formal in practice, the objective of Directive 2019/1023 cannot be met without amending the law. In summary, it is clear that Latvia should impose stricter requirements for Supervisors.

Accordingly, the Insolvency Law should be amended to lay down the minimum qualification requirements for Supervisors, and the profession should also have some regulation in this regard.

> **The ICS and the judges who were consulted** have expressed their support for the need to define the requirements for a Supervisor. In the opinion of the ICS and the judges, these requirements should include competence not only in matters of law but also in the financial and economic aspects of Debt Restructuring.

Czech Republic

Requirements for persons supervising debt restructuring

Insolvency trustees (similar to Supervisors in Latvia) are required to hold a degree in law, or in a field related to economics, and must pass multiple exams before qualifying for the position. In fact, the insolvency trustee is a regulated profession under Czech insolvency law.

Spain

Requirements for persons supervising debt restructuring

Before initiating the Extrajudicial Agreement procedure, a mediator or an intermediary from a public list must be appointed by the Commercial Register on the basis of a petition submitted by the debtor. The intermediary will be appointed as Insolvency Practitioner where the agreement is unfulfilled and the debtor files for insolvency.

Insolvency Practitioners in Spain are neither required to pass professional exams nor subject to licensing, but they must meet certain criteria before they can be appointed. Insolvency Practitioners must be lawyers or economists with at least five years' professional experience, credible training, and participation in bankruptcy proceedings. A legal entity that meets these criteria can also act as Insolvency Practitioner.

Portugal

Requirements for persons supervising debt restructuring

There are specific trainings and tests a Supervisor must pass before he can work and obtain a licence. These tests consist of multiple layers and include an interview, a knowledge test, and a case study.

France

Requirements for persons supervising debt restructuring

The court-appointed administrator and the Insolvency Practitioner are both regulated professions and are supervised by the public prosecutor's office. A public list of representatives of these professions is maintained in France. To become a member, potential candidates must meet the necessary education criteria and pass regulated exams.

In practice, most court-appointed administrators and Insolvency Practitioners have a legal or financial background and a formal legal education. Those who lack financial skills can enlist the assistance of additional experts. Although this is not a statutory requirement, creditors usually request adequate financial understanding.

The Czech and UK experts have commented that this issue could be resolved by imposing specific requirements for Supervisors, such as a degree in both Law and Business Economics, to ensure that the person supervising LPP is able to make a judgement on the viability and value of the business and its overall chance to successfully recover from LPP. However, given the size of the economy in Latvia, the authors of this report believe that this suggestion is unlikely to work in Latvia, as very few people will qualify for this role.

The judges have expressed the opinion that the Supervisor should be a respectable firm or a person whose opinion they could trust, such as Altum or respectable business consultants.

It should be noted that in the UK, Insolvency Practitioners (including administrators) mostly have an accountancy background and engage lawyers to assist with the administration of their duties.

The requirements for a Supervisor should certainly include having relevant business, financial and/or economic expertise. In complex Formal Restructuring cases, the Supervisor should be able to consult other experts, if necessary. It is advisable, therefore, to implement the possibility for the Supervisor to consult/subcontract advisors. This could potentially improve the quality of Formal Restructuring and Restructuring Plans where Supervisors are involved. However, the scope of this consultation should only cover any aspects of fields that are necessary when practising the Supervisor's duties and obligations, so that the required number of experts can qualify and further specialise in the future.

Judges have expressed strong support for reforms relating to persons that supervise Formal Restructuring. The judges take the view that Supervisors should contribute the most in terms of financial expertise, which the judges currently lack unless they are also specialised in Debt Restructuring. **These experts should also be skilled mediators** who can lead and support negotiations between the debtor and creditors before the Restructuring Plan is submitted to the court. At present, the **judges lack high-quality opinions from Supervisors on the viability of Restructuring Plans**. An independent expert should issue an opinion on the viability of a Restructuring Plan.

Such opinions could also be given by reputable, specialised national or commercial institutions or enterprises, or a team of experts with well-established expertise in business and in drafting business plans.

Supervisors should also be regulated and pass qualifying exams so that the courts could approve and select trustworthy persons with proven expertise, and these persons should have civil liability insurance cover. This expertise relates especially to financial skills necessary for evaluating Restructuring Plans and supervising Formal Restructuring.

This framework should also include clearly defined liability of Supervisors.

Because of the extent to which lawyers and finance experts are specialised, representatives from both fields should be able to become acquainted with aspects of the other field fairly quickly. The requirements should be based on a curriculum that fits into an accelerated programme of education.

Consequently, the requirements for Supervisors could be tested through exams, which would then certify these professionals as having both the necessary law and finance/economics expertise for performing their duties, in a similar way to how Insolvency Practitioners are supervised under the current framework.

To help debtors find the right Supervisor, there could be a publicly available list of Supervisors, preferably on the ICS website if the stakeholders agree on the certification (test) of Supervisors.

7.1.5 Supervision of Supervisor

Article 27(1) of Directive 2019/1023 requires MS to implement appropriate oversight and regulatory mechanisms to ensure that the work of practitioners is effectively supervised. Although the general rules on the supervision of practitioners are established in the section “Supervision and Remuneration of Practitioners,” the supervision of a Supervisor will be discussed in this subsection.

Supervisors are currently supervised by the ICS. Chapter IV1 “Disciplinary Liability of the Supervisor and Administrator of LPP” and Division F “Supervision of Formal Restructuring and Liquidation” of the Insolvency Law contain numerous articles on (1) a Supervisor’s liability and (2) supervising the Supervisor. For example, Article 176 lays down the procedure for filing complaints against a Supervisor. Article 174.1(11) provides that the ICS should perform the supervision of Supervisors and deal with complaints about their actions. Thus, Supervisors are currently supervised and no further developments in law are necessary to meet the requirement of Article 27(1) of Directive 2019/1023.

7.1.6 Liability of Supervisor

Another issue identified by the stakeholders is the lack of Supervisor’s liability. Directive 2019/1023 aims to ensure that practitioners involved in restructuring adhere to standards set for such tasks, and recommends that practitioners should be obtaining insurance for professional liability.[76]

Although Article 12.8 of the Insolvency Law lays down the general rule that a Supervisor is liable for damages he/she has caused, in practice there are very few cases where a claim against the Supervisor has been brought and proved.

The legal systems benchmarked in this report suggest different solutions to the issue of Supervisor’s liability.

Czech Republic

Liability for persons supervising debt restructuring

Insolvency trustees are generally held accountable to the same managerial responsibility standards as company directors.

The courts have the power to remove trustees with or without the request of the debtor and creditors. The following actions of a trustee may provide grounds for his removal: (i) the trustee fails to fulfil his obligations; (ii) the trustee does not act with due professional care; and (iii) the trustee seriously breaches any of the duties imposed by the court or law.

The courts may levy fines on trustees totalling up to EUR 8,000,000. The trustee licence may be revoked under certain conditions.

Portugal

Liability for persons supervising debt restructuring

The insolvency administrator’s activities are constantly monitored by a judge, who may ask for information at any time.

The insolvency administrator may be held liable for loss caused to the debtor or creditors in cases of (i) non-compliance with administrator duties, (ii) if the insolvent estate is insufficient to cover the creditor claims because of the administrator’s actions; (iii) supplying incorrect information or omitting information if negligence is proved (held jointly liable).

The insolvency administrator’s liability is limited to a period of two years after their nomination.

Although the general rules on liability under the Civil Law impose an obligation to cover losses, in practice there are very few cases where Supervisors are required to cover losses. Debtors are not keen on suing Supervisors, as this can be a lengthy and expensive process until the fault is proved in court.

[76] This is not a mandatory provision of Directive 2019/1023 (see Recital 87).

> Stakeholders have expressed the opinion that the Supervisor's civil liability insurance should be mandatory. They have indicated that this civil liability should be sufficient to cover losses, unlike the current insurance requirements for Insolvency Practitioners, which are considered insufficient.

Thus, introducing stricter Supervisor liability could improve the overall quality of Formal Restructuring and reduce the number of processes involving abuse and the risk of a conflict of interest. While Article 12.8 of the Insolvency Law permits Supervisors to insure their liability, the authors of this report believe that there should be an insurance requirement for Supervisors to mitigate the risk of misconduct and provide cover for potential losses, as it is in the UK, for example.

Under the Insolvency Law, the provision for a Supervisor's professional civil liability insurance is optional. According to the experts from other countries, this provision should be mandatory as it increases confidence in the process and imposes more responsibility on the Supervisor.

e. Recommendations

- To promote Formal Restructuring and distinguish it from insolvent liquidation, Supervisors as a professional body should be separated from Insolvency Practitioners, while not preventing the latter from acting as Supervisors.
- The Insolvency Law should be amended to include specific requirements for a Supervisor's (1) education, (2) background, and (3) experience. The Supervisor should ideally have expertise in business, and potentially in economics, or should be able to engage professional advisors having the necessary expertise.
- The Insolvency Law should be amended to permit Supervisors to assist debtors in drafting and negotiating Restructuring Plans with creditors, and in executing Restructuring Plans in Formal Restructuring processes.
- Supervisors should be appointed only in a limited number of scenarios: (i) in LPP during the stay of individual enforcement actions; (ii) in Formal Restructuring when the debtor, creditors or the court request the appointment of Supervisor; and (iii) in Formal Restructuring when the Restructuring Plan has been confirmed through a cross-class cram-down.
- The ICS should maintain a public list of Supervisors to help a debtor choose a Supervisor suitable for the debtor's needs, the size of business, and the case.
- The Insolvency Law should be amended to require civil liability insurance for Supervisors depending on the scale of each Formal Restructuring case.
- The Insolvency Law should be amended to permit the Supervisor to enlist the assistance of qualified experts in complex Formal Restructuring cases and/or where the Supervisor lacks a particular skill set.

7.2 Stay of individual enforcement actions

Article 6(1) of Directive 2019/1023 requires MS to implement a rule on the stay of individual enforcement actions[77] in the national legal Formal Restructuring and insolvency frameworks. **This has the purpose of protecting the debtor from any creditor taking individual actions against the debtor, while the latter is seeking approval for the Restructuring Plan from the majority of creditors.** Currently under Latvian law, a stay is always granted in LPP, provided that the statutory criteria are met. Nevertheless, Directive 2019/1023 gives MS freedom in deciding how the stay will be granted so that it could be applied automatically by operation of law or at the discretion of a judicial or administrative authority.[78]

Article 6(1–5) of Directive 2019/1023 contains several mandatory and optional provisions for restricting or eliminating the application of a stay to different classes of creditors or types of claims. For example, an application for a stay should not always be comprehensive or it may be refused by the court, where such a stay is not necessary. A stay could cover all types of claims, or certain categories may be excluded from the scope. A stay should not be applied to workers' claims unless the MS ensures that payment of such claims is guaranteed in preventive restructuring frameworks at a similar level of protection. Protections for workers' claims have been introduced and are mentioned below.

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[77] Please see Article 2(1)(4) of Directive 2019/1023. A stay of individual enforcement actions means a temporary suspension, granted by a judicial or administrative authority or applied by operation of law, of a creditor's right to enforce a claim against a debtor and, where so prescribed by national law, against a third-party security provider, in the context of a judicial, administrative or other procedure, or of the right to seize or realise the debtor's assets or business out of court.

[78] Ben Schuijling "INSOL Europe Guidance Note on the Implementation of Preventive Restructuring Frameworks under EU Directive 2019/1023: Stay of individual enforcement actions*", (April 2020).* Available on: https://www.insol-europe.org/publications/guidance-notes. [Accessed May 1, 2020].

Article 6(6–8) of Directive 2019/1023 further regulates the minimum and maximum mandatory duration of a stay period. The initial stay period must not exceed four months, but under certain conditions it may be extended up to 12 months in total. An extension should be possible only in well-defined and justified circumstances related to the protection of creditor rights, progress in negotiations on the Restructuring Plan, and the debtor's solvency test.

Article 6(9) of Directive 2019/1023 requires MS to ensure that judicial or administrative authorities can lift a stay where it becomes apparent that the Restructuring Plan is not supported by the required majority of creditors, where a lift request is submitted by the Supervisor, where one or more creditors or creditor classes are or would be unfairly prejudiced by the stay, or where the stay could lead to the debtor's insolvent liquidation.

Article 6 of Directive 2019/1023 contains optional provisions for lifting a stay. For example, MS may provide that a stay may be cancelled only before its extension or where creditors did not have the opportunity to be heard before the stay was applied. A further option is to set a period during which a stay cannot be lifted at all.

Debtors in Latvia can benefit from a stay used for supporting negotiations on the Restructuring Plan, but there are notable differences between Directive 2019/1023 and the Latvian legal framework.

Under Article 37(1) of the Insolvency Law, a court decision on the initiation of Formal Restructuring applies a stay within the meaning of Directive 2019/1023. However, the optional provision of the **second subparagraph** of Article 6(1) of Directive 2019/1023 has not been implemented, as **the Latvian courts do not have the power to refuse a stay where this is not necessary or where it would not achieve the debtor benefit objective prescribed by the first subparagraph** of Article 6(1).

The national framework is consistent with Article 6 (2), (3) and (5) of Directive 2019/1023, since a stay covers all types of creditor classes and claims, including secured claims, preferential claims, unsecured claims and workers' claims, which enjoy additional protection in compliance with the second subparagraph of Article 6(5) of Directive 2019/1023. The initiation of Formal Restructuring is a publicly known fact and information about it is available online.

The debtor is required to send the lists of creditors to all creditors before initiating LPP and to inform all creditors, because after the initiation of LPP, a Restructuring Plan must be sent to all known creditors for approval or rejection, except workers, since the debtor's employees do not have creditor status in Formal Restructuring under Article 38(4) of the Insolvency Law.

As to workers' claims, it is necessary to emphasise the protection available for their claims. Although a stay applies to workers' claims, **employees are protected** by the debtor's obligation to pay their claims in full within the execution of the Restructuring Plan unless their consent or approval has been received under Article 38(4) of the Insolvency Law.

During the insolvent liquidation proceedings, workers' claims are covered out of a specially formed state guarantee fund, if the debtor's assets are insufficient to cover payroll debts. If the debtor has sufficient funds, then workers' claims are privileged and will be settled before the claims of other creditors under Article 118 of the Insolvency Law.

Latvia has not implemented the optional provision of Article 6(4) of Directive 2019/1023 for excluding certain claims or categories of claims from the scope of a stay. While this might be relevant to large enterprises, for SMEs the administrative expenses may outweigh the benefits. Moreover, the current stay period is too short for the option available under Article 6(4) of Directive 2019/1023. **According to the experts, introducing this provision for excluding certain claims will not solve any of the key issues.**

Duration and lift of stay

Under Article 6(6) of Directive 2019/1023, the initial stay period should be limited to four months, with the possibility of extending it up to 12 months in total under Article 6 (7) and (8). Latvia has a stricter legal regime. Under Article 40(2) of the Insolvency Law, the stay period is automatic for two months from the day that the court initiated LPP, with the possibility of extending it for a third month if the majority of creditors specified by Article 42(3) of the Insolvency Law agree and the court is immediately notified. In practice, it can last longer than three months because of timing deviations, but it is still not possible to extend it formally beyond three months. Directive 2019/1023 offers a tailor-made approach to the extension, which is relevant, since in practice there are cases where a longer stay period would help reach the goals of LPP, however this should not be left open to abuse.

The stay should be extended month by month up to the maximum duration prescribed by Article 6(8) of Directive 2019/1023, when a professional or team of professionals with significant financial background, qualifications and experience are involved in drafting the Restructuring Plan. The extension should be based on circumstances related to progress in negotiating the Restructuring Plan and, if necessary, in raising funds to implement it. Such an extension would be relevant and could help solve some of the viability problems and could increase the number of successful Formal Restructurings.

The Latvian law is currently in line with Article 6(9)(c) of Directive 2019/1023 but should be improved within the framework proposed by Directive 2019/1023, especially with the provisions outlined in the second and the third subparagraph of Article 6(9) if the stay period is to be extended according to PwC's recommendations. **Accordingly, a lift of stay could be initiated before an extension is granted by a judicial or administrative authority, and it has been suggested that a time limit should be set during which the stay cannot be lifted at all, for example, in the first two months.**

As for access to a stay, the experts, authorities and institutions have raised important concerns, including that the stay is widely used in a dishonest and abusive manner. Where the debtor is dishonest or has acted in bad faith in LPP, the sanction/prosecution procedure is weak and insufficient to build a good reputation for LPP.

The problem arises from the existing legal framework and the business culture of SMEs in Latvia. Under Article 34 of the Insolvency Law, any restrictions on the initiation of LPP that lead to a stay are procedural and not related to any serious assessment of the company's financial capabilities or the prospect of its success. **Practically any debtor can obtain at least a two-month stay if a formal application has been submitted to the court. Since Article 4 of Directive 2019/1023 already makes recommendations for viability, the issue will not be repeated.**

After obtaining a stay under Article 40(1) of the Insolvency Law, the debtor should draw up a Restructuring Plan for LPP, which should be approved by the creditors and submitted to the court for confirmation within two months, with an option to extend the stay period for a third month with the support of the majority of creditors. **The stay period is quite often used to prepare for insolvent liquidation proceedings, as nobody then interferes with day-to-day activities or a transfer of assets contrary to the interests of creditors.**

The national legal framework does not prescribe effective liability and sanctions (although the law provides for criminal liability, it is not actually applied in practice) if a Restructuring Plan is not prepared within two months. There are no controls available to creditors or the court to act if they suspect that the company is being misused. **Creditors alone are unable to ensure adequate effective supervision of the debtor's activities during the stay period and it is not possible to influence ineffective or even abusive control of the debtor's assets and day-to-day running of the business.** It is not clear why more control is not required from the Supervisor, especially during the stay period. **Even judicial authorities do not have the power to lift a stay at the request of a creditor or the Supervisor.** The lack of safeguards for the interests of creditors during the stay period opens the stay to abuse where the debtor uses the stay for shifting assets to another company or enjoys an extended period of protection from creditor claims in court.

While Article 37(4) of the Insolvency Law requires the debtor to provide the Supervisor, at their request, with all information in writing on the drafting and approval of the Restructuring Plan without delay, and to provide documents supporting the validity of creditor claims, and to enable an on-site inspection of the debtor's economic activity and documents, **in practice the Supervisor is unable to exercise these rights until he/she is approved by the court. Such approval is usually given shortly before the expiry of the stay because of the long and mostly ineffective procedure for appointing a Supervisor under Article 35.1 of the Insolvency Law**. During the stay period, the debtor and creditors are trying to find a nominee willing to become a Supervisor and, most importantly, the nominee needs support from the majority of creditors.

Once the Supervisor is approved, in theory, the creditors can agree with the Supervisor on the extent to which the debtor is controlled, and this agreement should lead to effective and timely supervision. In practice, however, this is rarely the case regardless of whether banks or tax authorities are involved in LPP.

Spain

Stay of individual enforcement actions

In the pre-insolvency stage, where there is a likelihood of insolvency, a stay of individual enforcement actions is not automatically applicable to all of the debtor's assets, and the debtor has to indicate which executions are being carried out against its private assets and which assets are necessary to continue its professional or business activity (Articles 4 and 5 of the Spanish Insolvency Act).

Under the rules applicable to the pre-insolvency procedure, a stay does not affect public creditors, such as the national tax authority, and does not have a fixed period, instead ceasing when agreement is reached with the creditors or when the debtor progresses to insolvent liquidation proceedings.

In the pre-insolvency stage, creditors have an opportunity to appeal the decision of the court in which the stay has been approved. However, creditors face a similar issue here, as it is usually impossible to reject the decision in time and the debtor has usually progressed to liquidation or reached an agreement with creditors.

Spanish creditors are not divided into secured and unsecured creditors only. Instead, they are classified in restructuring agreement proceedings as (i) financial creditors and (ii) non-financial creditors, which are further divided into labour creditors, public creditors and commercial creditors. In extrajudicial payment agreement proceedings, creditors are divided into (i) secured creditors, (ii) public creditors, and (iii) other creditors.

The three-year time limit for recognising transactions as invalid in liquidation limits the scope for appealing against malpractice when Formal Restructuring results in insolvent liquidation.

The existing stay period (two months plus the possibility of extending it for a third month) and/or the following period of unsuccessful execution of the Restructuring Plan sometimes eliminate opportunities to challenge the debtor's previous transactions following the insolvent liquidation procedure, since the Insolvency Law limits the time for challenging the debtor's transactions to several suspicion periods (e.g. transactions can be challenged as invalid if they have been concluded **four months** before the day of the proclamation of liquidation, whether the person with whom or for whose benefit the transaction has been concluded knew or did not know of the losses caused to the creditors; transactions can be challenged as invalid if they have been concluded **three years** before the declaration of liquidation, but the person with whom or for whose benefit the transaction has been concluded knew or should have known of the losses caused). Such time limits are intended to contribute to the legal stability and certainty. The Insolvency Law therefore requires the Insolvency Practitioner to evaluate the debtor's transactions and bring an action in court for recognising a transaction as invalid regardless of its type if it has been concluded within three years before the date of proclamation of the legal entity's insolvent liquidation proceedings and caused losses to the debtor, and the person with whom or for whose benefit the transaction has been concluded, knew or should have known of the losses caused (see Article 96(2)(1) of the Insolvency Law). This includes both extreme malpractice and a transaction that has not been beneficial to the debtor, but without malice.

At the same time, Article 1415 of the Civil Law provides that any prohibited or indecent action whose purpose is contrary to laws, or which is intended to circumvent the law, may not be the subject matter of a lawful transaction and is void. Some Insolvency Practitioners have succeeded in challenging transactions that are more than three years old under the Civil Law (Article 1415 and others), since the general limitation period for challenging transactions in Latvia is ten years. However, case law has not been settled but tends to favour a three-year suspicion period prescribed by the Insolvency Law as *lex specialis*.

In other countries, the time limits for challenging an abusive transaction are significantly longer or indefinite. The UK Insolvency Act, for example, sets no time limit on a transaction defrauding creditors, although any action is subject to a 12-year limit under the statute of limitations.

To ensure certainty and prevent malicious debtors from avoiding litigation, which is currently achieved through the initiation of Formal Restructuring, several solutions are already provided by the report of Jauja, Zandersons: a) LPP suspends the time limit for appeal of transactions, b) the time limit is counted from the date of actual insolvency. An alternative would be to extend or waive the deadline for applying Article 96(1)(2) of the Insolvency Law itself. However, this would require reformulation of the Appeal of Transactions clause (Chapter XVII of the Insolvency Law) to separate malpractices from the other transactions. An abusive transaction should be recognised in liquidation as invalid without time limits, especially if a long time has passed because the debtor specifically delayed it.

f. Recommendations

- To deter misuse of Formal Restructuring, including a stay of individual enforcement actions, the Insolvency Law should define liability and sanctions for any misuse of the stay in LPP by the debtor's management board, including personal liability for losses so caused.
- The appointment of a Supervisor on the day that LPP are initiated should be implemented to supervise the debtor during the stay of individual enforcement actions, and if necessary, to advise on and assist in negotiations with creditors and in drafting the Restructuring Plan.
- The Insolvency Law should be amended to provide that the initial stay period may exceed two months only where a Supervisor is involved in the process of negotiating or drafting the Restructuring Plan. An extension of the stay should be justified by appropriate proof of progress but should not exceed 12 months.
- The Insolvency Law should be amended to enable the court to lift the extended stay period in certain circumstances, including those set out in Article 6(9), as required by Directive 2019/1023.
- A minimum period should be set, during which the stay of individual enforcement actions cannot be lifted, to give the parties time to assess the situation. The period should not exceed the initial stay period (two months in Latvia) unless there is evidence of abuse or negligence by the debtor.

7.3 Consequences of Stay of Individual Enforcement Actions

Article 7(1–2) of Directive 2019/1023 requires MS to implement a suspension of the debtor's obligation to file for a declaration of insolvent liquidation proceedings during a stay of individual enforcement actions, and also a suspension of the creditors' right to request the opening of insolvent liquidation proceedings that could lead to the debtor's liquidation.

The Latvian legal framework is consistent with these provisions of Directive 2019/1023. Article 37(1) of the Insolvency Law prescribes the consequences of a stay of individual enforcement actions and prohibits the liquidation of a debtor for whom a stay has been initiated. **Under the existing system, creditors may not request the initiation of insolvent liquidation proceedings when a stay has been declared** and thus debtors already enjoy the necessary protections in this regard. Furthermore, Article 60(3) of the Insolvency Law provides that a debtor showing any of the signs of insolvency specified by Article 57 of the Insolvency Law is suspended from the obligation to file for insolvency when an agreement has been reached with the creditors or Formal Restructuring has been initiated. It can be concluded, therefore, that the national legal framework needs no further amendment to comply with Article 7(1–2) of Directive 2019/1023.

Article 7(3) of Directive 2019/1023 permits MS to derogate from the above provisions when the debtor is unable to pay its debts as they fall due. If this derogation is applied, it is mandatory to ensure the protection of other creditors if the insolvent liquidation proceedings, which lead to liquidation, are not in the general interest of creditors. The interests may be balanced by allowing the court to maintain a certain stay.

Implementing this derogation would certainly complicate the Latvian Debt Restructuring and insolvency system and cost resources for the legislature when implementing and fitting new amendments in the Insolvency Law. Because there are no practical issues or inefficiencies with applying the protections prescribed by Article 7(1–2) of Directive 2019/1023 and because the current national system has developed a balance in protecting the interests of creditors and debtors, **it is not advisable to implement this derogation**. This could still be further discussed in the working groups by developing the necessary models and impact reviews for such changes.

Article 7(4–5) of Directive 2019/1023 requires MS to prevent creditors from terminating, modifying or avoiding the performance of essential executory contracts or otherwise delaying the supply of necessary goods or services to the debtor simply because he is willing or starting to use a stay of individual enforcement actions or other Formal Restructuring instruments. Essential executory contracts are defined as executory contracts that are necessary for continuing the day-to-day operations of the business, including contracts for supplies, the suspension of which would cause the debtor's activities to come to a standstill.[79] MS are allowed to extend this requirement to non-essential executory contracts. Directive 2019/1023 also aims to protect debtors from *ipso facto* clauses that enable creditors to withhold performance or terminate, accelerate or, in any other way, modify executory contracts to the detriment of the debtor by virtue of a contractual clause providing for such measures, solely by reason of (a) a request for the opening of preventive restructuring proceedings; (b) a request for a stay of individual enforcement actions; (c) the opening of preventive restructuring proceedings; or (d) the granting of a stay as such.

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[79] Ben Schuijling "INSOL Europe Guidance Note on the Implementation of Preventive Restructuring Frameworks under EU Directive 2019/1023: Stay of individual enforcement actions*", (April 2020).* Available on: https://www.insol-europe.org/publications/guidance-notes. [Accessed May 1, 2020].

Such *ipso facto* clauses being invoked when the debtor is merely negotiating a Restructuring Plan or requesting a stay can adversely affect the debtor's business and the successful rescue of the business. It is necessary, therefore, to provide that creditors are not allowed to invoke these clauses.

