

FOREIGN INVESTORS  
COUNCIL IN LATVIA

# INSOLVENCY ABUSE REPORT



**Deloitte.**

**2016**

## Foreign Investors Council in Latvia

Reg. No 50008063171

Address: 1 Strelnieku Street, Riga, LV-1010

Riga, 16 March 2016

### Re: Agreement on the provision of legal and advisory services

Dear M. Greiskalns,

This report has been prepared in accordance with the terms of the Engagement Letter, where FICIL and the Supporting Partners commissioned Deloitte and Deloitte undertook to carry out the Research with respect to legal and economic impact of the Insolvency abuse in Latvia and present its findings in the Report.

The result of our services is based on information provided by the Client and the Supporting Partners' representatives and publicly available sources. We rely on such information as being accurate, and we have not performed an audit of these data.

Our Report may be used by the Client and the Supporting Partners for their internal purposes. The Client is allowed to distribute the Report for information purposes in the interest of general public, after its presentation to the Government of the Republic of Latvia. The Client and the Supporting Partners shall observe the limitations of intellectual property rights and shall explicitly refer to Deloitte when using or disclosing the information concerning the Report.

Our Report is structured in five sections where the analysis of current insolvency system and potential insolvency abuse indicators is provided; after examination of the economic impact of the insolvency abuse, we summarise the conclusions of the Report and provide recommendations.

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Deloitte accepts no liabilities for damages or loss of profit, if any, suffered by any party or person as a result of decisions made or actions taken based on the Report.

In addition, events subsequent to the issuance of our Report may occur, for which we express no opinion and take no responsibility as to how those events may impact the third parties.

We hope that our Report will provide the necessary insight about the impact of the insolvency abuse in Latvia. Should you have any further questions or issues related to the Research or the Report, please do not hesitate to contact us.

Best regards,

Igor Rodin  
Partner, Deloitte Latvia SIA

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# Glossary

<b>Bank of Latvia</b>	The Bank of Latvia is the central bank of Latvia.
<b>Central Bureau of Statistics / CSB</b>	The Central Bureau of Statistics is acting as the main performer and coordinator of the official statistical work in the Republic of Latvia.
<b>Claims</b>	Creditor claims from the Secured and Unsecured within the insolvency proceedings.
<b>Commercial Pledge Register</b>	Publicly available register where the information regarding the commercial pledges is stored.
<b>Commercial Register</b>	Publicly available register where the information regarding the companies and their statutory information and commercial activity is stored.
<b>Companies</b>	9,512 companies that were announced insolvent during the time period from 1 January 2008 to 31 December 2014.
<b>Complaints</b>	Complaints submitted to the Insolvency Administration related to the procedure of insolvency proceedings or actions of the Insolvency Administrators.
<b>Deloitte</b>	Deloitte Latvia SIA, registration No 40003247787.
<b>Economic costs of insolvency</b>	Economic costs of insolvency take into account financial and non-financial costs of insolvency.
<b>Economic impact from insolvency abuse</b>	Economic impact from insolvency abuse takes into account financial and non-financial loss from insolvency abuse.

<b>Employee Claim Guarantee Fund</b>	The Fund which provides compensation of Employees claims in case of insolvency of the Employer.
<b>Employee claims</b>	Employees' claims against the insolvent Company.
<b>Engagement Letter</b>	The engagement letter on the provision of legal and advisory services, dated 18 March 2015 concluded between Deloitte, FICIL and the Supporting Partners.
<b>FICIL or the Client</b>	The Foreign Investors Council in Latvia, registration No 50008063171, is a nongovernmental organisation which has commissioned Deloitte to perform the Research.
<b>Financial institutions / Secured creditors</b>	Banks or other financial institutions that have a secured claim against the debtor within the insolvency proceedings.
<b>Financial costs of insolvency</b>	Financial costs of insolvency take into account direct costs (unrecovered claims to creditors) and indirect costs.
<b>Financial loss from insolvency abuse</b>	Financial loss from insolvency abuse represents financial costs of insolvency incurred due to the insolvency system abuse.
<b>Insolvency Administration</b>	The Insolvency Administration, is a public institution implementing the national policy of insolvency.
<b>Insolvency administrators</b>	Private individuals who have acquired a certificate of an administrator of insolvency proceedings and who have the rights and duties specified in the Insolvency Law.
<b>Insolvency date</b>	The date when the company has been announced insolvent by the court.

# Glossary

<b>Insolvency Law from 1996</b>	The Law On the Insolvency of Undertakings and Companies, adopted on 12 September 1996, published in the official journal «Latvijas Vēstnesis» on 2 October 1996, No 165.
<b>Insolvency Law from 2008</b>	The Insolvency Law, adopted on 1 November 2007, published in the official journal «Latvijas Vēstnesis» on 22 November 2007, No 188.
<b>Insolvency Law from 2010</b>	The Insolvency Law, adopted on 26 July 2010, published in the official journal «Latvijas Vēstnesis» on 6 August 2010, No 124.
<b>Insolvency Register</b>	Publicly available register where the information regarding the insolvent companies and private individuals is stored.
<b>Insolvency reports</b>	All reports, which during the insolvency proceedings are filled out and submitted by the Insolvency administrators according to the Insolvency Law to the Insolvency Administration.
<b>Latvian Chamber of Commerce and Industry</b>	Latvian Chamber of Commerce and Industry, registration No 40003081501, is a nongovernmental organisation uniting micro, small, medium and large-sized companies from all regions and economic sectors of Latvia.
<b>Legal protection procedure / LPP</b>	Process performed according to the Insolvency Law and is aimed to renew the ability of a debtor to settle its obligations, if a debtor has come into financial difficulties or expects to do so.
<b>Lursoft</b>	SIA LURSOFT IT, registration No 40003170000, is a company which owns extensive and legally valid database of all companies registered in Latvia, based on the original documents from the Commercial Register.

<b>Non-financial costs of insolvency</b>	Non-financial costs of insolvency represent costs due to depreciation of assets, opportunity cost of capital and due to the GDP multiplier effect.
<b>Non-financial institutions / Unsecured creditors</b>	Companies that usually have an unsecured claim against the debtor within the insolvency proceedings.
<b>Non-financial loss from insolvency abuse</b>	Non-financial loss from insolvency abuse is calculated based on non-financial costs of insolvency allocated to the population of abusive insolvencies.
<b>Period of analysis</b>	1 January 2008 – 31 December 2014.
<b>Report</b>	The final report, prepared by Deloitte, which contains findings of the Research.
<b>Research</b>	The Insolvency Abuse Research with respect to legal analysis and economic impact of the insolvency abuse in Latvia.
<b>State Audit Office</b>	The State Audit Office is the supreme audit institution serving the public interest by providing independent assurance on the effective and useful utilisation of central and local government resources.
<b>State Revenue Service / SRS</b>	The State Revenue Service is a public institution responsible for monitoring and administrating the national policy in customs, duties and taxes matters.
<b>Supporting Partners</b>	Members of the Research who have commissioned Deloitte to perform the Research.

# Executive summary (1/3)

FICIL has commissioned Deloitte to undertake a study of the economic impact of insolvency abuse in Latvia. Our aim is to expand the evidence available to policy makers as they consider structural reforms and further changes in the legislative framework.

In order to carry out our research, we have obtained and analysed relevant data about 9,512 Companies that were announced insolvent during the Period of analysis. Key sources of information include the Insolvency Administration, the State Revenue Service (SRS), the Commercial Register, the Insolvency Register, the State Audit Office, the Central Bureau of Statistics (CSB), Financial and Non-financial institutions and publicly available information.

Due to the limitation of incomplete data set regarding the whole population, we have applied a conservative approach in estimating the impact in order to avoid any overstatements. As a result, our estimates may understate the actual economic impact due to insolvency abuse.

Our key findings are summarised below:

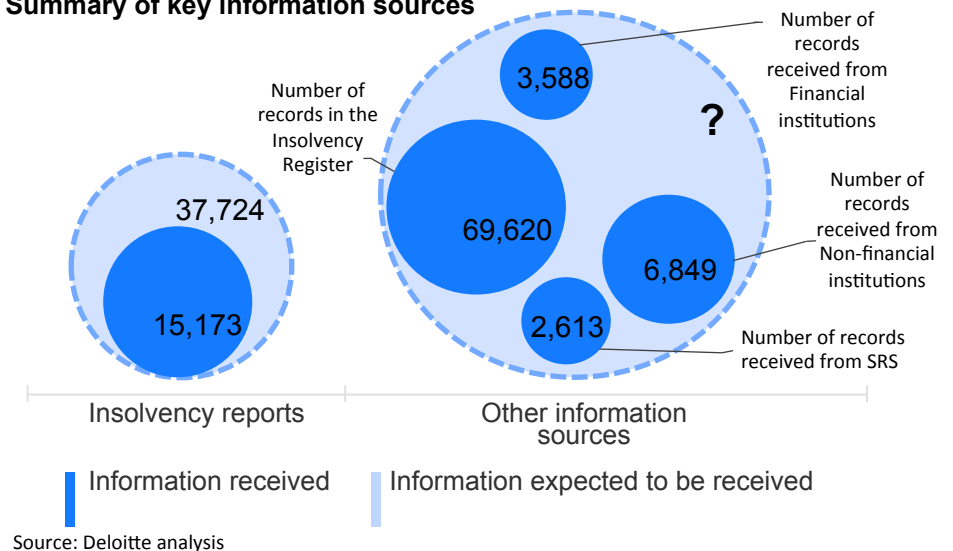
## 1. The insolvency administrators do not comply with reporting requirements and there is no sufficient system for monitoring and measuring the efficiency of insolvency in Latvia

- According to the Insolvency Law, insolvency administrators are obliged to report to the Insolvency Administration data on the insolvency cases on regular basis. However, compliance of submission of reports by insolvency administrators is 40%. Reports contain partial information or are not filled out at all. Report templates do not contain all the necessary information for monitoring efficiency of the procedure and there is no system for processing and analysing the data. Therefore it is not possible to monitor how insolvency administrators comply with the law and it is not possible to measure efficiency of a particular insolvency case or its administrator and the whole insolvency system.

## 2. There is a significant amount of late insolvencies which causes significant loss for the business and the creditors

- The rate of potentially late enacted insolvency procedures is 52%. During the two last years before the inception of the insolvency procedure, potentially insolvent companies lost 42% of their asset value and their liabilities increased by 45%. Respectively it decreases the recovery rate of creditors within insolvency procedures

Summary of key information sources

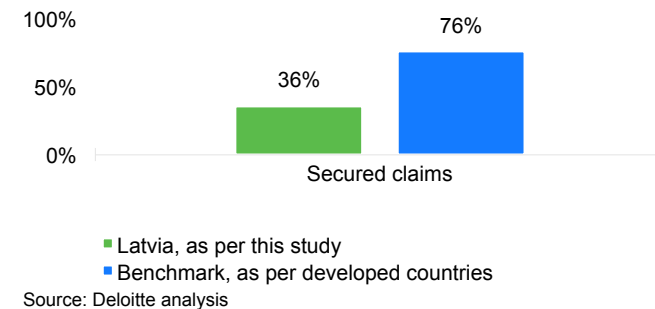


# Executive summary (2/3)

## 3. Insolvency recovery rates in Latvia are significantly lower compared to international benchmarks. The reason of the gap is poor practice of application of the law rather than the wording of the Insolvency Law.

- Based on the analysis of the recovery rates by year of an announced insolvency, we estimate that the median recovery rate over the period 2008-2014 is 36% for secured claims and 2% for unsecured claims (including preferential unsecured creditors: employees and SRS).
- Taking into account the available benchmarks (76% for secured claims based on the World Bank Doing Business study), the recovery rate is twice lower than in the developed countries and the recovery rate gap for Latvia is at the substantial level of 40 percentage points for secured creditors.
- According to the Doing Business study Latvia has scored 12 in the index of strength of insolvency framework which is almost the average of the OECD benchmark: 12.2. The Insolvency Law reforms which provided the score in the insolvency framework index were introduced in Latvia until 2011. But the rates of efficiency are still significantly behind the OECD benchmarks (in relation to secured creditor recovery). Therefore significant improvement of efficiency of the insolvency system in Latvia can be achieved by improving implementation and developing judiciary framework rather than amending the Insolvency Law.

### Recovery rates comparison



## 4. Financial and non-financial costs of insolvency in Latvia during 2008-2014.

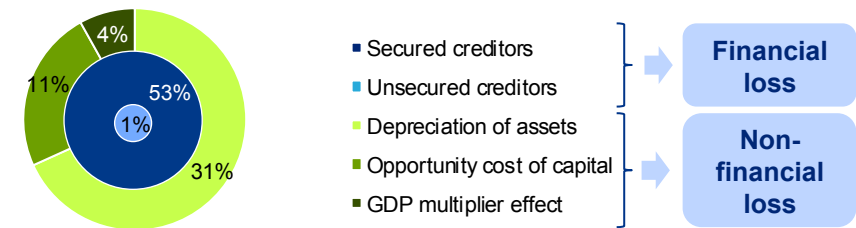
- Financial costs of insolvency, estimated taking into account direct (i.e. unrecovered claims) and indirect costs, amount to BEUR 6.6 (27% if compared to Latvian GDP in 2014), largely borne by Non-financial institutions (BEUR 4.1), Financial institutions (BEUR 1.6) and the State Revenue Service (BEUR 0.9).
- Non-financial costs of insolvency, estimated taking into account induced costs, amount to BEUR 1.2, which reflects the impact from depreciation of fixed assets (BEUR 0.8), the GDP multiplier effect (BEUR 0.1) and the opportunity cost of capital (BEUR 0.3).

# Executive summary (3/3)

## 5. Insolvency abuse resulted in significant economic impact in Latvia during 2008-2014.

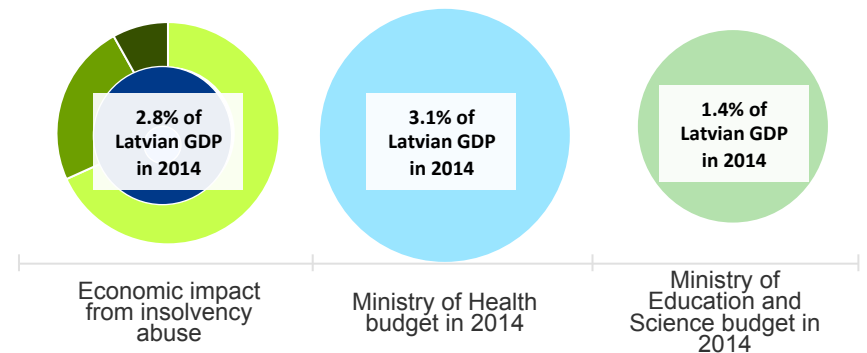
- Indicators of insolvency abuse. Based on the available data, we have developed a set of indicators that are collectively associated with insolvency abuse. The indicators include events prior to insolvency (e.g. changes in the companies' shareholders, board members and/or address, termination of legal protection process), suspicious behavior of administrators (e.g. several administrators declining the assigned insolvency), unusual events during insolvency (e.g. appearance of new creditors, many complaints, criminal or civil proceedings). Based on a coincidence of several indicators within the population of the Companies, we have identified a subpopulation of potentially abusive insolvencies.
- Economic** impact due to insolvency abuse. Taking into account the analysis of the potentially abusive insolvencies, we have estimated that the economic impact of insolvency abuse is in the range from MEUR 580 to MEUR 750 with the mean of MEUR 665. Calculation takes into account financial loss (direct and indirect loss to secured and unsecured creditors) and non-financial loss (due to depreciation of assets, due to opportunity cost of capital and due to GDP multiplier effect).
- The wide scale of abuse and problems of application of the Insolvency Law is confirmed by a questionnaire organised by the Latvian Chamber of Commerce. 76.8% of entrepreneurs believe that insolvency procedures are not conducted transparently and fair, 74.3% have encountered insolvency abuse, 76.8% of those who have been victims of insolvency abuse reported that there were no negative legal consequences for the abusers.

**Breakdown of the economic impact due to insolvency abuse, %**



Source: Deloitte analysis

**Comparison to Latvian GDP in 2014**



Source: Deloitte analysis

## 6. There is a risk of future financial costs if corrective action for improving the efficiency of the insolvency system is delayed.

- Assuming that it would take three years for Latvia to reach the OECD benchmark recovery rates, we estimate that the future financial costs of insolvency amount to MEUR 128 for a continuing trend of new insolvencies. Assuming that the recovery rate gap is not closed, the future financial costs are MEUR 852 for a 10 year period.