Article 6 of the Insolvency Law describes the general principles to be observed by all the parties in Formal Restructuring and insolvent liquidation proceedings. These principles include prevention of arbitrariness, the principle of good faith etc. Articles 41 and 40(4)(14) of the Insolvency Law provide for compensating secured creditors for the limitation of their rights during Formal Restructuring. However, no provisions in the Latvian legal framework impose a direct restriction on creditors who seek to modify their relationship with the debtor when he pursues Formal Restructuring. In practice, these principles often remain unobserved and fail to adequately protect debtors, with no consensus among the Debt Restructuring practitioners and experts on whether such principles truly prohibit such behaviour.

This results in unfair prejudice from creditors as soon as the Formal Restructuring procedures are initiated; the suppliers (often unsecured creditors) on whom the business relies heavily, by monitoring their business partners, preclude debt cancellation, thus making Formal Restructuring impossible without interrupting the business itself.

Creditors on whom the debtor's economic activities rely frequently pressure and distort the debtor's economic activity (e.g. by not supplying manufacturing materials necessary for the continuation of activities) and thus handicap the Formal Restructuring procedures for the debtor. **Introducing Article 7 (4) and (5) of Directive 2019/1023 will address this issue to some extent.**

None of the countries consulted offered effective recommendations for successfully implementing Article 7 (4) and (5) of Directive 2019/1023 within their national legal frameworks, because simple rules are not enough. In practice, creditors tend to carry out individual activities running contrary to the interests of general creditors. Considering such behaviour, **creditors should be provided with extra benefits or safeguards that would encourage them not to take adverse actions against the debtor**. Such benefits could include, for example, tax breaks for goods and services purchased and sold to the debtor during the period of the debtor's Formal Restructuring.

> One of the suggestions made by the stakeholders for incentivising positive behaviour of creditors is to offer additional guarantees for goods and services supplied to the debtor within Formal Restructuring.

Also, a potentially significant role in protecting the debtor could be assigned to the Supervisor. In order for the Supervisor to effectively defend the debtor's interests from the beginning of the stay, his/her appointment should also be made at the very beginning of the stay. Although Directive 2019/1023 does not indicate that the appointment of Supervisor during the stay period is automatic, considering the issues identified in Latvian Formal Restructuring, in order to improve its quality and to decrease potential abuse of the stay period, it is advisable to appoint the Supervisor at the beginning of the stay. In that case, the Supervisor could be given the power to protect the debtor from creditors who carry out individual activities that are contrary to the interests of the general creditors. For example, after or even before becoming acquainted with the Restructuring Plan, the Supervisor could have responsibilities to evaluate and identify vital contracting parties whose mutual agreements are urgently needed for the debtor to continue its business activity. After identifying such essential business partners and agreements, the Supervisor should be given the power to notify the court, which after evaluation of the necessity, decides on the mandatory nature of the execution of these contracts by the creditors. If such a decision has been made, the debtor should provide compensation or additional safeguards to the creditors in return for limiting their rights during LPP.

Given the existing problem with creditors taking adverse actions against the debtor, an effective legal instrument for protecting the debtor from abusive individual actions should be found and evaluated. During the interviews, the experts identified the problem, but no effective solutions were proposed or even found in other jurisdictions.

The discussions between the experts and the authors of this report have led to a number of solutions. Given their rather restrictive nature, the following solutions should be further explored and could serve only as a starting point for future discussion. Where such a creditor terminates, accelerates or modifies an executory contract in any other way, the Supervisor or the Insolvency Practitioner (if Formal Restructuring turns into insolvent liquidation proceedings) may have the power, for example:

1) to initiate litigation without stamp duties, with a claim for damages from the creditors connected with individually made actions. The amount of loss should be presumed, such as, for example, the amount of the defaulted contract; or
2) with permission of the court, to limit the statutory creditors' rights or even remove a creditor from the debtor's list of creditors.

By raising the prestige of Formal Restructuring and increasing creditor confidence, which will only happen by increasing the implementation percentage and decreasing the number of abusive processes, this would also lead to fewer individual actions by creditors.

In view of the above, the implementation of Article 7 (4) and (5) of Directive 2019/1023 should be supplemented by other regulatory means, which could take the form of an earlier appointment of Supervisor and his/her subsequent expanded rights and involvement in protecting the debtor.

Netting Agreements

As emphasised in Recital 94 of Directive 2019/1023, the stability of financial markets relies heavily on financial collateral arrangements. Because the value of financial instruments given as collateral security may be very volatile, it is crucial to realise their value quickly before it goes down. This is why the provisions of Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements should apply notwithstanding the provisions of Directive 2019/1023.

Article 7(6) of Directive 2019/1023 permits MS to exempt netting arrangements, including close-out netting, on financial markets, energy markets and commodity markets,[80] from the effects of a stay of individual enforcement actions even where they are not covered by Directives 98/26/EC and 2002/47/EC and Regulation (EU) No 648/2012, if such arrangements are enforceable under the national laws when insolvency proceedings are opened. The exemption should not extend to contracts for the supply of goods, services or energy necessary for the operation of the debtor's business, unless such contracts take the form of a position traded on an exchange or other market, such that it can be substituted at any time at current market value.

However, the stay should apply to the enforcement by a creditor of a claim against the debtor, arising from the operation of a netting arrangement, i.e. once close-out netting has been carried out and the net balance defined.

A number of jurisdictions around the globe have adopted specific netting and close-out netting enactments for which International Swaps & Derivatives Association, Inc. (the ISDA) and other international institutions such as UNIDROIT have provided a regulatory framework and principles. According to a legal concept paper titled *Developing a Legal and Regulatory Framework for Hedging Instruments in Latvia: Introduction of Close-Out Netting Relevant for Derivatives and Repurchase Transactions* (2018), Latvia is among the last EU jurisdictions to not have fully implemented the close-out netting legislation.

The Latvian Financial Collateral Law provides that under close-out netting provisions, on the occurrence of an enforcement event, whether through set-off, netting or other activities comparable in terms of legal consequences: (1) the mutual obligations of the contracting parties are amended so that they become immediately due, and the amounts payable are specified by considering the current value of the initial obligations (or the mutual obligations are terminated and replaced with a reciprocal duty to pay the amounts determined by considering the current value of the initial obligations); and (2) the net balance is prepared, being the excess of the sum payable by one party over the sum payable by the other party.

In the absence of established court practice on the enforceability of close-out netting provisions, and for transactions not covered by the Latvian Financial Collateral Law, Latvian courts are likely to analogise close-out netting to contractual set-off, as this is the closest concept to netting.

Restrictions on set-off are not expressly recognised as being among the consequences of initiating Formal Restructuring prescribed by Article 37 of the Insolvency Law. However, Article 38(3) permits a set-off if the debtor's claim against the creditor has arisen at least three months before the court decision on the initiation of Formal Restructuring.

In the case of Formal Restructuring, the Insolvency Law allows a set-off even during the stay period, provided the debtor's claims against the creditor have arisen at least three months before the court decision on the initiation of Formal Restructuring. These rules would make the enforceability of close-out netting questionable if the commencement of Formal Restructuring is itself an enforcement event, as the claim for the net balance will only arise after the commencement of Formal Restructuring, and the three-month period would not be observed.

Moreover, if the Restructuring Plan provides for continuation of the netting arrangement, there is uncertainty as to whether the creditor can terminate the transactions and perform close-out netting based on the principles of creditor equality and prevention of arbitrariness under the Insolvency Law, which stipulate that a creditor may not perform individual activities against the debtor that harm the interests of the creditors in general.

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[80] Article 7(6)(1) and Recitals 94 and 95 of Directive 2019/1023. Ben Schuijling "INSOL Europe Guidance Note on the Implementation of Preventive Restructuring Frameworks under EU Directive 2019/1023: Stay of individual enforcement actions*", (April 2020).* Available on: https://www.insol-europe.org/publications/guidance-notes. [Accessed May 1, 2020].

In view of the above, *prima facie* the Latvian legal framework is partially consistent with Article 7(6) of Directive 2019/1023. Nevertheless, while the material regulation of netting arrangements, including close-out netting, should be subject to special legislation, a general reference may be added to the Insolvency Law, stating that it should apply to the extent that it is not in conflict with the Financial Collateral Law and any other national enactments that might regulate netting agreements.

The application of the stay period on different financial collateral arrangements should therefore be expressly regulated in those other legal acts or in the Insolvency Law so as to avoid legal uncertainty in the future even if there are no major practical issues in regard to collateral arrangements as of yet.

> Stakeholders have expressed their support for prescribing a period when during which a set-off is not permitted. At the same time. It has also been noted that the three-month prohibition period is a necessary rule that restricts the conclusion of fraudulent agreements before the initiation of Formal Restructuring. Stakeholders have also noted that the three month time months is a rather short time frame for achieving this goal.
>
> Also, in this context, stakeholders have mentioned a need to implement further measures which are aimed at preventing the fraudulent behaviour of directors during the stay of individual enforcement actions.
>
> One such solution offered by stakeholders for achieving this goal would be to allow the conclusion of netting agreements on the condition that other creditors are informed notified and have an opportunity to challenge such actions.

Introducing Article 7(6) of Directive 2019/1023 into the Latvian legal system should be further discussed in the working groups with substantive involvement of representatives of the regulated industries described in Article 7(6) of Directive 2019/1023 and considering the need for further development of the legal framework for close-out netting.

Article 7(7) of Directive 2019/1023 requires MS to prohibit a declaration of insolvent liquidation that could lead to the debtor's liquidation in cases of early termination of the stay.

Article 7(7) of Directive 2019/1023 has been partially introduced in the national legal framework. Under Article 51(2)(1) of the Insolvency Law, the court will terminate Formal Restructuring and initiate insolvent liquidation proceedings if the debtor's Formal Restructuring has been unsuccessfully initiated for the second time in a year. Preliminarily, this appears in line with Article 7(7) because one of the goals of the Insolvency Law is to prevent abuse of LPP and to ensure that a company in financial distress whose creditors are unwilling to compromise is not pushed into insolvent liquidation. It is also important not to allow the debtor to constantly initiate LPP and to enjoy formal protection where the debtor's assets would lose their value or where the debtor could create an even larger debt sheet and not pay off the existing debt. **The court should additionally establish at least one more sign of insolvency specified by Article 57 of the Insolvency Law in order to declare the debtor insolvent. In that case, the requirements of Directive 2019/1023 would be fully met.**

g. Recommendations

- Restrictions should be introduced in the Insolvency Law to prevent withholding of performance or termination, acceleration or some other way of modifying executory contracts to the detriment of the debtor by virtue of a contractual clause relating to Formal Restructuring and any related stay, and to render any purported reliance on such a clause null and void, requiring the contracting party to continue performing its obligations under the contract as if the clause had no effect. Protection for essential executory contracts should also be introduced.
- Protecting the debtor from contracting parties who purport to terminate executory contracts, or fail to perform their obligations under contracts in breach of the amended Insolvency Law, could be assigned to the Supervisor, acting on the debtor's behalf, who would have extended rights.
- Since Latvian legislation has not fully introduced netting arrangements, including close-out netting, and may not fully exempt such arrangements from the effects of a stay of individual enforcement actions in LPP and insolvent liquidation, the issue should be further evaluated in consultation with representatives of the regulated industries to ensure sufficient protection of financial markets.
- If Formal Restructuring has been initiated for the second time in a year but is not declared, the court should be required to establish at least one other sign of insolvency apart from subsequent failures to declare Formal Restructuring. The creditors' right to file for liquidation should be reinstated immediately after such subsequent rejection by the court.

8 Restructuring Plans

8.1 Content of the Restructuring Plan

Article 8 of Directive 2019/1023 lays down content requirements for Restructuring Plans, while Article 8(1) lists the details that a Restructuring Plan must include:

Table 5 Overview of the legal framework of the content of the Restructuring Plan and recommendations to amend it.

Requirements	Status of Latvian Law
The debtor's identity	Such provision is included in Article 341.2(1)(1) of the Civil Procedure Law and in Article 40 of the Insolvency Law. **Therefore**, no additional amendments **to** the law are necessary.
The debtor's assets and liabilities at the time of submitting the Restructuring Plan, including a value of the assets	Provision for liabilities is included in Article 40(4)(1) of the Insolvency Law, however provision for assets is not included in Latvian law,[81] and **the law should therefore be amended**.
Description of the debtor's economic situation and the position of workers	Such provision is not included in Latvian law, and **the law should therefore be amended**.
Description of the causes and extent of the debtor's difficulties	Although Latvian law does not expressly provide that the debtor should include such information in the Restructuring Plan, in practice all debtors usually include such a description. Thus, **the Insolvency Law should be amended** to meet this requirement of Directive 2019/1023.
Affected parties, whether named individually or described by debt categories, as well as their claims or interests covered by the Restructuring Plan	Such provision is included in Article 40(4) of the Insolvency Law. **Therefore**, no additional amendments to the law are necessary.
Classes into which the affected parties have been grouped for the purpose of adopting the Restructuring Plan, and the values of claims and interests in each class	Such provision is included in Article 40(4) of the Insolvency Law. **Therefore**, no additional amendments to the law are necessary if the existing creditor class structure remains (please note that **Insolvency Law would have to be amended if new classes of creditors are introduced in the future).**
Parties unaffected by the Restructuring Plan, together with a description of reasons why it is proposed that they should not be affected	The current Latvian Formal Restructuring rules provide that all creditors must be covered by a Restructuring Plan, including any creditor claims to be satisfied after the deadline for implementing the Restructuring Plan. Please see below an analysis of the concepts of affected and unaffected creditors in the Latvian Formal Restructuring framework.
Identity of the practitioner in the field of restructuring	Such provision is included in Article 40(4) of the Insolvency Law. **Therefore**, no additional amendments to the law are necessary.

[81] Article 40(4)(13) of the Insolvency Law lists the debtor's pledged assets that are necessary for implementing the Restructuring Plan and to which restrictions are applicable, in accordance with which the secured creditors may not execute their right in respect of the debtor's property, which serves as security for the claims thereof until termination of the legal protection proceedings.

Duration of the Restructuring Plan, including in particular:	Such provision is included in Article 40(4) of the Insolvency Law. **Therefore**, no additional amendments to the law are necessary.
(i) any proposed restructuring measures;	Such provision is included in Article 40(4) of the Insolvency Law. **Therefore**, no additional amendments to the law are necessary.
(ii) the proposed duration of any proposed restructuring measures;	Such provision is included in Article 40(4) of the Insolvency Law. **Therefore**, no additional amendments to the law are necessary.
(iii) arrangements for informing and consulting employees' representatives in accordance with Union and national law;	Such provision is not included in Latvian law, and **the law should therefore be amended**.
(iv) overall consequences for employment, such as dismissals, short-term working arrangements or similar;	Such provision is not included in Latvian law, and **the law should therefore be amended**.
(v) the debtor's estimated financial flows;	Such provision is included in Article 40(4)(5) of the Insolvency Law. **Therefore**, no additional amendments to the law are necessary**.**
(vi) any new financing anticipated as part of the Restructuring Plan, and the reasons why the new financing is necessary for implementing the Restructuring Plan.	Such provision is included in Article 40(4)(6) of the Insolvency Law. **Therefore**, no additional amendments to the law are necessary**.**
A statement of reasons why the Restructuring Plan has a reasonable prospect of preventing the debtor's insolvency and securing the viability of the business, including the necessary preconditions for the success of the Restructuring Plan.	Such provision is formally included in Latvian law. However, **amendments to the law are needed** (for a more detailed analysis, see the analysis directly below this table).

Article 8(1) (h) of Directive 2019/1023 imposes an obligation on MS to include in the Restructuring Plan a statement of reasons which explains why the Restructuring Plan has a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business, including the necessary pre-conditions for the success of the Restructuring Plan. MS may require that that statement of reasons be made or validated either by an external expert or by the practitioner in the field of restructuring if such a practitioner is appointed.

Latvian law has a formal requirement under Article 43 of the Insolvency Law that requires the Supervisor to form an opinion on whether, in his/her opinion, the Restructuring Plan meets the formal requirements of the Insolvency Law. In practice, such opinion by the Supervisor includes an evaluation of whether **the Restructuring Plan meets the formal requirements of law and a formal evaluation of viability of the business.** It should be noted that an evaluation of the business under Article 8(1)(h) of Directive 2019/1023 is not considered a viability test mentioned in Article 4 of Directive 2019/1023.

The Restructuring Plan should be created as **a viable business plan with sound financial calculations. In practice, it should be developed as a real business Restructuring Plan or at least it should include criteria for analysis from a business perspective and a review of viability and cash flows performed by an experienced expert in order for the Supervisor to reach their opinion**. This would, of course, make LPP more complex and expensive, and possibly less accessible, but this would make debtors prepare a robust Restructuring Plan, which is in the interests of the debtor, the creditors and the courts.

The costs of LPP are cited among the reasons why Restructuring Plans are of poor quality and have no business perspective. A large proportion of Latvian commercial entities are SMEs where Formal Restructuring proceedings are too complicated and expensive to deal with in a financial distress situation. Thus, **Restructuring Plans lack the quality required to achieve the objective of restoring solvency.**

The poor quality of the Restructuring Plan can be due to the lack of subjective and qualitative requirements under Latvian law for a Supervisor's education and previous experience (for a detailed analysis please see the section *Practitioners in restructuring, insolvency and debt discharge procedures and supervision and remuneration of practitioners*). Currently under Latvian law, almost any person without a business or economic background can be a Supervisor. It is therefore likely that such a Restructuring Plan has not been evaluated from a business perspective. **As this process is very formal in practice, the objective of Directive 2019/1023 cannot be met without adopting it in the legal system.**

The second subparagraph of Article 8(1)(h) permits MS to require that a statement of reasons should be made or validated **either by an external expert** or by a practitioner in the field of restructuring if one is appointed. Adopting this provision could solve the problem of the low quality of Restructuring Plans and consequently the overall failure of LPP. **It is recommended that Latvian law should include such provision.**

Article 8(2) of Directive 2019/1023 requires MS to make a comprehensive checklist for Restructuring Plans available online, adapted to the needs of SMEs. Although some tools are available on the ICS website (http://mkd.gov.lv/lv/link_part_166), **they are not sufficient to recognise the Latvian law as fully consistent with Article 8(2) of Directive 2019/1023.**

It would be very beneficial especially for SMEs if comprehensive online tools where made available. Because the drafting of a Restructuring Plan is still one of the most expensive components of Formal Restructuring, an online platform offering easy-to-use Restructuring Plan templates for SMEs would make Formal Restructuring far more accessible. The relatively simple structure of SME debts would make such an idea possible in practice as Restructuring Plans could form rather simple templates and would not require comprehensive investment.

As most of the enterprises in Latvia are SMEs, these tools should be easy to use and practical. Such tools could also include guidance on how to develop workable business plans. It should be noted, however, that Restructuring Plans would still have to be prepared by professionals, especially the financial part of a Restructuring Plan that ensures viability of the business. this recommendation would make the Latvian legal system consistent with Article 8(2) of Directive 2019/1023. These tools could potentially be published on the ICS website as a platform offering the most relevant and up-to-date information on the relevant field.

8.1.1 Affected and unaffected creditors

Table 5 above shows that the debtor must include information in the Restructuring Plan to distinguish between affected and unaffected creditors. It would be necessary here to analyse how the Latvian legal framework regulates the concepts of affected and unaffected creditors.

While no Article in Directive 2019/1023 (including Article 8) expressly requires MS to introduce Formal Restructuring procedures and "unaffected creditors," this requirement can be indirectly deduced from the overall aim of Directive 2019/1023.

Directive 2019/1023 provides a definition of "affected parties" in Article 2(1)(2), which reads as follows: "affected parties" means creditors, including, where applicable under national law, workers, or classes of creditors and, where applicable, under national law, equity holders, whose claims or interests, respectively, are directly affected by a Restructuring Plan.

An "unaffected" party is simply a person on whose rights the Restructuring Plan has no effect, or at least no direct effect.82 Recital 39, for example, provides that debtors should be able to fully satisfy the claims of unaffected creditors without subjecting them to restructuring, while Recital 43 provides that unaffected creditors should not have voting rights in adopting a Restructuring Plan.

Keeping this in mind, the Insolvency Law does not contain a concept of affected and unaffected creditors as evidenced by the content of the following provisions of the Insolvency Law. Article 40(1) of the Insolvency Law provides that a Restructuring Plan must name all creditors, and the debtor cannot choose which creditors to exclude (see also Latvian Supreme Court Civil Division ruling SPC-38-2013 of 11 September 2013). Article 42(1) of the Insolvency Law provides that in LPP, the debtor cannot independently exclude a creditor's claim as invalid because this would create the risk of creditors being unfairly excluded from the Restructuring Plan (see also Latvian Supreme Court Civil Division ruling SPC-28-2014 of 30 September 2014). **It can be concluded, therefore, that the Insolvency Law does not permit the recognition of unaffected creditors as such**.

Moreover, Paragraph 4 of Article 38(4) of the Insolvency Law provides that a Restructuring Plan may affect workers' claims with their prior consent, but creditor status is not conferred on them. However, these provisions are certainly not sufficient for concluding that the legal system meets the requirements of Directive 2019/1023.

[82] See Recitals 39 and 43 of Directive 2019/1023 and Tomas Richter and Adrian Thery, "INSOL Europe Guidance Note on the Implementation of Preventive Restructuring Frameworks under EU Directive 2019/1023: Claims, Classes, Voting, Confirmation and the Cross-Class Cram-Down", (April 2020). Available on: https://www.insol-europe.org/publications/guidance-notes. [Accessed May 1, 2020].

Future reforms of the Insolvency Law could address the lack of these concepts and bring benefits to the current legal framework. Allowing derogations from the universal application of a Restructuring Plan could give more flexibility to Debt Restructuring in general and would allow Restructuring Plans to be tailored to each individual case of financial distress. It is evident that under some circumstances not all debts must be restructured and that applying the Restructuring Plan to a specific class of creditors might be enough to alleviate the debtor and not unnecessarily affect other creditors. It could also speed up the Formal Restructuring procedure in general by simplifying and giving more flexibility to the voting process. With additional flexibility Formal Restructuring could become more effective both in terms of cost and time.

In practice, if the concept of unaffected creditors were to be introduced in the Latvian legal system, debtors with financially detrimental debts from, for example, financial creditors (credit institutions) could propose that the Restructuring Plan should apply specifically to this class of creditors, leaving suppliers, business partners and other creditors outside the scope. In such situations, it could very well be that restructuring only the debts of some credit institutions is enough to avert the debtor's insolvent liquidation where the debtor may be able to continue paying the claims of other creditors.

While not being universal, the concept of unaffected creditors exists in other European countries. Some legal systems may contain alternative interpretations that differ from the spirit and goals of Directive 2019/1023.

Portugal

Is there a concept of "unaffected creditors," meaning that some creditors are not affected by debt restructuring?

Although undefined in the Portuguese legal system, similar mechanisms to those envisaged by Directive 2019/1023 can be identified in the *Regime Extrajudicial de Recuperação de Empresas* procedure.

Under Portuguese law, a debtor may pick and choose creditors with whom to negotiate the Restructuring Plan, which becomes binding only on those creditors. Nevertheless, the participating creditors must together represent at least 15% of all claims.

Under the procedural requirements, the debtor first makes a proposing protocol which then has to be approved by 15%. The debtor must also provide an accountant's or auditor's opinion which states that the debtor is indeed subject to financial distress and is recoverable. After this has been done, the debtor must deposit the negotiation protocol, and negotiations can begin (taking no longer than three months). Next, the debtor must present a financial diagnostics document, the Restructuring Plan can be signed, and the closing of negotiations must be registered with the Portuguese institution responsible for SME competitiveness and innovation (*Instituto de Apoio às Pequenas e Médias Empresas e à Inovação*).

These negotiations are confidential and do not affect the debtor's reputation and might even offer fiscal benefits.

In the Special Revitalisation Proceedings, different measures can be envisaged for different creditor classes, and it may even happen that some classes are not covered by any measure.

However, the Restructuring Plan must abide by the principle of creditor equality, which means, for instance, that creditors whose claims were recognised as secured cannot be treated differently between each other (unless they accept a differentiated treatment, which is presumed if the creditor votes for the Restructuring Plan) but they can be subject to a different treatment than the remaining creditors that are not included in the same class.

Czech Republic

Is there a concept of "unaffected creditors," meaning that some creditors are not affected by debt restructuring?

As for affected and unaffected creditors, Czech law offers a different interpretation to the one presented in Directive 2019/1023.

While Directive 2019/1023 gives the debtor a choice to apply a Restructuring Plan only to some creditor classes, Czech law provides that all claims must be filed and processed. However, certain creditors are grouped into a separate class of "unimpaired" claims, where they are not affected by the Restructuring Plan (no change in their amount, due date or any other characteristic) and are considered to have voted in favour of the Restructuring Plan.

Spain

Is there a concept of "unaffected creditors," meaning that some creditors are not affected by debt restructuring?

Spanish insolvency law was first familiarised with the concept of unaffected creditors in 2013 and additional reforms in 2015 further cemented the concept in the Spanish debt restructuring framework.

Voluntary bilateral agreements are concluded between the debtor and creditors that agree to be affected by the Restructuring Plan. Creditors that are not party to the agreement remain unaffected. Affected creditors have something to gain from such agreements. They may benefit from further securitisation of their claims or receive any other benefit available under the individualised agreement if the debtor later becomes insolvent and the Restructuring Plan is confirmed by the court.

While being applicable to debtors of all types, in practice such agreements are usually concluded between large enterprises and their financial creditors. Their usage rate remains low, the main reason being that debt restructuring in general is initiated too late and because the agreements are designed for large enterprises while the Spanish business environment mostly consists of SMEs.

France

Is there a concept of "unaffected creditors," meaning that some creditors are not affected by debt restructuring?

In the French safeguard procedure, creditors are separated into three distinct classes: (i) the financial institutions committee; (ii) the major trade creditors committee; and (iii) the bondholders' group.

The two committees and the bondholders' group are asked to vote on the draft safeguard plan proposed by the company (including debt restructuring, recapitalisation of the company, debt-for-equity swaps etc) at two-thirds majority (by value) for each class.

If the committees do not vote on the draft safeguard plan within six months from the date of the opening judgment, or if a majority refuse to adopt the Restructuring Plan after a vote, the creditors may consult individually or collectively. If the creditors have agreed to grant longer payment terms or remission of debt, the commercial court will recognise the existence of such terms. The commercial court may impose longer payment terms on creditors who did not agree to any longer payment terms or remission of debt (but in that case the safeguard plan or payment reschedule cannot last longer than ten years).

In comparison, in preventive proceedings ("mandate ad hoc" and "conciliation") debtors define the scope of affected creditors, i.e. debtors choose the parties with whom to renegotiate the existing debt.

The French accelerated financial safeguard proceedings (applicable to debtors with financial debt issues) *de facto* exclude all creditors that are not financial creditors, this being the nature of the proceedings rather than the choice of debtors themselves. Also, in accelerated safeguard proceedings and rehabilitation proceedings, a three-class creditor structure is applied, without foreseeing unaffected creditors.

Importing the concept of unaffected creditors into the Latvian legal framework could, however, have potential drawbacks, one being that the necessary legislative changes might cost considerable resources, in part because such a systematic impact on the national legal system requires extensive prior research.

Nevertheless, the concept of unaffected creditors and the possibility of Restructuring Plans not affecting all creditors should be introduced. Consequently, because the concept of unaffected creditors is foreign to the Latvian legal system, the analysis in this report does not evaluate or distinguish between affected and unaffected creditors, and some conclusions and recommendations could be subject to change if this concept were to be introduced in the future.

> A possible solution to the concept of affected and unaffected parties has been expressed in the opinion of stakeholders. The proposal suggests retaining the universality in applying Restructuring Plans to all creditors, since doing otherwise could increase the risks of fraudulent preferences and the reputation of Formal Restructuring could suffer. Some exceptions could still be prescribed by the Insolvency Law.
>
> One such class of unaffected creditors could comprise essential creditors (vital to the debtor's commercial activity). Another class could be small creditors whose claims are more expensive to manage in Formal Restructuring – these creditors could also remain unaffected by Formal Restructuring. Any such exceptions to the norm should be based on clear statutory criteria.

As stated in Key Finding 21, Latvian law does not permit a Restructuring Plan to run more than two years even where this is contrary to business logic. Directive 2019/1023 does not impose a time frame on the execution of a Restructuring Plan since a longer period may be needed to reschedule any debts. According to the proposed approach, where qualified experts (Supervisors) may draw up a Restructuring Plan, in order to reduce obstacles to Formal Restructuring and execution of the Restructuring Plan, the law should permit execution of the Restructuring Plan for a period of more than two years.

h. Recommendations

- The Insolvency Law should be amended to provide that a Restructuring Plan must include a statement of reasons why the Restructuring Plan has a reasonable prospect of preventing the debtor's insolvency and securing the viability of the business, including the necessary preconditions for the success of the Restructuring Plan.
- A comprehensive checklist for Restructuring Plans should be created.
- An online platform should be introduced to make various tools for handling information about Debt Restructuring available to debtors.
- Further amendments to the Insolvency Law should be considered with a view to introducing the concept of unaffected creditors, who should be neither included in the Restructuring Plan nor allowed to vote on it. The debtor should be required to state the reason for excluding certain creditors.

8.2 Adoption of the Restructuring Plan

Article 9 of Directive 2019/1023 contains mandatory and optional provisions for adopting and voting on Restructuring Plans, including the rights of subjects, possible creditor classes, and a possible voting verification procedure.

Article 9(1) of Directive 2019/1023 requires MS to ensure that debtors have the right to submit a Restructuring Plan to all affected parties.

Article 42 of the Insolvency Law provides that a debtor must make the Restructuring Plan available to all creditors, seek their approval, and specify a time limit for this.

Under this provision, the debtor seeks approval for the Restructuring Plan from all creditors (employees do not acquire creditor status under Article 38 of the Insolvency Law). All creditors must be included in the Restructuring Plan, whether or not the debtor's claim is in dispute, so all creditors must be informed about the Restructuring Plan and must receive a copy of it. As the debtor has to propose the plan to all creditors, **Article 9(1)** can be interpreted **to have been partially introduced in the Latvian framework, as the Restructuring Plan under Directive 2019/1023 has to be proposed to affected creditors only**.

The Insolvency Law does not refer to or consider other parties that might be affected or unaffected by the Restructuring Plan since voting rights are given to creditors only. The Insolvency Law contains no directly comparable provisions where the concept of affected or unaffected parties is considered, although future reforms could change this (as discussed above at section *"Affected and unaffected creditors* above").

This calls for further discussions and evaluations since it can be concluded that the current provisions of the Insolvency Law are partly consistent with Article 9(1) of Directive 2019/1023: debtors have a right (versus an obligation under the Insolvency Law) to submit the Restructuring Plan to all affected parties (under the Insolvency Law meaning only creditors and employees where their claims are indeed affected) but do not have a right to select persons to whom the Restructuring Plan applies.

Debtors often fail in practice to include all creditors in Restructuring Plans, and lower courts fail to evaluate whether all creditors have been included, despite the existing requirement under Latvian law to seek approval from all creditors. This has seriously affected the rights of otherwise sound claims from existing creditors on multiple occasions.

Latvian Supreme Court Civil Division ruling SPC-5/2015 of 20 February 2015

A creditor alleged that another fictitious creditor had been created in LPP for the purpose of receiving approval for a Restructuring Plan. The lower court had not reviewed the allegation and had not investigated whether any fictitious transactions had been made for the purpose of creating a fake creditor.

In this judgment, the court identified two goals of the LPP: (i) to promote restoration of the debtor's solvency; and (ii) to protect the interests of creditors. The court further declared an agreement between the debtor and creditors on measures intended for restoring the debtor's solvency as a basis for the LPP.

Two key elements are necessary for the LPP to succeed: (i) a clear and realistic Restructuring Plan has to exist for how the debtor, burdened by debts, can again make a profit, and (ii) the creditors have to support continuation of the debtor's business and not only believe in its viability but be ready to restructure their claims. From a practical viewpoint, the LPP has a chance of success only if major creditors are involved in saving the debtor and if there is trust between the parties.

The court further noted its obligation to review not only the Restructuring Plan and the Supervisor's opinion but also any creditor objections.

The court has to review whether the debtor acted in good faith when filing for LPP, especially when such review is sought by a creditor. The court also has to determine whether actual claims exist between the creditors and the debtor so as to disallow any fictitious transactions.

Latvian Supreme Court Civil Division ruling SPC-28/2014 of 30 September 2014

LPP had been initiated for a debtor who had failed to include a creditor in the Restructuring Plan. There was a dispute over whether the ignored creditor actually had any claims against the debtor and whether the ignored creditor should have been recognised.

The lower court had sided with the debtor's opinion and accepted the debtor's information that a mutual agreement had been made between the debtor and the ignored creditor for the cancellation of debt. The lower court had failed to indicate which legal sources and evidence had been used to reach this conclusion.

The debtor's accounting records contained no evidence to prove that the debts had indeed been cancelled. Accordingly, the lower court had been wrong in initiating LPP and concluding that the Restructuring Plan complied with the applicable legal norms and had been properly submitted and approved.

Latvian Supreme Court Civil Division ruling SPC-27/2014 of 31 October 2014

The number of a secured creditor's claims had been significantly reduced in two separate LPPs without his prior consent. Consequently, the creditor's rights had been breached, which stipulate that a secured creditor's consent must be obtained before reducing his claim as a tool for restoring the debtor's solvency in LPP.

Latvian Supreme Court Civil Division ruling SPC-7/2015 of 24 March 2015

The debtor had failed to consider all creditors in LPP by ignoring an ongoing dispute at the time of drafting the Restructuring Plan and thus breached the non-discrimination principle which does not permit debtors to pick and choose creditors.

Latvian Supreme Court Civil Division ruling SPC-0017-15 of 28 December 2015

A creditor alleged that another fictitious creditor had been created in LPP for the purpose of receiving approval for a Restructuring Plan. The lower court had not reviewed the allegation and had not investigated whether any fictitious transactions had been made for the purpose of creating a fake creditor.

The Insolvency Practitioner's opinion had also dismissed the creditor's allegation and argued that the fake creditor's claim indeed existed because it had been confirmed by an arbitration award. The Supreme Court overruled the lower court's judgment.

These examples show that although the law includes certain provisions which guarantee the rights of all creditors in the Formal Restructuring procedure, in certain cases this does not work adequately in practice. This can be due to the restructuring culture in Latvia as evidenced by the fraudulent actions of debtors, and due to the inability of courts and other institutions to tackle such offences because of inadequate resources and/or specialisation and expertise.

The second subparagraph of Article 9(1) of Directive 2019/1023 permits MS to provide that creditors and Supervisors may submit a Restructuring Plan to the debtor. MS may provide conditions under which they may do so. In general, the Latvian legal framework does not prohibit the creditor from drafting the Restructuring Plan, but in practice it is the debtor who develops the Restructuring Plan and proposes it to the creditors.

Under Article 107(1) of the Insolvency Law, creditors may draft the Restructuring Plan and submit it to the court for approval only during insolvent liquidation proceedings. If the debtor is not declared insolvent, there is no option for creditors or experts to file for Formal Restructuring, and no procedures or conditions are specified.

The initiative with Formal Restructuring could be taken by creditors, but rather as an early warning or request for the debtor to pay attention to his obligations and possible Formal Restructuring. Such messages from the creditors should have a purely informative character. Most successfully these would take the form of a template message, warning the potential debtor not of his duties to pay debts to the sending creditor but instead of the potential risks associated with having unsustainable debt with a possible need to restructure. The receiving debtor would benefit from an additional early warning tool, while the sending creditor could stimulate the debtor's financial discipline, promoting the repayment of his debt.

Under the Insolvency Law, once a Restructuring Plan is drafted, all creditors have the right to vote on it, except for persons who have a certain status in relation to the debtor. The creditors who can vote on the Restructuring Plan are divided into two classes: secured and unsecured. Voting on the Restructuring Plan takes place separately within each class.

Article 9(2) of Directive 2019/1023 requires MS to ensure that parties that are not affected by a Restructuring Plan should not have voting rights in adopting it. From the analyses of Article 38 (4) and (8), unaffected parties without voting rights are employees[83] if the Restructuring Plan does not affect their rights, and voting rights should not be granted for the costs of Formal Restructuring nor in respect of the sanctions laid down by the Latvian Administrative Violations Code[84] and the Criminal Law. **It can be concluded that the Insolvency Law partially conforms with Article 9(2) since the Insolvency Law does not recognise the concept of unaffected parties as such (see analysis in the chapter *"Affected and unaffected creditors"* above).**

Article 9(3) of Directive 2019/1023 provides that voting rights in adopting a Restructuring Plan may be denied for (i) equity holders; (ii) creditors whose claims rank below the claims of ordinary unsecured creditors in the normal ranking of liquidation priorities; and (iii) any party related to the debtor or the debtor's business, with a conflict of interest under national law.

Certain affected parties lack voting rights in Latvia. The Insolvency Law first and foremost prescribes a general principle that only those persons with creditor claims can vote on a Restructuring Plan. For this reason, also, for example, equity holders without creditor claims cannot vote on the adoption of Restructuring Plans.

Under Article 42 (3) and (6) of the Insolvency Law, the following persons are not allowed to exercise creditor rights in approving Formal Restructuring: 1) persons incorporated in one group of companies with the debtor; 2) natural persons who as shareholders have a decisive influence on the debtor; 3) persons who have acquired a claim against the debtor from the above persons in the last two years before the Restructuring Plan was approved. Also, voting rights are granted only to the creditors' principal debt claims (side claims are not counted in the vote).

It can be concluded, therefore, that the Latvian legal system already excludes some of the affected parties prescribed by Article 9(3) of Directive 2019/1023 from voting but has a much narrower scope of application. It should therefore be evaluated whether those not currently excluded should also be subject to such restrictions. More specifically, it should be considered whether *all* equity holders with a creditor claim and with a decisive influence over the debtor, and persons with a conflict of interest (e.g. the debtor's representatives and interested parties pursuant to Chapter XII of the Insolvency Law) should also be prevented from voting on the Restructuring Plan.

Such exclusions should be considered and further evaluated because not having such exclusions increases the risk of abuse and lowers the protection of creditors who should have the most say in adopting a Restructuring Plan.

Under Article 9(4) of Directive 2019/1023, creditors should be separated into different classes according to their commonality of interest. As a minimum, creditors of secured and unsecured claims should be treated in separate classes. Under Article 42(2) of the Insolvency Law, voting on Formal Restructuring must take place separately within the following groups of creditors: 1) secured creditors in the secured part of their claims; 2) non-secured and secured creditors in the unsecured part of their claims. **Accordingly, the obligation has been introduced in the national legal framework.**

[83] See further analysis of the status of employees in Formal Restructuring in Chapter 7.2 Stay of individual enforcement actions.

[84] The Latvian Administrative Violations Code ceased to apply from 1 July 2020 and has been replaced by a new law. Administrative offences will be codified into different laws.

Article 9(4) of Directive 2019/1023 permits MS to create an additional creditor class for employees. It is worth noting that under Article 38 of the Insolvency Law, the methods to be applied in legal protection cannot affect employees for work remuneration without their consent. Also, as described in the section *Workers and their rights* of this report, workers' claims are sufficiently safeguarded. It is PwC's view, therefore, that creating a separate creditor class for employees would not have a significant impact since their wages are sufficiently protected. Also, there is no real possibility of this having a significant impact on the viability of a Restructuring Plan since workers tend to accept it if their wages are not affected.

Article 9(4) of Directive 2019/1023 permits MS to give SMEs the option of not treating parties affected by Formal Restructuring in separate classes. Also, according to Recital 45, SMEs may be exempted from treating affected parties in separate classes. In practice, this could create situations where the two existing classes of creditors in Latvia (secured and unsecured) are merged into one. However, as will become evident further, the Latvian legal system should not give SMEs such additional flexibility.

This approach was already established in the previous Insolvency Law of 01.11.2007. Under Article 46.1 of the 01.11.2007 Insolvency Law (ceased to apply from 01.11.2010), unsecured and secured creditors were not separated into classes, so a simple majority of creditor basic claims were needed to confirm the Restructuring Plan. As a result, fictitious unsecured creditors were formed, who overvoted other real creditors. Learning from these past lessons, it is not desirable to reintroduce earlier practices.

The last requirement of Article 9(4) of Directive 2019/1023 is that MS must adopt appropriate measures to ensure that classes are formed with a particular view to protecting vulnerable creditors such as small suppliers.

Article 38 (8) and (2) of the Insolvency Law requires that within a class of creditors and for each type of creditor claim (principal debt, penalty, or interest), the Restructuring Plan may only provide for proportional repayment or reduction of the principal debt, penalty, or interest. Article 40 of the Insolvency Law also imposes a restriction on significantly unfavourable provisions, which may be applied only with the consent of the creditor concerned.

From the joint analysis of the cited provisions, including principles of LPP, such as the principles of preservation of rights, creditor equality, prevention of arbitrariness, honouring of obligations and good faith, which are set forth under Article 6 of the Insolvency Law, the national legal framework for protecting vulnerable creditors such as small suppliers is sufficient. Also, this issue did not arise in interviews with the stakeholders, so **PwC does not see the necessity to create an additional class for small suppliers.**

Article 9(5) of Directive 2019/1023 requires the court to verify voting rights and the formation of classes. This obligation is covered by Article 341.6(3)(2) of the Civil Procedure Law, so it is fully implemented.

Article 9(5) of Directive 2019/1023 permits MS to require the courts to verify voting rights and the formation of classes at an early stage, even before the Restructuring Plan has been submitted to the court. At the moment, the voting and justification of creditor claims are sufficiently evaluated by creditors, the Supervisor, a sworn auditor (when required by law) and by the court. The authors of this report consider, therefore, that this provision should not be introduced in the national legal framework.

Article 9(6) of Directive 2019/1023 determines the voting arrangements and the quorum required to support a Restructuring Plan in each class. **This obligation has been introduced in the national legal framework under Article 42(3) of the Insolvency Law,** which prescribes how a Restructuring Plan should be approved. More specifically, the Restructuring Plan is approved if the following majorities of creditors in each class vote in favour by signing their consent:

1) Secured creditors whose total principal claims make up two-thirds of the total sum of principal claims of all secured creditors;

2) Unsecured creditors whose total principal claims make up more than half of the total sum of principal claims of unsecured creditors.

Currently creditors can vote by giving their consent in any written form, with no formal voting procedure required. In other words, the debtor is required to obtain approval from the majority of creditors by any means. Accordingly, **Article 42(3) of the Insolvency Law is consistent with Article 9(7) of Directive 2019/1023, which permits MS to provide that a formal vote on adopting a Restructuring Plan may be replaced by an agreement with the requisite majority.**

In general, the Latvian legal framework is consistent with the provisions of Directive 2019/1023. Nevertheless, the adoption of Formal Restructuring when the support of the SRS and other governmental institutions is needed may be difficult or sometimes impossible for the following reasons:

1) the bureaucratic burden within the legal time frame in which the institutions are able to take an appropriate decision on the Restructuring Plan;

2) the authorities and other creditors do not always act as a reasonable member of the business community would have acted, i.e. according to the stakeholders, there have been cases where the authorities and other creditors have not given their consent or even any reply to a reasonable and workable Restructuring Plan, which led to it not being approved.

Another issue related to the voting procedures is the substantial asymmetry of information between the parties. Because Formal Restructuring is a very complex process, especially from a financial standpoint, there are often numerous fraudulent opportunities available to the parties, which might remain unobserved by the court and administrative authorities.

To mitigate this risk and to make the involvement of courts more useful and effective, the judges should have the opportunity to consult dissenting creditors by asking them to produce motivated justification for their dissent. These could reveal not only shortcomings in the Restructuring Plans but also other matters deserving of further investigation. The resulting amendments to the Insolvency Law would not seriously burden the creditors (it being optional for the dissenting creditor to cooperate) and would simply expand the toolkit of courts, potentially giving them access to more information that could be used to substantiate their decisions on the approval of Restructuring Plans.

The option of making these justifications mandatory for public creditors could be explored. This would produce higher levels of confidence in the Latvian business community that their attempts have been truly evaluated and would improve trust in public institutions like the SRS. Having more available information, it would be easier for the judges to make informed decisions on the viability and conformity of Restructuring Plans.

It should nonetheless be made clear that the main responsibility of the courts should be to perform the viability and evaluation tests prescribed by Directive 2019/1023 and that such additional information should only supplement those decisions.

i. Recommendations

- It is advisable to evaluate the procedures for seeking and receiving approval for a Restructuring Plan from the SRS and other institutions whose review process is too lengthy and cumbersome. State creditors should accelerate their decision-making on Formal Restructuring.
- To help the court form an opinion on granting a cross-class cram-down, the court should be authorised to invite dissenting creditors to state their reasons in writing, or at a court hearing, for dissenting from approval of the Restructuring Plan.
- The Insolvency Law should not limit the time frame for the initial execution of a Restructuring Plan, and the existing two-year cap should be lifted.
- The Insolvency Law should provide that any parties that are not affected by a Restructuring Plan should not have voting rights in adopting it.
- SMEs should not be exempted from the requirement for treating creditors in separate classes.

8.3 Confirmation of the Restructuring Plan

Article 10(1) of Directive 2019/1023 requires MS to implement judicial confirmation of Restructuring Plans which (i) affect the claims or interests of dissenting affected parties; (ii) provide for new financing; and (iii) involve the loss of more than 25% of the workforce, if such loss is permitted under national law.

Article 10(2) lists conditions that must be met for the Restructuring Plan to be confirmed. Under Article 10(2) (i), Restructuring Plans must be adopted in accordance with the rules prescribed by Article 9; (ii) creditors with sufficient commonality of interest in the same class should be treated equally and in a manner proportionate to their claim; (iii) notification of the Restructuring Plan has to be given in accordance with national law to all affected parties; (iv) where there are dissenting creditors, the Restructuring Plan has to satisfy the best-interest-of-creditors test; and (v) where applicable, any new financing is necessary to implement the Restructuring Plan and does not unfairly prejudice the interests of creditors.

Applying the best-interest-of-creditors test ensures that no dissenting creditor is worse off under the Restructuring Plan than it would be either in the case of liquidation, whether piecemeal liquidation or sale of the business as a going concern, or in the event of the next-best-alternative scenario if the Restructuring Plan were not to be confirmed (see Recitals 50 and 52 of Directive 2019/1023). Under Recital 52, MS should be able to choose one of those thresholds when implementing the best-interest-of-creditors test in national law.

Article 10 of Directive 2019/1023 further prescribes the necessity for the courts to evaluate whether new financing is indeed necessary for the Formal Restructuring process and whether this would unfairly prejudice the interests of creditors. Article 10 also contains a requirement for ensuring an efficient process for the confirmation of Restructuring Plans.

In comparison, the Insolvency Law makes no distinction between Restructuring Plans that foresee significant losses of the workforce, i.e. 25% as envisaged by Directive 2019/1023, and restructuring measures that do not plan for workforce reductions (see Article 40 of the Insolvency Law). Consequently, Restructuring Plans require court confirmation under any circumstances, including for their impact on the workforce, be they 5% or 50% reductions. Generally, Restructuring Plans can also contain measures affecting the workforce if they achieve the goals of Formal Restructuring and meet more general labour requirements (see Article 38 of the Insolvency Law). Thus, regardless of the extent to which the workforce is affected, Restructuring Plans will always have to be confirmed by the court. It should be noted that workforce reductions often form part of a proposed operational restructuring as an essential ingredient of the Restructuring Plan.

A notable distinction between Directive 2019/1023 and the national law is that the Insolvency Law often lacks clear conditions for evaluating a Restructuring Plan but provides for an evaluation of the criteria prescribed by Directive 2019/1023. The courts evaluate whether a Restructuring Plan meets the requirements of the Insolvency Law, e.g. whether it has been approved by all creditor classes and does not discriminate against certain creditors, and whether approval has been sought from all creditors, thus complying with the requirements of Directive 2019/1023 (see Chapter VII of the Insolvency Law).

Under Article 40 (3) and (4)(15) of the Insolvency Law, a Restructuring Plan must demonstrate that the benefits gained by creditors who have not approved it are at least as good as they would have been if insolvent liquidation had been proclaimed instead of Formal Restructuring.

In most cases, justification of the best-interest-of-creditors test in Latvia would be supported by justification of the value of the company's assets. In insolvent liquidation, the debtor's property is sold and the income is distributed among the creditors in order of priority (see Chapter XXI *"Settling Creditor Claims in the Legal Entity's Insolvent Liquidation Proceedings"* of the Insolvency Law).

The debtor's justification is mostly based on assumptions and speculations about future asset market value changes, however the justification and any creditor objections to it may be supported by evidence (e.g. certified valuations of assets) and independent third-party opinions *(please also see the dispute resolution procedure described in the section "Valuation by Judicial or Administrative Authority" below)*.

Also, under Article 42(5) of the Insolvency Law, the scope of creditor objections is not limited and dissenting creditors may argue for a different Restructuring Plan (an alternative scenario) or raise other arguments as part of the challenge. Although such objections are allowed, they are based on further speculations about the valuation of assets and the distribution of income in insolvent liquidation proceedings.

This is not, however, a mandatory requirement for Restructuring Plans, which must only ensure that the other element of the best-interest-of-creditors test prescribed by Directive 2019/1023 is implemented, i.e. that creditors stand to gain more than in the event of insolvent liquidation. These challenges are allowed but their satisfaction is not required for a Restructuring Plan to be approved by a court.

Considering that such challenges can be raised by dissenting creditors and they must be resolved (see the dispute resolution procedure described under section 8.7.1 "Current system" below in line with Article 14 of Directive 2019/1023), they are even more difficult to prove and evaluate. Not all of the thresholds of the best-interest-of-creditors test provided by Directive 2019/1023 should be implemented.

In view of the above and Recital 52 of Directive 2019/1023, Latvia is already in line with the best-interest-of-creditors test, which provides that no dissenting creditor should be worse off under a Restructuring Plan than he would be in the case of insolvent liquidation. The Insolvency Law does not require Restructuring Plans to ensure that creditors are not worse off than in the next-best-alternative scenario, although such challenges are permitted.

Accordingly, the requirement for a Restructuring Plan to pass the best-interest-of-creditors test contained in Directive 2019/1023 is already met, since the Restructuring Plan must ensure that the creditors are better off if it is implemented than they would be in the event of insolvent liquidation. The next-best-alternative scenario of the best-interest-of-creditors test should not be implemented because it would result in less certainty and increase evaluation burdens.

However, the courts always examine this requirement, which contradicts the procedure laid down by Directive 2019/1023. Accordingly, **the Insolvency Law should be amended to preclude the courts from examining the Restructuring Plan for compliance with the best-interest-of-creditors test when it has not been challenged on these grounds**.

New and interim financing is a viable tool of Formal Restructuring in the Latvian legal system. Moreover, justification for the choice of this method must be included in the Restructuring Plan and later be reviewed by the Supervisor (new and interim financing is further analysed in the chapter dedicated to this topic). However, this aspect of Restructuring Plan is also poorly evaluated. The courts and Supervisors lack the necessary financial and business expertise to determine whether the promise of funding is at all enforceable (whether the promise has sufficient foundation) and whether new financing is indeed necessary for a successful restructuring effort.

Article 10(3) of Directive 2019/1023 requires MS to ensure that administrative authorities may refuse to confirm a Restructuring Plan where that plan would not have a reasonable prospect of preventing the debtor's insolvent liquidation or securing the viability of the business. A serious contradiction exists between the national insolvency framework and Directive 2019/1023 over the ability of the Latvian judges to reject any Restructuring Plans that lack a reasonable prospect of preventing insolvent liquidation and securing the viability of the debtor's business. While Directive 2019/1023 provides that such a review is mandatory, current practice appears to contradict this, and the courts confirm Restructuring Plans that only formally meet the statutory requirements. Supervisors charged with producing an evaluation are consulted, yet this is also a mere formality because their opinions are very formal and they nearly always reach a positive conclusion on the viability of the Restructuring Plan, which clearly contradicts the results of most debt restructuring processes.

> **Judges** have expressed a concern that under the current framework, the opinions of Supervisors are quite pointless for multiple reasons: (i) Supervisors are personally interested and would benefit from the resulting remuneration if the Restructuring Plan is confirmed and Formal Restructuring is initiated, and thus always produce positive conclusions; (ii) Supervisors only formally evaluate the Restructuring Plan and lack the necessary financial and economic expertise; and (iii) Supervisors are not liable for the opinion provided.

On very few occasions the court may refer to the poor prospects of Restructuring Plans, but only where such objections have been raised by creditors. Based on these considerations, **the Insolvency Law should be amended to include clear instructions for the courts to reject not only Restructuring Plans that do not formally comply with the Insolvency Law but also Restructuring Plans that lack a reasonable chance of success**. However, in the light of the necessary expertise to make such a decision, the justification of the court should be based on the opinion of a qualified expert. The results would further reduce the number of Formal Restructurings initiated and should increase the number of successful proceedings. This could, however, increase the costs incurred in drawing up Restructuring Plans and lead to a higher burden, especially on SMEs, and thus should be remedied by some other innovations or amendments to the existing framework.

Czech Republic

Under what conditions can the courts reject Restructuring Plans?

Similar to the current procedure in Latvia, the Czech courts only formally examine Restructuring Plans for compliance with the applicable legal requirements. The viability of a Restructuring Plan is not evaluated.

The Czech courts may, however, reject Restructuring Plans that do not have a reasonable chance of being successful. The opinion of the practitioner, e.g. equivalent to Supervisor, is considered when making such decisions.

Spain

Under what conditions can the courts reject Restructuring Plans?