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# Introduction

# 1.1. Aim of the Research (1/2)

An effective and transparent insolvency procedure is one of the key components that ensures solid economic growth and stability. According to the World Bank<sup>1</sup> an effective legal framework should provide for timely, efficient, and impartial resolution of insolvencies and prevent the improper use of the insolvency system. If the insolvency proceedings are misused, such abuse may result in significant negative impact on the economy and result in losses for the key stakeholders of the economy: businesses, investors, employees, and the public sector.

Within the last 5 years several significant cases of the abuse of the insolvency system have been broadly discussed publicly<sup>2</sup>. There is a general assumption of the business community that the Latvian insolvency system is being abused on a regular basis<sup>3</sup>. For the last couple of years, the government's, legislator's, mass media's and general public's attention was mainly focused on the insolvency administrators who were broadly criticised for their activities.

During those discussions it was recognised that there are no state guaranteed markets for scientists, engineers, artists or IT experts, but the insolvency practitioners enjoy a market guaranteed by the state (being appointed by the courts). It was also discussed that all insolvency and reorganisation proceedings according to the Insolvency Law are carried out by just over 300 insolvency administrators. Part of them are (more or less transparently) mutually linked (working outside and parallel to the classical professional insolvency practitioners firms), forming the so-called collective farms.

This report draws attention to the shortcomings of the insolvency industry. It draws attention to real-life cases showing that the insolvency industry is out of control. Numerous companies have been liquidated with very poor recovery rate of creditor claims, only few have resumed operations after reorganisation. Many people have lost their jobs, homes, investments and savings.

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<sup>1</sup> The World Bank principles for effective insolvency and creditor/debtor rights system, revised 2015, [http://siteresources.worldbank.org/EXTGILD/Resources/5807554-1357753926066/2015\\_Revised\\_ICR\\_Principles\(3\).pdf](http://siteresources.worldbank.org/EXTGILD/Resources/5807554-1357753926066/2015_Revised_ICR_Principles(3).pdf)

<sup>2</sup> For example, Winergy case, Delfīns un partneri case, Tērbatas biznesa centrs case, Dam Property more information available: <http://www.pretkorupciju.lv/>.

<sup>3</sup> Questionnaire of the Latvian Chamber of Commerce and Industry from 2013

# 1.1. Aim of the Research (2/2)

The final responsibility for perpetuating the insolvency abuse rests with the Insolvency Administration which has failed to safeguard the interests of the stakeholders.

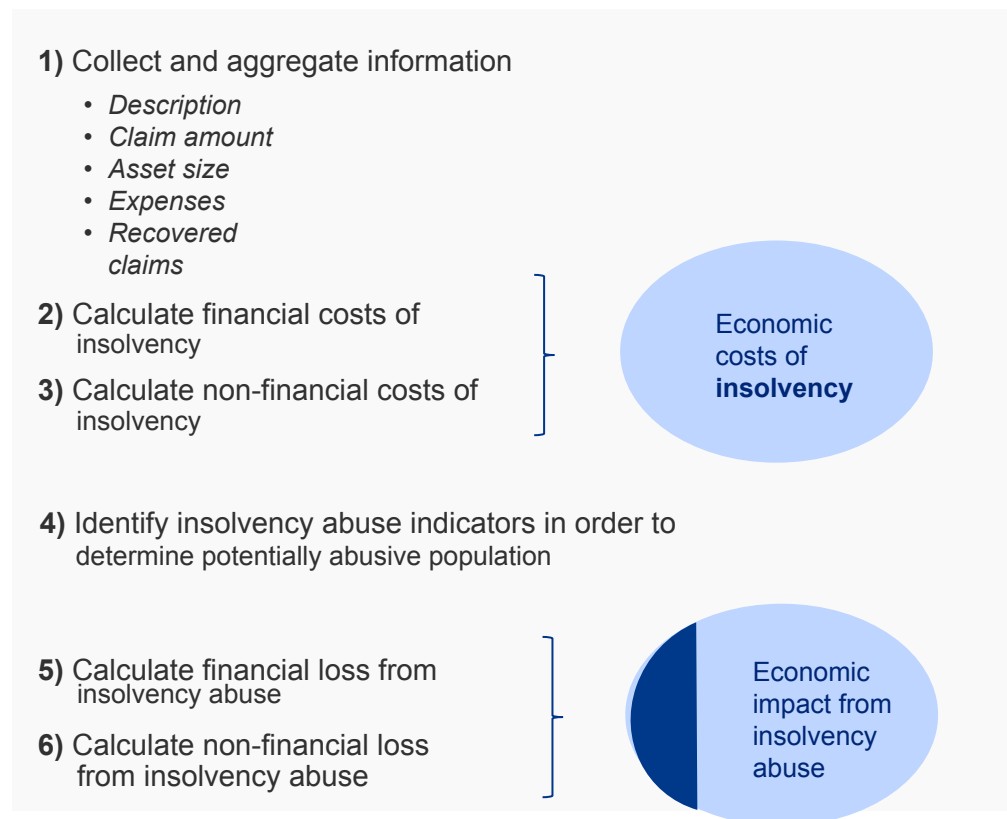
However, there is no comprehensive data on the scale of potential insolvency system abuse and on the impact of these abuses on the state economy and its stakeholders. The lack of data on insolvency abuse leads to a fragmented approach in solving the indicated problems of the insolvency system and to a reluctance of the government to admit the insolvency abuse as a high priority issue.

In order to prevent further threats of insolvency abuse and negative consequences for the business environment, we believe that it is necessary to assess the scale and the economic impact of insolvency abuse in Latvia, so that the Latvian government and general public could assess the impact of the insolvency abuse and evaluate the priority of combating it and prevention.

# 1.2. Methodology (1/3)

Our study estimates the economic impact of insolvency abuse in Latvia based on the population of the Companies (insolvency proceedings announced within the Period of Analysis representing 9,512 Companies in total<sup>1</sup>).

The calculation have involved the following steps:



Please find more detailed description of the calculation steps below.

**1) Collect and aggregate information.** We have collected and applied in analysis information from different sources including:

- Insolvency Administration;
- Lursoft;
- Financial and Non-financial institutions;
- State Revenue Service.

From the information received we have been able to quantify creditor claims, assets, expenses related to the insolvency proceedings and recovered claims per each of the Companies.

Please refer to slides 15-16 for more information on information sources and to slides 18-23 for description of the Companies.

**2) Calculate financial costs of insolvency.** Taking into account the data received, we have calculated financial costs of insolvency, which included direct and indirect costs.

**Direct costs** have been estimated for Secured and Unsecured creditors representing the amount of unrecovered claims. Direct costs or unrecovered claims have been calculated as follows:

- total creditor claim amount at the Insolvency date,
- deducting recovered amount during insolvency process.

Recovered amount represented recovered claims deducting direct insolvency proceedings expenses i.e. expenses specified in the Insolvency reports.

<sup>1</sup> The Report contains no analysis on the insolvency of private individuals or insolvency of international companies or financial institutions.

# 1.2. Methodology (2/3)

**Indirect costs** have been calculated as follows:

- Indirect expenses to the creditors due to insolvency proceedings (i.e. payable by Financial and Non-financial institutions);
- Indirect expenses related to employee claim compensation incurred to the state due to insolvency proceedings (compensation provided through the Employee Claim Guarantee Fund).

Please refer to slide 27 for more information on financial costs of insolvency calculation.

**3) Calculate non-financial costs of insolvency.** We have estimated non-financial costs of insolvency or induced costs, which have been analysed as follows:

- Depreciation of assets;
- Opportunity cost of capital;
- GDP multiplier effect.

Costs due to **depreciation of assets** have been calculated under the assumption that Companies assets are not employed during insolvency proceedings, therefore, the value of depreciation is lost in the time period between the beginning and the end of the insolvency proceedings.

The **opportunity cost of capital** has been calculated under the assumption that Companies assets are not employed during insolvency proceedings, therefore, they are not used effectively i.e. they do not generate return.

Costs due to **the multiplier effect** have been calculated under the assumption that GDP decreases, as Companies employees are “in-between jobs” due to insolvency proceedings and are unable to receive part of their income, therefore their expenditure decreases.

Please refer to slide 28 for more information on non-financial costs of insolvency calculation.

**4) Identify insolvency abuse indicators in order to determine potentially abusive population.** We have developed a list of potential insolvency abuse indicators which we have later validated during interviews with Financial and Non-financial institutions. Based on the information about insolvency abuse indicators per Company, we have determined the population of potentially abusive insolvencies.

Potentially abusive insolvencies within the sample of the Companies with large Secured creditors claims (above MEUR 5) have been determined during the interviews with Financial institutions.

Potentially abusive insolvencies within the rest of the population have been determined taking into account a coincidence of at least 3 insolvency abuse indicators per Company.

Please refer to slides 36-40 for more information on insolvency abuse indicators.

## 1.2. Methodology (3/3)

**5) Calculate financial loss from insolvency abuse.** We have estimated the financial loss from insolvency abuse based on the gap between the creditor recovery rate of abusive insolvencies and the creditor recovery rate of insolvencies without abuse (benchmark recovery rate). We have estimated the financial loss from abuse by multiplying the difference in recovery rates with the claim amount of the Companies classified as potentially abusive insolvencies.

The gap for secured claims is estimated based on the actual recovery rate for abusive insolvencies deducting the expected recovery rate. The expected recovery rate is estimated taking into account expected recovery from collateral. The collateral value has been indexed with a real estate index as per CSB and 30% forced sale haircut has been applied to the value.

The gap for unsecured claims is estimated based on the actual recovery rate for abusive insolvencies deducting the average actual recovery rate for insolvencies without abuse.

Please refer to slide 41 for more information on economic impact of the insolvency abuse calculation.

**6) Calculate non-financial loss from insolvency abuse.** We have calculated the non-financial loss from insolvency abuse based on non-financial costs of insolvency allocated to the population of abusive insolvencies. As mentioned before (paragraph 3) non-financial costs include costs due to depreciation of assets, opportunity cost of capital and costs due to the multiplier effect.

We have allocated non-financial costs to the population of abusive insolvencies based on the proportion of fixed assets and collateral in the population of abusive insolvencies to the total population of the Companies. The non-financial costs allocation takes into account the estimated proportion of fixed assets and collateral, as non-financial costs rely substantially on the value of fixed assets and collateral (costs of depreciation or opportunity costs are estimated based on the value of fixed assets and collateral).

Please refer to slide 41 for more information on economic impact of the insolvency abuse calculation.

# 1.3. Key information sources (1/2)

In order to proceed with our quantitative analysis, we have collected data from various information sources, including the Insolvency Administration, Lursoft, the State Revenue Service, Financial and Non-financial institutions and publicly available sources.

Below is a summary of the key information sources and data collected. Please refer to Annex for detailed breakdowns and explanations.

## 1.1. Insolvency Administration

- a) Insolvency reports, including 18,132 files in different electronic formats;
- b) Complaints, including 3,931 records of complaints regarding insolvencies;
- c) Actions of the insolvency administrators, including 7,856 records of actions of the insolvency administrators during the election process (becoming a candidate for administration / withdrawing from administration);
- d) Employee claim register, including 19,271 employee claims submitted to 1,131 respective Companies.

## 1.2. Lursoft

- a) Annual reports, including 23,396 records;
- b) Data from the Insolvency Register, including information on 9,512 Companies;
- c) Data from the Commercial Register, including 9,499 Companies with records about shareholders and 8,934 Companies with records about members of the board;
- d) Data from the Commercial Pledge Register, including records about 3,077 Companies.

## 1.3. Financial and Non-financial institutions

- a) Financial institutions - information on 1,935 Companies, including the claim and the recovered amount and other information;
- b) Non-financial institutions - information on 2,719 Companies, including the claim and the recovered amount and other information.

## 1.4. State Revenue Service (SRS)

- a) Information on the claim amounts and written-off amounts for the period 2012 – 2014, including 2,613 Companies. (As per communication from the SRS, the information for the period 2008-2011 is not available.)

# 1.3. Key information sources (2/2)

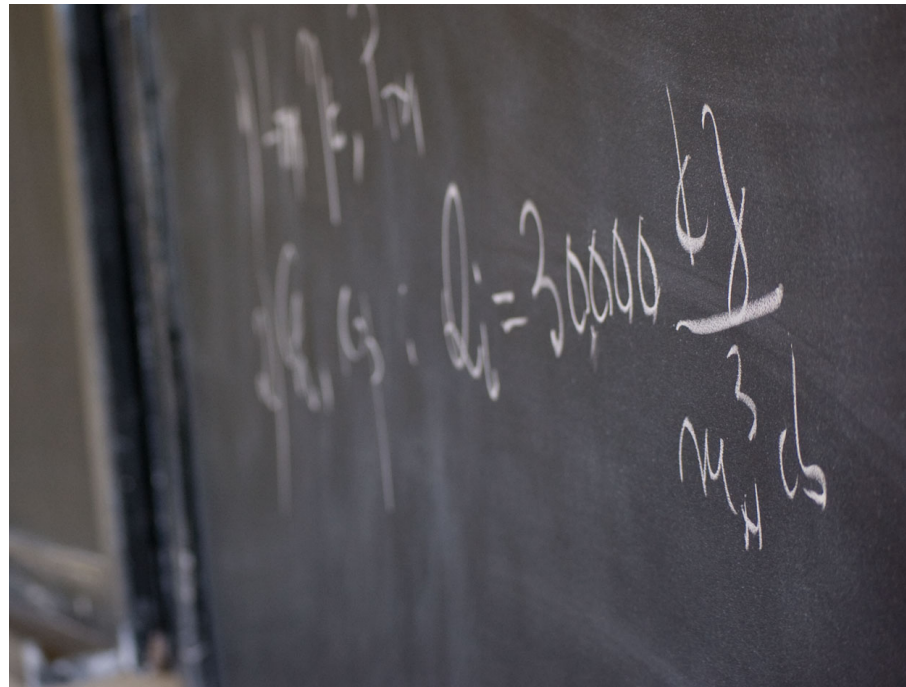
## 1.5. Other sources

- a) The World Bank principles for effective insolvency and creditor/debtor rights system, revised in 2015  
[http://siteresources.worldbank.org/EXTGILD/Resources/5807554-1357753926066/2015\\_Revised\\_ICR\\_Principles\(3\).pdf](http://siteresources.worldbank.org/EXTGILD/Resources/5807554-1357753926066/2015_Revised_ICR_Principles(3).pdf)
- b) Doing Business. Resolving insolvency  
<http://www.doingbusiness.org/data/exploretopics/resolving-insolvency>
- c) <http://www.pretkorupciju.lv>
- d) Report of the State Audit Office: «Is insolvency policy effective in Latvia?»  
[http://www.lrvk.gov.lv/uploads/reviziju-zinojumi/2014/2.4.1-5\\_2014/2.4.1-5\\_2014/revzin\\_mn\\_3mar2015.pdf](http://www.lrvk.gov.lv/uploads/reviziju-zinojumi/2014/2.4.1-5_2014/2.4.1-5_2014/revzin_mn_3mar2015.pdf)
- e) Questionnaire on insolvency system from the Latvian Chamber of Commerce and Industry, 2013 <http://www.amcham.lv/data/Events/Survey%20results%202013.pdf>





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# Analysis of the Insolvency System

# 2.1. Description of insolvent Companies

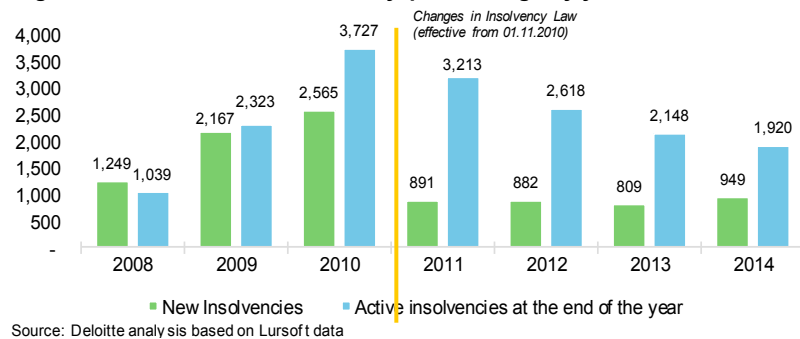
## General information

From the total 9,512 Companies: 20 reports were filed according to the Insolvency Law from 1996, 5,645 reports were filed according to the Insolvency Law from 2008, 39 Companies filed both of the above forms of the reports simultaneously and 3,808 Companies had reports filed in accordance with the Insolvency Law from 2010. The most common type of Companies analysed was limited liability company, representing ca. 96% of total population. Other types of insolvent Companies included joint stock companies (1%), sole proprietorships (1%), private enterprises (1%) and farms (1%).

### 1. Active vs terminated proceedings

The number of active insolvency proceedings peaked in 2010. Following the introduction of the Insolvency Law from 2010, the number of active insolvency proceedings have decreased.

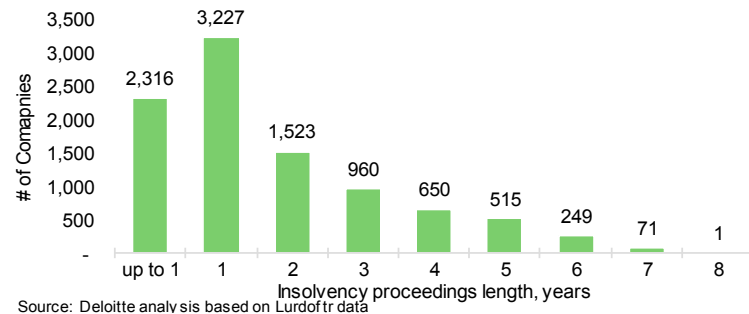
**Figure 1: New and active insolvency proceedings by year**



### 2. Length of terminated insolvency proceedings

Figure 2 depicts the distribution of the number of Companies versus the number of years of insolvency proceedings. For the majority (58%) of the Companies, the insolvency proceedings lasted for 1 year or less compared to 6 years or more for a handful (3%) of the Companies.

**Figure 2: Insolvency proceedings by length in years**



The average length of terminated insolvency proceedings for the Companies during 2008 – 2014 was 1.5 years, ranging from the highest point of 2.2 years for Companies that were announced insolvent in 2009 and slowly declining to 0.7 years by 2014.

The average length of insolvency proceedings for the Companies for which the insolvency administrators filed reports according to the Insolvency Law from 1996 was 2.9 years, while under the Insolvency Law from 2008 and the Insolvency Law from 2010 the average length of the proceedings was 2.1 and 1.2 years respectively.

### 3. Age structure of the Companies

Deloitte was provided with information on the company age at the Insolvency date for 8,218 (86%) companies. The average Company age was 9.1 years while the minimum and maximum 0.7 and 24 years respectively. On the bottom spectrum of outliers there were 8 Companies aged 1 or less years and 195 Companies aged between 1 and 2 years at the Insolvency date.

## 2.2. Creditor claims amount (1/2)

### General information

Deloitte received and analysed data on creditor claims from the following information sources (see Figure 3 for details):

- Companies' annual reports from Lursoft;
- Insolvency reports submitted to the Insolvency Administration;
- The State Revenue Service;
- Financial / Non-financial institutions.

### 1. Information Sources

#### 1.1 Lursoft

Deloitte received annual reports of the Companies from Lursoft. There was information on 8,099 (85% of total population) Companies having liabilities, amounting to BEUR 7.4 (claim available closest to the date of the insolvency announcement).

#### 1.2 Insolvency Administration

Deloitte received Insolvency reports from the Insolvency Administration. Only the Insolvency reports filed under the Insolvency Law from 1996 and 2008 contained information on the total amount of creditor claims, covering 3,755 (40%) Companies with the total claim amounting to BEUR 1.9. As the creditor claims can change during the Insolvency process, the maximum indicated value was taken from all Insolvency reports filed about each company.

#### 1.3 State Revenue Service

Deloitte received data from the SRS on total claims for 2,613 Companies (covering the period 2012-2014, as the information for 2008-2011 was not available). The amount of the claims at the Insolvency date is BEUR 0.44.

### 1.4 Financial institutions

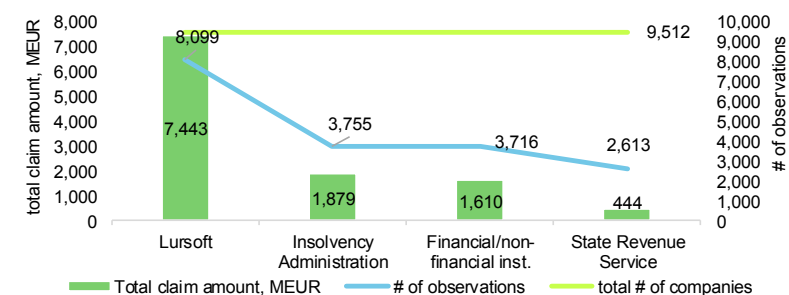
Deloitte received data on the total claims for 1,935 Companies from Financial institutions. The claims are dated by the Insolvency date and are in total BEUR 1.6.

### 1.5 Non-financial institutions

Deloitte received data on the total amount of creditor claims for 2,719 Companies from Non-financial institutions. The claims are dated by the Insolvency date and are in total MEUR 35.

As illustrated by Figure 3, the largest coverage of insolvent Companies in terms of creditor claims is provided by the Lursoft data, followed by the other sources of information. The data from State Revenue Service has the lowest coverage due to the limited time period (2012-2014).

Figure 3: Total creditor claims by source



Source: Deloitte analysis based on Lursoft, Insolvency Administration, Financial and Non-financial institutions, SRS data

## 2.2. Creditor claims amount (2/2)

### 2. Comparison of data sources

#### 2.1 Lursoft and the Insolvency Administration

Information on the creditor claims according to both sources is provided about 3,103 (33% of population) Companies. For such Companies, the amount of creditor claims is BEUR 1.9 according to Lursoft annual reports, and BEUR 1.8 according to Insolvency reports. The modest difference of 5% due to events between the issuance of the last annual report and the insolvency indicates that the two sources of information are, on average, well aligned.

#### 2.2 Lursoft and the State Revenue Service

Information on tax liabilities according to both sources is provided about 2,005 (21%) Companies. For such Companies, the amount of tax liabilities is BEUR 0.29 according to Lursoft annual reports and BEUR 0.28 according to SRS data. The minor difference of 3% due to events since the last annual report indicates that the information from these two sources is consistent.

#### 2.3 Lursoft and Financial institutions

Deloitte has received information on loans with financial institutions for 3,430 (36%) Companies as per Lursoft data and for 1,935 (20%) Companies as per financial institutions data. The total amount of loans with financial institutions amounts to BEUR 2.6 as provided by Lursoft, and amounts to BEUR 1.6 as provided by financial institutions. Thus, the data provided by financial institution covers 78% of the total amount of loans in the population.

For Companies where information is provided according to both sources, total claim amount is BEUR 1.5 as per Lursoft data and BEUR 1.4 as per financial institutions data (the difference of 8% being due to incomplete coverage).

#### 2.4 Lursoft and Non-financial institutions

There are 7,288 (77%) Companies with creditor claims (i.e. accounts payables) according to Lursoft data, and 2,719 (29%) Companies with claims to non-financial institutions based on the data from non-financial institutions.

For the 2,413 Companies with data from both sources, the claims amount to BEUR 0.79 as per Lursoft annual reports and BEUR 0.03 as per non-financial institutions data. In this case, the claim amounts are not comparable, as the non-financial institutions contribute only to a fraction of the total claim.

### 3. Summary of creditor claims

Given the consistency of information obtained from various sources, we have taken the following approach in arriving at the total amount of creditor claims:

- a) Primarily, we relied on the claims amount from the Insolvency reports;
- b) In case of no information available in the Insolvency reports, we used the Lursoft data;
- c) In case of no information available in either the Insolvency reports or Lursoft data, we took the data from Financial and Non-financial institutions and the State Revenue Service.

Thus the combined amount of total creditor claims is BEUR 7.5.

## 2.3. Asset size (1/3)

### General information

This section covers the analysis of assets of the Companies.

#### 1. Asset size at the Insolvency date

This subsection covers the analysis of the initial asset amount (i.e. asset amount at the Insolvency date) of the Companies.

##### 1.1 Asset size according to Insolvency reports

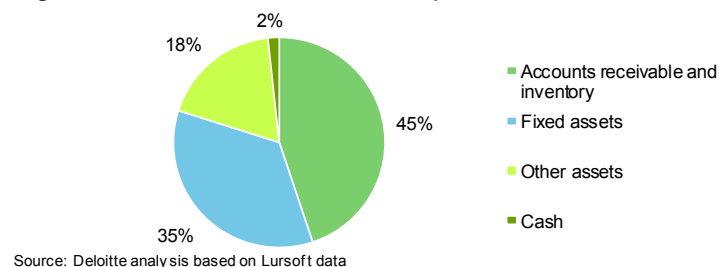
Asset amount per company is estimated based on asset value indicated in the first (initial) Insolvency report. In case of missing information, the maximum value among all other submitted Insolvency reports is taken into account.

The value of total assets at the Insolvency date is BEUR 1.6 based on the Insolvency reports data about 2,216 Companies.

##### 1.2 Asset size according to annual reports from Lursoft

The asset amount as per Lursoft data is estimated based on the value indicated in the annual report closest to the Insolvency date. Total assets as per Lursoft are calculated to be BEUR 4.6 based on 7,365 Companies. Figure 4 shows the breakdown of assets according to Lursoft data.

Figure 4: Breakdown of asset value as per Lursoft data



#### 1.3 Size of collateral

The value of the collateral at the Insolvency date is calculated taking into account the data provided by Financial institutions. If the date of collateral valuation provided by Financial institutions differed from the Insolvency date, the value of collateral is adjusted by applying the relevant real estate index as per the Central Bureau of Statistics of Latvia.

#### 1.4 Assets of comparable Companies as per Lursoft and Insolvency reports data

Data regarding 1,967 (21%) Companies is provided according to both sources. Total asset size of such Companies is BEUR 1.2 as per both sources. The minor difference of 1% between the two sources indicates that the information is consistent.

#### 2. Size of assets planned to be yet recovered during insolvency

The asset amount planned to be recovered per company is estimated based on the value indicated in the first (initial) Insolvency report. In the case of missing information, the maximum value among all other submitted Insolvency reports is taken into account.

The amount of assets planned to be recovered is MEUR 300 based on 733 Companies.

## 2.3. Asset size (2/3)

### 3. Sum of recovered assets

We base the analysis on the assumption that the Insolvency reports reflect full and truthful information on the recovered assets. In practice, however, it may not be the case, since the reports may differ over time and may be subject to interpretation of the administrators.

#### 3.1 Net recovered assets as per the Insolvency reports

Based on the Insolvency reports, the net amount of recovered assets is calculated as a sum of the following:

- Funds recovered from the debtor (from sale of assets, income from accounts receivable etc.);
- Deducted expenses directly associated with the insolvency proceedings.

Based on 1,391 observations, the net amount of recovered assets is MEUR 179.

#### 3.2 Recovered assets as per Financial institutions data

Based on the data received from the Financial institutions, the net amount of recovered assets is calculated as a sum of the following:

- Recovered amount based on data from the Financial institutions;
- Deducted expenses associated with the insolvency proceedings indicated by the Financial institutions.

Based on 1,935 observations, the net amount of recovered assets is MEUR 634.

### 4. Remaining assets after the insolvency proceedings

#### 4.1 Remaining assets as per Insolvency reports

According to the Insolvency reports, the value of remaining assets for currently active proceedings is MEUR 306, based on 644 observations.

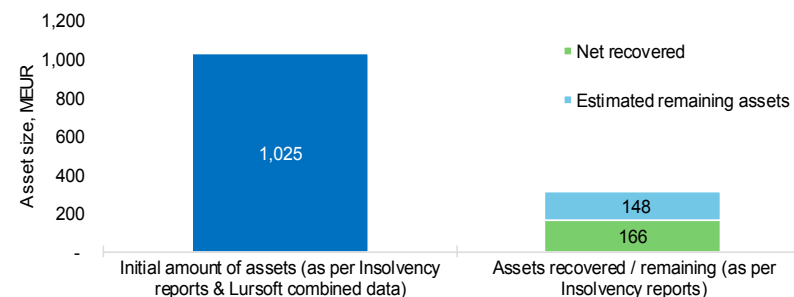
#### 4.2 Remaining assets as per Financial institutions data

According to the data from Financial institutions, the value of remaining collateral in active insolvency proceedings as of 31 December 2014 is MEUR 107, based on 54 observations.

### 5. Summary of initial, recovered and remaining assets

Figure 5 summarizes the data about the companies where information about the initial, recovered and remaining amount of assets is available.

Figure 5: Initial, recovered and remaining assets



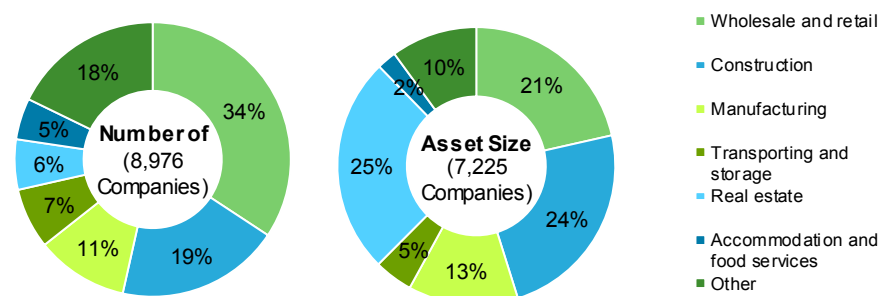
Source: Deloitte analysis based on Lursoft and Insolvency Administration data

## 2.3. Asset size (3/3)

### 6. Breakdown by industry

We have been provided with information on industry classification for 8,976 Companies and on both the industry classification and asset size for 7,225 Companies. Figure 6 shows a breakdown of the analysed Companies by the main industries by their number and asset sizes.

Figure 6: Breakdown by industry



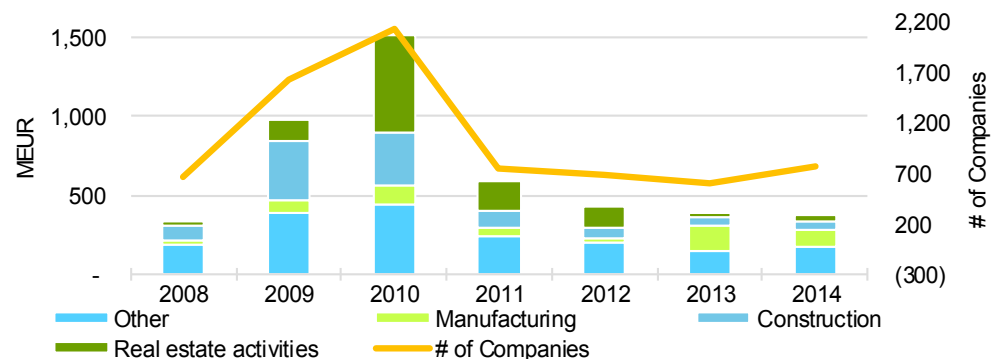
Source: Deloitte analysis based on Lursoft data

### 7. Trends by industries (asset size)

During the Period of the analysis, the construction and real estate industries experienced the largest amount of insolvency proceedings, according to asset size. The number of the insolvency proceedings for the real estate industry peaked in 2010 which could be related to the global economic recession that hit Latvia in 2009 and led to a high number of insolvencies in the related industries, including construction.

In recent years (2013 and 2014), manufacturing is one of the top industries according to the assets size. In 2013, a large amount of assets within the industry is associated with one specific insolvency case. See Figure 7 for details on trends by industries.

Figure 7: Asset size by industries for the Companies



Source: Deloitte analysis based on Lursoft data

### 8. Summary of asset size

- Total assets sum to BEUR 4.6 based on 7,365 observations per Lursoft data.
- Per insolvency reports' 1,391 observations, the net amount of the recovered assets is MEUR 179.
- Per financial institution data and 1,935 observations, the net amount of the recovered assets is MEUR 634.
- Per insolvency reports, the remaining assets for currently active proceedings are MEUR 306 based on 644 observations.
- Per financial institution data, the value of the remaining collateral in active insolvency proceedings as of 31 December 2014 is MEUR 107 based on 54 observations.

## 2.4. Expenses related to insolvency proceedings

### General information

This section covers our analysis of expenses related to insolvency proceedings.

Expenses related to insolvency proceedings are divided in the following groups: direct expenses and indirect expenses.

#### 1. Direct expenses of insolvency proceedings

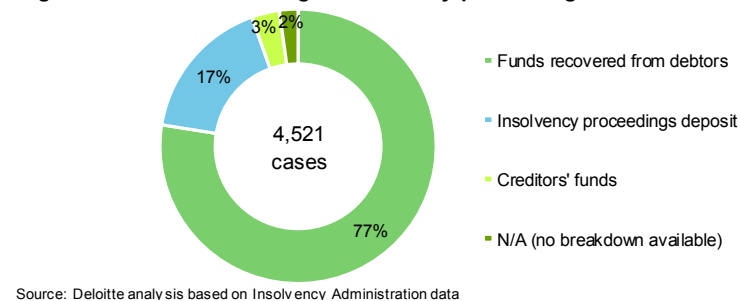
Direct expenses related to insolvency proceedings are calculated based on the information available in the Insolvency reports. The calculation takes into account data from the latest available report for each insolvency case (usually a closing report); in cases where no closing report is available (as before November 2010 there was no differentiation in the forms), the calculation takes into account the maximum value from other submitted Insolvency reports (we did not sum or average the values from all submitted reports per Company, as there was no pattern when the reports reflected accumulated expenses and when – only period-based expenses).