In the Spanish *homologación judicial* procedure (mostly restricted to large enterprises and complex restructurings), the courts are limited in deciding on confirmation of Restructuring Plans. Creditors need to raise claims for the courts to have the authority to reject Restructuring Plans on these grounds.

Under extrajudicial payment agreements, dissenting creditors may challenge Restructuring Plans before a court that has jurisdiction over the debtor's insolvency proceedings within ten days of publication.

The objection will not suspend execution of the resolution and may only be based on the lack of concurrence of the majorities required for adopting the resolution (taking into account, where appropriate, the creditors who should be present but have not been summoned), on exceeding the statutory limits, or on the disproportionate nature of the measures agreed.

All disputes are dealt with jointly under the bankruptcy proceedings, and decisions to annul agreements are published in the Insolvency Register. The annulment of the agreement gives rise to the conduct of a further competition.

Subject to refinancing agreements, the competence to hear the approval will correspond to a commercial judge who, where appropriate, is competent to declare insolvency proceedings.

The application may be made by the debtor or by any creditor who has signed the refinancing agreement and must be accompanied by the refinancing agreement adopted, the auditor's certification of the sufficiency of the majorities required to adopt the agreements with the effects envisaged for each case, the reports, if any, issued by independent experts and the certification of the capital increase agreement if it has been adopted. The judge, having examined the request for homologation, issues an order admitting it for processing and declares suspension of the singular executions until homologation is agreed on.

The judge grants the approval provided that the agreement meets the necessary requirements and declares the extension of effects when the auditor certifies the concurrence of the required majorities.

The resolution approving the approval of the refinancing agreement is adopted through an urgent procedure within 15 days and is published by a notice inserted in the Insolvency Public Registry and the "*Official State Gazette*," using an extract containing the required data.

Within 15 days of the publication, the creditors of financial liabilities affected by the judicial homologation who have not signed the homologation agreement or who have shown their disagreement with it may challenge it.

All objections are dealt with jointly by the bankruptcy proceedings, and all objections are notified to the debtor and the other creditors who are parties to the refinancing agreement so that they can appeal the objection. The decision on the challenge to the approval, which must be made within 30 days, is not subject to appeal and is given the same publicity as that provided for the approval decision.

Article 10(4) of Directive 2019/1023 requires MS to ensure that where a judicial or administrative authority is required to confirm a Restructuring Plan in order for it to become binding, the decision is taken in an efficient manner with a view to expeditious treatment of the matter. Currently, the Restructuring Plan review process is efficiently organised, and cases are mostly initiated the next day after a Restructuring Plan is received. Furthermore, the substantive review process of the Restructuring Plan does not usually last more than 15 days after the Supervisor's opinion is received. Accordingly, the Latvian law is consistent with Article 10(4) of Directive 2019/1023.

However, this would most likely change significantly if other requirements of Directive 2019/1023 were implemented, and so the legislature should be careful to maintain the effectiveness of the review process going forward, which is clearly a requirement of Directive 2019/1023. **Judicial training should be initiated early and ahead of implementing the provisions of Directive 2019/1023** so as to prepare the courts for the new obligations and prevent shocks to the system.

j. Recommendations

- The Insolvency Law should be amended to provide that the courts may reject any Restructuring Plans that have a high chance of failure.
- The Insolvency Law should clarify the application of the best-interest-of-creditors test required by Directive 2019/1023 and provide that the courts will only examine compliance with the test if the Restructuring Plan has been challenged by a dissenting creditor on failure to satisfy this test.

8.4 Cross-class Cram-down

The most basic Restructuring Plan is one in which creditors in Formal Restructuring accept the division of payment obligations into instalments over a longer period and/or a discount on their claim and expect that they will end up receiving more than they would if the company and its assets were simply liquidated.

When a Restructuring Plan is accepted and implemented, the debt is thereby covered and/or potentially reduced, and the company is again in a position where it can service its debt. This is a better outcome for many creditors than insolvent liquidation. Adopting a Restructuring Plan may ensure that the debtor can again become solvent and that the future proceeds from his continued business activity may generate value that can later be distributed to creditors in repayment of the existing debt.

Since it is almost never possible for all creditors to reach a consensus and unanimously agree on a Restructuring Plan, the Insolvency Law provides for a type of mechanism that makes the wishes of the majority of each class binding on any creditors in the same class that are opposed to the Restructuring Plan. Being used within the confines of each creditor class, this may be referred to as an intra-class cram-down.

Under the Insolvency Law, for a Restructuring Plan to be accepted, within each class at least more than a half of unsecured creditors by value and two-thirds of secured creditors by value of the total amount of the main claims have to vote in favour of the Restructuring Plan (see Article 42 of the Insolvency Law). The dissenting minority of creditors is therefore said to have been "crammed down."

Directive 2019/1023 introduces a new type of cram-down to the Insolvency Law. This type of cram-down known in other jurisdictions and defined by Directive 2019/1023 as a cross-class cram-down essentially provides that the Restructuring Plan can be also accepted against the wishes of an entire class of creditors provided that certain preconditions are met which are necessary to ensure that the dissenting class/-es of creditors voting against the Restructuring Plan are adequately protected. Because of this, a Restructuring Plan can be approved by the court through a cross-class cram-down only where the Restructuring Plan has been –

(i) confirmed in accordance with Article 10 (2) and (3) of Directive 2019/1023 (see Chapters 8.2 and 8.3 above);

(ii) **approved by a majority** of the voting classes of affected parties, provided that at least one of those classes is a class of secured creditors or is senior to the ordinary unsecured creditors class

or, failing that,

at least one of the voting classes of affected parties or where so provided under national law, impaired parties, **other than** an equity holders class or any other class which, upon a valuation of the debtor as a going concern, would not receive any payment or keep any interest, or, where so provided under national law, which could be reasonably presumed not to receive any payment or keep any interest, if the normal ranking of liquidation priorities were applied under national law;

(iii) it ensures that dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class (the **RPR**)

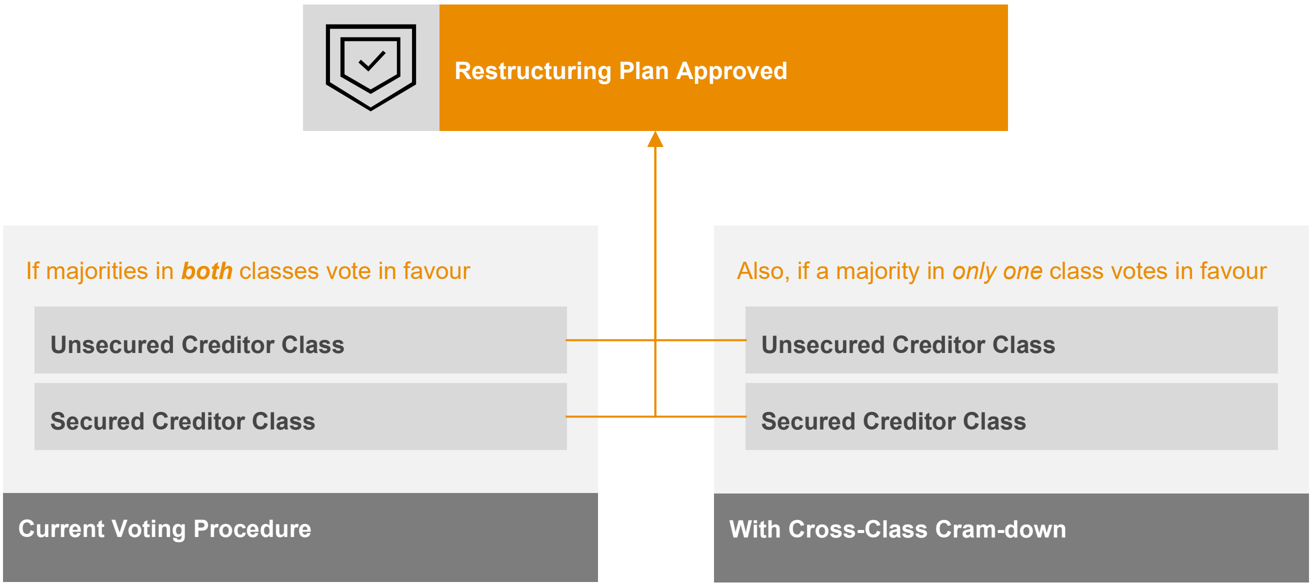
or

the claims of affected creditors in a dissenting voting class are satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the Restructuring Plan (the **APR**);

(iv) no class of affected parties can, under the Restructuring Plan, receive or keep more than the full amount of its claims or interests.

To illustrate the process comparison with the current Latvian voting procedure, please see Figure 15 below.

Figure 15 Cross-class cram-down comparison with the current voting procedure[85]



While being new to the Latvian legal system, the cross-class cram-down retains prominence in other jurisdictions. The most well-known cross-class cram-down provisions are found in section 1129 of Chapter 11 of the US Bankruptcy Code. Under those provisions, the court may, on request of the proponent of the Restructuring Plan, confirm it and bind other classes of creditors on the following conditions:

(i) if any class of claims is impaired under the Restructuring Plan, at least one impaired class has accepted it; and

(ii) the Restructuring Plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the Restructuring Plan. The condition that a Restructuring Plan be fair and equitable with respect to a class includes a number of additional requirements, which vary depending on whether that class is secured or unsecured.

The UK

Existence of cross-class cram-down and comparable mechanisms

In England and Wales, the administration procedure under Schedule B1 of the Insolvency Act is sometimes used in conjunction with a scheme of arrangement under the Companies Act 2006 to achieve a restructuring and a “vertical” cram-down within each class of creditors. There is no limit to how many classes may theoretically be created and therefore the consent of majority creditors in each class (75% by value) is needed for the plan to be binding on such class(es) of creditors. The constitution of a class depends on whether the rights of the creditors in the class are sufficiently similar for them to be able to consult together. The court retains a discretion and will only sanction a scheme if it is satisfied that the scheme is fair. “Out of the money” creditors and any creditors that are not affected by the scheme are not required to vote on the plan.

[85] Article 9(4) of Directive 2019/1023 requires MS to ensure that affected parties are treated in separate classes that reflect sufficient commonality of interest based on verifiable criteria in accordance with national law. As a minimum, creditors of secured and unsecured claims have to be treated in separate classes for the purposes of adopting a Restructuring Plan.

The existing creditor class structure in Latvia indicates that the Insolvency Law complies with the minimum threshold of this mandatory provision: creditors are grouped into two classes (secured and unsecured).

Czech Republic

Existence of cross-class cram-down and comparable mechanisms

Provisions relating to a cross-class cram-down exist in a more simplified form than the US Chapter 11 procedure. The court can overrule the majority vote of an entire class where the creditors cannot reasonably have voted as they did, and the creditors are not worse off under the plan compared to their position in the case of insolvency proceedings leading to liquidation. This is one type of cross-class cram-down. Experience shows, however, that this type of cross-class cram-down is not often used in the Czech Republic.

Creditors are also divided into two classes: secured and unsecured. The existing regulations allow a cross-class cram-down, and plans can be submitted to the court without the prior consent of all creditor groups.

Recital 58 of Directive 2019/1023 provides that equity holders in SMEs who are not mere investors but are the owners of the enterprise and contribute to the enterprise in other ways, such as managerial expertise, might not have an incentive to restructure under such conditions. For this reason, the cross-class cram-down may remain optional for debtors that are SMEs, **and further discussions should be held on whether to provide for SMEs exception.**

As stated above, the Insolvency Law does not provide for a cross-class cram-down. Nevertheless, a cross-class cram-down may well be applied to the current Latvian class structure where creditors are separated into two classes: secured and unsecured.

Recital 54 of Directive 2019/1023 foresees a national legal system with only two creditor classes, as in Latvia. Under such circumstances, the consent of at least one class is deemed sufficient for a cross-class cram-down to take place if the other conditions for applying it are met.

8.4.1 Classification of creditors

Further discussions could still focus on whether creditors should be separated into more classes. **The separation of creditors between several classes can be directly prescribed by the Insolvency Law or left as an optional provision that can be used by the debtor's decision and court approval.** When deciding on the introduction of additional creditor classes, the specifics of the existing creditor class regime, the Latvian business environment and the relatively simple financing models used by Latvian SMEs should be taken into consideration.

For voting purposes, the Insolvency Law recognises only two classes of creditors: secured and unsecured. However, special voting rules apply to the tax authority, the debtor's workers, and related parties.

Traditional Formal Restructuring methods cannot be applied to the tax authority's claims (if those thresholds provided under Article 38(5) of the Insolvency Law are exceeded), whether these are classified as secured or unsecured debt, if the tax authority does not vote in favour of the Restructuring Plan.

Workers do not acquire creditor status and consequently do not have voting rights. Workers' claims are not counted towards the entire pool of claims for voting purposes. Formal Restructuring methods cannot be applied to workers' claims without their prior consent.

In addition to workers, whose claims do not count towards the entire pool of claims for voting purposes, the following related persons holding either secured or unsecured debt do not have voting rights:

(i) persons incorporated in one group of companies with the debtor;

(ii) natural persons who as shareholders have a decisive influence on the debtor;

(iii) persons who have acquired a claim against the debtor from the persons specified at (i) and (ii) above in the last two years before the Restructuring Plan was approved.

In summary, neither workers nor related persons vote on the Restructuring Plan. Approval of the Restructuring Plan therefore rests on the support of –

(i) secured creditors in the secured part of their claim; and/or

(ii) additional approval from the tax authority if it holds a secured claim and the Restructuring Plan affects the tax authority's claims more than prescribed by Article 38(5) of the Insolvency Law;

AND

(iii) unsecured creditors, and secured creditors in the unsecured part of their claims;

(iv) additional approval from the tax authority if it holds an unsecured claim and the Restructuring Plan affects the tax authority's claims more than prescribed by Article 38(5) of the Insolvency Law.

In view of the above, the Insolvency Law prescribes a very simple structure of creditor classes and the seniority of creditors within each class does not play a significant role (except for the claims of the tax authority, workers and related parties).

Such a simplified approach, where the seniority interests of creditors within each class hold little weight coupled with the principle of equality within each creditor class (with the notable exception of the SRS, workers, certain secured creditors and providers of new capital) prescribed by Article 38(2) of the Insolvency Law[86] could theoretically create evident inequality (especially in the secured creditor class with different layers of collateral). Furthermore, this could create theoretical situations where the debtor finds it difficult to draft a viable Restructuring Plan that could gain the support of the majority of creditors.

However, to reach a valid conclusion that more creditor classes should be created in Latvia and that doing so would improve the current situation, a further in-depth analysis should be conducted, including the necessary analysis of the credit profile of Latvian enterprises.[87]

The rules of classification into more than the existing two-class system may allow more flexibility in treating creditor claims, since the dual classification may limit the ability of parties to tailor debt repayments to a company's unique business needs and to ensure sustainability of Restructuring Plans. It may also afford additional flexibility to recognise the diversity of claims.

The future Insolvency Law could, for example, separate equity holders into their own class. This appears to be the most likely scenario since especially equity holders are so different from other ordinary creditors in their relation to the debtor. Doing so would contribute to the additional Formal Restructuring benefits that are analysed further in this report.

The following general rules can be considered in developing more flexible classification solutions:

1.1. **Multiple classes** of claims should be permitted to accommodate the development of a sustainable repayment plan modelled on a debtor's specific revenue projections and variable treatment for different classes and types of claims.[88]

1.2. **Similarity** – all claims in a class should be substantially similar in nature. Not all secured or unsecured claims are similar. Some secured creditors have different collateral and repayment terms, based on the nature of the financing (e.g. short-term, long-term, mortgage, project, receivables, inventory etc). Some are under-secured due to the quality of their collateral. Similarly, some unsecured claims arise from generally similar claims based on supplier contracts, while others arise from long-term unsecured bonds, or may be subject to contractual subordination clauses. Sometimes similar claims can be placed in a separate class if there is a legitimate business purpose and provided such claims are not being treated in a discriminatory manner relative to other similar claims.

1.3. **Gerrymandering is not allowed** – formation of classes for the "sole purpose" of obtaining plan (or class) approval is never permitted.

1.4. Additional classification considerations:

1.4.1. *bifurcation of claims* permits the separation of an under-secured claim into two claims: one secured (in the amount of the collateral's value) and the other unsecured (for the amount in excess of the collateral's value);[89]

1.4.2. a convenience class of claims permits formation of a class of small claims (below a stated amount) for the purpose of paying such claims in full to avoid including the claimants in the Restructuring Plan voting process, which simplifies the solicitation and voting process on the plan without materially disadvantaging other creditors; and

1.4.3. subordinated claims can be placed in a separate class for contractually subordinated claims, claims of insiders or affiliated entities (e.g. for intercompany loans), or where legal justifications exist to subordinate certain claims.

[86] Formal Restructuring within a class of creditors and for each type of creditor claim (principal debt, penalty, or interest) may only provide for proportional repayment or reduction of the principal debt, penalty, or interest.

[87] It can be concluded from the stakeholder interviews and the observations in practice that the structure of creditors most often consists of the following: 1) the tax authority; 2) credit institutions and/or collateral of further layers; 3) other capital providers; 4) workers; 5) suppliers; 6) small creditors; 7) equity holders.

[88] See ICR Principles C14 (reorganisation proceedings); EU Directive on Preventive Restructuring Frameworks, second chance and measures to increase efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU (2018).

[89] For example, section 506(a) of the US Bankruptcy Code enables a secured creditor's claim to be bifurcated into "a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property" and an unsecured claim for the remainder of the allowed amount of such claim. This could allow the unsecured portion of the claim to be classified with unsecured creditors.

1.5. **Class voting rules** may also be reviewed in the light of expanded classifications. Common considerations include unimpaired classes, simplified voting majorities, and cross-class cram-downs:

1.5.1. Unimpaired classes contain claims to be paid in full on executing the plan or that will be paid strictly according to the terms of their pre-insolvency contracts, meaning any defaults will be cured and then creditors will be paid timely pursuant to their contract terms. When a class is unimpaired, it is deemed to have accepted the Restructuring Plan and creditors in the class need not be solicited to vote on it.

1.5.2. Simplified majority rules allow class approval based solely on a requisite majority in amount of claims, as compared to requiring a majority by amount of claims and by majority of creditors in each class. The "majority of creditors by number" part of the test is typically required to ensure that there is general agreement among the class as opposed to having one large creditor sway the voting outcome of the class. The "majority of creditors by number" requirement should be viewed sceptically.[90]

1.5.3. Cross-class cram-down provisions allow a plan to be approved even if one or more classes of creditors oppose it. Typical cram-down provisions require distributions under the plan to satisfy "absolute priority" rules, meaning creditors are paid strictly according to distributional priorities established for a liquidation proceeding, i.e. first to secured creditors from net sales proceeds of their collateral, second, unsecured claims according to priorities (labour, tax, general unsecured etc), followed by distributions to equity. In such cases, the dissenting class must either be paid in full (i.e. unimpaired) or no one with a claim junior to claims of dissenting creditors receives/retains anything under the plan. Naturally, if junior unsecured claims receive nothing, then equity is also wiped out (although exceptions are sometimes made for new value contributions by equity holders, and reservations of stock for forward-looking employee/management stock plans).

1.5.4. Cram-down and "relative priority": Cram-down plans hinge on the going concern value of the business. Because such valuations can be costly, the EC adopted an RPR requirement under Directive 2019/1023, which allows a plan to be approved where (i) a majority of classes approve the plan, including at least one class of creditors that is either secured or senior to ordinary creditors, and (ii) the dissenting class of creditors must be treated at least as favourably as any equal ranking class and more favourably than any junior class if liquidation priorities were applied.

1.5.5. Other rules of fairness applicable to secured creditors is a requirement that they should receive distributions in an amount at least equal to the value of their collateral and that they should not be forced to accept replacement collateral inferior in value. All creditors are generally entitled to a distribution in an amount at least equal to or greater than the amount they would receive in a liquidation proceeding.

Stakeholders have repeatedly raised concerns over the introduction of new creditor classes. According to the experts, this would lead to more complex procedures and prevent debtors from taking up Formal Restructuring. Moreover, the risks of abuse are said to increase.

An alternative way of resolving such issues would be to maintain the existing two-class system and to give debtors freedom to further separate creditors into classes according to individual circumstances, if need be. This would increase the general flexibility of Formal Restructuring while not creating additional complexity where it is unnecessary. A notable drawback to this approach would be that the risks of abuse would still increase in comparison to the existing Insolvency Law classification. These could, however, be reduced if Supervisors and the courts have the necessary capacity and competence to review the classification of creditors.

Such reforms would have a significant impact on Formal Restructuring and therefore require further evaluation, similar to any other changes affecting the existing creditor class structure. These alternatives are nevertheless important since they seem to offer additional benefits to the current system and should therefore be taken into consideration.

8.4.2 Alternative minimum support requirements

Application of the cross-class cram-down mechanism varies considerably according to the creditor class structure, i.e. whether Latvia retains its existing two-class structure of only secured and unsecured creditors or whether new and additional classes are introduced. The following alternative choice to be made by the legislature in Article 11 of Directive 2019/1023 should be guided by this consideration.

[90] This position is also held by the recent INSOL Europe Guidance Note on the implementation of Directive 2019/1023. See p.24.

Article 11(1)(b) contains two alternative tests[91] dealing with the minimum support requirements for confirming a Restructuring Plan through a cross-class cram-down. The first alternative prescribed by Article 11(1)(b)(i) requires that a Restructuring Plan should gather the support of a majority of classes, one of which is secured creditors or a class senior to ordinary unsecured creditors. The support test in Article 11(1)(b)(ii) contains a lower threshold requirement where support from any one in-the-money creditor class is sufficient.

Characterising a creditor class as in the money refers to that creditor class receiving some value from the debtor's estate pursuant to the ordinary liquidation procedure. This means that if Debt Restructuring were not to take place, the in-the-money creditor class would be entitled to at least some satisfaction of their claims if liquidation was undertaken for the debtor.

Naturally, not all creditor classes are always in the money since the debtor's estate is usually inadequate to guarantee value for all creditors.

In the Latvian Formal Restructuring context, this leads to situations where, for example, senior creditors receive value in liquidation and unsecured creditors are left with nothing. In this case, the senior creditor class can be said to be in the money while unsecured creditors cannot be recognised as such. Here, the support of the secured class would have to be obtained for the Restructuring Plan to be consistent with Article 11(1)(b)(ii).

There are, of course, other alternatives, and under most circumstances, not all senior creditors could be recognised as in the money and all unsecured creditors as the opposite. The debtor's estate could be more substantial, and the unsecured creditor class could be entitled to some benefit in the event of liquidation. It could also be the case that neither class is fully covered if the debtor is liquidated. Because of this, the courts would be tasked with determining whether the class voting in favour of the Restructuring Plan is indeed in the money.

Apart from either class being in the money, the value is likely to break off somewhere within the class.

Here it would be beneficial to consider both tests under the current two-class system and in the light of the potential arrival of more creditor classes.

There are serious doubts as to whether Article 11(1)(b)(i) would work at all if only two creditor classes remain, i.e. whether the majority requirement would be met since the support of one class (50%) hardly qualifies as a real majority. Moreover, if the Insolvency Law introduces new unsecured creditor classes (it could be said that the tax authority already is a *de facto* separate class) but retains only one secured creditors class or senior to the ordinary unsecured creditors class, a minimum support threshold requiring the support of secured creditors/senior to the ordinary unsecured creditors class (Article 11(1)(b)(i)) would seriously hamper the application of a cross-class cram-down. Restructuring Plans could only be crammed down over unsecured creditors. This would give even more leverage to credit institutions (usually secured creditors in Latvia) and diminish the rights of the debtor's small suppliers and other business partners (usually unsecured creditors).

Accordingly, **Article 11(1)(b)(ii) appears to be better suited for implementation if the existing two-class system remains**. This would ensure that in-the-money unsecured creditors and secured creditor classes are on a more equal footing and that a Restructuring Plan unreasonably vetoed by secured creditors can still be approved. A cross-class cram-down would otherwise simply not achieve the goal of avoiding exactly this type of holdout behaviour.

An alternative scenario of more classes being introduced in Latvia should also be considered since the reservations would no longer be relevant. Here Article 11(1)(b)(i) should be preferred since there are valid reasons for doing so.

For instance, Article 11(1)(b)(i) is by far more easily applicable in practice. The courts would only have to determine that a majority of classes, one of which is a secured creditor class, supports the Restructuring Plan. In contrast, if Article 11(1)(b)(ii) is chosen, a valuation exercise has to be made in order to determine whether the supporting creditor class is indeed in the money. This would result in further expenditure of resources both for the court and the parties, give rise to possible litigation, and breed further legal uncertainty into the voting procedure. Moreover, Article 11(1)(b)(i) is practically tested in Germany where the rule is applied.

The following visualisation should clarify how Article 11(1)(b) (i) and (ii) would apply depending on the existing structure of classes. Note that the application of a cross-class cram-down substantially changes only with respect to the minimum support requirements and that the other requirements of Article 11 remain unchanged depending on the number and nature of creditor classes.