Direct expenses related to insolvency proceedings include the following costs: remuneration to the insolvency administrators, maintenance of the Company assets, travel expenses, taxes and other costs.

According to the information retrieved from the Insolvency reports, the total direct expenses related to insolvency proceedings in the Period of the analysis amount to MEUR 27.8 (based on data from 4,521 Companies in calculation).

According to the Insolvency reports, insolvency proceedings expenses are mostly covered by funds recovered from the debtors. Figure 8 shows a breakdown of the sources of the funding of insolvency proceedings.

Figure 8: Sources of funding of insolvency proceedings



#### 2. Indirect expenses related to insolvency proceedings

##### 2.1 Indirect expenses to creditors

Several Financial and non-financial institutions have submitted the expenses they have incurred due to insolvency proceedings, including the following:

- External legal costs;
- Maintenance of the collateral (if the creditor is responsible for these costs);
- Employee costs for the time spent on the insolvency cases;
- Other related costs.

The total costs as reported by Financial and Non-financial institutions amount to MEUR 6.2. Not all information sources reported the costs.

##### 2.2 Indirect expenses related to employee claim compensation

Indirect expenses related to employee claim compensation incurred to the state are calculated as the amount of the resources granted through the Employee Claim Guarantee Fund, net of payroll taxes that are recovered by the State Revenue Service. The expenses amount to MEUR 9.2.



# 2.5. Recovered claim amount

## General information

This section covers the calculation of the recovered claim amount for terminated insolvency proceedings.

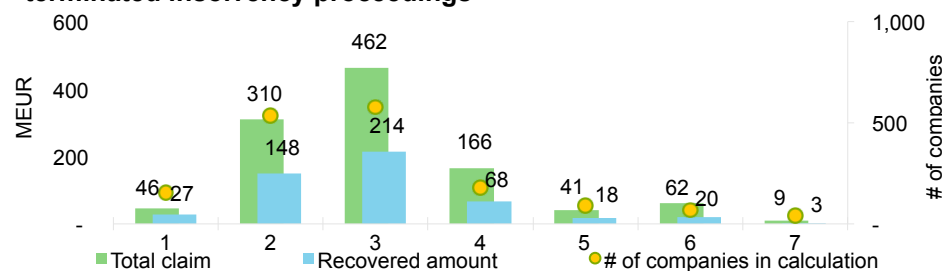
### 1. Recovery to Secured creditors

The calculation is based on data received from Financial institutions and takes into account the following:

- The recovered amount deducting the Financial institutions' expenses related to the recovery;
- The claim amount as reported by the Financial institutions.

Figure 9 summarises the calculation results for terminated proceedings where information on the recovered amount is available. For the period 2008 – 2014, the total claim amount is BEUR 1.1 and the recovered amount is BEUR 0.5.

**Figure 9: Secured claim vs recovered amounts for terminated insolvency proceedings**



Source: Deloitte analysis based on Financial institutions data

The median recovery rate for secured claims is 36% for 2008 – 2014; breakdown by year:

Year	2008	2009	2010	2011	2012	2013	2014
Recovery rate	39%	35%	33%	45%	60%	39%	29%

Source: Deloitte analysis based on Financial institutions data

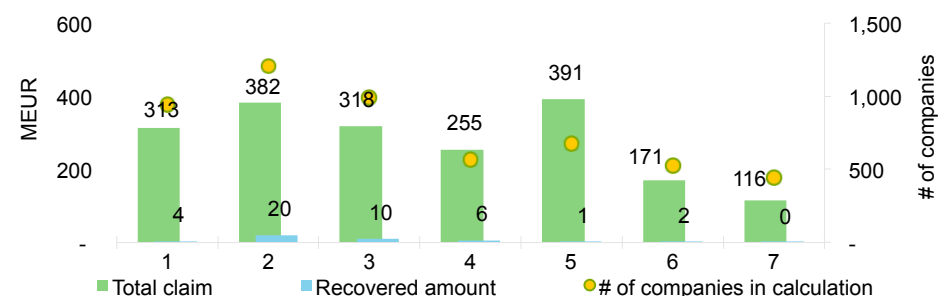
### 2. Recovery to Unsecured creditors

The calculation is based on data from the Insolvency reports, SRS and Lursoft and takes into account the following:

- Recovered amount deducting direct expenses related to the insolvency proceedings (if an insolvency is terminated with the note on the absence of assets, then zero recovery is assumed);
- Additional income received during the insolvency proceedings;
- Claim amount to Unsecured creditors (including preferential unsecured creditors: employees and SRS)

The unsecured claim amount is MEUR 1,948, and the recovered amount is MEUR 42 (terminated insolvency proceedings where information on recovered amount is available). Figure 10 summarises calculation results.

**Figure 10: Unsecured claim vs recovered amounts for terminated insolvency proceedings**



Source: Deloitte analysis on Non-financial institutions data

- The average recovery rate for unsecured claims (including preferential unsecured creditors: employees and SRS) is 2% for 2008 – 2014.

## 2.6. Summary of data available

Figure 11 summarises the data available, based on different information sources, including the amount of claims and assets at the Insolvency date, insolvency proceedings costs and net recovered amount.

As data coverage per different information sources is not full, the Figure 11 also shows the number of Companies per each information source as well as the combined amount per all sources (if applicable).

**Figure 11: Summary of data available**

	Combined	Lursoft	Insolvency reports	State Revenue Service	Financial institutions	Non-financial institutions
<b>Claims, MEUR</b>	<b>7,500</b>	<b>7,443</b>	<b>1,879</b>	<b>444</b>	<b>1,575</b>	<b>35</b>
# companies	8,751	8,099	3,755	2,613	1,935	2,719
% of 9,512	92%	85%	39%	27%	20%	29%
<b>Assets, MEUR</b>	<b>4,686</b>	<b>4,602</b>	<b>1,248</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>
# companies	7,524	7,365	2,126	n/a	n/a	n/a
% of 9,512	79%	77%	22%	n/a	n/a	n/a
<b>Expenses, MEUR</b>	<b>34</b>	<b>n/a</b>	<b>28</b>	<b>n/a</b>	<b>6.1</b>	<b>0.1</b>
# companies	4,961	n/a	4,521	n/a	53	880
% of 9,512	52%	n/a	48%	n/a	0%	9%
<b>Recovered claims, MEUR</b>	<b>n/a</b>	<b>n/a</b>	<b>179</b>	<b>n/a</b>	<b>634</b>	<b>n/a</b>
# companies	n/a	n/a	1,391 (if recovered amount >0)	n/a	1,935	n/a
% of 9,512	n/a	n/a	15%	n/a	20%	n/a

Source: Deloitte analysis

# 2.7. Financial costs of insolvency

## General information

This section covers the estimated financial costs of insolvency in Latvia during the Period of the analysis. The estimated financial costs of insolvency take into account direct and indirect costs.

### 1. Direct costs of insolvency or unrecovered claims to the creditors

The direct costs associated with insolvency proceedings are calculated based on the unrecovered creditor claims. Figure 12 summarises the costs by creditor groups. The direct costs are calculated as follows:

- total creditor claim amount at the Insolvency date,
- deducting net recovered amount during the insolvency process.

### 1.1 Direct costs of insolvency or unrecovered claims to the Secured creditors

Figure 13 shows the calculation steps, where:

- Claims are the Secured creditor claims, based on the data from the Financial institutions at the Insolvency date and Lursoft where no information available;
- Unrecovered claims or direct costs for observed and terminated cases, the calculation based on terminated insolvency proceedings where information on the actual recovered amount is available;
- Unrecovered claims or direct costs for estimated and/or not terminated cases, the calculations based on the active / terminated insolvency proceedings where information on the actual recovered amount is not available. The estimation takes into account the recovery rates that are calculated based on the companies with available data.

### 1.2 Direct costs or unrecovered claims to Unsecured creditors

Figure 14 shows the calculation steps, where:

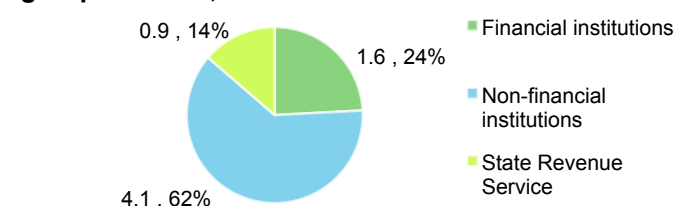
- Claims are Unsecured creditor claims based on the data from Insolvency reports and Lursoft where no information available;
- Unrecovered claims or direct costs for observed and terminated cases, the calculations based on terminated insolvency proceedings where information on actual recovered amount is available from the Insolvency reports or State Revenue Service (due to data limitations actual recovered amount as per the SRS is only available for the insolvency proceedings with zero recovery);
- Unrecovered claims or direct costs for estimated and/or not terminated cases, the calculations based on active / terminated insolvency proceedings where information on actual recovered amount is not available. The estimation takes into account the recovery rates that are calculated based on the companies with available data.

### 2. Indirect costs

The indirect costs associated with the insolvency proceedings calculated as:

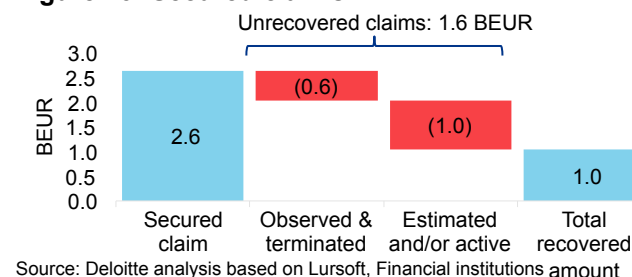
- Indirect expenses to the creditors due to the insolvency proceedings based on information from Financial and Non-financial institutions, which amount to MEUR 6.2;
- Indirect expenses payable from the Employee Claim Guarantee Fund to the employees of the insolvent Companies net of payroll taxes; the calculation is based on information from the Insolvency Administration's annual reports, which amounts to MEUR 9.2.

**Figure 12: Unrecovered claims by creditor groups - BEUR, %**



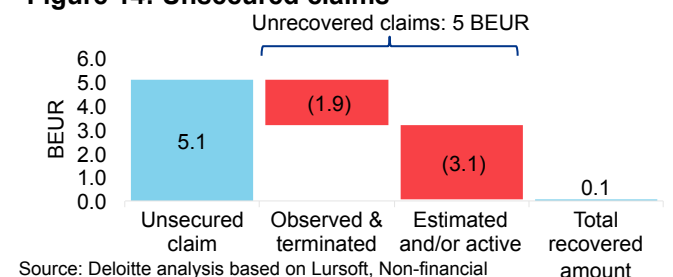
Source: Deloitte analysis based on Lursoft, Insolvency Administration, Financial and Non-financial institutions, SRS data

**Figure 13: Secured claims**



Source: Deloitte analysis based on Lursoft, Financial institutions data

**Figure 14: Unsecured claims**



Source: Deloitte analysis based on Lursoft, Non-financial institutions, Insolvency Administration data

## 2.8. Non-financial costs of insolvency

### General information

This section summarises our approach and calculation results of non-financial costs of insolvency.

### 1. Non-financial costs of insolvency

Non-financial costs of insolvency represent the induced costs which take into account the costs due to depreciation of assets, due to opportunity cost of capital and due to the multiplier effect.

#### 1.1 Induced costs

Costs due to **depreciation of assets**. Assets are not employed during insolvency proceedings, therefore, the value of depreciation is lost in the time period between beginning and end of insolvency proceedings. Assumptions:

- The calculation takes into account the insolvency proceedings' length and fixed assets / collateral value and a 10% depreciation (straight line method).

Costs due to **the opportunity cost of capital**. Assets are not employed during insolvency proceedings, therefore, they are not used effectively i.e. they do not generate return. Assumptions:

- The calculation takes into account the insolvency proceedings' length and fixed assets / collateral value and a 3.5% opportunity cost of capital (per annum);
- Only fixed assets / real estate collateral value is taken into account, as net working capital might deteriorate due to insolvency (conservative approach);
- Opportunity cost of capital is conservatively estimated as ROA (return on assets) for assets in the Latvian economy (based on the data from the Central Bureau of Statistics (CSB)).

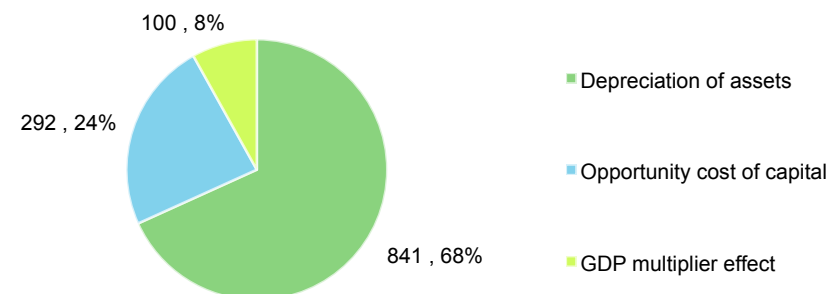
Costs due to **the multiplier effect**. Employees of the Companies are "in-between jobs" due to insolvency proceedings and are unable to receive part of their income, therefore, their expenditure / consumption decreases. Due to decreased consumption less money is turned around in the economy, thus having a negative impact on GDP. The negative impact on GDP is calculated taking into account the GDP multiplier, which is calculated as follows:

$$GDP\ multiplier = \frac{1}{1+MPC} \quad \text{where } MPC \text{ (Marginal Propensity to Consume)} = \frac{\Delta Household\ consumption}{\Delta Disposable\ income}$$

Assumptions:

- The decrease in the household income or "unreceived income" is calculated taking into account the number of employees in the Companies, number of months without income for employees, average net salary in the Latvian economy (private sector):
  - 19,291 employees submitted claims during 2008-2014, based on the data provided by the Insolvency Administration;
  - The time period during which employees are "in-between jobs" prior and during insolvency proceedings is estimated to be 6 months;
  - Average net salary in the private sector during 2008-2014 ranges from 433 to 548 EUR/month;
- GDP multiplier is calculated based on the CSB data on household expenditure and disposable income. The estimate is 2.84;
- In order to estimate costs due to the multiplier effect we have multiplied the estimated "unreceived income" with the GDP multiplier.

Figure 15: Induced costs split - MEUR, %



Source: Deloitte analysis

## 2.9. Lack of control over insolvency data

According to the Insolvency Law, insolvency administrators are obliged to report to the Insolvency Administration data on the insolvency cases on a regular basis. However, the analysis of the data provided by the Insolvency Administration indicates that the system does not work for the following reasons:

### 1.1. Non-compliance with the reporting requirements by the insolvency administrators

- a) Compliance of submission of all reports of insolvency administrators stipulated by the law is 40%;
- b) Some of the Insolvency reports contain partial information or are not filled out at all.

### 1.2. Insufficient quality and amount of data

- a) Submitted Insolvency reports are stored in different forms (.doc, .xls, .pdf, .ost, etc.) which makes data analysis more complicated;
- b) The report templates do not contain all necessary information for measuring the efficiency of the insolvency case. For instance since the Insolvency Law of 2010 the amount of creditors claim is not indicated in the reports, therefore it is not possible to monitor the recovery rates.

### 1.3. Lack of monitoring

As a consequence of the current data collection and processing system, it is not possible to:

- a) Check the quality of the submitted information and documents to the Insolvency Administration (Insolvency reports etc.);
- b) React timely to shortages of information;
- c) Compare and double-check the information available to the Insolvency Administration with other sources, such as the State Revenue Service, the Commercial Register in order to obtain a full overview over the case;
- d) Measure the efficiency of the particular insolvency case/insolvency administrator and the whole insolvency system.

## 2.10. International benchmarks (1/2)

### Doing Business report

The Doing Business report<sup>1</sup> is the World Bank Group's annual statement of the state of economies around the world. Inter alia Doing Business separately analyses insolvency proceedings in each country by measuring the time, cost, and outcome of an insolvency process for a case study firm and the recovery rate for its secured creditors (Resolving Insolvency).

In 2015 the World Bank has developed a new comparative index and analysed the strength of national insolvency legal frameworks and measured whether economy has adopted internationally recognised good practices in 4 areas: commencement of the insolvency proceedings, management of the debtor's assets, reorganisation proceedings, and creditor participation in insolvency proceedings.

Within the research Deloitte compared the scores of OECD high income countries with the scores of Latvia according to the Doing Business report and according to the Deloitte research.

#### 1.1. Length of proceedings

According to Doing Business 2015, the average length of insolvency procedures in the OECD high income countries was 1.7 years whereas in Latvia it was 1.5 years.