There are three realistic alternatives for the future application of a cross-class cram-down:

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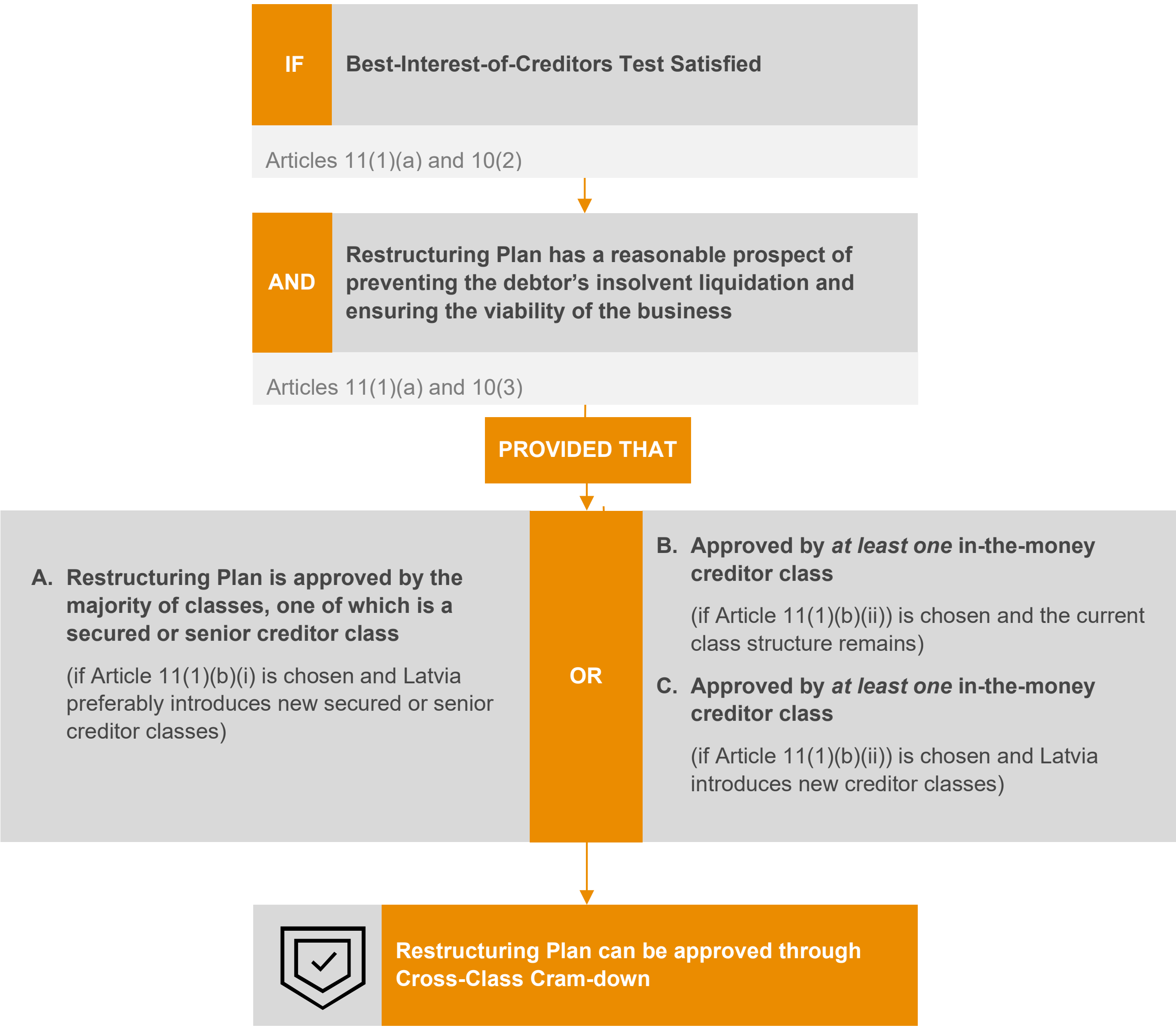
[91] It must be noted that Article 11(1)(b) can also be interpreted differently. A grammatical analysis could signal to the reader that there is no alternative between the two tests and both can be introduced. The issue here is the wording "*or, failing that*" which connects both provisions and the suggestion of Recital 54 on the minimum class support requirements. A more in-depth analysis of the procedural documents of Directive 2019/1023 reveals that the original intention of Article 11(1)(b) was indeed to offer MS a choice of implementing Article 11(1)(b)(i) or 11(1)(b)(ii).

A. The legislature opts for Article 11(1)(b)(i) and introduces new creditor class/-es (**advisable if new secured or senior creditor classes are added to the Insolvency Law**); or

B. The legislature opts for Article 11(1)(b)(ii) instead and the existing class structure remains; or

C. Article 11(1)(b)(ii) is chosen in combination with the introduction of new creditor classes.

Figure 16 Application of cross-class cram-down to different creditor class structures



As noted before, the choice of a minimum support requirement largely depends on the number and type of creditor classes Latvia would have after introducing Directive 2019/1023 into the national legal system. **If the existing two classes remain, Latvia would have to opt for Article 11(1)(b)(ii), i.e. supporting one in-the-money-class.**

If more secured or senior creditor classes are introduced, the test of Article 11(1)(b)(i) requiring a majority support, one of which is a secured or senior creditor class, should be preferred.

These are not, however, the only choices to be made with respect to Article 11 of Directive 2019/1023. There are other alternative conditions for applying a cross-class cram-down, one of which is the very significant need to determine the applicable creditor priority rule.

8.4.3 Choice between RPR or APR

As stated in the beginning of this chapter, one of the preconditions for a Restructuring Plan to be accepted through a cross-class cram-down, apart from the best-interest-of-creditors test, which also protects dissenting creditors, is that dissenting creditors are protected by applying either RPR or APR. Article 11 of Directive 2019/1023 describes these rules as follows:

1 (c) [..] dissenting voting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class; [..] " (**RPR**)

2 (a) By derogation of point (c) of the first paragraph, MS may provide that a dissenting voting class of affected creditors is satisfied in full by the same or equivalent means if a more junior class is to receive any payment or keep any interest under the Restructuring Plan." (**APR**)

Figure 17 Overview of the comparative voting procedure between Directive 2019/1023 and the Latvian insolvency scheme

Regime	Unaffected creditors	Number of creditors' classes	Intra-class cram-down (horizontal)	Court's rights not to confirm a Restructuring Plan	'Best-interest-of-creditors' test	Cross-Class-Cram Down («CCC») (vertical)
Latvia's Scheme (Insolvency Law)	**No** (Debtors cannot choose which creditors to include and affect with the Restructuring Plan and which can remain unaffected. Restructuring Plan is binding to all creditors and employees, if it is confirmed by the court)	**2** (Secured and unsecured creditor class with a special regime for tax claims; Employees are not treated as creditors, but they cannot be affected without their prior consent)	**Yes** 1) two-thirds or more in value of all secured creditors claims; no majority in number); 2) 50% or more in value of all unsecured creditors; no majority in number).	**Yes** (if Restructuring Plan fails to comply with the following requirements: Restructuring Plan has not been supported by the majority of creditors, failure to comply with the 'best-interest-of-creditors' test, the Restructuring Plan does not have a reasonable prospect of preventing the insolvency of the debtor or ensuring the viability of the business, the Restructuring Plan does not comply with other requirements of the Insolvency Law)	**Yes** (the test consists of comparison of the situation of the dissenting creditors in case of an insolvent liquidation)	**No**
RPR (Directive 2019/1023)	**Yes** (Restructuring Plan is not binding to such creditor)	**≥ 2** (two, but usually more than two)	**Yes** (supported by a % not higher than 75 % of the amount of claims or interests in each class, or, additionally to this threshold, supported by a % not higher than 75 % of the number of affected creditors)	**Yes** (if Restructuring Plan fails to comply with the following requirements: the Restructuring Plan has not supported by the majority of creditors, failure to comply with the 'best-interest-of-creditors' test, the Restructuring Plan does not have a reasonable prospect of preventing the insolvency of the debtor or ensuring the viability of the business, the Restructuring Plan does not comply with Article 10(2) of Directive 2019/1023)	**Yes** (the test consists of comparison of the situation of the dissenting creditors in case of a liquidation and/or in the event of the next-best-alternative scenario if the Restructuring Plan were not to be confirmed)	**Yes** (a dissenting class can be bound to a Restructuring Plan, as long as this class is treated 'more favorably' than any lower ranking class.)
APR (Directive 2019/1023)	**Yes** (Restructuring Plan is not binding to such creditor)	**≥ 2** (two, but usually more than two)	**Yes** (supported by a % not higher than 75 % of the amount of claims or interests in each class, or, additionally to this threshold, supported by a % not higher than 75 % of the number of affected creditors)	**Yes** (failure to comply with several requirements, including the Restructuring Plan has not supported by the majority of creditors, failure to comply with 'Best interest of creditors' test, the Restructuring Plan would not have a reasonable prospect of preventing the insolvency of the debtor or ensuring the viability of the business, the Restructuring Plan does not complies with Article 10(2) of Directive 2019/1023)	**Yes** (the test consists of comparison of the situation of the dissenting creditors in case of a liquidation and/or in the event of the next-best-alternative scenario if the Restructuring Plan were not to be confirmed)	**Yes** (the claims of dissenting senior creditor classes have to be covered in full before any junior classes receive any satisfaction of their claims)

To illustrate the differences between APR and RPR, please see Figure 18 below.

Figure 18 Comparison between APR and RPR

Common Pool of Creditor Assets

APR	RPR
Senior Creditor Class Receives payment	**Senior Creditor Class** Treated more favourably than junior creditors and equity holders
Junior Creditor Class May receive any payment only if senior creditor class fully satisfied	**Junior Creditor Class** Treated more favourably than equity holders
Equity Holders May receive any payment or keep any interest only if senior and junior creditors fully satisfied	**Equity Holders** Treated less favourably than senior and junior creditors

It should therefore be evaluated which of the two alternative rules (APR or RPR) is more relevant for Latvia, considering that the majority of enterprises in Latvia are SMEs.

The authors of the INSOL Europe Guidance Note have provided an example of the practical application of the APR visualised by showing the debtor's capital structure:

A. Capital structure (total 30 M) Classes top-down by seniority ranking

10 M	Senior
10 M	Junior
10 M	Mezzanine
	Equity

Note that this capital structure provides an example of how the ranking of creditors could be reflected in a real-world scenario. For example, when the fictional "Mezzanine" class votes against the Restructuring Plan and is crammed down, the equity holders class would be subject to equity wipe-out if the former could not be paid in full. The same principle would apply if the Junior creditors class had to be crammed down (Mezzanine and Equity classes would receive nothing before the Junior class etc).

Using the same example and applying the RPR would produce different results. Class hierarchy would remain but now each more senior dissenting class would have to be treated more favourably instead of receiving full satisfaction before any more junior class can receive or retain any value.

Criticisms of the RPR

MS can implement the APR, which extensively supports the rights of creditors. MS can also opt for the RPR, the method prioritised by Directive 2019/1023. The RPR differs from the APR in that dissenting creditor classes have to be treated “as favourably” as any other class of the same rank and “more favourably” than any more junior class. Here lies the core difference between the two rules: the APR provides that dissenting creditor classes have to be fully satisfied before more junior classes receive or retain anything, while the RPR merely provides that such dissenting classes have to be treated more favourably than any more junior classes.

Critics of the RPR mainly point out that the RPR contained in Directive 2019/1023 differs considerably from the idea originally proposed in the United States. Some have gone so far as to state that the interpretation of the RPR in Directive 2019/1023 is incorrect and that the safeguards present in the US model have not been imported correctly with the RPR, thus seriously endangering the rights of creditors.

The RPR has attracted more criticism of not only its fundamental characteristics but also its practical workings.

The RPR critics include the authors of a recent Guidance Note of INSOL Europe.[92] They have been rather vocal in their disapproval of the RPR and suggest that MS should opt instead for the much more tested and well-understood APR in order not to subject legal systems to so much uncertainty.

The RPR is characterised as distorting the creditor hierarchy that exists outside Formal Restructuring and insolvent liquidation.

When applying the RPR, shareholders of the company initiating Formal Restructuring may retain their stake while senior creditors might lose significantly due to the interpretable nature of the concepts “as favourably” and “more favourably.” For example, a dissenting senior creditor with a claim of EUR 2,000,000 and a junior creditor with a claim of EUR 50,000 might both be subject to a reduction in their claim. Where the senior dissenting class claim is reduced by 10% and the claim of the junior class is reduced by 30%, the question arises whether the senior class is indeed treated more favourably than the junior class, because while proportionally this is true, the real net loss for the senior creditor is far more detrimental than the loss of the junior creditor class which supports the Restructuring Plan.

The additional need for conducting valuations of relative creditor treatment could lead to additional expenditures for courts and other affected parties. Apart from these additional expenses, expanded litigation could also be expected since the parties would most likely utilise the more uncertain practice and methods associated with the RPR.

> It should be noted that applying the RPR to the Latvian legal system has been criticised by a number of stakeholders. For example, representatives of the financial industry have voiced concerns that the RPR would increase the cost of credit and limit its availability, since credit institutions as creditors are bound to be subject to higher risk.

Criticisms of the APR

The APR governs the order of payments to creditors and shareholders in a way that the claims of dissenting senior creditor classes have to be covered in full before any junior classes receive any satisfaction of their claims. The cross-class cram-down provisions of the US Bankruptcy Code incorporate the APR as the relevant priority rule, which has attracted criticism.

When applying the APR, the claim of the dissenting senior creditor class has to be fully covered before the junior class retains or gains any satisfaction. Moreover**, the shareholders of the company would have to lose their stake to the senior dissenting class if senior creditors are not satisfied in full by some other means, leading to the issue of the motivation of directors to initiate Formal Restructuring in the first place**.

[92] Guidance Note #1, April 2020: The Implementation of Preventive Restructuring Frameworks Under EU Directive 2019/1023: Claims, Classes, Voting, Confirmation and the Cross-Class Cram-Down, INSOL Europe. Available at: https://www.insol-europe.org/publications/guidance-notes. [Accessed May 1, 2020].

The APR has been recognised as too rigid and has led to situations where senior classes seriously hamper Formal Restructuring efforts by intentionally vetoing Restructuring Plans. The experts have argued that under the regime of the APR **equity holders are demotivated to pursue early Formal Restructuring as they would lack realistic chances to retain any stake in the distressed company if Formal Restructuring is initiated**.[93]

Furthermore, some experts have suggested that equity holder involvement in Formal Restructuring is especially important for SMEs, which benefit from the personal contacts and regionally specific expertise of equity holders who are not rarely also the directors in the context of SMEs.

It is also important to note that apart from being SMEs, enterprises in Latvia also have a very simple capital structure in which the tax authority and credit institutions hold by far the largest share of debt. In most Latvian Formal Restructurings, banks and tax authorities wield the most influence and Restructuring Plans depend most especially on their support.

Conclusions on the RPR and the APR

It becomes evident that the APR is a more tested and certain alternative while it also appears to be rather unsuitable for Latvia. The APR would work more effectively in countries with a number of large enterprises, which is far from the current environment in Latvia comprising SMEs. This is especially important since the application of the APR to SMEs appears to be problematic. The transfer of equity from the previous owners to creditors is likely to lower the value of SMEs and offer little in remedy to creditors. For example, credit institutions would hardly benefit from, and may not therefore be interested in, receiving shares in small and distressed enterprises.

Given the specifics of the Latvian business environment with SMEs as the prevailing type of company, it would be more reasonable for the legislature to opt for the RPR since there are many owner/managers. Although the RPR version as introduced by Directive 2019/1023 has yet to be tested and serious concerns exist as to possible abuse, additional safeguards should mitigate any risks.

While these priority rules can be universally applied to any number of creditor classes, other aspects of applying a cross-class cram-down would largely depend on other choices made by the legislature in implementing Directive 2019/1023.

8.4.4 Additional safeguards and possible derogations

The second subparagraph of Article 11(2) permits MS to maintain or introduce provisions derogating from its first subparagraph where this is necessary for achieving the aims of a Restructuring Plan and does not unfairly prejudice the rights or interests of any affected parties.

Implementing the cross-class cram-down mechanism together with the choice of RPR can seriously endanger the interests of some creditors. In a scenario where one creditor class votes in favour of the Restructuring Plan and it is imposed on the dissenting class through a cross-class cram-down, it is all within the power of the approving class to pick and choose the amount of reduction to be imposed on the claims of both classes. If the dissenting class is more senior than the approving junior class, situations can occur where the lacking competence or bad intention of the approving junior class causes loss to the dissenting senior class. In this scenario, the approving class could very well approve a self-inflicted 50% reduction in claims where a 49% reduction of the more senior class would fulfil all the statutory obligations and yet be obviously unfair. Given the derogation and to prevent unreasonable use or even abuse of the cross-class cram-down, the **Insolvency Law should, in addition to the best-interest-of-creditor test, contain further safeguards for creditor interests in the form of provisions forbidding any creditor claim reductions that reach further than necessary for restoring the debtor to solvency.** Thus, more safeguards should be introduced in addition to the RPR and the best-interest-of-creditor test. For example, maximum debt reduction limits could be set directly in the Insolvency Law, providing that a cross-class cram-down applies if the Restructuring Plan provides for the most principal debt coverage or at least 80% of it (this limit and other such safeguards should be further discussed in the working groups).

It should also be noted that, if the Restructuring Plan includes measures affecting tax debts, prior authorisation is also necessary from the tax authority when the Restructuring Plan involves an extension of its debt claims for a period of more than six months or the debt reduction is foreseen to a greater extent than prescribed by the Insolvency Law, as in fact the tax authority claims have more advantages over other creditors (see Article 38(5) of the Insolvency Law). This can cause issues in practice, where an otherwise viable Restructuring Plan confirmed by secured creditors could be supported by unsecured creditor classes and blocked by the tax authority, refusing to give permission for the restructuring of sometimes small tax debts.

[93] The experts have indicated that such a transfer of ownership rights from equity holders to creditors might raise concerns over compatibility with the Commercial Law. While these doubts should not discourage a choice in favour of the APR, this issue should be further evaluated when making the ultimate choice between the two priority rules.

For these reasons and to achieve an effective implementation of the cross-class cram-down mechanism, the advantages of the SRS should also be subject to a cross-class cram-down.

In practice, removing the SRS prior approval advantage in cross-class cram-down cases would mean that, for voting purposes, the SRS claims are treated equally with those of other private entities as either secured or unsecured claims (depending on the existing status of the claim). However, such reforms should be undertaken with caution, keeping in mind that the SRS claims are also claims of the society and that public funds must enjoy adequate protection.

> **While the majority of stakeholders support such reforms, others raise concerns that any further reduction in the advantages of the SRS is not acceptable.**

> **Stakeholders** have also noted a proposition that debt-to-equity swaps currently confined to Article 39 of the Insolvency Law could be expanded to encompass the claims of public creditors. Doing so would expand the tools available to creditors such as the SRS and could increase the amount of credit retrieved.
>
> Public creditors could remain in the capital structure of enterprises for a limited time, allowing the previous equity holders to return once credit is repaid.

Derogations found in the later subparagraphs of Article 11(1) should not have special reform priority because the current and arguably simple creditor class structure does not produce practical issues (the best-interest-of-creditors test and the RPR can still be applied even with two creditor classes if principles from Article 118 of the Insolvency Law are applied) and according to the national legal framework the application for the enforcement of a Restructuring Plan is always submitted to the court for approval by the debtor. Moreover, it is easily applied to the existing business environment of SMEs and does not require systemic reform and review.

Given the discrepancies between the current national laws and regulations, and considering that such a new mechanism is mandatory for MS under Directive 2019/1023, and also taking account of the possible positive results of a cross-class cram-down, which would speed up some Formal Restructuring proceedings and remove gridlock where creditors unreasonably obstruct these efforts, it is necessary for the Latvian legal system to adopt a cross-class cram-down. However, this mechanism is unlikely to do much in solving some of the more substantial and systemic challenges, as it would not necessarily improve the quality of Restructuring Plans, which most often leads to unsuccessful Formal Restructuring.

k. Recommendations

- The Insolvency Law should be amended to permit the courts, at the debtor's request, to approve a Restructuring Plan that is not approved by one of the creditor classes (secured or unsecured) if the Restructuring Plan conforms with other provisions of Directive 2019/1023 and has been approved by at least one of the creditor classes, with adequate protection for the dissenting class.
- In addition to introducing Article 11(1)(c) of Directive 2019/1023, the Insolvency Law should offer more safeguards for creditor interests. The RPR is preferable by virtue of being more appropriate for the Latvian business environment, which is dominated by SMEs and has only two distinct creditor classes.
- The Insolvency Law should be amended to permit the courts to apply a cross-class cram-down to the tax authority's claims, despite the tax authority's current right of veto pursuant to Article 38(5) of the Insolvency Law.
- The Insolvency Law could be amended to introduce the concept of more than two creditor classes (currently secured and unsecured) for voting purposes. Such amendments could regulate how creditors are separated into classes by specifying a larger number of potential classes, or it could be left up to the debtor to group the creditors into classes according to their commonality of interest. The formation of classes can be later approved by the court, or a mixture of both mechanisms could be introduced.

8.5 Equity Holders

Recital 57 of Directive 2019/1023 describes some of the tools that can be used to prevent equity holders from unreasonably preventing or creating obstacles to the implementation of a Restructuring Plan. MS may restrict the voting rights of equity holders or not make the adoption of a Restructuring Plan conditional on the agreement of equity holders that, on a valuation of the enterprise, would not receive any payment or other consideration if the normal ranking of liquidation priorities were applied.

Article 12(2) of Directive 2019/1023 requires MS to ensure that equity holders are not allowed to unreasonably prevent or hinder the implementation of a Restructuring Plan.

Directive 2019/1023 provides two alternative solutions for tackling the negative effects that equity holders can create for the implementation of Restructuring Plans.

The first solution is to subject the interests of equity holders to the effects of Restructuring Plans and to grant them voting rights and other rights conferred on creditors. According to this approach, all equity holders (with or without a creditor claim) would have voting rights and could be subject to a cross-class cram-down. This solution assumes that once included in the negotiations, the equity holders would have a chance to express their views and stand on an equal footing with other creditors as opposed to remaining as outsiders with diverging interests. In this option, the voting rights and the cross-class cram-down are tools for preventing the equity holders from obstructing the Restructuring Plan.

If this approach is not followed, the second alternative solution provides that MS should instead adopt statutory provisions to restrict the behaviour of equity holders while balancing the protection of their rights. According to this approach, equity holders would not have voting rights on the Restructuring Plan and would not take part in adopting it. However, not granting creditor rights to equity holders, or prescribing some other statutory tools, would not prevent equity holders from hindering Formal Restructuring.

Rights of equity holders in the Latvian Insolvency Law

As stated in Chapter 8.2 of this report, **equity holders without creditor claims cannot vote on the adoption of Restructuring Plans**.

The Insolvency Law further restricts the rights of some equity holders with creditor claims. Article 42(6)(2) of the Insolvency Law provides that related enterprises and parties, such as persons incorporated in one group of companies with the debtor, natural persons who as shareholders have a decisive influence on the debtor, and persons who have acquired a claim against the debtor from the above persons in the last two years before Formal Restructuring was approved, are not allowed to exercise creditor rights in approving it.

Article 6 of the Insolvency Law regulates the main principles of Formal Restructuring and insolvent liquidation. For example, Article 6(8) prescribes the principle of good faith – persons involved in insolvency proceedings have to exercise their rights and carry out their duties in good faith. A debtor and creditor may not use the insolvency proceedings in order to make a living unfairly. Article 6(3) of the Insolvency Law contains the principle of preventing arbitrariness, which means that neither a creditor nor the debtor may perform individual activities that harm the interests of the creditors in general. Yet the existing restrictions do not constitute sufficiently serious restraints capable of preventing equity holders from creating unreasonable obstacles to the implementation of a Restructuring Plan.

It can be concluded, therefore, that the Latvian legal framework already imposes some restrictions on equity holders. Nevertheless, the Insolvency Law is not fully consistent with Article 12 of Directive 2019/1023 for the following reasons:

- **(i) equity holders without creditor rights do not have voting rights;**
- **(ii) only certain equity holders (those with creditor rights) have voting rights;**
- **(iii) the Insolvency Law does not contain specific provisions to limit the actions of equity holders, apart from general legal norms and principles that could be attributed also to equity holders.**

For this reason, any future amendments to the Insolvency Law should opt for one of these solutions to comply with Article 12 of Directive 2019/1023, which requires either –

- (i) not to exclude equity holders from the effects of Articles 9–11 of Directive 2019/1023; or
- (ii) to exclude equity holders from the effects of Articles 9–11 but then to ensure by other means that equity holders are not allowed to unreasonably prevent or hinder the adoption and confirmation of a Restructuring Plan.

Stakeholder meetings have demonstrated that equity holders can abuse Formal Restructuring by undermining the debtor's efforts to initiate Formal Restructuring by adopting a Restructuring Plan. By having the right to vote, any equity holders without a controlling influence over the debtor can capitalise on certain situations where there are not enough votes in favour of a Restructuring Plan, and can thus drain concessions from **other equity holders who seek to save the debtor's business.**

As stated before, one solution to reducing such unwanted behaviour would be to separate all equity holders in a class of their own and provide them with the right to vote on Restructuring Plans. The socioeconomic impact of such change is unpredictable within the scope of this report, and further research would have to be undertaken in order to fully understand how extending voting rights to a new class of equity holders would affect Formal Restructuring and insolvent liquidation processes. Pursuant to other conclusions of this report, further studies and discussions have to be conducted on implementing structural changes to the Latvian creditor class structure.

The other solution would therefore be to further codify equity holder liability in the Insolvency Law, although interested parties can already sue **equity holders** under the current legal framework if their actions can be proved to have caused damage to the debtor. A future amendment to **the Insolvency Law could provide that equity holders cannot unreasonably prevent or hinder the adoption and confirmation of a Restructuring Plan, or even require that at the request of other interested parties, the dissenting equity holder should state in writing the reasons for voting against the Restructuring Plan**. Other benchmarked countries have created different levels of restriction on equity holders.

France

How are equity holders restrained from unreasonably preventing the adoption of Restructuring Plans?

Under the French legal system, in formal restructuring, a committee of creditors may draft their own Restructuring Plan, and individual shareholders blocking it are forced to sell their shares, or their stake is diluted through a capital increase.

In the event of a forced sale of shares (*cession forcée*), all or part of the shares of dissenting creditors are acquired by those other shareholders supporting the Restructuring Plan.

Upon this *squeeze out* of dissenting shareholders, other supporting shareholders may request the court for also the sale of their shares.

Any future amendments to the Insolvency Law should pay special attention to the fact that most Latvian enterprises have a very small number of equity holders, i.e. **SMEs are usually managed and owned by a few natural persons**. Nevertheless, legislation would benefit from creating general rules applicable to the rights of equity holders (restriction on unreasonably preventing or hindering the adoption and confirmation of a Restructuring Plan) and from making further distinctions between different types and structures of enterprises with the use of categorisation and subsequent application of rules that are based on economic and financial criteria, e.g. fewer restrictions should be placed on individual equity holders in larger enterprises where power is not as polarised.

Future reformers should also note that Directive 2019/1023 suggests separation and further categorisation of equity holders in different classes based on their voting rights where this might prove beneficial (see Recital 58). Keeping this in mind, as stated above, the relatively simple capital and management structure of Latvian enterprises does not absolutely require such further categorisation. Yet such distinctions combined with the suggestions contained in this report for dealing with equity holder misbehaviour could prove beneficial to increase the flexibility of imposed restrictions in order not to restrict the right of equity holders where this is not necessary.

It should also be noted that a general lack of financial literacy and occasional fraudulent actions across business management in Latvia would be at least partly limited by introducing provisions that limit their actions, which can often hurt the ability of enterprises to restructure their debts and regain solvency.

I. Recommendations

- Amendments to the Insolvency Law should (i) separate equity holders in their own class and provide voting rights to all equity holders, or (ii) exclude equity holders from the effects of Articles 9–11 and expand the restrictions and liability on any equity holders seeking to obstruct the development and initiation of Formal Restructuring, for example:
  a) further codifications of equity holder liability;
  b) further obligations on equity holders with voting rights to state their reasons for voting against the adoption and confirmation of a Restructuring Plan.

8.6 Workers and their Rights

Protection of workers' rights in Formal Restructuring remains at the core of Directive 2019/1023 and is an integral part of broader regulation, also in Latvia. However, Article 13 of Directive 2019/1023 prescribes clear mandatory elements that have to be introduced also in national legal frameworks for the purpose of protecting workers' rights.

This includes the need to require employers to keep their workers informed in cases of preventive restructuring, especially about any circumstances that could affect their rights; to keep the existing rights of workers unaffected, for example, the ability to organise collective bargaining; and to seek approval from workers where a Restructuring Plan covers changes to work organisation or contractual relationships.

The Latvian legal system contains laws and provisions that seek to protect workers' rights, and none of the provisions contained in the laws aims to limit those rights.