According to the Deloitte research, the length of insolvency procedures in Latvia has decreased during the last 8 years: The length of proceedings commenced under the law for period 2008-2010 was 2.1, whereas the length of proceedings commenced in 2011-2014 was 1.2 years. The length of the procedures where the debtors had assets was 1.5 years in 2011-2014 which is still better than the average of the OECD countries.

#### 1.2. Cost of insolvency

According to the Doing Business research the cost of insolvency includes court fees and government levies; fees of the insolvency administrators, auctioneers, assessors and lawyers; and all other fees and costs, which corresponds to the term "expenses related to the insolvency proceedings" within the Deloitte research.

According to Doing Business 2015 the average cost of insolvency procedures in the OECD high income countries was 8.8% of the debtor's estate whereas in Latvia it was 10%.

The costs of insolvency proceedings have to be revealed by the insolvency administrators within the reports submitted to the Insolvency Administration. However, since 60 % of the reports are missing, the data in the reports is not complete and not consistent, a comprehensive and reliable measurement of the average costs is not possible.

#### 1.3. Recovery rate

According to Doing Business 2015, the average recovery rate of secured creditors was 71.9% in the OECD high income countries and 48.2% in Latvia.

According to the Deloitte research the average rate for secured creditors in Latvia in 2008-2014 was 36%. However, the rate has increased in the last 3 years and in 2012-2014 period the average recovery rate for secured creditors was 46%. According to Doing Business the average recovery rate in the OECD high income countries was 76% in 2008-2014.

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<sup>1</sup> The World Bank Group flagship publication, available: <http://www.doingbusiness.org/reports/global-reports/doing-business-2015>

## 2.10. International benchmarks (2/2)

### 1.4. Strength of the insolvency framework

According to Doing Business, Latvia has received 12.0 points out of 16 possible for the strength of the insolvency legal framework. In comparison - the average of the OECD high income countries is 12.2, the average for Europe – 9.2.

Based on these scores in the strength of the insolvency framework index, we believe that the best international practises have been introduced in the Latvian Insolvency Law.

Since the reforms of the Insolvency Law have been introduced in Latvia already several years ago (2008-2011) but there is still significant gap between the recovery rates in Latvia and the OECD high income countries, the reason of the gap is related to the application of the law rather than the wording of the law.

**Figure 16: Insolvency key indicators in Latvia and in the OECD high income countries**

Criteria	OECD high income countries average according to Doing Business 2015	Latvia according to Doing Business 2015	Latvia according to Deloitte research 2012-2014
<b>Length</b>	1.7	1.5	1.2 / 1.5 (proceedings with assets)
<b>Costs</b>	8.8	10	No data
<b>Recovery rate</b>	71.9	48.2	46
<b>Strength of insolvency framework</b>	12.5	12	N/A

## 2.11. Late insolvency

The Insolvency Law provides criteria of insolvency and obliges the company to apply for the insolvency proceedings or seek for restructuring when the insolvency criteria are met.

The majority of the insolvency criteria stipulated by the Insolvency Law are based on cash flow approach. Data analysed within the Deloitte research do not allow one to determine the Insolvency date based on the cash flow insolvency test. However, a sign of the financial distress might be the negative equity of the company. If the company has a negative equity for a long period of time and finally is announced insolvent it is highly likely that the insolvency proceedings were delayed.

In order to determine the potential percentage of late insolvencies we analysed the data of the companies which had negative equity two consequent years before the announcement of the insolvency proceedings.

### 1.1. Number of late insolvencies

Data on equity during the two years before the Insolvency date was available for 6,539 companies. 3,422 companies from 6,539 or 52% had a negative equity at least two years before the announcement of the insolvency proceedings. This number indicates the significant scale of potentially late insolvencies.

### 1.2. Financial impact of late insolvency

We analysed 2,652 companies whose data on equity two years before insolvency and in the year of the commencement of the insolvency procedure was available.

Taking into account that change of asset amount and liabilities of distressed companies may be caused by the enforcement actions of the creditors, we split the companies which assets were encumbered with commercial pledge.

Companies with negative equity 2 years before the insolvency and with pledge free assets lost EUR 45% of their asset value and their liabilities increased by EUR 36% during the last 2 years before the commencement of the insolvency procedure. A significant decrease of assets and an increase of liabilities were typical also for companies with no pledge but a positive equity 2 years before the insolvency: loss of assets: 38%; increase of liabilities: 53%.

Companies with encumbered assets lost significant amount of assets regardless of equity, but the liabilities of the companies increased significantly less. The small increase of liabilities in population indicates that decrease of asset value is likely caused by the enforcement of the pledge which also led to the settlement of secured liabilities.

The numbers confirm that potential hesitation to apply for the insolvency or restructuring procedures by a financially distressed debtor may lead to decrease of asset and business value, and an increase of amount of debts, causing loss for both the debtor itself and the creditors. Excluding potential enforcement actions the average decrease of asset value is 42%, whereas the average increase of liabilities is 45% during the last 2 years before the commencement of the insolvency procedure.

**Figure 17: Amount of companies' assets and liabilities 2 years prior insolvency and on Insolvency date**

			Equity		Assets				Liability			
2Y Equity	Pledge	Case Count	2Y Equity, MEUR	0Y equity, MEUR	2Y Assets, MEUR	0Y Assets, MEUR	Asset change, MEUR	Asset change rate	2Y Liability, MEUR	0Y Liability, MEUR	Liability change, MEUR	Liability change rate
Positive	No Pledge	640	112	(298)	518	323	(0)	(38%)	(406)	(621)	(214)	53%
Positive	Pledge	847	637	(968)	2,795	1,339	(1)	(52%)	(2,158)	(2,307)	(150)	7%
Negative	No pledge	635	(84)	(370)	314	173	(0)	(45%)	(399)	(543)	(144)	36%
Negative	Pledge	530	(186)	(561)	890	541	(0)	(39%)	(1,076)	(1,102)	(27)	2%

Source: Deloitte analysis based on Lursoft data





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# The Economic Impact of Insolvency Abuse

# 3.1. Most common types of insolvency abuse (1/2)

## General information

Deloitte developed a list of the most common types of insolvency abuse which we have later validated during interviews with Financial and Non-financial institutions. We also studied publicly available information on the abusive and potentially abusive insolvency cases.

Deloitte interviewed and consulted:

- State institutions (the Insolvency Administration, the State Revenue Service, the State Audit Office and the Bank of Latvia);
- 28 largest companies (both private and state-owned companies from financial, construction, real estate and other industries).

In addition Deloitte performed a detailed analysis of 40 cases with high risk of potential insolvency abuse, which were either provided to Deloitte during the interviews as illustrative examples for the insolvency abuse, or chosen from publicly available resources.

In order to measure the scale of insolvency abuse a questionnaire for business community was organised in cooperation with the Latvian Chamber of Commerce. Please find the results of the questionnaire in Annex 3.

As a result we identified the most common types of insolvency abuse:

## 1. Phoenix phenomenon

The debtors in bad faith transfer their valuable assets or their business to other companies. Such companies usually are related to the debtor. By the time of the insolvency proceeding the debtor is actually a shell company. The shell companies have limited or no assets to pay to their creditors. The creditors have very little chance to recover their losses. The most common activities for achieving the desired result are:

- Creation of fictitious deals and creditors;
- Manipulation of the accounting data;
- Destruction of the accounting documents;
- Appointment of fictitious representatives and shareholders of the company;
- Conducting a chain of actions (change of legal address; legal protection procedure prior the insolvency procedure; manipulation with candidacy queues) to receive a debtor-loyal insolvency administrator, who acts in favour of the debtor.

## 2. Retention of control

The debtors experiencing financial difficulties abuse the legal instruments available within the insolvency proceedings and/or legal protection process to retain the control over their assets and manage to receive cash flow from the assets. Control over assets is ensured with an assistance of debtor-loyal Insolvency administrators.

The most common abusive activities for achieving the desired result are:

- Creation of fictitious deals and creditors;
- Creation of liabilities in favour of the debtor related persons;
- Involvement of debtor-loyal Insolvency administrators. The methods for appointing the loyal administrator are: change of legal address; a legal protection procedure prior the insolvency procedure; manipulation with candidacy queues);
- Conscious counter-actions by the insolvency administrators (namely, respecting the fictitious deals or claims, challenging the founded claims, delaying the sale of assets etc.).

# 3.1. Most common types of insolvency abuse (2/2)

## 3. Raiderism

The insolvency legal framework is being abused for a hostile take-over of a company / assets by the minority shareholders / management / third party acting in bad faith.

The most common activities for achieving the desired result are:

- Creation of a fictitious creditor claim and submission of the insolvency application against the “target” company to the court and/or abusive admitting of the insolvency by the management of the debtor;
- Take-over of the assets and its abusive use with the insolvency proceedings.
- Involvement of debtor-loyal Insolvency administrators. The methods for appointing a loyal administrator are: change of the legal address; a legal protection procedure prior the insolvency procedure; manipulation with candidacy queues);
- Conscious counter-actions by the Insolvency administrators (namely, respecting the fictitious deals or claims, challenging the founded claims, delaying the sale of assets etc.).

## 4. Manipulations of the insolvency administrators

In some cases insolvency administrators act in bad faith in favour of their own financial benefit.

The most common activities for achieving the desired result are:

- Creation of fictitious costs;
- Delaying the sale of assets for using the cash flow from the assets;
- Manipulation with the manner of sale in order to obtain the highest remuneration;
- Cession of the rights of the claim for low values to the related parties;
- Misappropriation of the received compensation from the sale of assets;
- Disproportionate determination of the reward;
- Manipulation with the decision of the creditors meetings.

## 3.2. Indicators of insolvency abuse (1/5)

### General information

Taking into account the most common types of insolvency abuse and actions taken for achieving the bad faith goals, Deloitte developed a list of the 9 most evident indicators of potential insolvency abuse which we have later validated during interviews with Financial and Non-financial institutions. Additionally, we analysed several technical indicators that also might identify abuse.

We assume that some of the indicators alone do not guarantee that the insolvency abuse has taken place. However, together with other indicators and factual circumstances they build a foundation of a potential insolvency abuse.

Deloitte determined the following actions as indicators of a potential insolvency abuse:

### Actions prior to insolvency

#### 1. Change of legal address of the debtor

Legal address of the company is used for determination of the competent court which will open the insolvency proceedings / legal protection process case, appoint the administrator and review all actions within the case.

Prior 2014 the selection procedure of the insolvency administrators was based on an electronic queue which allowed to manipulate and foresee the appointments within particular court house.

There was a practice to change the legal address shortly before the Insolvency date in order to get the case heard by the court which might be more debtor friendly and to receive the debtor-loyal insolvency administrator, as well as to make the debtor less accessible for creditors.

#### 2. Change of members of the board

The change of the board members shortly before the Insolvency date is done in order to safeguard previous board members from scrutinising the insolvency proceedings and any liabilities. Usually the new board members are fictitious, they have no assets and sometimes they do not even contact the insolvency administrator. There is barely a sound reason for a person to become a board member of insolvent company and to accept the role of safeguarding previous board members.

#### 3. Change of shareholders

Similarly as in the case of change of member of the board, change of shareholders of the company might indicate that due to the abuse of the insolvency the company has already no assets and/or provide no profit to the shareholders therefore they have no interest to participate in the equity of the company. Often the new shareholders are fictitious. There is barely a sound reason for a person to become a shareholder of an insolvent company

#### 4. Termination of the legal protection process

According to the Insolvency Law, Legal protection procedure (LPP) automatically converts into insolvency procedure if the debtor fails to comply with the plan of LPP. The termination of LPP shortly after the plan approval by the court indicates that the plan has not been sound and the procedure has been used to delay time and obtain a debtor-loyal administrator. The latter was possible until 2015 because the insolvency administrator for LPP was chosen by the debtor and remained his/her position if LPP was converted into insolvency proceedings.

## 3.2. Indicators of insolvency abuse (2/5)

### Actions during insolvency

#### 5. Fictitious creditors

Fictitious creditors as an instrument can be used by the debtor in various ways: it allows to influence the voting rights when creditor's decisions are required by law. Fictitious claims might also be used to withdraw the proceeds of the insolvency proceedings. Usually the indicators of fictional creditors are claims significantly exceeding the amount of secured claim. Such claims are often not recorded prior the annual reports of the debtor.

#### 6. Suspicious behaviour of the insolvency administrator

The study of abusive cases indicates that insolvency administrators might occur to be "debtor friendly" and find themselves in conflict of interests (having business together with a debtor or other links). As an indicator of the link between the Insolvency administrator and the debtor is a common legal address before the announcement of the insolvency of the debtor and declining the Insolvency administrators' candidacy queues in favour of other Insolvency administrators.

#### 7. Complaints filed to the Insolvency administration

The current legal framework allows the creditors to file complaints to the Insolvency Administration in order to challenge the actions of the Insolvency administrator. Numerous complaints might indicate that misconduct by the

Insolvency administrator has taken place and the insolvency proceedings might be abusive to the creditors.

#### 8. Initiation of criminal proceedings

If the creditors are sure that during the insolvency proceedings criminal offence has been committed, they are entitled to file an application to the police and request to initiate the criminal proceedings.

In case the criminal proceedings are initiated by the police, it indicates that the actions made within the insolvency proceedings most likely are extensively breaching the law and potentially the insolvency abuse has taken place.

#### 9. Initiation of civil proceedings

Within the insolvency proceedings there are several options how to protect the interests of the creditors before the court (for instance, to appeal the administrator's decision on not admitting the creditor's claim).

Therefore if the civil proceedings are initiated and are directly related to the facts and documents of the insolvency proceedings or with procedural steps, it may indicate that the insolvency proceedings were not carried out correctly.

### Other technical indicators

When analysing the data, we have determined several financial indicators that might identify potential abuse, including abnormally low recovery rate, given the sufficient amount of collateral, or abnormally low recovery rate, given the large amount of assets, etc.

## 3.2. Indicators of insolvency abuse (3/5)

### General information

This section covers the potential indicators of insolvency abuse among the sample Companies.

#### 1. Change of legal address

We compared legal addresses of the Companies at the Insolvency date and every month prior to it. We identified 827 Companies that had its legal address changed 6 months or less prior to the Insolvency date. Figure 18 shows the distribution by years:

**Figure 18: # of Companies that had a legal address changed prior to insolvency**

	2008	2009	2010	2011	2012	2013	2014	Grand Total
0-3 months	33	98	143	77	64	53	46	514
4-6 months	32	61	100	37	31	21	31	313
<b>Total</b>	<b>65</b>	<b>159</b>	<b>243</b>	<b>114</b>	<b>95</b>	<b>74</b>	<b>77</b>	<b>827</b>

Source: Deloitte analysis based on Lurs oft data

#### 2. Change of members of the board

We identified 8,934 Companies (or 93.9%) with at least one record about members of the board.

There were 204 Companies that had at least one member of the board changed 6 months or less prior to the Insolvency date. Figure 19 shows the distribution by years:

**Figure 19 # of Companies that had a member of the board changed prior to insolvency**

	2008	2009	2010	2011	2012	2013	2014	Grand Total
0-3 months	5	18	15	9	3	8	7	65
4-6 months	16	42	37	10	8	9	17	139
<b>Total</b>	<b>21</b>	<b>60</b>	<b>52</b>	<b>19</b>	<b>11</b>	<b>17</b>	<b>24</b>	<b>204</b>

Source: Deloitte analysis based on Lurs oft data

#### 3. Change of shareholders

We identified 9,499 Companies (or 99.9%) with at least one record about shareholders.

There were 1,213 Companies that had a shareholder structure changed 6 months or less prior to the Insolvency date. Figure 20 shows the distribution by years:

**Figure 20: # of Companies that had a shareholder structure changed prior to insolvency**

	2008	2009	2010	2011	2012	2013	2014	Grand Total
0-3 months	60	142	163	60	53	56	58	592
4-6 months	68	164	170	57	56	44	62	621
<b>Total</b>	<b>128</b>	<b>306</b>	<b>333</b>	<b>117</b>	<b>109</b>	<b>100</b>	<b>120</b>	<b>1,213</b>

Source: Deloitte analysis based on Lurs oft data

#### 4. Termination of legal protection process

There were 268 Companies that had a legal protection process terminated 6 months or less prior to the Insolvency date. An upward trend could be observed over the recent years. Figure 21 shows the distribution by years:

**Figure 21: # of Companies that had LPP terminated prior to insolvency**

	2008	2009	2010	2011	2012	2013	2014	Grand Total
0-3 months	2	6	21	19	45	56	91	240
4-6 months	0	3	3	1	2	6	13	28
<b>Total</b>	<b>2</b>	<b>9</b>	<b>24</b>	<b>20</b>	<b>47</b>	<b>62</b>	<b>104</b>	<b>268</b>

Source: Deloitte analysis based on Lurs oft data

## 3.2. Indicators of insolvency abuse (4/5)

### 5. Fictitious creditors

We compared the amount of creditor claims as provided by Lursoft (annual reports), the Insolvency reports and Financial institutions. We identified two groups of Companies that potentially had an indication of abuse:

- Group 1: creditor claims as per Insolvency reports were at least by 100% larger than claims as per Lursoft and Financial institutions data;
- Group 2: creditor claims as per Insolvency reports were at least by 100% larger than claims as per Financial institutions data; the difference between creditor claims as per Insolvency reports and as per Lursoft was less than 100%.