Furthermore, Article 11 of the Labour Law includes the right of workers to receive information on the economic and financial wellbeing of their employer, and to participate in consultations about decisions undertaken by their employer which might affect the workers. Unfortunately, none of the provisions within the law include a proactive duty of employers to inform their workers of the above circumstances which may at times lead to lack of information sharing and subsequently to a situation where the workers may be uninformed of the Restructuring Plans of the employer to pursue Formal Restructuring or insolvent liquidation. Workers lacking a proper understanding of Formal Restructuring consequences most likely refrain from requesting information on these procedures. **The obligations contained in Directive 2019/1023 are not precisely regulated in the Latvian legal system.**

Czech Republic

Protection of workers' rights in debt restructuring

Latvia is not alone in lacking the necessary specific safeguards for employees. Czech law also lacks an employer's obligation to inform workers of the existence of formal restructuring, but it is customary for employers to do so nevertheless. The parties often cooperate in planning and executing debt restructuring, with workers enjoying additional protection, as their claims have special priority over those of creditors.

Having no provisions to require employers to inform their workers practically results in cases where the workers might not be aware that their company has begun Formal Restructuring if the procedure does not affect their regular relationship with the employer. For this reason, **the Insolvency Law should be amended to provide that workers should be proactively informed of Formal Restructuring and insolvent liquidation proceedings undertaken by the employer, such communication should be in writing, and the employer should prove the fulfilment of these obligations.** This might give workers a more realistic chance of participating in Formal Restructuring, while having access to information can help them protect their rights.

However, because workers are still poorly organised, introducing such new obligations for employers would not seriously remedy the existing systemic challenges. The Latvian economy is not based on manufacturing and does not rely on enterprises with large headcounts. Furthermore, workers' rights protected by Directive 2019/1023 are rarely exercised, e.g. very few collective agreements have been reached (only two across all industries),[94] and unionisation of workers remains low.[95]

Furthermore, according to the existing Formal Restructuring and insolvent liquidation framework, workers do not have creditor status, yet their claims may be subject to the measures of Restructuring Plans if they so agree.

This leads to the conclusion that **while the Latvian legal system protects workers, and their rights are far from being systematically uncared for, changes need to be made so as to additionally ensure that they remain protected also during Formal Restructuring.**

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[94] Collective agreements, Ministry of Welfare. Available at: http://www.lm.gov.lv/lv/darba-devejiem/kopligumi. [Accessed November 4, 2019].

[95] Fridrihsone, Madara. Only a tenth of workers in Latvia are members of unions, organisations want to grow the number of their members. (LSM.lv, May 1, 2017). Available at: https://www.lsm.lv/raksts/zinas/latvija/latvija-arodbiedribas-ir-tikai-desmita-dala-stradajoso-organizacijas-velas-audzet-biedru-skaitu.a234901/. [Accessed November 4, 2019].

A possible solution to the lack of workers' protection involves ensuring that where Formal Restructuring is promptly initiated, wages are guaranteed by a workers' guarantee fund or workers' claims are shielded from any adverse consequences that may arise when the stay of individual enforcement actions has been initiated as mentioned above in the section "Stay of Individual Enforcement Actions."

However, there are multiple issues regarding the satisfaction of workers' claims even if they are guaranteed and not affected by a stay of individual enforcement actions under the Insolvency Law. According to multiple possible scenarios, workers' rights might not be effectively ensured:

- The employer's application for Formal Restructuring is rejected and the employer becomes insolvent, significantly hampering the efforts of workers to retrieve their claims. Moreover, the satisfaction of workers' claims can be purposefully delayed by the employer even after the Restructuring Plan has been accepted and initiated by the court.
- Formal Restructuring is lengthy, and workers might have their claims satisfied after a significant period.
- Given the existing fraud and bad faith in the use of Formal Restructuring, the employer might use the stay of individual enforcement actions to remove the company's assets and thus leave nothing for the satisfaction of workers' claims.

Under Article 5 of the Law on Protection of Employees in the Event of Employer Insolvency, the workers' guarantee fund only covers the wages paid within the year preceding the initiation of liquidation. Thus, if the employer has attempted Formal Restructuring within this period, workers' claims can be significantly reduced.

These issues could be solved through different legislative incentives and changes:

(i) The Insolvency Law could be amended so as not to stay the enforcement of workers' claims when Formal Restructuring has been initiated. This could hamper the realisation of Formal Restructuring, albeit insignificantly, in many circumstances, for example, workers' claims rarely lead to the insolvency of enterprises and are insignificant compared to the claims of other types of creditors, such as credit institutions and the SRS;

(ii) The stay of individual enforcement actions could also be applied to workers' claims, who would have the opportunity to turn to the workers' guarantee fund for the satisfaction of their claims when Formal Restructuring has been initiated. However, this would require a significant expenditure of state funds;

(iii) The Insolvency Law could be amended to permit the debtor voluntarily ask for the satisfaction of workers' claims out of the workers' guarantee fund when Formal Restructuring is initiated. This could further promote the use of Formal Restructuring and would greatly benefit the workers. However, mechanisms should be introduced to prevent abuse of this situation, for example, the debtor could be required to repay some amount of the financial assistance received.

m. Recommendations

- The Insolvency Law should be amended to regulate the types of information available to workers and the frequency of providing such information, with assurances that certain rights will not be affected Formal Restructuring (LPP or ELPP). There should also be rules to ensure that workers receive fair treatment.
- Workers' claims arising from an employment contract or relationship should be guaranteed by the workers' guarantee fund on the initiation of Formal Restructuring. Alternatively, the stay of individual enforcement actions should not affect workers' claims.

8.7 Valuation by Judicial or Administrative Authority

Article 14(1) of Directive 2019/1023 provides for a mechanism for judicial or administrative authorities to decide on the valuation of a business only where a Restructuring Plan is challenged by a dissenting affected party on the grounds of either –

a. an alleged failure to satisfy the best-interest-of-creditors test under Article 2(1)(6);[96] or

b. an alleged breach of the conditions for a cross-class cram-down under Article 11(1)(b)(ii).

Recital 63 of Directive 2019/1023 states that it should be possible that such a decision also consists of an approval of a valuation by an expert or of a valuation submitted by the debtor or another party at an earlier stage of the process. Where the decision to carry out a valuation is taken, MS should be able to provide for special rules, separate from general civil procedural law, for a valuation in restructuring cases, with a view to ensuring that it is carried out in an expedited manner. Nothing in Directive 2019/1023 should affect the rules on burden of proof under national law in the case of a valuation.

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[96] Under Article 2(1)(6), the best-interest-of-creditors test means a test that is satisfied if no dissenting creditor would be worse off under a Restructuring Plan than he would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going concern, or in the event of the next-best-alternative scenario if the Restructuring Plan were not confirmed.

8.7.1 Current system

The existing mechanism in the Latvian legal system provides that dissenting parties (in most cases likely to be the creditors) can raise objections to the Restructuring Plan with the debtor. Under Articles 42(5), 40(6)(2) and 43.1 of the Insolvency Law, if the debtor has ignored any creditor objections to claims or to the Restructuring Plan, those objections are reviewed, and an opinion is produced by an independent sworn auditor who is not the Supervisor.

Currently Latvian law does not restrict the type or scope of creditor objections. Creditors can submit objections to other creditors' claims or to any other detail of the Restructuring Plan, including the proposed measures of legal protection by the debtor and/or concerns over the Restructuring Plan's compliance with the best-interest-of-creditors test. Under Article 40 (3) and (4)(15) of the Insolvency Law, this test requires the debtor to include in the Restructuring Plan a justification for the fact that the gain of creditors who have not approved the Restructuring Plan, by implementing LPP, is at least as large as what they would have gained if the debtor's insolvent liquidation proceedings had been proclaimed when the Restructuring Plan was approved. These objections are reviewed, and an opinion is produced by an independent sworn auditor (who is not the Supervisor) and later attached to the Restructuring Plan when submitted to the court for review.

Thus, Latvian law provides that the debtor has a positive obligation to review all creditor objections, which have to be either accepted and incorporated in the Restructuring Plan or ignored and later submitted to the court. Creditors are not granted the procedural freedom to submit objections directly to the court; unless the Supervisor in his/her opinion recognises any of the creditor claims as *prima facie* unjustified (see Article 43 of the Insolvency Law), they must instead be directed to the debtor (see Article 42(5) of the Insolvency Law). Thus, if any objections consistent with the purposes of Article 1 of the Insolvency Law have been ignored, a dissenting affected party must be given the right to lodge a challenge with the court before the Restructuring Plan is confirmed.

The purpose of this requirement is to give the debtor a chance to eliminate deficiencies in the Restructuring Plan and allow the Supervisor to review creditor objections for the purpose of drafting an opinion. Under Article 341.6(3) of the Civil Procedure Law, before passing judgment on approval of the Restructuring Plan and its implementation, the court will evaluate the Supervisor's opinion, the sworn auditor's opinion if attached to the Restructuring Plan, and any creditor objections.

If the Restructuring Plan meets the requirements of the Insolvency Law and has been supported in accordance with the procedures and within the time limit prescribed by the Insolvency Law, the court will satisfy the application and give a judgment on the implementation of LPP. As under the Insolvency Law, the Supervisor is appointed by the court in all Formal Restructuring proceedings and required to give an opinion on the viability of the Restructuring Plan, the Supervisor's opinion is available for court evaluation in all proceedings.

According to the proposed approach (see Figures 14 and 15 above), Supervisors will not be mandatory in all Formal Restructuring proceedings, so a new mechanism for appointment of properly qualified experts should be implemented.

Because of the existing rules, it would initially seem that Latvia has adopted a mechanism that helps resolve disputes between the debtor and creditors in adopting the Restructuring Plan, so the affected parties already enjoy the procedural protections afforded by Directive 2019/1023, and Latvia has ensured that, for the purpose of deciding on a valuation under Article 14(1) of Directive 2019/1023, the court has an opportunity to hear properly qualified experts.

However, the current review and valuation procedure does not reach the same standard of investigation as prescribed by Article 14 of Directive 2019/1023, because while Directive 2019/1023 calls for evaluation of the debtor's business and of the viability of the Restructuring Plan when it is challenged by a dissenting affected party, the current provisions in force do not always reach their goal.

Currently the courts tend to fulfil their obligations by evaluating whether a Restructuring Plan meets the formal statutory requirements (see Article 341.6 of the Civil Procedure Law). **In practice, this means that the judges do not evaluate the business sense of the Restructuring Plan or the viability of the debtor's business. Restructuring Plans are only formally evaluated by the courts, although the Latvian legal framework (see Article 341.6 of the Civil Procedure Law relating to the aim and principles laid down by Articles 1, 3 and 6 of the Insolvency Law) does not prevent the courts from evaluating the Restructuring Plan with respect to the viability of the debtor's business in every case.**

The judges are qualified lawyers with an extensive background in terms of legal education and previous practice. However, with such a set of skills, these experts often lack in-depth knowledge of business and Formal Restructuring to successfully evaluate Restructuring Plans, which are often based on economic and financial considerations.

Because of this, the judges take the view that they either require assistance from qualified experts who have the expertise or that they should be able to specialise in Formal Restructuring, thus acquiring expertise through active training and practice.

If the latter solution is chosen, the judges should be tasked with reviewing all the Restructuring Plans submitted and related claims so as to further advance their experience because Formal Restructuring in Latvia is poorly utilised and the number of such cases remains extremely low.

The rights and tools for examining a Restructuring Plan that other MS have given to their courts are similar to Latvia, for example:

Czech Republic

How do the courts evaluate Restructuring Plans?

The Czech courts evaluate Restructuring Plans only formally, although they have the power to reject any Restructuring Plans that do not have a reasonable chance of success. A very similar mechanism to the one in Latvia is employed, where the courts seek the opinions of trustees and sworn auditors in deciding on the acceptance of Restructuring Plans.

Portugal

How do the courts evaluate Restructuring Plans?

The Portuguese courts have developed the necessary expertise in accounting and economics to properly evaluate Restructuring Plans and are able to engage experts for evaluation purposes. However, the courts have the power to reject only Restructuring Plans that fail to fulfil the formal statutory criteria, e.g. obtaining approval from creditors.

The UK

How do the courts evaluate Restructuring Plans?

The UK courts rely on the expertise and opinions of experts who oversee the drafting and review of Restructuring Plans prepared in the context of a scheme of arrangement.

Article 14 of Directive 2019/1023 provides that it is mandatory to evaluate the viability of the debtor's business when certain types of claims of affected parties are received. **It is therefore necessary for the current legislation to expand and include requirements for the judges not to limit themselves to evaluating only the formal requirements for a Restructuring Plan or evaluating it only when it has been challenged by dissenting creditors (see Articles 10(2)(d) and 14(1) of Directive 2019/1203) but also to evaluate and reject any Restructuring Plans that lack a reasonable chance of success (see analyses of Article 10 in this report).** However, an important decision must be made in terms of how to proceed with evaluating the viability of Restructuring Plans, which no doubt requires additional expertise.

Lack of economic expertise has been addressed in numerous interviews.[97] The legal experts have pointed to the formalistic nature of reviews conducted by the courts. They have even suggested that the courts should go further in not only reviewing the viability of the Restructuring Plan, but that they should also have the competence to determine when other measures should be applied to the particular business. For example, the courts should be able to direct enterprises to Formal Restructuring when receiving a submission for the initiation of insolvent liquidation proceedings if this would be more beneficial for the business.

The courts have often been unsuccessful in properly evaluating Restructuring Plans and should be assisted or further specialised as evidenced by the following Supreme Court rulings:

[97] For example, experts from credit institutions have revealed that in their experience courts and Supervisors lack the necessary economic and financial expertise to evaluate Restructuring Plans, for example, by evaluating whether the payment schedule in the Restructuring Plan is realistic. Representatives of the State Police have pointed out that the judges often lack the necessary expertise and specialisation to oversee Formal Restructuring and request too little information from the debtor when deciding on the conformity of Restructuring Plans. The experts suggest creating a specialised court for dealing with Formal Restructuring and insolvency matters.

Latvian Supreme Court Civil Division ruling SKA-270/2011 of 25 January 2011

The debtor had ongoing court proceedings with another entity that was neither recognised as a creditor and nor included in the Restructuring Plan. The ignored creditor was not informed and was unable to participate in approval of the Restructuring Plan. The court had initiated LPP.

The Supreme Court found that **the lower court had wrongfully initiated LPP** when a creditor who represented more than half of all unsecured claims against the debtor was not included in the Restructuring Plan.

Latvian Supreme Court Civil Division ruling SPC-38/2013 of 11 September 2013

LPP had been initiated for the debtor, who failed to include a creditor in the Restructuring Plan. The dispute was over whether the ignored creditor had any claims against the debtor and should have been recognised.

The lower court had sided with the debtor's opinion and taken into account the debtor's information that an agreement had been concluded between the debtor and the ignored creditor for the cancellation of a debt. The lower court had failed to indicate which legal sources and evidence had been used to reach such a conclusion.

The debtor's accounting records contained no evidence to prove that the debts had indeed been cancelled. Accordingly, the lower court was wrong in initiating LPP and concluding that the Restructuring Plan complied with the applicable legal provisions and that it had been properly submitted and approved.

Latvian Supreme Court Civil Division ruling SPC-16/2017 of 15 May 2017

The Supreme Court analysed a lower court's judgment and found that it had failed to adequately evaluate a creditor's reservations about the Restructuring Plan.

The lower court had not determined that the creditors' benefit from initiating LPP would be at least as substantial as if the debtor's insolvent liquidation proceedings had been initiated. The lower court had failed to identify discrepancies between the balance sheet and the Restructuring Plan and failed to notice that the Restructuring Plan did not adequately indicate the debtor's assets.

Latvian Supreme Court Civil Division ruling SPC-13/2017 of 16 February 2017

The ICS had requested removal of the Insolvency Practitioner from the debtor's insolvent liquidation proceedings on the grounds that the Insolvency Practitioner had breached multiple provisions of the Insolvency Law and that limitations imposed by the Insolvency Law apply to the Insolvency Practitioner and prevent the further performance of her duties. The ICS claim was rejected by the lower court.

The Supreme Court overruled the decision by which the claim had been rejected, and found that because of multiple historical and professional ties between the Insolvency Practitioner and the debtor's representative, a conflict of interest foreseen in the Insolvency Law might have indeed existed.

The Insolvency Practitioner had failed to submit the Restructuring Plan to the institution that oversees the insolvency register. The Insolvency Practitioner had failed to check whether the Restructuring Plan had indeed been sent to all creditors. The opinion prepared by the Insolvency Practitioner lacked the necessary quality and contained serious flaws.

There were serious concerns over possible conclusive actions between the debtor and the Insolvency Practitioner and that LPP had been initiated for the purpose of obtaining a favourable Insolvency Practitioner for the eventual insolvent liquidation proceedings.

The Supreme Court found that the lower court had failed to adequately review the ICS concerns and had only formally replied to the protest. The Supreme Court noted that it is especially important to review the circumstances that might cause wrongdoings and conflicts of interest when the person supervising LPP is appointed at the debtor's suggestion.

Latvian Supreme Court Civil Division ruling SPC-1/2016 of 28 January 2016

The case was concerned with a seemingly fictitious real estate transaction concluded by the debtor before the initiation of LPP. Similar to the cases analysed above, in this dispute the lower court had ignored a creditor's reservations about the seemingly fictitious transaction and a fake creditor.

The lower court had failed to evaluate the creditor's reservations about the possibility of recovering the debts, i.e. whether the debtor stands a real chance to actually receive the sum of money for the sale of the real estate and whether the Restructuring Plan correctly relies on those future assets.

Latvian Supreme Court Civil Division ruling SPC-18/2015 of 29 December 2015

LPP had been initiated for the debtor. Because new means of securing claims had been imposed on the debtor, no further commercial activity or fulfilment of the Restructuring Plan was possible. The debtor became subject to insolvent liquidation proceedings. The debtor had failed to submit amendments to the Restructuring Plan and had not given notice to the person supervising LPP on implementation of the Restructuring Plan.

The lower court had breached procedural law by terminating LPP and initiating insolvent liquidation proceedings when the legality of the initiation of LPP was being reviewed by the Supreme Court in a separate case.

In view of this information, it would then be crucial to continue improving the expertise of judges so as to enable them to better evaluate the viability of the debtor's business and the Restructuring Plans submitted. This can be done by organising judicial training and introducing specialisation within the current judicial system, which would be consistent with the current reforms undertaken in other fields of law. However, lack of professional integrity and possible corruption can also affect the quality of judgments, representing issues that would not be remedied by additional investment in the competence of judges.

The required specialisation has not yet been fully introduced, and the Latvian judges do not have the necessary financial and business expertise to carry out such an in-depth business evaluation on their own.

8.7.2 Appointment of experts

To achieve the objective and obtain assistance for the courts, Article 14 requires MS to ensure that the courts have access to qualified experts when reviewing a valuation of the debtor's business in the light of the above challenges by affected parties. This **mandatory provision giving the judges freedom to consult qualified experts should be introduced** in Latvian law to assist the judges in tackling especially complex cases of Formal Restructuring.

If the recommendations for Supervisors are introduced, Supervisors could ensure a sufficient level of quality and review of the Restructuring Plan and thus provide an opinion prescribed by Article 14 of Directive 2019/1203. As a result, the terms "expert" and "Supervisor" could be used interchangeably.

As visualised in Figures 14 and 15 and explained in the chapter on Supervisors, future amendments to the Insolvency Law could facilitate two different scenarios for appointing Supervisors in Formal Restructuring proceedings:

1) a Supervisor is always mandatory;
2) a Supervisor is optional unless the court or the stakeholders (the debtor or creditor(s)) during Formal Restructuring request the appointment of a Supervisor.

In the scenario where the stakeholders (the debtor or creditor(s)) during Formal Restructuring request the appointment of a Supervisor, similar procedures for appointing a Supervisor under Article 341.5 of the Civil Procedure Law can be applied. At the request of the debtor or creditor(s), the court would pick a Supervisor from the suggested candidates.

Where the appointment of a Supervisor is initiated –

1) **at the debtor's request**, the court would appoint a Supervisor from the list of candidates provided by the debtor, with the cost of Supervisor borne by the debtor; or
2) **at the creditor(s) request**, the court would appoint a Supervisor from the list of candidates provided by the creditor(s), with the cost of Supervisor borne by the creditor(s) under Article 5(3)(c) of Directive 2019/1023.

At the same time, the judges should be given the power not to appoint a suggested Supervisor as a qualified expert if the court establishes that there are restrictions on carrying out the Supervisor's duties in the relevant Formal Restructuring. Thus, the court should be able to send a request for the relevant stakeholder(s) to provide information on a new candidate(s) for the position of Supervisor or choose the most appropriate candidate from a list of Insolvency Practitioners provided by the ICS. In that case, the ICS should provide a list of only Insolvency Practitioners that meet the qualification criteria described in section "4.1.4 Qualification of the Supervisor."

Under the existing rules of Article 93(4) of the Civil Procedure Law, if the court admits that no evidence has been submitted for any of the facts on which a party's claims or objections are based, the court should notify the parties and, if necessary, set a time limit for submitting evidence.

Based on this rule and considering that Article 14 requires the courts to decide on the valuation of a business only where a Restructuring Plan is challenged by a dissenting affected party, if the court would like a second opinion on any unjustified facts or on a party's objections unresolved under Articles 43 and 43.1 of the Insolvency Law, the court should carry out the obligation to inform the party (the debtor or creditor(s)) and ask them to submit a list of Supervisors or other qualified experts or ask for a list of candidates from the ICS, from which the court could appoint an expert (natural person or legal entity) for this purpose. So **when the initiative to appoint a Supervisor comes from the court**, the debtor (or creditors if they agree to finance the Supervisor) is asked to name a Supervisor candidate or candidates from which the court can select the most appropriate candidate or choose the most appropriate candidate from the list of Insolvency Practitioners provided by the ICS. In any case, the Supervisor has to conform with the qualification criteria described in section "4.1.4 Qualification of the Supervisor."

Although Directive 2019/1023 requires MS to give the judges freedom to consult qualified experts, it is silent about rules for financing such experts. Because the general rules of the Civil Procedure Law stipulate that initially costs of the expert are borne by the party who engaged him, the financing issue should be further explored and discussed.

Consequently, there are numerous contradictions between the national legal framework for Formal Restructuring and the spirit and nature of Directive 2019/1023. These contradictions boil down to the following three issues:

- The national law does not foresee an effective mechanism for evaluating the viability and business sense of the Restructuring Plan;
- For the purposes of Article 14(1) of Directive 2019/1023, the national law does not clearly stipulate a dissenting affected party's right to lodge a challenge with the court called on to confirm the Restructuring Plan;
- The national law does not stipulate a dissenting affected party's right to appeal against the decision confirming a Restructuring Plan (see recommendations for appeals in the chapter *Appeals* of this report).

n. Recommendations

- The existing mechanism in the Latvian Civil Procedure Law should be further developed to permit the courts to summon and consult a Supervisor or other qualified expert when deciding on issues arising in LPP or ELPP. As a minimum, the courts should be able to appoint or hear a Supervisor or other qualified expert when assessing a valuation in disputes over confirmation of a Restructuring Plan, as required by Directive 2019/1023.
- For the purposes of Article 14(1) of Directive 2019/1023, the Insolvency Law should be amended to permit a dissenting affected party to lodge a challenge with the court on confirmation of a Restructuring Plan.

8.8 Effects of Restructuring Plans

Article 15 of Directive 2019/1023 prescribes the binding effects of a court-approved Restructuring Plan and its non-binding effects on unaffected creditors that are not involved in adopting it.

Article 45 of the Insolvency Law provides that a court-approved Restructuring Plan should be mandatory and binding on all creditors, including dissenting ones. Under Article 40 of the Insolvency Law, a Restructuring Plan must contain all payment obligations to creditors and be sent by the debtor to all creditors (see Articles 40(6)(2) and 53(1)(5) of the Insolvency Law).

It follows from Article 40 of the Insolvency Law that all creditors must be included in the Restructuring Plan. The debtor cannot choose any creditors to be excluded from it.

Article 38 (2) and (8) of the Insolvency Law provides that within a class of creditors and for each type of creditor claim (principal debt, penalty, or interest), the Restructuring Plan may only provide for proportional repayment or reduction of the principal debt, penalty, or interest. This principle of proportionality should not extend to any claims for payment of taxes, wages or indemnity without the creditor's or employee's consent. Currently all creditors must be involved in adopting and implementing a Restructuring Plan, however Directive 2019/1023 calls for flexibility in the preventive restructuring framework so that only creditor classes affected by the Restructuring Plan have to vote on it.

It should be noted that OCW are governed by party autonomy, are not approved by the court, and are not mandatory or binding on any creditors that were not involved in adopting the Restructuring Plan. Such OCW are binding only on the parties to the agreement under the general *pacta sunt servanda* principle that contracts are binding and must be performed by the parties.

In view of the above, the national legal framework for Formal Restructuring is fully consistent with Article 15(1) of Directive 2019/1023. However, because the concept of unaffected creditors is not regulated by the Insolvency Law, it can be concluded that the current Formal Restructuring framework is not consistent with Article 15(2) of Directive 2019/1023. Please see the analysis of unaffected creditors in the chapter *Content of the Restructuring Plan* above.

o. Recommendations

- The Insolvency Law should be amended to introduce the definition of unaffected creditors and the criteria and principles relevant to Formal Restructuring.

8.9 Appeals

Under Article 16 of Directive 2019/1023, interested affected parties should be able to appeal an administrative authority's decision confirming a Restructuring Plan. **Currently only a decision rejecting a Restructuring Plan can be appealed** (see Articles 341.6(8) and 341.7(5) of the Civil Procedure Law*).* While there is a legal mechanism[98] for reviewing a decision confirming a Restructuring Plan, this is more complicated than the appeal mechanism.

As Directive 2019/1023 provides that decisions accepting the initiation of Formal Restructuring also have to be appealable, Article 16(1) of Directive 2019/1023 must be introduced.

Directive 2019/1023 significantly affects Latvia's civil procedure system, so the following issues should be considered when implementing the appeal mechanism:

1) The Civil Procedure Law currently lays down different rules for appealing a decision rejecting a Restructuring Plan (appeals and ancillary appeals). If an appeal against a decision confirming a Restructuring Plan is envisaged, no clear justification for such a distinction can be found, so the procedure for such appeals should be the same.
2) The consequences of an appealed decision are at the discretion of the legislature by choosing which stakeholder should enjoy more protection (the debtor's or creditors' interests). Either alternative requires a fast and effective appeal procedure. However, as the promotion of Formal Restructuring is a priority, in PwC's view, the appeal against a decision confirming a Restructuring Plan should not suspend its implementation, but the interests of creditors should be protected by a very effective and expedited appeal procedure.

It should be noted that in other jurisdictions it is possible, under certain circumstances, to appeal an administrative authority's decision confirming a Restructuring Plan, for example:

Spain

Can court decisions on debt restructuring be appealed?

Under certain circumstances, creditors who did not support the agreement and are affected by it can challenge the court decision by which the restructuring agreement was approved. The resulting court decision on the claim cannot be appealed and is final.

Creditors who did not vote in favour or voiced their opposition may challenge the extrajudicial payment agreement if they are affected by it. The initiation of the challenge does not suspend the execution of the agreement.

The ruling on the challenge can be further appealed, and if the agreement is annulled on the challenge of the creditors, the debtor's insolvency proceedings are automatically initiated.

[98] See Chapter 60 of the Civil Procedure Law "Examination of Cases Connected with Breach of Significant Substantive or Procedural Provisions of Law". Available at: https://likumi.lv/ta/id/50500-civilprocesa-likums. [Accessed March 4, 2020].

Portugal

Can court decisions on debt restructuring be appealed?

The debtor, shareholders, recognised creditors and the debtor's representatives – spouses and heirs – can appeal unfavourable decisions of the court within five days after the decision has been declared.

The court of appeals can then (i) issue a note for the lower court to repeat the voting procedure if the appeal has proved inconsistencies in the counting procedure; (ii) reverse the decision by which debt restructuring has been denied if no inconsistencies have been identified.

France

Can court decisions on debt restructuring be appealed?

Most court decisions on formal restructuring proceedings cannot be appealed by the parties. The only appealable decision is one by which the court grants the initiation of debt restructuring at the debtor's request.

Because the right of appeal may be exercised dishonestly, unreasonably or even abusively, when implementing the appeal mechanism, Latvia should not derogate from the first subparagraph of Article 16(3) of Directive 2019/1023, which provides that an appeal **should have no suspensive effects on the execution of a Restructuring Plan**.

Article 440.2 and subsequent provisions of the Civil Procedure Law offer an expanded framework for "expedited appeals." In the light of international practice and from a systemic perspective, it is PwC's opinion that the appeal procedure should be dealt with under the "expedited appeal" procedure of the Civil Procedure Law.

This framework sets deadlines for each procedural action (transferring a case to a higher court, time for submission of stakeholders' explanations, deadlines for the start of the case within a certain period after receipt of statements etc). In practice this regulation does not always provide efficiency, as cases are different and the courts practice extensive judicial discretion (for example, if the regulation provides for proceedings to be opened within 15 days, the courts respect the time limit but finish it within six months).

To ensure that valuations in restructuring cases are carried out in an expedited manner as set forth in Recital 63 of Directive 2019/1023, the legislature should generally improve the procedures for dealing with expedited appeals and should establish a time frame within which the courts would be required to render a judgment. The exact number of days necessary for rendering such judgments should be further discussed in the working groups, as it falls outside the scope of this report and requires substantial involvement from the representatives of the judicial community.

In addition to avoiding lengthy litigation over confirmation of a Restructuring Plan, **the Civil Procedure Law should specify a deadline for lodging an appeal against the decision confirming a Restructuring Plan.**

Article 16 of Directive 2019/1023 proposes introducing a compensation mechanism for an injured party if its appeal against the Restructuring Plan is upheld. The introduction of such compensation could be considered, for example, if the amount of compensation is fixed or limited, depending on the size of the company, to ensure that the compensation does not destroy the debtor already facing financial difficulties and to prevent the appeal from turning into litigation for damages. Given the risk of the new compensation mechanism turning into litigation for damages or being just another instrument for creditors to claim against the debtor, more detailed discussions should be held before making the decision on its implementation. **If, however, Latvia decides to implement a compensation mechanism, the fact that the decision to confirm a Restructuring Plan is taken (verified) by the court, not by the debtor, should be considered to ensure that the amount of compensation is proportionate.**

> Stakeholders have noted that it would indeed be fair to offer compensation to creditors affected by the initiation and application of unlawful Restructuring Plans, although this issue is of less practical importance.
>
> It would also be unfair to require creditors to evaluate the fairness and legality of Restructuring Plans. Accordingly, the responsibility for paying such compensation should lie with either the debtor or the Supervisor (civil insurance).

p. Recommendations

- The Civil Procedure Law should be amended to make the decision confirming a Restructuring Plan appealable.
- The Civil Procedure Law should specify a deadline for lodging an appeal against the decision confirming a Restructuring Plan.
- The appeal procedure should be dealt with under an “expedited appeal” procedure of the Civil Procedure Law.
- An appeal against the decision confirming a Restructuring Plan should have no suspensive effects on the execution of that Restructuring Plan.
- Further research and/or debate should be conducted on the question of implementing a compensation mechanism for an injured party if its appeal against the Restructuring Plan is upheld.

9 Protection of New Financing, Interim Financing and Other Restructuring Related Transactions

9.1 Protection of New Financing and Interim Financing

Requirements of Article 17(1) of Directive 2019/1023

Directive 2019/1023 acknowledges that the success of a Restructuring Plan often depends on whether financial assistance is extended to the debtor for supporting, firstly, operation of the business during restructuring negotiations and, secondly, implementation of the Restructuring Plan once confirmed.[99] Article 17 of Directive 2019/1023 therefore requires MS to ensure that new financing and interim financing are adequately protected.

Under Directive 2019/1023, financial assistance should be understood in a broad sense, including the provision of money or third-party guarantees and the supply of inventories, raw materials and utilities, for example, through allowing the debtor a longer repayment period. Article 2 (7) and (8) of Directive 2019/1023 defines “new financing” and “interim financing” as follows:

- **New financing** is any new financial assistance which is provided by an existing or a new creditor in order to implement a Restructuring Plan and which is included in that Restructuring Plan;
- **Interim financing** is any new financial assistance which is provided by an existing or a new creditor and includes, as a minimum, financial assistance during the stay of individual enforcement actions, and which is reasonable and immediately necessary for the debtor’s business to continue operating or to preserve or enhance the value of that business.

Article 17(1)(a) of Directive 2019/1023

Article 17(1)(a) requires MS to ensure that, as a minimum, any new and interim financing will not be declared void, voidable or unenforceable if the debtor subsequently goes into insolvent liquidation.

Neither new financing nor interim financing is expressly defined in Latvian law. However, Article 40(5) of the Insolvency Law recognises the concept of new financing as follows:

> “A plan for LPP measures **may give preference** to persons that allocate **funds for implementing the plan**, according to the amount of funds allocated. If the LPP are terminated and the legal entity’s insolvency proceedings proclaimed simultaneously, the acquired advantages must remain in effect and the claims against the debtor arising from the funds allocated for implementing the plan must be treated as expenses of the insolvency proceedings. Those advantages must not affect the interests of secured creditors.”

In view of this, the legislature should first and foremost lay down clear definitions for both forms of post-commencement finance in the Insolvency Law. Notable in this context is the fact that unlike some other Latvian laws (e.g. Article 1 of the Credit Institutions Law), the Insolvency Law does not have a separate article on definitions. Because of this, definitions of new and interim financing could be most effective if inserted in a **new article of the Insolvency Law dedicated to new and interim financing**. Doing so would be vital before any other protections can be created. Adopting clear definitions of new and interim financing could also have the positive effect of popularising the two types of financing and eventually lead to an increase in lending to debtors in financial difficulty if additional protections are offered.

The Insolvency Law contains no provisions for protecting new or interim financing and does not, therefore, fully meet the minimum requirements of Article 17(1)(a) of Directive 2019/1023.

Article 96 of the Insolvency Law requires the Insolvency Practitioner to evaluate the debtor’s transactions and to challenge them in court as invalid **regardless of their type** if such a transaction has (i) been concluded within three years before the initiation of insolvent liquidation and (ii) caused a loss to the debtor, and (iii) the other party or parties to the transaction had to know that concluding such a transaction would harm the debtor.

[99] See Recital 66 of Directive 2019/1023.

The Latvian legal system therefore contains a very general avoidance-action regime (*a single avoidance action*) whereby any harmful transactions meeting the requirements of the Insolvency Law can be subject to avoidance in the event of insolvent liquidation. This is in contrast to other jurisdictions where a further distinction is made between the different negative effects a transaction can have on the rights and interests of creditors (a *double set of avoiding powers*). Thus, new financing can also be challenged on the grounds of Article 96 of the Insolvency Law.

Relative protection is, however, indirectly afforded to new financing since this must always be included in the Restructuring Plan, which is then subject to (i) creditor confirmation and (ii) court review.

The Insolvency Administrator's appeal against any new financing transactions would be extremely unlikely, and no such attempts can be identified in the case law. In practice, creditor confirmation and court review preclude any Restructuring Plans containing detrimental new financing from coming into force.

However, no legal provision in theory prevents the Insolvency Administrator from attempting avoidance actions against new financing. This could potentially lead to situations where new financing is avoided after creditor and court oversight has failed and the Insolvency Administrator's appeal proves successful.

The current lack of protection for new and interim financing could be acting as a deterrent to potential finance providers. This being one of the reasons, the Legislative Guide on Insolvency Law[100] by the United Nations Commission on International Trade Law ("UNCITRAL") suggests ensuring that finance providers retain their claims and priority ranking in subsequent insolvent liquidation.

Similarly, Recital 67 of Directive 2019/1023 states that national insolvency laws providing for avoidance actions of interim and new financing (…) could jeopardise the availability of financing necessary for the successful negotiation and implementation of a Restructuring Plan. It becomes clear that without formalised provisions in the Insolvency Law, the Latvian legal system will not fully reach the goals of Directive 2019/1023, which goes beyond merely protecting new and interim financing and expects MS to increase the practical application of post-commencement finance.

In view of the above, the Insolvency Law would have to be amended in two ways. Firstly, the Insolvency Law needs a new article to expressly provide that new and interim financing cannot be declared void, voidable or unenforceable if the debtor subsequently goes into insolvent liquidation (in addition to offering definitions of new and interim financing). **Secondly, Article 96 of the Insolvency Law should be amended to exclude new and interim financing transactions from its scope.** These two amendments would ensure that the Insolvency Law meets the requirements of Article 17(1)(a) of Directive 2019/1023.

Article 17(1)(b) of Directive 2019/1023

Article 17(1)(b) requires MS to ensure that grantors of new and interim financing will not incur any civil, administrative or criminal liability on the basis that such financing is detrimental to the general body of creditors, unless other additional grounds laid down by national law are present.

No provisions in the Insolvency Law, or in Latvian law in general, attribute liability to grantors of new and interim financing on the sole basis that such financing is detrimental to the general body of creditors. Transactions themselves can, however, be voided under Article 96 of the Insolvency Law (see above on Article 17(1)(a) of Directive 2019/1023). It can be concluded, therefore, that **Latvian law meets the requirements of Article 17(1)(b) of Directive 2019/1023**.

However, **the Insolvency Law could benefit from having a new paragraph to expressly provide that grantors of new and interim financing should not incur any civil, administrative or criminal liability** on the sole basis that such financing is detrimental to the general body of creditors. This provision would be best inserted in the same article of the Insolvency Law that deals with new and interim financing (including definitions and protections for both types of financing as stated above). Doing so could have the positive effect of encouraging lending.

Article 17(2) of Directive 2019/1023

Article 17(2) of Directive 2019/1023 permits MS to provide that Article 17(1) applies only to new financing if the Restructuring Plan has been confirmed by a judicial or administrative authority, and to interim financing that has been subject to ex ante control.

The Insolvency Law provides that in order to gain adequate protection (as foreseen by Article 17(1) of Directive 2019/1023) funds for implementing a Restructuring Plan must be included in it and are therefore subject to indirect court approval since Restructuring Plans must always be confirmed by the court. Accordingly, the Insolvency Law is consistent with Article 17(2) of Directive 2019/1023 on new financing, i.e. protection of new financing is conditional on court approval.

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[100] The Legislative Guide on Insolvency Law: Part I and Part II, the United Nations Commission on International Trade Law (UNCITRAL), 2005. Available at: https://uncitral.un.org/en/texts/insolvency. [Accessed 4 November 2019].

While interim financing is not subject to such prior confirmation (naturally since this type of financing is granted before the Restructuring Plan is confirmed), **Article 17(2) should not be introduced for interim financing**, especially because this would lead to further expenditures of resources and could discourage finance providers if some type of confirmation were required before making such transactions.

Article 17(3) of Directive 2019/1023

Article 17(3) of Directive 2019/1023 permits MS to exclude from protection any interim financing granted after the debtor became unable to pay its debts as they fall due.

The Insolvency Law neither contains any comparable provisions nor creates preconditions for the allocation of interim financing depending on the debtor's financial standing. Not having such express rules in the Insolvency Law does not create issues in practice since the Insolvency Practitioner may later challenge any transaction that harms the debtor and is unreasonable or unnecessary (see Article 96(1)(2) of the Insolvency Law). Thus, the Latvian law already contains mechanisms for limiting abuse of new and interim financing, and the authors of this report believe that the optional provisions of **Article 17(3) of Directive 2019/1023 should not be transposed**, to avoid limiting the flexibility of Formal Restructuring and the availability of interim financing.

Article 17(4) of Directive 2019/1023

Article 17(4) permits MS to provide that grantors of new or interim financing are entitled to priority payments in subsequent insolvent liquidation proceedings over other creditors who would otherwise have superior or equal claims.

As noted above, Article 40(5) of the Insolvency Law allows a preference to be given to persons that allocate funds for implementing a Restructuring Plan. If Formal Restructuring is terminated and the legal entity's insolvent liquidation proceedings proclaimed simultaneously, the acquired advantages should remain in effect, and the claims against the debtor arising from the funds allocated for implementing the Restructuring Plan should be treated by the Insolvency Practitioner as expenses of the insolvent liquidation proceedings. The advantages conferred on the persons allocating new and interim financing should not, however, affect the interests of secured creditors.

In view of this, the **Insolvency Law is partially consistent with Article 17(4) of Directive 2019/1023** since new and interim financing can only be prioritised over unsecured claims. **The existing priority allocation should not be changed** even if it could potentially encourage new lenders by lowering the risk of investing, because the associated risks of fraudulent behaviour would be too high. Also, secured debt could naturally become more expensive if it were subject to the possibility of being overridden by new and interim financing.

> Stakeholders have expressed support for defining new and interim financing in the Insolvency Law. With this in mind, stakeholders suggest that these additional methods for financing debtors should not affect the rights of existing creditors.

q. Recommendations:

- An additional article on new and interim financing should be inserted in the Insolvency Law to (i) define the two types of financing, to (ii) protect them from voidance actions, and to (iii) expressly limit the liability of grantors of new and interim financing.
- Article 17(3), which permits MS to exclude from protection any interim financing granted after the debtor became unable to pay its debts as they fall due, should not be transposed nationally, to avoid limiting the flexibility of Formal Restructuring and the availability of interim financing.
- Grantors of new and interim financing should not be entitled to payments with higher priority than secured creditors but should enjoy higher payment priority than unsecured creditors in the context of the debtor's subsequent insolvent liquidation.

9.2 Protection of Other Restructuring Related Transactions

Article 18(1) requires MS to ensure that, in the event of a debtor's subsequent insolvent liquidation, any transactions that are reasonable and immediately necessary **for negotiating a Restructuring Plan** are not declared void, voidable or unenforceable on the grounds that such transactions are detrimental to the general body of creditors, unless other additional grounds laid down by national law are present.

Such provision is partially introduced in the Latvian legal system. The Insolvency Law provides that clearing transactions in certain circumstances are allowed. However, these transactions and their status should be evaluated if LPPs are transformed into insolvent liquidation proceedings. While Recital 68 of Directive 2019/1023 provides that MS **should not be required to limit the protection of interim finance to cases where the Restructuring Plan is adopted by creditors or confirmed by a judicial or administrative authority,** Article 18(2) permits MS to provide that Article 18(1) only applies where the Restructuring Plan is confirmed by a judicial or administrative authority or where such transactions were subject to *ex ante* control.

The experts believe that implementing this provision without implementing Article 18 (2) and (3) could increase the risk of a stay of individual enforcement actions being used in bad faith (e.g. by transferring assets). Although the Commercial Law lays down a general rule for the liability of members of the management board, case law shows that such liability in LPP cases is assessed very rarely. **To mitigate this risk, there should be a mechanism for effective supervision and easy application of administrative liability. Implementing Article 18 (2) and (3) could mitigate this risk.**

The transactions listed in Article 18(4) are not defined in the law and are mandatory. It would be necessary, therefore, to amend the law to include definitions of these financing methods, provided that Article 18 (2) and (3) is implemented as well.

r. Recommendations

- The Insolvency Law should be amended to provide that certain transactions that are reasonable and necessary should not be declared void, voidable or unenforceable in the process of (1) negotiating a Restructuring Plan and (2) when they are carried out in accordance with a Restructuring Plan confirmed by the court.
- It would be beneficial to amend the Insolvency Law in order to include definitions of transactions that are reasonable and immediately necessary for negotiating a Restructuring Plan.
- To mitigate the risk that transactions protected by negotiation of the Restructuring Plan will be used in bad faith, the optional provisions of Article 18(2–3) of Directive 2019/1023, which require court control or confirmation of the Restructuring Plan and exclude any transactions made after the debtor became unable to pay its debts as they fall due, should be implemented in Latvian law.

10 Duties of Directors

Requirements of Directive 2019/1023

Article 19 of Directive 2019/1023 requires MS to lay down strict obligations on company directors to (i) have due regard to the interests of all stakeholders, (ii) take steps to avoid insolvency, and (iii) avoid any conduct that threatens the viability of the business. This provision aims to ensure that directors are not dissuaded from exercising reasonable business judgment or taking reasonable commercial risks, particularly where to do so would improve the chances of a restructuring of potentially viable enterprises.

Directive 2019/1023 specifies various steps to be taken by the directors to minimise losses and to avoid insolvency, such as seeking professional advice, including on Debt Restructuring and insolvency, for instance by making use of early warning tools where applicable; protecting the company's assets so as to maximise value and avoid loss of key assets; considering the structure and functions of the business to examine viability and reduce expenditure; refraining from committing the company to the types of transaction that might be subject to avoidance unless there is an appropriate business justification; continuing to trade in circumstances where it is appropriate to do so in order to maximise going-concern value; holding negotiations with creditors and entering preventive restructuring procedures.[101]

Latvian legal system on duties of directors

The Commercial Law imposes a general obligation on company directors to act vigilantly, meticulously and in the best interests of the company (see Article 169 of the Commercial Law). A more detailed description of director duties is provided by the legal literature and case law. Directors are personally liable for financial damage caused to the company if they fail to carry out those obligations, but this liability is rarely enforced in practice, with very few directors convicted of such offences.

Since Formal Restructuring is a voluntary procedure, there are no obligations on directors to submit an application for the initiation of Formal Restructuring within a certain time limit after the debtor starts facing or foresees financial difficulties. However, directors are subject to strict filing deadlines for the initiation of insolvent liquidation proceedings. Under Article 57(5) of the Insolvency Law, directors have a duty to act if the debtor fails to honour debts for two months after they have fallen due, unless they reach an agreement on Formal Restructuring with the creditor(s).

As to particular duties of the directors when the company faces financial difficulties, there is case law (e.g. SKC-20/2015 and SKC-7/2016) focusing mainly on the directors' duties to respect the interests of creditors and to save the debtor's assets for the insolvent liquidation procedure so that the creditor claims are satisfied to the maximum.

A reference to the duty of directors to make an effort in restructuring their enterprises (within LPP or by OCW) is made by Article 60(3) of the Insolvency Law, requiring the debtor to file for insolvency if he has any of the signs of insolvency specified by Article 57 of the Insolvency Law. Accordingly, the debtor is suspended from the obligation to file for insolvency when an agreement has been reached with creditors within OCW or when Formal Restructuring has been initiated. This provision is deemed to relieve from liability any directors who are making an effort to restructure their enterprise instead of applying for insolvent liquidation and might therefore be regarded as an incentive for the directors to seek restructuring.

However, there are at least couple of factors that limit the efficiency of this provision. Firstly, cases of enforcing directors' liability for abuse and negligence (including insolvent trading) are so rare that there is no strong motivation for directors to use restructuring as a tool against potential liability; the law refers to a situation where the debtor already shows signs of insolvency. Secondly, even if a director makes a restructuring effort at this stage as an alternative to filing for insolvency, it might be already too late for successful restructuring. The director's liability for insolvent trading cannot therefore be seen as a self-sufficient incentive for directors to start restructuring the company at an early stage, and other incentives such as EWS should be involved.

The Criminal Law also imposes liability on company directors. Directors can be held liable if they have knowingly taken actions contributing to the insolvent liquidation of the company, submitted false information, obstructed the insolvent liquidation process or the rules of Formal Restructuring (see Articles 213, 214, 215 and 215.[1] of the Criminal Law). However, according to the interviews, these offences are rarely prosecuted.

The Law on Taxes and Duties prescribes further liability for directors who can be held personally liable for the company's tax debts (see Chapter XI of the Law on Taxes and Duties).

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[101] See Recital 70 of Directive 2019/1023.

If, however, in view of these existing duties, the national legislation fails to define the obligations arising from Directive 2019/1023, the Insolvency Law and the Commercial Law should be amended to include the duties of company directors prescribed by Directive 2019/1023.

Consultation with the State Police has revealed a serious lack of capacity to tackle breaches of the Insolvency Law and fraudulent economic crimes related to Formal Restructuring. Individual inspectors are often overloaded with cases and lack the necessary capacity to effectively tackle them, which would also lead to these breaches of law being enforced. However, the capacity of the State Police might be just one of several obstacles, so a more detailed research of law enforcement should be conducted to obtain comprehensive information on obstacles to successfully imposing the sanctions on directors prescribed by the current legal framework.

While the Latvian law is consistent with the provisions of Directive 2019/1023, despite the possible obstacles to enforcing liability for breach of duties of directors, a couple of new approaches might improve law enforcement and prevention of abuse of director duties.

10.1 Proposed Approach

Firstly, the current legal framework should be revised to identify criminal sanctions for breach of director duties that are rarely applied. According to the interviews with the ICS and the SRS, the number of cases where sanctions have been applied to directors for not submitting accounting documents to the Insolvency Practitioner have significantly increased after the ICS took over the competence of imposing administrative fines from the State Police. The same trend is typical of statistics on sanctions for failure to file for insolvency. The number of cases has significantly increased since the competence of enforcing this sanction was transferred to the SRS. Thus, converting criminal sanctions that are rarely applied into administrative **sanctions applicable by the ICS or the SRS is an option worth considering. This might potentially increase the number of cases where sanctions are applied.**

Secondly, the administrative penalty system could become more “automated” where it is easy to identify a breach within IT systems. For instance, the future legislation could include systems of automatic penalties for directors if the annual reports are submitted late or if the debtor has failed to honour debts against the tax authorities for two months after they fell due, has not even tried to reach an agreement and has not applied for the insolvent liquidation proceedings within two months. Such automatic penalties would limit the resource expenditure of institutions and promote better practices for disciplining debtors.

It should be noted, however, that the introduction of automatic penalties should in no way limit the right of appeal and those affected by automatic penalties should have an opportunity to challenge the application. The automation should be limited to the initial application of the penalty so as to minimise the unnecessary administrative burden.

Such a system should be quick and easy, as it would relate mostly to SMEs, and the fine should be more administrative and should be automatically generated according to certain criteria. A similar approach has been introduced for violations of certain road traffic offences. The authors of this report note that in order to apply an administrative penalty, it is necessary to determine the composition of the administrative violation: object, objective party, subject, subjective party and to consider general administrative principles. Nevertheless, to determine specific violations, the scope for amending the current system and application of sanctions on certain violations should be further evaluated.

In other benchmarked countries, the legislature has developed various solutions to ensure good conduct of directors and shareholders in Formal Restructuring proceedings.

Czech Republic

Existing measures aimed at reducing undesirable behaviour from parties involved

Civil and criminal liability for obstructing debt restructuring proceedings can be applied to most stakeholders (with clear liability applicable specifically to directors and other statutory bodies).

No automatic fines are prescribed by the Czech legal system.

Portugal

Existing measures aimed at reducing undesirable behaviour from parties involved

The duty to cooperate with the insolvency administrator and creditors extends to the debtor's staff employed by the debtor for at least two years. These persons may be held liable for supplying incorrect information if it has resulted in losses for the creditors.

Thirdly, along with the liability of directors, more effort should go into preventing the misconduct of company shareholders and beneficial owners. Since the vast majority of Latvian enterprises are SMEs, their shareholders and beneficial owners play a significant role in running them, whereas only their directors are in the spotlight of liability. To avoid the sanctions and liability for different kinds of misconduct, there is a widespread practice to replace directors with fake ones or to let the company exist with no directors at all.

This would not be possible without the action or acceptance by the shareholders or beneficial owners. The Commercial Law could be amended to include shareholder liability where legal action cannot be pursued against the debtor's former management. This would allow the creditors to gain restitution also where it is not recoverable from the debtor's directors and would motivate the shareholders to take active steps and monitor the actions of their directors. Shareholder liability should not arise where fraudulent behaviour of the directors is proved. The extent of punishment for both offences should depend on the extent of damage caused to the creditors and other parties concerned. This should not include any extensive punitive measures where the financial detriment is not recognised. On the other hand, the authors of this report note that piercing the corporate veil is a volatile issue and should be carefully evaluated in order not to contradict the principles of the Commercial Law.

The Law on Taxes and Duties prescribes further liability for directors who can be held personally liable for the company's tax debts (see Chapter XI of the Law on Taxes and Duties). Amendments to this law enter into force on 1 July 2020 and provide for notifying taxpayers of their upcoming duty to file tax returns (including annual accounts) five days before the due date and the automatic application of a fine if the tax return is not filed. The new regulation of Article 141 of the Law on Taxes and Duties comes into force along with the new Administrative Liability Law. Late tax filings will result in fines differentiated according to the frequency of the offence and the number of days past due. Guidelines on automatically punishable (fineable) taxpayer identification criteria are still being developed by the SRS.

Further obligations for directors arise from case law and from the general principles of law contained in Latvian private law enactments.[102]

While it is understandable that no limits should be set for the State Police to enforce the law on any subjects and offences, this institution should be encouraged to focus instead on more substantial criminal arraignments, and the above offences should instead be pursued in administrative processes, with Supervisors, shareholders and creditors having the duty to protect the process and creditors' interests.

The authors of this report are aware that this approach has to be discussed with all stakeholders. Also, piercing the corporate veil is a very complex issue that has to be further researched. Numerous stakeholders support further discussion and agree that solutions need to be found to the problems in practice, including discussions/studies for assessing the accountability of board members and shareholders.

s. Recommendations

- Obstacles to the successful criminal prosecution of directors should be removed and/or criminal sanctions should be converted into administrative fines imposed by the ICS or the SRS to enable their wider application as a deterrent.
- Although the State Police has recently undertaken serious structural reforms and more resources have been made available for increasing its capabilities, the policy makers should continue strengthening the operational capacity of the State Police in order to further increase its ability to enforce obligations of directors and to prevent fraud in Formal Restructuring and insolvent liquidation proceedings.
- Latvia should continue strengthening the existing obligations in the Latvian legal framework to ensure that company directors (i) have due regard to the interests of all stakeholders, particularly creditors, and (ii) take steps to avoid insolvent liquidation.