Since data about creditor claims was provided only in the Insolvency reports filed according to the Insolvency Law from 1996 and 2008, the analysis could only cover the period 2008-2011. We identified 178 Companies within either of the Groups. See Figure 22 for details:

**Figure 22: # of Companies with potentially fictitious creditors**

	2008	2009	2010	2011	2012	2013	2014	Grand Total
Group 1	2	8	12	1	n/a	n/a	n/a	23
Group 2	26	73	52	4	n/a	n/a	n/a	155
<b>Total</b>	<b>28</b>	<b>81</b>	<b>64</b>	<b>5</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>178</b>

Source: Deloitte analysis based on Lursoft data

### 6. Suspicious behavior of the insolvency administrator

#### 6.1 Administrator candidacy

We identified 69 Companies that had 2 or more candidates declined from the position of the Insolvency administrator within 24 hours. Such cases were related to 59 Insolvency administrators selected at the end of the election process.

See Figure 23 for details:

**Figure 23: # of Companies that had 2 or more candidates declined from the position of the Insolvency administrator within 24 h**

	2008	2009	2010	2011	2012	2013	2014	Grand Total
Companies	8	19	19	8	8	5	2	69

Source: Deloitte analysis based on Insolvency Administration data

#### 6.2 Administrator address

There were 7 Companies that had a similar legal address with the insolvency administrator address, provided that the Company registered such an address prior to the Insolvency date.

### 7. Complaints filed to the Insolvency administration

10 or more complaints were filed to the Insolvency Administration in relation to 83 Companies during the Period of the analysis. See Figure 24 for details:

**Figure 24: # of companies with 10 or more complaints**

	2008	2009	2010	2011	2012	2013	2014	Grand Total
Companies	10	20	23	12	6	10	2	83

Source: Deloitte analysis based on Insolvency Administration data

### 8. Criminal proceedings

We received information from several Financial institutions (not all submitted the data) that criminal proceedings were initiated in relation to at least 18 Companies.

### 9. Civil proceedings

We received information from several Financial institutions (not all submitted the data) that civil proceedings were initiated in relation to at least 13 Companies.

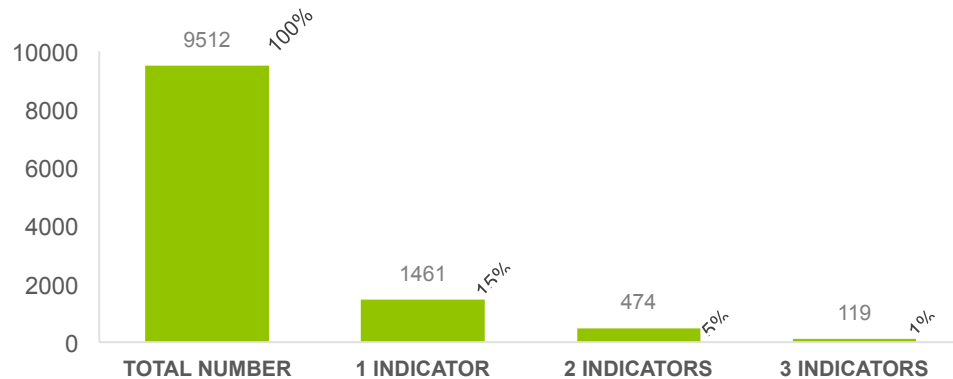
## 3.2. Indicators of insolvency abuse (5/5)

### Companies with indicators of insolvency abuse

Deloitte has determined that 1,461 Companies out of 9,512 or 15% had at least one indicator of insolvency abuse. 474 of the total amount of companies or 5% had at least two indicators of insolvency abuse. 119 or 1% of all companies had at least three indicators of insolvency abuse.

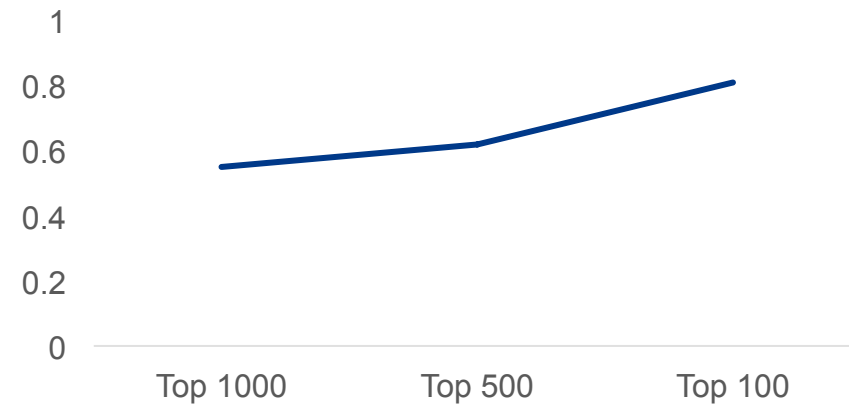
There is a link between the value of assets of the Company and the possibility of insolvency abuse. Within TOP 100 Companies with the most valuable assets there were 0.81 insolvency abuse indicators per company, within TOP 500 the number was 0.62 and within TOP 1000 – 0.55.

**Figure 25: Number of companies with insolvency abuse indicators**



Source: Deloitte analysis based on Lursoft, Insolvency Administration data

**Figure 26: Abuse indicators per case**



Source: Deloitte analysis based on Lursoft, Insolvency Administration data



# 3.3. Economic impact of insolvency abuse

## General information

This section summarises our approach and calculation results of the economic impact of insolvency abuse.

### 1. Approach

Our approach takes into account the following steps:

- 1) Taking into the account insolvency abuse indicators mentioned on the previous slides, we have determined the population of potentially abusive insolvencies:
  - Potentially abusive insolvencies within the sample of the Companies with large Secured creditors claims (above MEUR 5) have been determined during the interviews with Financial institutions.
  - Potentially abusive insolvencies within the rest of the population have been determined taking into account a coincidence of at least 3 insolvency abuse indicators per Company.
- 2) We have estimated the financial loss from insolvency abuse based on the gap between the creditor recovery rate of abusive insolvencies and the creditor recovery rate of insolvencies without abuse (benchmark recovery rate). We have estimated the financial loss from abuse by multiplying the difference in recovery rates with the claim amount of the Companies classified as potentially abusive insolvencies.
  - The gap for secured claims is estimated based on the actual recovery rate for abusive insolvencies deducting the expected recovery rate. The expected recovery rate is estimated taking into account the expected recovery from collateral. The collateral value has been indexed and a haircut has been applied to the value.
  - The gap for unsecured claims is estimated based on the actual recovery rate for abusive insolvencies deducting the average actual recovery rate for insolvencies without abuse.

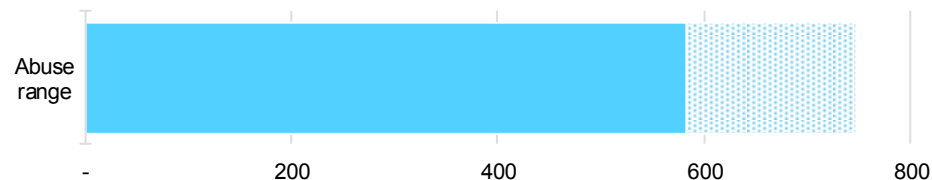
- 3) We have calculated the non-financial loss from insolvency abuse based on non-financial costs of insolvency allocated to the population of abusive insolvencies. As mentioned before (slide 27) non-financial costs include costs due to depreciation of assets, opportunity cost of capital and costs due to the multiplier effect.

We have allocated the non-financial costs to the population of abusive insolvencies based on the proportion of fixed assets and the collateral in the population of abusive insolvencies to the total population of the Companies. The non-financial costs allocation takes into account the estimated proportion of fixed assets and collateral, as non-financial costs rely substantially on the value of the fixed assets and the collateral (costs of depreciation or opportunity costs are estimated based on the value of the fixed assets and the collateral).

### 2. The economic impact of the insolvency abuse calculations

The economic impact of insolvency abuse is estimated in the range as shown below on Figure 27. The resulting mean is MEUR 665.

**Figure 27: Economic impact from insolvency abuse, MEUR**



Source: Deloitte analysis based on Lursoft, Insolvency Administration, Financial and Non-financial institutions, SRS data

Economic impact from insolvency abuse takes into account the following:

- Financial loss, amounting to MEUR 358, including financial loss to secured creditors (MEUR 352) and unsecured creditors (MEUR 6);
- Non-financial loss, amounting to MEUR 307, including loss due to depreciation of assets (MEUR 209), due to opportunity cost of capital (MEUR 73) and due to GDP multiplier effect (MEUR 25).

## 3.4. Recovery rates of unsecured creditors

The recovery rate of unsecured creditors largely depends on the debt structure of the debtor. If all or a substantial part of the debtor's assets are encumbered in favour of the secured creditors, the recovery potential for unsecured creditors are substantially less rather than if assets are free from securities regardless of insolvency abuse. In order to measure the direct impact of insolvency abuse on unsecured creditors we additionally analysed the insolvency procedures where the debtor's assets were not encumbered.

### 1.1. Number of insolvency proceedings without secured creditors

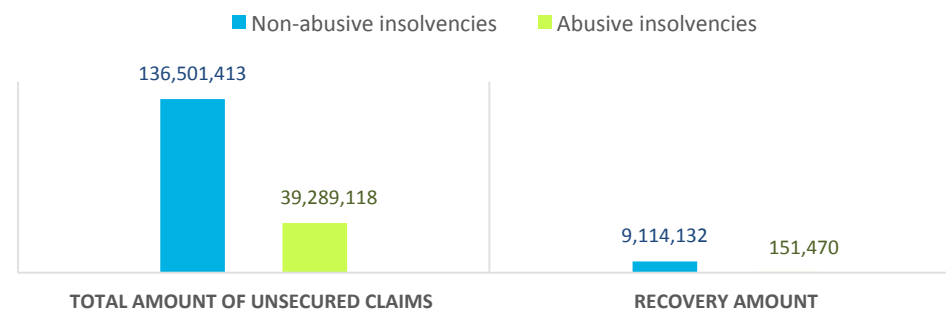
According to available data we identified 493 companies which did not have secured claims within the insolvency proceedings.

457 companies did not contain any indicator of insolvency abuse, however 36 companies - did. We analysed companies which contained at least 2 of 9 of the insolvency abuse indicators where we could determine that on the Insolvency date the total amount of loss of assets in comparison with the amount of assets one year prior to the Insolvency date exceeded 70%.

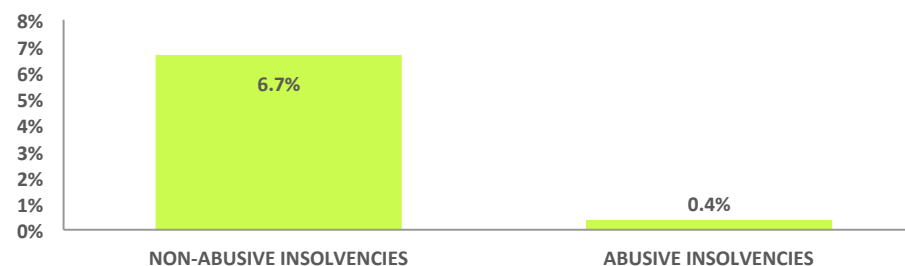
### 1.2. Analysis of recovery rate for unsecured creditors

Within the population that had no insolvency abuse indicators, the recovery rate for unsecured creditors was 6.7%, whereas within the population with at least two insolvency abuse indicators, the recovery rate was 0,4%.

**Figure 28: Amount of total and recovered unsecured claims within insolvency cases with no secured creditors**



**Figure 29: Amount of recovered unsecured claims within abusive and non-abusive insolvency cases with no secured creditors**





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# Consequences of an Inefficient Insolvency System

# 4.1. Future costs of an inefficient insolvency system

## General information

This section covers the calculation of the future financial costs of an inefficient insolvency system.

### 1. Future financial costs of an inefficient insolvency system

If the benchmark recovery rate is achieved in the future, the gap between current recovery rate and benchmark should be closed, in this way minimizing insolvency costs and maximizing recovery. Future financial costs are calculated based on the assumption that the gap is closed in 3 years and the system becomes effective or not closed at all, i.e. the system does not become more effective and benchmark recovery level is not achieved. In this case, the costs are estimated for 10 year period.

#### Calculation assumptions

- The benchmark insolvency recovery rate is gradually achieved in 3 years or not achieved for new insolvency proceedings;
- The amount of new insolvency proceedings is 883 p.a., calculated based on the historical average for 2011-2014;
- The current recovery rate for secured and unsecured creditors is based on historical data;
- The benchmark recovery rate is 76% for the secured creditors (average of the OECD high income countries in 2008-2014 according to Doing Business);
- The average claim amount is based on the historical data about the average claim amount for secured and unsecured creditors per company.

Our estimated future loss is MEUR 128 if the benchmark is achieved in 3 years; our estimated future loss is MEUR 852 if the benchmark is not achieved in 10 years.



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## Conclusions and Recommendations

# 5.1. Conclusions (1/4)

## 1. Quality and availability of insolvency data

According to the Insolvency Law, the insolvency administrators are obliged to report to the Insolvency Administration data on particular insolvency cases on regular basis. However, the compliance of submission of the reports by the insolvency administrators is 40%. Substantial part of the reports contain partial information or are not filled out at all. Report templates do not contain all the necessary information for monitoring efficiency and there is no system for processing and analysing the data. Therefore it is not possible to monitor whether the insolvency administrators comply with the law and submit the reports and it is not possible to measure the efficiency of a particular insolvency case/insolvency administrator and the whole insolvency system.

## 2. Financial and economic cost of insolvency

9,512 companies were declared insolvent in the period of 2008-2014. The number of commenced insolvency proceedings peaked in 2010 as a result of the global economic recession and reached 2,565. Since 2011 the number of insolvencies has decreased due to legislative change which increased the costs of the commencement of the insolvency procedure. The average number of announced insolvencies in 2011-2014 was 883 per year.

The book value of assets of the companies declared insolvent 2008-2014 is BEUR 4.6 based on the observation of 7,365 companies.

The financial costs to the creditors caused by the insolvency of the debtors due to direct and indirect costs amounts to BEUR 6.6 in the period 2008-2014 (27% if compared to Latvian GDP in 2014). The costs are largely borne by Non-financial institutions (unsecured creditors): BEUR 4.1, Financial institutions (secured creditors) follow with BEUR 1.6 and the State Revenue Service (unsecured preferential creditor) BEUR 0.9.

Non-financial costs of insolvency amount to BEUR 1.2, reflecting the costs from depreciation of fixed assets (MEUR 841), the GDP multiplier effect (MEUR 100) and the opportunity cost of capital (292 MEUR).

# 5.1. Conclusions (2/4)

## 3. Efficiency of the insolvency system

There are 3 worldwide recognised indicators for measuring efficiency of the insolvency proceedings: 1) the length of the procedure, 2) the costs of the proceedings and 3) recovery for the creditors.

The length of the insolvency proceedings in Latvia has decreased during the last 8 years: the length of the proceedings commenced under the law for the period 2008-2010 was 2.1 whereas the length of the proceedings commenced in 2011-2014 was 1.2 years. The length of the procedures where the debtors had assets was 1.5 years in 2011-2014 which is still better than the average of the OECD high income countries according to the Doing Business report 2015 (1.7).

According to Doing Business 2015 the average cost of the insolvency proceedings in the OECD high income countries was 8.8% of the debtor's estate whereas in Latvia it was 10%. The costs of insolvency proceedings have to be revealed by the insolvency administrators in the reports submitted to the Insolvency Administration. However since 60 % of the reports are missing, the data in the reports is not complete and not consistent, a comprehensive and reliable measurement of the average costs is not possible.

The average recovery rate for secured creditors in Latvia was 36% in 2008-2014. The rate has increased during the last 3 years and in the period 2012-2014 the average recovery rate for secured creditors was 46% which is still significantly less than the international best practice benchmarks. According to Doing Business 2015, the average recovery rate for secured creditors in OECD high income countries was 76% in the period 2008-2014. The recovery rate for unsecured creditors (including preferential unsecured creditors: employees and SRS) in Latvia was 2% in the period 2008-2014.