[102] See, for example, Supreme Court Judgments No.SKC-154/2019 of 12 July 2019, No.SKC-343/2017 of 30 November 2017, and No.SKC-7/2016 of 7 July 2016.

11 Measures to Increase the Efficiency of Restructuring, Insolvency and Debt Discharge Procedures

11.1 Practitioners in Restructuring, Insolvency and Debt Discharge Procedures, and their Supervision and Remuneration

As the requirements and analysis for Supervisors were provided in the section "Supervisors" above, in order to benchmark Latvian law to Article 26 of Directive 2019/1023, this section focuses on other practitioners appointed by a judicial or administrative authority in restructuring, insolvency and debt discharge procedures, i.e. Insolvency Practitioners.

11.1.1 Requirements for Insolvency Practitioners

In Latvia, practitioners in Formal Restructuring and insolvent liquidation proceedings are currently (1) the Insolvency Practitioner and (2) the Supervisor.

Directive 2019/1023 requires MS to ensure that –

a. practitioners appointed by a judicial or administrative authority in restructuring, insolvency and debt discharge procedures ("practitioners") receive suitable training and have the necessary expertise for their responsibilities;

b. the conditions for eligibility, as well as the process for the appointment, removal and resignation of practitioners are clear, transparent and fair;

c. in appointing a practitioner for a particular case, including cases with cross-border elements, due consideration is given to the practitioner's experience and expertise, and to the specific features of the case; and

d. in order to avoid any conflict of interest, debtors and creditors have the opportunity to either object to the selection or appointment of a practitioner or request replacement of the practitioner.

Directive 2019/1023 also provides that suitable training, qualifications and expertise for practitioners could be acquired while practising their profession.[103]

Chapter II of the Insolvency Law prescribes requirements and restrictions that must be fulfilled in order to become an Insolvency Practitioner for legal entities or natural persons. These requirements are an age threshold, a second-level higher education in law, MS official language skills, minimum work experience, passing the Insolvency Practitioner's examination, and an impeccable reputation.

The Cabinet of Ministers determines the minimum content and extent of the training course, as well as details of attendance at the course to be included in the certification. Insolvency Practitioners have to go on regular trainings and retake the Insolvency Practitioner exam every two years.

The requirements for the appointment, removal and resignation of Insolvency Practitioners prescribed by Articles 17, 17.1, 17.2, 17.3, 17.4 and Chapter III of the Insolvency Law are clear, transparent and fair. **Accordingly, the Latvian statutory requirements for Insolvency Practitioners are in line with Article 26(1) of Directive 2019/1023.**

11.2 Insolvency Proceedings for Entrepreneurs

In Latvia, natural persons can pursue economic activity by registering for one of several tax regimes with the SRS. When specific criteria are met, a natural person is required to apply for individual merchant status in the Commercial Register, for example, if annual turnover from economic activity exceeds EUR 284,600, the entrepreneur employs more than five person simultaneously for the performance of economic activities, or if the entrepreneur wants to be a broker or commercial agent. A natural person may apply for registration in the Commercial Register even if he does not meet these requirements. A natural person can also pursue economic activity as a general partner in a partnership, or as a founder or shareholder in a farm or fishery operation.

[103] See Recital 87 of Directive 2019/1023.

It is important to note that a natural person-entrepreneur is responsible for all liabilities with all of his/her property (unlimited liability) regardless of the status acquired. Under Article 127 of the Insolvency Law, the natural person's insolvency proceedings are available to any natural person who has been a taxpayer in Latvia in the last six months and is in financial difficulties. Article 123(1–2) of the Insolvency Law provides that a natural person who is also **an individual merchant, a general partner in a partnership, or a founder or shareholder in a farm or fishery operation, may submit a request to the court for initiation of the natural person's insolvency only after the legal entity's insolvent liquidation procedure has been completed.**

Article 56 of the Insolvency Law provides that the legal entity's insolvent liquidation process is applicable to an individual merchant, a partnership, and a natural person who has been a general partner in a partnership, or a founder or shareholder in a farm or fishery operation. It follows from a joint analysis of these provisions that the natural person's insolvency procedure is not available to a natural person-entrepreneur who has one of the special legal statuses, which is a legal fiction, and that such a natural person is first subject to the legal entity's insolvent liquidation procedure.

Article 121(1–2) of the Insolvency Law provides that where the legal entity's insolvent liquidation process is declared for an individual merchant or for a partnership, persons who have claims of a commercial nature against the natural person may exercise their rights as creditors.

Thus, **it should be noted that** the legal entity's **insolvent liquidation procedure and** the natural person's **insolvency procedure are two distinct remedies, which cannot take place with the same person simultaneously.** Moreover, in insolvency legislation, the legislature has declared the commercial status of a natural person-entrepreneur as more chronologically important. The natural person's insolvency procedure may therefore be initiated only after the legal entity's insolvent liquidation procedure has been completed (see Judgment of the Supreme Court Civil Division of 20 May 2016 on Case No.C19050715, SPC-11/2016).

The legislation on the legal entity's insolvent liquidation procedure is also applicable to an individual merchant, a partnership, and a natural person who has been a general partner in a partnership or a founder or shareholder in a farm or fishery operation. Such natural persons must first complete the legal entity's insolvent liquidation procedure. After termination of the legal entity's insolvent liquidation procedure, there is no discharge from liabilities to creditors, so if there are still any liabilities left, the entrepreneur can initiate the natural person's insolvency procedure regardless of the types of liabilities (professional or personal debts), since the natural person's insolvency proceedings lead to a full discharge of debt.

Going through two distinct insolvency proceedings is both time-consuming (may be longer than three years) and costly (statutory fees must be paid for each process separately), meaning that debt relief is not as accessible to entrepreneurs with special status as to other individuals who are simply entrepreneurs without special status. In view of this, not all entrepreneurs have a direct access to the natural person's insolvency proceedings. **Only a natural person-entrepreneur without the special legal status and a non-entrepreneur natural person have a direct access to the natural person's insolvency proceedings.**

The natural person's insolvency proceedings comprise the bankruptcy procedure and the procedure for extinguishing obligations in succession. During bankruptcy proceedings, the Insolvency Practitioner will compile creditor claims, identify the insolvent natural persons, and conduct property sales. When the Insolvency Practitioner has sold the natural person's property in order to cover the creditor claims at least in part, the bankruptcy procedure is completed. If the Insolvency Practitioner has determined that the natural person has no type of property, the bankruptcy procedure is also complete. If it is found that there is no property of any kind, the average duration of the bankruptcy procedure is 3–4 months. If there is any property, the bankruptcy procedure can be twice as long (but it all depends on the amount of property and how quickly it can be implemented).

The bankruptcy procedure and insolvency proceedings of a natural person and of a legal entity are not significantly different in essence. The main difference is that after termination of the bankruptcy procedure of the legal entity's insolvent liquidation proceedings, entrepreneurs are not fully discharged from their debts.

On completion of the bankruptcy procedure of the natural person's insolvency proceedings, the natural person should prepare a Restructuring Plan for extinguishing obligations, including the monthly income and the amount to go to the creditors in proportion to their claims. Within the scope of extinguishing obligations, the natural person transfers part of his income (no less than one-third of all income or one-third of the minimum wage in Latvia) to the creditors. During the insolvency, the natural person is required to earn as much income as possible, so in general the existence of insolvency proceedings is not a reason for disqualification from taking up or pursuing a trade, business, craft or profession, unless the insolvent person is a member of a profession to which specific ethical rules or specific rules on reputation or expertise apply. For example, insolvent persons cannot become Insolvency Practitioners or Supervisors for the duration of and five years after their own insolvency has been concluded. Similar rules exist for attorneys at law and for some positions in the financial and insurance industries. The period for extinguishing obligations depends on the total amount of creditor claims at the time of completing the bankruptcy procedure or on the natural person's income (in particular where the creditor claim level is low and the person's income is high). The minimum duration of a Restructuring Plan for extinguishing obligations in Latvia is six months, and the maximum is three years. This period is calculated depending on the amount of income of the debtor (see Article 155 of the Insolvency Law which describes the criteria for calculating said term).

It follows that Latvia has only partially ensured that entrepreneurs are discharged from their debts on expiry of the discharge period without having to apply to a judicial authority for an additional procedure, and the period after which all insolvent entrepreneurs can be fully discharged from their debts does not exceed three years. In view of this, Article 21(1) of Directive 2019/1023 has not been fully implemented. If all natural persons-entrepreneurs had the same conditions, the Latvian law would meet the requirements of Articles 21–24 of Directive 2019/1023 for the insolvency proceedings of entrepreneurs, including the introduction of derogations pursuant to Article 23 of Directive 2019/1023.

t. Recommendations

- Since in most cases an individual merchant, a general partner in a partnership or a founder or shareholder in a farm or fishery operation need to go through two separate insolvency proceedings to obtain the full discharge of debts, Directive 2019/1023 should be transposed to enable the authorities to –
  - (i) combine entrepreneur insolvency cases into one proceeding after which they are fully discharged from their debts; or
  - (ii) at least synchronise the two insolvency proceedings to ensure that the natural person's insolvency proceedings can afterwards be declared automatically at the debtor's request;
  - (iii) ensure that the period after which all insolvent entrepreneurs can be fully discharged from their professional and personal debts does not exceed three years.
- When merging the two proceedings, the information on the natural person's and legal entity's insolvency should be available in the insolvency register.
- When merging or synchronising the two proceedings, the Insolvency Practitioner should be required to remove the special status of entrepreneur from the Commercial Register on completion of the sale of assets and other obligations within the legal entity's insolvency procedure.

11.3 Judicial and Administrative Authorities

Trainings and specialisation

Article 25 of Directive 2019/1023 requires MS to ensure that members of the judicial and administrative authorities dealing with restructuring, insolvency and debt discharge procedures receive suitable training and have the necessary expertise for their responsibilities. The main objective of this provision is to increase the overall level of professionalism of all actors involved in Formal Restructuring. Recital 86 of Directive 2019/1023 suggests specialisation of the judges to achieve effectiveness of the procedures.

The interviews find **a lack, or insufficient verification, of financial and economic expertise among judicial authorities and Supervisors, which could lead to procedural inefficiencies.** Although the Latvian judges have various trainings, they might not be sufficient in complex business cases involving Formal Restructuring. According to the Ministry of Justice, as at 30 January 2020, a total of 112 judges were reviewing liquidation and Formal Restructuring cases.

The Latvian Judicial Training Centre provides education to judges and court employees with the aim of strengthening the rule of law and facilitating a uniform understanding of law across the EU. Article 89(5) of the Law on Judicial Power requires the judges to continuously enhance their expertise throughout their career. However, there is no other statutory requirement for the judges to have a certain type of training. In practice, the judges can usually choose trainings they wish to attend.

> **Judges** have raised concerns over judicial training. In their view, training is pointless if it is not accompanied by the specialisation of judges. In practice, those attending workshops and lectures gain valuable insights but quickly forget the acquired skills because they are not regularly used afterwards.
>
> The judges cannot follow the most relevant court practice and innovations in Formal Restructuring if they must constantly be well versed in other fields of law. This means that the judges have to renew their expertise every time they receive a case related to Formal Restructuring.

Currently there is no specialisation of judges or commercial courts in Latvia, however significant reforms on a certain instrument have been undertaken by the Latvian government, and a draft law on the creation of a court specialised in economic matters is being debated by the Latvian parliament in its second reading, with Cabinet Order No.407 "The Concept Report on the Creation of an Economic Court" already drafted and in force.

> Stakeholders have noted that although the draft amendments to the Law on Civil Procedure (No.554/Lp13) do not currently provide for the transfer of insolvency cases of legal entities, redress cases and out-of-court redress cases to the Economic Court, according to the Cabinet meeting of 7 January 2020 (Record No.1, 27.§, paragraph 4) they will be subject to an assessment of the functioning of the Economic Court by 1 April 2022, including an assessment of the possibilities of extending the jurisdiction of the Economic Court to such cases.

As stated in the Concept Report on the Creation of an Economic Court (Cabinet Order No.407 of 22 August 2019), the quality of financial proceedings is significantly hampered if the judges hearing them do not have specific expertise on the relevant financial matters.

A major benefit of creating a new specialised court is that it is also possible to provide specialisation for disputes relevant to the rule of law in the business environment, which have so far been subject to the ordinary jurisdiction of courts. This also applies to liquidation and Debt Restructuring cases.

It should be noted that, for example, in terms of the purpose of Formal Restructuring, which is to restore the debtor's ability to settle his obligations if the debtor is, or is deemed to be, in financial difficulty, and of the jurisdiction of the court, to approve the measures of Formal Restructuring, the expertise of the judge, analysing the possibilities for its realisation and their impact on the purpose of the redress procedure, may be relevant for an efficient and high-quality decision.

The dialogue with the judges revealed that there are about 25 cases a year in Latgale Suburb Court and 100–125 cases in Latvia. The judges suggested creating a specialised court for Formal Restructuring and insolvent liquidation. In their opinion, this could improve the overall quality and efficiency of Formal Restructuring.

France and Spain have specialised commercial judges and courts that rule on debt restructuring cases. Those judges practice in understanding the business perspective and seeing the case from a viability perspective and often also have an economic and financial background. In France, the commercial judges are not lawyers but "businessmen judges."

In countries where specialised commercial courts have been established, it is quite common for these courts to deal with cases related to insolvency matters. In Croatia, the commercial courts are hierarchical and organised in two instances, and they deal, inter alia, with insolvency-related cases.

Ireland has separate courts for small claims (up to EUR 2,000) and a separate Commercial Court. As to the substance, the court acts as the Supreme Court's specialised body able to deal with cases without delay. The immediate handling of cases is achieved through special procedures that speed up the progress of cases falling within the jurisdiction of that court. The court deals with cases classified as "commercial matters" under the laws and regulations, such as disputes arising out of commercial law, insolvency law etc. For an action to be admissible before that court, the amount of the action must be at least EUR 1 million (with certain exceptions).

In Portugal, specialised commercial courts (*Tribunais de Comércio*) have been set up to deal with liquidation cases where the debtor is a legal entity or the insolvency-related assets of a natural person include a company.

In Latvia, the plan to create an economic court has attracted some criticism. Some legislators have pointed to corruption risks, while members of the judicial community remain sceptical about an economic court's ability to solve the current issues plaguing the Latvian judicial system.

The economic court could, however, prove to be beneficial in solving some of the issues identified in this report if the court were to also review cases relating to Formal Restructuring and insolvent liquidation. Because an increase in judicial specialisation would also speed up Formal Restructuring, creating an economic court would improve the KPI of Formal Restructuring and is therefore advisable within the context of this report as a way to implement the goals of Directive 2019/1023 by creating a specialised court as foreseen in Recital 86 of Directive 2019/1023.

Expeditious procedures

Article 25(b) of Directive 2019/1023 requires MS to ensure that restructuring, insolvency and debt discharge procedures are dealt with in an efficient manner, with a view to the expeditious treatment of procedures. Under Articles 341.1 and 341.6(2) of the Civil Procedure Law, procedures for Formal Restructuring are subject to an expedited procedure. Accordingly, the Latvian legal system is consistent with the provisions of Article 25(b).

u. Recommendations

- Judges within the existing court framework should pursue further specialisation and focus on increasing their judicial expertise in order to be able to tackle ever more complex Formal Restructuring and liquidation cases.
- Given the proposal for introducing a specialised economic court in Latvia, it is advisable to discuss the possibility of including Formal Restructuring and insolvent liquidation procedures within its jurisdiction.

11.4 Supervision and Remuneration of Practitioners

Article 27 of Directive 2019/1023 requires MS to implement appropriate oversight and regulatory mechanisms to ensure that the work of practitioners is effectively supervised, with a view to ensuring that their services are provided in an effective and competent way, and, in relation to the parties involved, are provided impartially and independently. Those mechanisms have to include measures for the accountability of practitioners who have failed in their duties. Moreover, Directive 2019/1023 requires MS to develop effective procedures and rules for remuneration of practitioners.

Latvia has adopted various Rules (e.g. No.246 “Procedures for Keeping Records by Insolvency Practitioners and Insolvency Practitioners of Legal Proceedings’’ and No.233 “Regulations on Disciplinary Matters of Insolvency Practitioners of Insolvency Proceedings and Persons Supervising Legal Protection Proceedings”) and articles of the Insolvency Law relating to those Rules. The Rules regulate the supervision, remuneration and liability of practitioners. Article 12.3 of the Insolvency Law requires a Supervisor to be impartial and have no conflict of interest. All information on the authorities or bodies supervising practitioners is publicly available on the ICS website: http://mkd.gov.lv/lv/link_part_166/. **Accordingly, the Latvian legal system is consistent with the provisions of Article 27 (1) and (2) of Directive 2019/1023.**

Article 27(3) permits MS to encourage the development of codes of conduct applicable to the profession of Supervisor. In Latvia, a code of conduct has been drafted and applies to Insolvency Practitioners and Supervisors, yet it is clear that the current version of the code should be amended to match the proposed new role and responsibilities of Supervisors. To facilitate a more professional community of Supervisors with clear and practically applicable guidelines for professional behaviour, the code of conduct should be amended. The amended code of conduct should (i) further promote the development of skills necessary to perform Supervisor duties; (ii) describe the purpose of the Supervisor and the goals to be achieved; and (iii) lay down the economic principles that should guide Supervisors in overseeing Formal Restructuring.

Article 27(4) of Directive 2019/1023 requires MS to ensure that the remuneration of practitioners is governed by rules consistent with the objective of an efficient resolution of procedures. Also, MS have to ensure that appropriate procedures are in place to resolve any disputes over remuneration.

The Supervisor’s remuneration is not fixed or strictly regulated under Latvian law. It is usually an agreement between the parties, and thus no requirements are imposed by Latvian law. Under the Insolvency Law, creditors agree in writing with the Supervisor on the amount of remuneration and the procedure for covering the costs. If no other agreement is reached, the Supervisor’s remuneration is covered by the creditors who supported the Restructuring Plan. Under Article 40(12)(f) of the Insolvency Law, it is mandatory to indicate the amount of remuneration in the Restructuring Plan.

According to the proposed approach, the law should be amended to provide that the debtor remunerates the Supervisor unless creditors request the Supervisor’s assistance. However, under Article 5(3)(c) of Directive 2019/1023, where the Supervisor is requested by the creditors, the cost of Supervisor should be borne by the creditors. No applicable procedures have been included in the Insolvency Law on the resolution of disputes over the Supervisor’s remuneration.

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Stakeholders have commented that the weakness of the regulation concerns creditors who do not have a good prospect of recovering their debt but incur additional expenses nevertheless. In this context, an idea that the Supervisor should be remunerated by the state is suggested, yet there are uncertainties about subordination and the Supervisor’s accountability (since the state’s main interests lie in maintaining enterprises and jobs) as well as lack of creditor interest because they do not pay the salary. Some stakeholders have abandoned this proposal or acknowledged a lack of understanding and capacity.

Disputes over remuneration are resolved according to the procedure laid down by the agreement, which is most likely a time-consuming process. Latvian law contains applicable procedures for the resolution of disputes over the Insolvency Practitioner’s remuneration, but there are no such regulations on the Supervisor’s remuneration. In practice, such disputes are resolved according to the procedure laid down by the agreement. With no major problems identified with the remuneration mechanism, it has been suggested that the law should not be strictly implemented or amended on remuneration, as this should be subject to an agreement between the parties. The Insolvency Law or Rules could lay down principles and guidelines, leaving the parties to decide on the Supervisor’s remuneration. For example, the remuneration could be proportional to the size of the debt, the level of assets, or the size of the company. However, as this is a time-consuming process, the Supervisor has the right to resign from the fulfilment of his obligations. **Accordingly, the Latvian law is partially consistent with Article 17(4) of Directive 2019/1023 but needs amending to implement clear guidelines on remuneration and dispute resolution.**

v. Recommendations

- To improve the quality and image of Formal Restructuring, secondary legislation or guidelines should be adopted to ensure that Supervisor remuneration is comprehensively regulated as required by Directive 2019/1023 and there are mechanisms for settling disputes over Supervisor remuneration.
- The professional code of ethics for Insolvency Practitioners and Supervisors should be updated in accordance with Directive 2019/1023 to (i) describe the purpose of a Supervisor and the goals that should be achieved by Supervisors; to (ii) lay down economic principles that should guide Supervisors in overseeing Formal Restructuring proceedings, and to (iii) promote the development of skills necessary to perform Supervisor duties.

11.5 Use of Electronic Means of Communication

Article 28 of Directive 2019/1023 requires MS to ensure that during Formal Restructuring and insolvent liquidation proceedings, all stakeholders can use electronic means of communication (including cross-border situations) for at least the following steps: (i) filing claims; (ii) submitting Restructuring Plans and repayment plans; (iii) notifying creditors (if they have consented to receiving notifications by electronic means); and (iv) lodging challenges and appeals.

Recital 90 of Directive 2019/1023 explains that this requirement aims to (i) reduce the length of procedures; (ii) facilitate better participation of creditors; and (iii) ensure similar conditions among creditors.

Recital 91 of Directive 2019/1023 gives MS freedom in facilitating the possibilities to use electronic means of communication. MS can establish mandatory systems of electronic filing and service of documents and can choose the means of electronic communications and the way that such transmitted information is secured.

Under the Insolvency Law, Supervisors and Insolvency Practitioners must ensure that they are reachable by email (see Article 12.5 of the Insolvency Law), the insolvency register contains the email addresses of all Insolvency Practitioners (see Article 18 of the Insolvency Law), and Insolvency Practitioners must notify the ICS within five days of a change of email address (see Article 26 of the Insolvency Law). Each case of Formal Restructuring included in the insolvency register contains the email address of the relevant Supervisor (see Article 36 of the Insolvency Law), and the Restructuring Plan contains the email address of the potential Supervisor (see Article 40(4) of the Insolvency Law). Other provisions of the Insolvency Law point to the active use of electronic means of communication in performance of the duties of Supervisors and Insolvency Practitioners.

The ICS manages an electronic insolvency system that is used for multiple purposes prescribed by Article 12.1 of the Insolvency Law. The system contains information on persons involved in Formal Restructuring and insolvent liquidation proceedings, information on the status of each Formal Restructuring and insolvent liquidation proceeding, detected offences of Supervisors and Insolvency Practitioners etc. Insolvency Practitioners are selected from the list contained in the system (see Article 19 of the Insolvency Law). The system is limited in its publicity.

The current procedural system ensures that stakeholders in Formal Restructuring and insolvent liquidation proceedings can conduct the necessary procedural actions by fully utilising electronic means of communication. Correspondence with the court, i.e. submitting all relevant documentation to the court and receiving any documentation from the court, can be conducted electronically if the person agrees to this (see Article 56 of the Civil Procedure Law).

This means that also correspondence with the court in Formal Restructuring and insolvent liquidation proceedings can go through electronic means of communication, for example, debtors can submit Restructuring Plans to the court by email and using electronic signatures. Appeals, submissions, challenges and requests can be submitted to the court electronically if the person chooses to do so and can also opt in to receive documentation from the court by electronic means of communication. In practice, the electronic means of communication are extensively used in practice.

As for the Supervisor's communication with creditors, the parties can also use electronic means of communication. For example, creditors can submit their claims to the Supervisor and Insolvency Practitioner by email and using electronic signatures.

Accordingly, the Latvian legal system is consistent with the requirements of Directive 2019/1023 for using electronic means of communication.

12 Monitoring Procedures and Data Collection

Article 29 of Directive 2019/1023 requests MS to collect and aggregate data relevant to Formal Restructuring and insolvent liquidation proceedings for a future need to communicate this data with the EC.

Directive 2019/1023 requires MS to collect multiple types of data, and the current efforts of the governmental institutions are partly consistent with the mandatory and optional provisions of Article 29 (see Table 6 below).

Article 29 prescribes data that MS are required to collect (mandatory provisions) and data that MS have a choice to collect (optional provisions).

Table 6 Overview of data collection comparison between Directive 2019/1023 and current national efforts

Data to be collected and aggregated under Directive 2019/1023	Mandatory/ Optional	Data currently collected by the Latvian authorities
Number of procedures opened and applied for. Mandatory collection. Should be broken down according to criteria.	Mandatory	Every application and submission to the courts is registered in their internal systems. Moreover, public platforms exist where judgments and information on different procedures are available albeit anonymised, including every application and procedure connected with Formal Restructuring and insolvent liquidation. The electronic insolvency register contains information on the initiated and executed Formal Restructuring procedures, and information on executed liquidations. Progress of liquidations could be further broken down into types of debtors if combined with the Commercial Register.
Average length of procedures from the submission of the application. Mandatory collection. Should be broken down according to criteria.	Mandatory	The electronic insolvency register should contain this information and the length of each procedure should be evident because information exists on the time of when it was initiated and is also accompanied by a decision to terminate the proceedings. It is, however, questionable whether such data is available in a readable and accessible form or instead must still be aggregated from the larger set of data contained across the individual decisions.
Number of restructuring procedures broken down by type of outcome. Mandatory collection. Should be broken down according to criteria.	Mandatory	See comments on the previous data sets. Data can also be retrieved here from the electronic insolvency register.
Number of applications for restructuring procedures.	Mandatory	See comments on the previous data sets. Data can also be retrieved here from the electronic insolvency register.
Average cost of each type of procedure.	Optional collection	Data relating to costs of Formal Restructuring and insolvent liquidation is available in so far as revealed by the Civil Procedure Law. For example, one can see the costs associated with the submissions to courts. No data is being gathered on other costs associated with Formal Restructuring, i.e., costs of drafting the Restructuring Plan and legal representation fees.
Average recovery rates for each type of creditors.	Optional collection	No current information sources contain such information.

Number of entrepreneurs who start a business after having undergone Formal Restructuring or insolvent liquidation	Optional collection	See comments on the previous data sets. Data can also be retrieved here from the electronic insolvency register and combined with the data of the Commercial Register if its data retention policies allow such retention.
Number of job losses linked to Formal Restructuring and insolvent liquidation	Optional collection	No current information sources contain such information.

It can be concluded, therefore, that the current efforts of the governmental institutions meet the requirements of Directive 2019/1023 for data collection. The information held by the insolvency register is partially available to the public online,[104] but data collection on Formal Restructuring is fragmented and not available for a sufficient analysis of the process. The data defined by Directive 2019/1023 as having value in terms of reflecting the effectiveness of Formal Restructuring and insolvent liquidation legislation is collected in Latvia in so far as it is available for use. However, the collection is not done systematically, and nothing structured would therefore be available if such information were requested by the EC, for example.

w. Recommendations

- Latvian governmental institutions should expand their data gathering efforts on Formal Restructuring and liquidation matters and systematically structure and publish such data to monitor the effectiveness of procedures, including time, cost, and creditor recoveries.

[104] See further information on the Insolvency Register. Available at: https://maksatnespeja.ur.gov.lv/insolvency/search/lv. [Accessed December 12, 2020].