According to Doing Business 2014 Latvia has received 12.0 points out of 16 possible for the strength of the insolvency legal framework which means that the international best practice has been adopted in the Latvian Insolvency Law. In comparison - the average of the OECD countries is 12.2. Since the reforms of the Insolvency Law have been introduced in Latvia already several years ago (2008-2011) but there still is a significant gap between the recovery rates in Latvia and the OECD countries, we believe that the reason of the gap is related to the application of the law rather than the wording of the law.

Assuming that it will take three years for Latvia to reach the benchmark recovery rates, we estimate that the future cost of insolvency amounts to MEUR 1128 for a continuing trend of new insolvencies. Assuming that the recovery rate gap is not closed, the future cost is MEUR 852 for a 10 year period.

# 5.1. Conclusions (3/4)

## 4. Impact of abuse

There are 4 most typical types of insolvency abuse: 1) phoenix phenomenon or transferring of assets before the insolvency, 2) retention of control over assets by abusing insolvency proceedings, 3) hostile takeover of assets by abusive insolvency proceedings, 4) abuse of power by the insolvency administrators for personal benefit.

The indicators of insolvency abuse deployed for identification of potentially abusive insolvency cases within the Research are as follows: change of legal address shortly before insolvency, change of shareholders and management shortly before insolvency, terminated Legal protection procedure shortly before insolvency, fictitious creditors, suspicious behaviour of insolvency practitioners, initiated criminal and civil procedures.

1,461 companies out of 9,512 or 15% had at least one indicator of insolvency abuse, 474 of companies or 5% had at least two indicators and 119 or 1.25% at least three indicators. There is a link between value of assets of the insolvent Company and the possibility of insolvency abuse. Within TOP 100 Companies with the most valuable assets there were 0.81 insolvency abuse indicators per company, within TOP 500 the number was 0.62 and within TOP 1000 – 0.55.

The wide scale of abuse and problems of application of the Insolvency Law is confirmed by the questionnaire organised by the Latvian Chamber of Commerce. 76.8% of entrepreneurs believe that the insolvency procedures are not conducted transparently and fair, 74.3% have encountered insolvency abuse, 76.8% of those who have been victims of insolvency abuse reported that there were no negative legal consequences for the abusers.

Based on the available data and the set of insolvency abuse indicators the economic impact from insolvency abuse is in the range from MEUR 580 to MEUR 750.



# 5.1. Conclusions (4/4)

## 5. Late insolvency

Hesitation to apply for the insolvency or restructuring proceedings by a financially distressed debtor may lead to a decrease of assets and business value and increase of the amount of debts, causing loss for both the debtor itself and the creditors.

Assuming that the negative equity during the long period preceding the announcement of the insolvency may indicate long term financial difficulties and therefore also delayed application of insolvency proceedings, we indicated that 3,422 companies out of 6,539 or 52% had a negative equity at least two years before the Insolvency date.

The average decrease of asset value of companies with unencumbered assets is 42%, whereas the average increase of liabilities is 45% during the last 2 years before the announcement of the insolvency proceedings. It confirms that potentially delayed insolvency proceedings may cause significant loss to the creditors.

# 5.2. Recommendations

## 1. Reporting and monitoring of insolvency proceedings

A system for monitoring at least the following KPIs should be introduced: 1) length of insolvency proceedings; 2) costs of insolvency proceedings; 3) recovery rate for both secured and unsecured creditors.

## 2. Timely resolution of insolvency

Timely resolution of insolvency has to be encouraged either by sanctions and/or by measures that facilitate desirable behavior of the debtors. In order to increase the general prevention, the competence of the state police to impose administrative sanctions for delayed insolvency should be transferred to the Insolvency Administration.

## 3. Improving the judiciary system

The competence and capacity of the Insolvency Law enforcement authorities: the Insolvency Administration, the courts and the state police should be significantly increased;

## 4. Fighting abuse of insolvency system

Effective investigation of economic crimes and a fair trial should be defined as high priority.

## 5. Facilitating business rescue culture

Business rescue culture and mutual trust among stakeholders should be facilitated inter alia via education of the business community, the state authorities and the general public

## 5.3. Recommendations from the industry

During the interviews representatives of different industries expressed their opinion on solutions which could solve the problems of the insolvency abuse. Deloitte has summarised the initiatives and they are as follows:

### 1. Recommendations from the Unsecured creditors

- To introduce more restrictions on conducting a business to shareholders and directors of companies who abuse the insolvency system and repeatedly run companies insolvent.
- To introduce a new system where the restrictions to conduct a business could be applied by other institutions than the police and the court, due to the length of criminal proceedings and small amount of cases which are initiated **by the police involved with the insolvency abuse**.
- To improve the availability of detailed information on the debtors for the creditors, allowing the creditors to prevent their loss due to potential insolvency of the debtor.
- To establish a new unit within the police, specialised in economic crimes connected with insolvency proceedings.

### 2. Recommendations from the Secured creditors

- To increase the power of the supervisory institution - the Insolvency Administration.
- To oblige the Insolvency Administration to be more active in setting guidelines and clarifications for the insolvency issues, as well as be more restrictive in infringement cases of the Insolvency Law by the insolvency administrators.
- To clarify the penalty system of the Insolvency administrators, by ensuring gradation of penalty, dependent on the infringement.
- To improve the regulation of insurance of Insolvency administrator's liability and to provide public information on an insurance of a particular Insolvency administrators.
- To establish specialised business courts for insolvency cases with highly experienced professionals.
- To establish principle "one court – one case – one judge", where all claims, related to the same insolvency proceedings, are reviewed.
- To conduct all disputes related to a particular insolvency case (such as creditor claim) within the same court.
- To ensure specialisation of judges respective to their industry background.
- To establish "fast-track" procedures for extraordinary and urgent cases.
- To preserve the proceeds of auctions and all monetary assets in the accounts of the Treasury.
- To introduce a list of business jurisdictions and clarify the jurisdictions where documents, confirmed by notary, are of the same legal force as in Latvia.
- To increase the capacity of the police regarding investigation of economic crimes, e.g. insolvency abuse.



FOREIGN INVESTORS  
COUNCIL IN LATVIA



## Annexes

# Annex 1: Information sources

## Lursoft

### General information

Deloitte has received a list of the Companies and data about them from the Lursoft data base.

### Received data

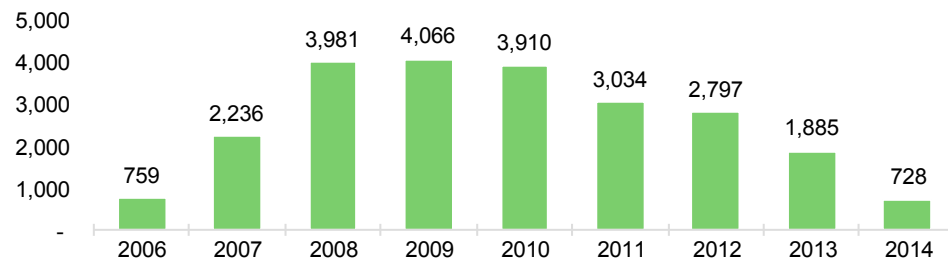
#### 1. General information about the Companies

This includes the company name, legal address, registration date and number, industry, legal form of the company, VAT number, industry classification, etc.

#### 2. Annual reports

This includes information from the annual reports for at least 2 years prior to the announcement of the insolvency and (if available) after the Insolvency date. Deloitte received a total of 23,396 reports distributed as seen on Figure 30.

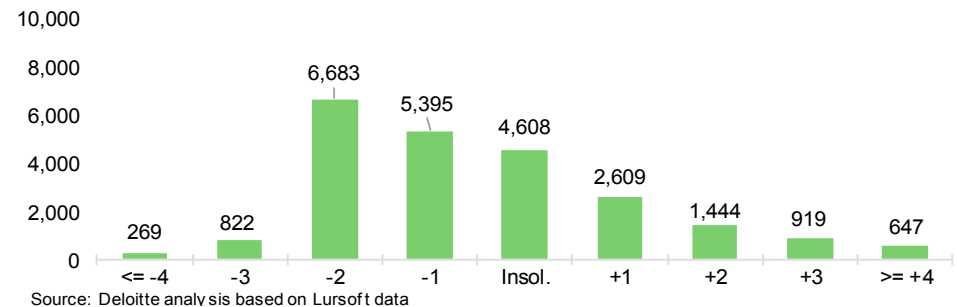
Figure 30: # of annual reports per year



Source: Deloitte analysis based on Lursoft data

The largest number of annual reports were available for the two years prior to the year of the insolvency announcement. Figure 31 depicts the availability of the annual reports prior (-1, -2, etc.), during (Insol.) and after (+1, +2, etc.) the insolvency announcement year.

Figure 42: Available annual reports vs insolvency announcement year



Source: Deloitte analysis based on Lursoft data

#### 3. Records from the Commercial Register

This takes into account information on shareholders and members of the board, including data at incorporation and subsequent changes. Data availability is as follows:

- 9,499 Companies (or 99.9%) with at least one record about the shareholders;
- 8,934 Companies (or 93.9%) with at least one record about the members of the board.

#### 4. Records from the Commercial Pledge Register

This includes records from the Commercial Pledge Register about 3,077 Companies (or 32.4%).

#### 5. Information from the Insolvency Register

This includes information on records (creditors meeting, insolvency administrator appointment or change, legal protection process announcement, initiation, termination, etc.) from the Insolvency Register: In total 69,620 records, including 9,512 records of the insolvency announcement.

# Annex 1: Information sources

## Insolvency Administration (1/2)

### General information

Deloitte has requested the following information about the Companies:

- Insolvency reports that are submitted by the insolvency administrators
- Records of complaints
- List of employee claims
- Records of actions of the insolvency administrators during the election process

### 1. Types of the Insolvency reports

Deloitte received and analysed 18,132 Insolvency reports. The Reports have to be submitted by the insolvency administrator to the Insolvency Administration on a quarterly / half-yearly basis (depending on the applicable law) during the insolvency proceedings. Due to changes in the law, several types of reports had to be submitted over the Period of analysis, depending on the insolvency initiation date:

- Up to 1 January 2008
- From 1 January 2008 to 1 November 2010
- From 1 November 2010 to 31 December 2014

The distribution of the reports by the submitted year can be seen on Figure 32.

Figure 32: Types of Insolvency reports

Year	<2008		>2010			Annexes	Duplicates	Total
	<2008	2008-2010	Initial	Regular	Closing			
2008	62	874	-	-	-	-	-	936
2009	6	2,063	-	-	-	51	-	2,120
2010	6	1,990	-	-	-	64	-	2,060
2011	4	1,283	321	133	22	795	101	2,659
2012	2	610	449	594	102	593	246	2,596
2013	1	831	636	1,584	162	1,290	393	4,897
2014	-	270	459	1,262	181	441	251	2,864
<b>Total</b>	<b>81</b>	<b>7,921</b>	<b>1,865</b>	<b>3,573</b>	<b>467</b>	<b>3,234</b>	<b>991</b>	<b>18,132</b>

Source: Deloitte analysis based on Insolvency Administration data

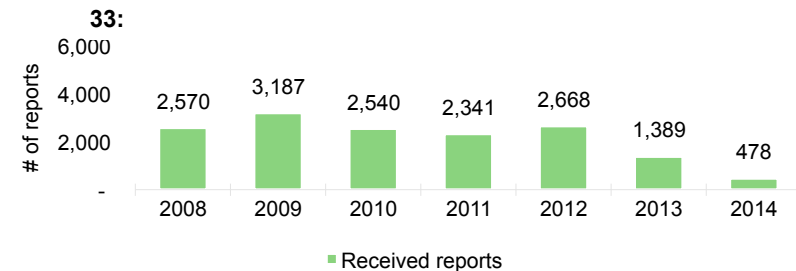
Since the Insolvency Law from 2010, three separate report types are to be submitted: initial, regular and closing. All reports share similar structure with common key sections such as the process-related expenses, the amount of the remaining assets and the income from the sale of assets.

Starting from 01 November 2010 when the Insolvency Law from 2010 entered into force, the Insolvency reports do not include the section about the creditor claims, which is one of the most noticeable differences.

### 1.1 Statistics on the received Insolvency reports

As there is no standardised electronic template, the Insolvency reports are in various formats (.doc, .xls, .pdf, .ost, etc.). In order to extract and import the data, Deloitte developed a VBA-based tool that recognises different report templates and automatically loads the content in a single database. Accordingly, some of the files were not readable (e.g. scanned documents) or were not imported fully (e.g. inappropriately modified templates prepared by the insolvency administrators).

Figure 44: Received Insolvency reports



Source: Deloitte analysis based on Insolvency Administration data

The expected number of Insolvency reports was calculated under the assumption of one report per quarter / per half a year (depending on the applicable law). Under this assumption, the number of total expected reports was 37,724, compared to 15,173 reports received (excluding annexes). From the total of 18,132 received reports, 59% were fully importable, 15% were only partly importable, while 25% (where the largest part were annexes) could not be imported and 1% of them were empty.

# Annex 1: Information sources

## Insolvency Administration (2/2)

### 1.2 Breakdown of annexes

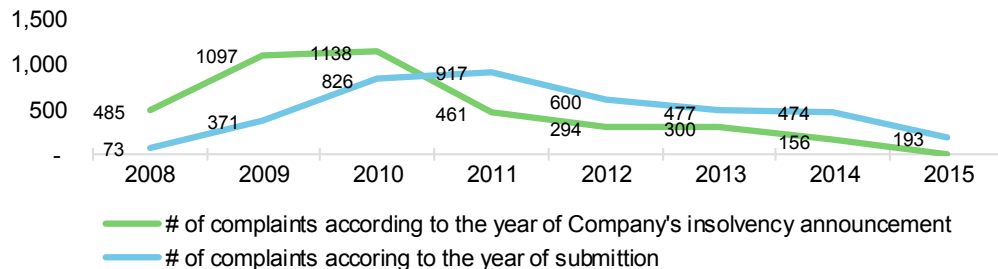
Due to non-comparable types and formats, we selected annexes submitted only during 2011 (representing the year with the largest number of annexes) for a more detailed analysis. A breakdown of the annexes in the sample was as follows:

- 64% annual reports
- 18% plans of sale of assets
- 14% notes on absence of assets
- 4% registers of creditor claims

### 2. Complaints

According to the Insolvency Law, any party involved in the insolvency proceedings can submit complaints about the involved parties during and 1 year after the proceedings. Deloitte reviewed the database of the complaints addressed to the Insolvency Administration and identified 3,931 complaints related to 829 (or 8.7%) Companies. See Figure 34 for details:

**Figure 34: # of complaints**



Source: Deloitte analysis based on Insolvency Administration data

### 3. Employee claims

The Insolvency Administration repays the employees of an insolvent company their claims due to the insolvency proceedings and becomes a creditor to the company instead of the employees. During the Period of analysis there was a total of 19,291 employee claims submitted to 1,131 Companies.

### 4. Actions of insolvency administrators during the election process

We received a list of actions of the insolvency administrators during the election process (as recorded in the Insolvency Administration's electronic database), including:

- Application to a queue (action by an insolvency administrator candidate)
- Withdrawing from a queue (action by an insolvency administrator candidate)
- Becoming an insolvency administrator candidate (chosen randomly)
- Withdrawing from administrating (action by an Insolvency administrator)

See Figure 35 for details:

**Figure 35: Records of actions of Insolvency administrators**

	2008	2009	2010	2011	2012	2013	2014	2015	Total
Becoming an administrator candidate	-	460	2,674	966	1,072	884	901	100	7,057
Withdrawing from administrating	88	221	233	80	93	40	30	14	799
<b>Total</b>	<b>88</b>	<b>681</b>	<b>2,907</b>	<b>1,046</b>	<b>1,165</b>	<b>924</b>	<b>931</b>	<b>114</b>	<b>7,856</b>

Source: Deloitte analysis based on Insolvency Administration data

We received information regarding 5,951 (or 63%) Companies. As per the discussion with the Insolvency Administration, some historical data was lost due to a change in the reporting systems in 2009.

# Annex 1: Information sources

## Financial and Non-financial institutions

### 1. Data requested from the Financial institutions

Deloitte requested the following information about the Companies from the Financial institutions (on the Insolvency date; on the date of the termination of the insolvency proceedings; if proceedings not terminated, then on 31 December 2014):

- Claim amount
- Amount of provisions
- Information about pledged assets
- Amount of the recovered debt
- Expenses related to the insolvency proceedings
- Other data

All the information was provided in the form of an anonymised database, i.e. without identifying the company name, legal address, or registration number.

### 2. Data received from the Financial institutions

Data information about 1,935 (20.3%) Companies having claims with Financial institutions was gathered from 7 Financial institutions.

### 3. Data requested from the Non-financial institutions

Deloitte requested the following information about the Companies from the Non-financial institutions (at the Insolvency date; at the date of termination of the insolvency proceedings; if proceedings not terminated, then on 31 December 2014):

- Claim amount
- Amount of provisions
- Information about pledged assets
- Amount of the recovered debt
- Expenses related to the insolvency proceedings
- Other data

### 4. Data received from the Non-financial institutions

There was information about 2,917 (29%) Companies being debtors to the Non-financial institutions. The data was gathered from 6 Non-financial institutions.



# Annex 2: Results of the interviews (1/2)

## General information

Deloitte interviewed 26 companies from different industries who are involved in insolvency proceedings as both Unsecured and Secured creditors. Respondents shared their experience of insolvency proceedings and overall observations on the current insolvency system, its effectiveness, transparency, and their view on the cooperation of the state institutions during the insolvency proceedings.

### Opinion of the Unsecured creditors on the current insolvency legal framework

- A common perception of the unsecured creditors is that in a case of the debtor's default and/or insolvency the creditor's recovery rate is close to nothing and the creditors are unprotected. It is almost useless to actively participate and spend resources on the debtor's insolvency proceeding.
- No effective protection by the state authorities (courts, police and other) is available in a case of breach of the law by the debtor.
- There are no negative legal consequences or sanctions in case of abusive behaviour.

### Opinion of the Secured creditors on the current insolvency legal framework

- The number of abusive cases has decreased since the Insolvency Law from 2010 was introduced. However, the abusive cases are still in place.
- The most popular types of abuse currently are:
  - Delaying the sale of the encumbered assets while using them for obtaining cash flow by the insolvency administrator and/or debtor;
  - Creation of "fake" creditors;
  - No transparency in financial transactions and deeds of some insolvency administrators;
  - Delaying the transfer of the proceeds of sale to the creditors.
- There is still a struggle with the "heritage" of the financial crisis and the previous insolvency procedures.
- The new concern is about insolvency proceedings of private individuals where the number of abuse has increased.
- The response from the state authorities on the abuse is poor and tolerant. There are no legally negative consequences for the abusers and no prevention.
- The length of any legal proceedings is also an issue.
- There are well known administrators and judges who abuse the system but there is no response by the state authorities.

# Annex 2: Results of the interviews (2/2)

## Opinion of the Secured and the Unsecured creditors on the performance of the supervising authorities

### **The insolvency administrators**

- The professionalism and expertise of the insolvency administrators varies. There are many insolvency administrators who conduct their duties properly. However, there is a well known group of insolvency administrators who regularly abuse their rights.

### **The Insolvency Administration**

- There are good precedents in preventing the abusive behavior of the insolvency administrators. However, their attitude is often formal, it takes a long time for actions and it takes a huge effort for the creditors to receive a feedback and further actions against the abuse in each particular case.

### **The courts**

- The main problem is the length of decision making and the incompetence regarding economic principles. This leads to tolerance towards abusive behaviour of the debtor and the insolvency administrators. There are publicly well known judges, involved in abusive insolvency cases and still on duty, which proves the inability of the judicial system to clean itself.

### **The police**

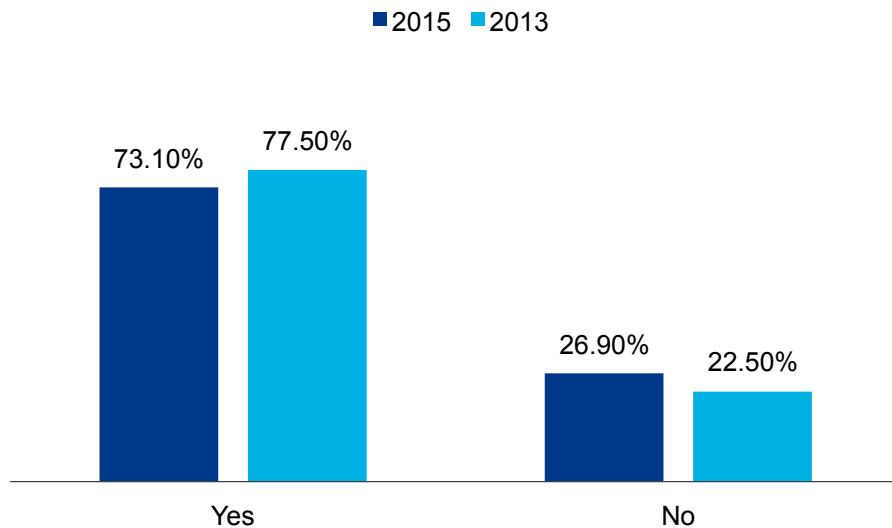
- The performance of the state police investigating economic crimes is less than satisfactory due to lack of competence and motivation. It is a general assumption that it is almost impossible to impose criminal charges on those who abuse insolvency system.

# Annex 3: Results of the questionnaire (1/3)

Deloitte with the assistance of the Latvian Chamber of Commerce and Industry developed a questionnaire, which was filled out by entrepreneurs in 2013 and in 2015. The questionnaire contains general questions about the influence of the insolvency proceedings and the insolvency abuse to the businesses and commercial activity of the companies and investors. In 2013 there were 138 respondents, whereas in 2015 – 167.

## 1. Have you encountered the insolvency proceedings and legal protection process (LPP) in your everyday business?

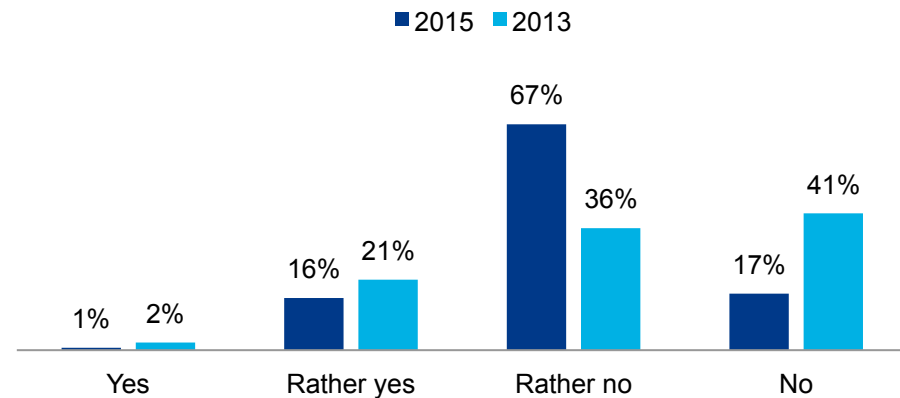
Figure 36: Question 1 analysis



Source: Deloitte analysis based on survey data

## 2. Do you agree that in practice the insolvency proceedings and LPP are transparent and fair?

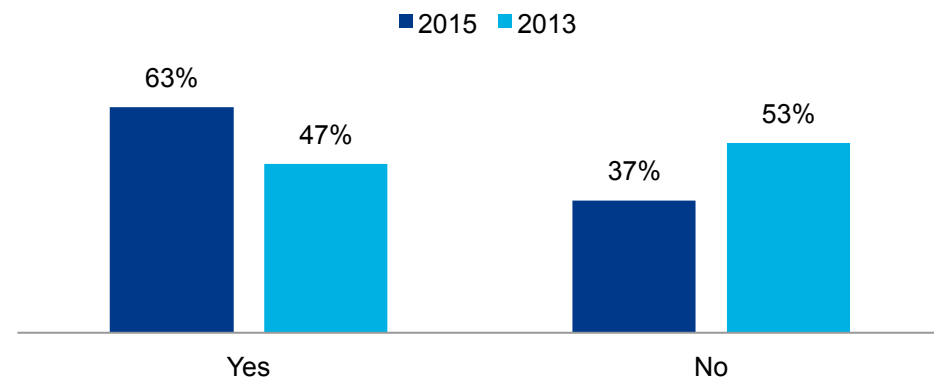
Figure 37: Question 2 analysis



Source: Deloitte analysis based on survey data

## 3. If you believe that the insolvency proceedings and LPP are not transparent and fair – does it influence your business decisions?

Figure 38: Question 3 analysis



Source: Deloitte analysis based on survey data

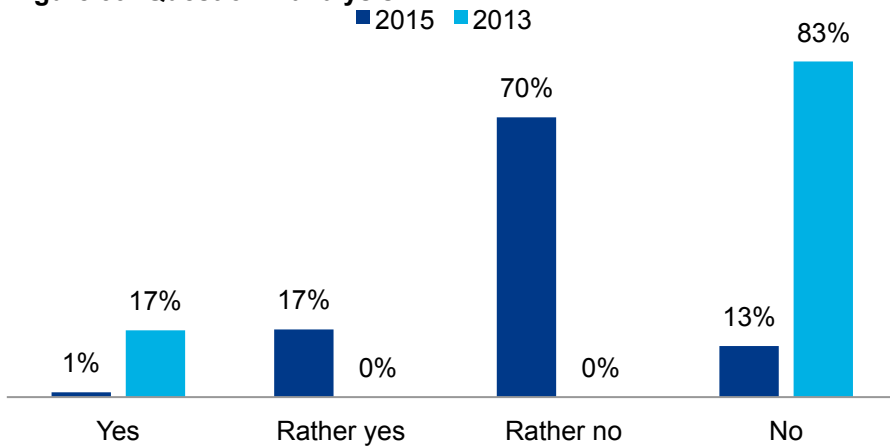
# Annex 3: Results of the questionnaire (2/3)

If you believe that the insolvency proceedings and LPP are not transparent and fair how exactly does it influence your business?

- No post-payment options;
- Critical and deep analysis of the debtor;
- Additional securities;
- Review of the business sector of the debtor;
- Cautious actions;
- More expensive services and higher rates, if applicable.

4. Do you believe that the state institutions will restore justice, in case your interests would be infringed upon within the insolvency proceedings or LLP?

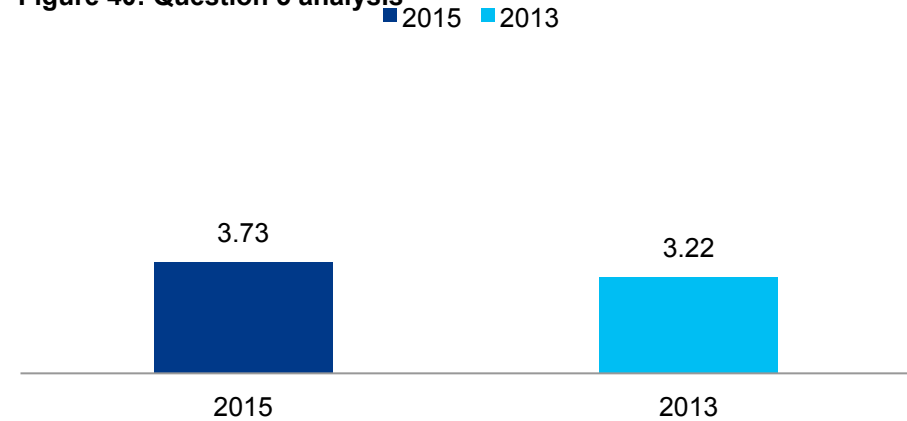
Figure 39: Question 4 analysis



Source: Deloitte analysis based on survey data

5. Please, rate on the scale from 1 to 10 your trust to the Insolvency Administrators?

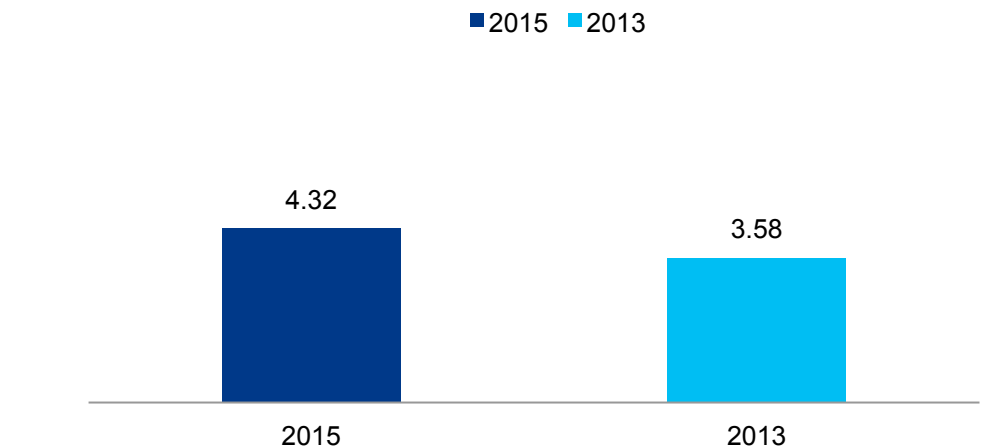
Figure 40: Question 5 analysis



Source: Deloitte analysis based on survey data

6. Please, rate on the scale from 1 to 10 your trust in the Insolvency Administration?

Figure 41: Question 6 analysis

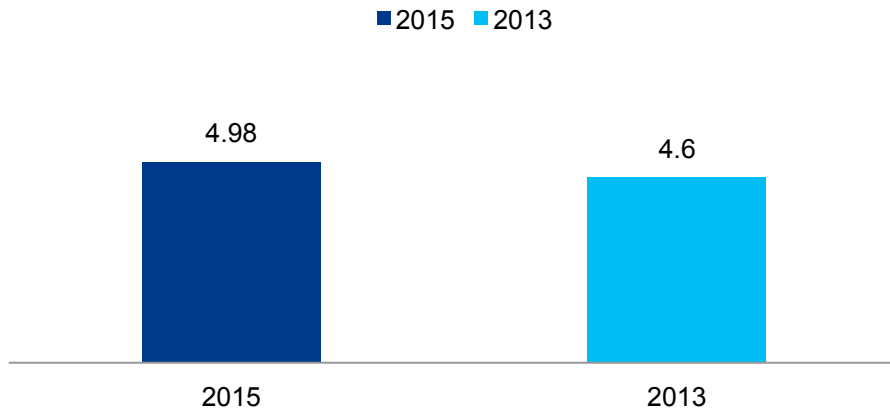


Source: Deloitte analysis based on survey data

# Annex 3: Results of the questionnaire (3/3)

7. Please, rate on the scale from 1 to 10 your trust in the state courts?

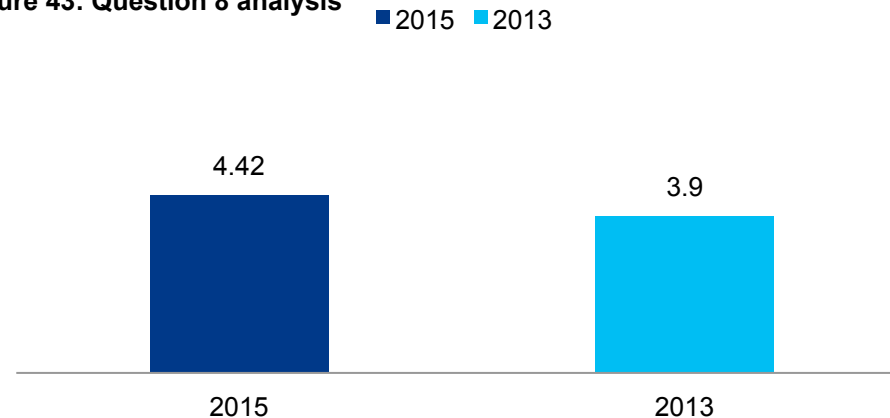
Figure 42: Question 7 analysis



Source: Deloitte analysis based on survey data

8. Please, rate on the scale from 1 to 10 your trust in the State Police?

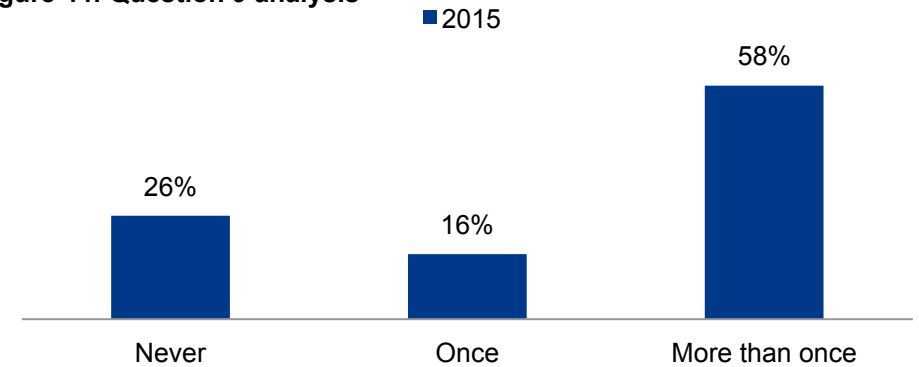
Figure 43: Question 8 analysis



Source: Deloitte analysis based on survey data  
Insolvency Abuse Report

9. Have you encountered a situation when your debtor has abusively led the company to the insolvency proceedings or otherwise avoided fulfilment of obligations?

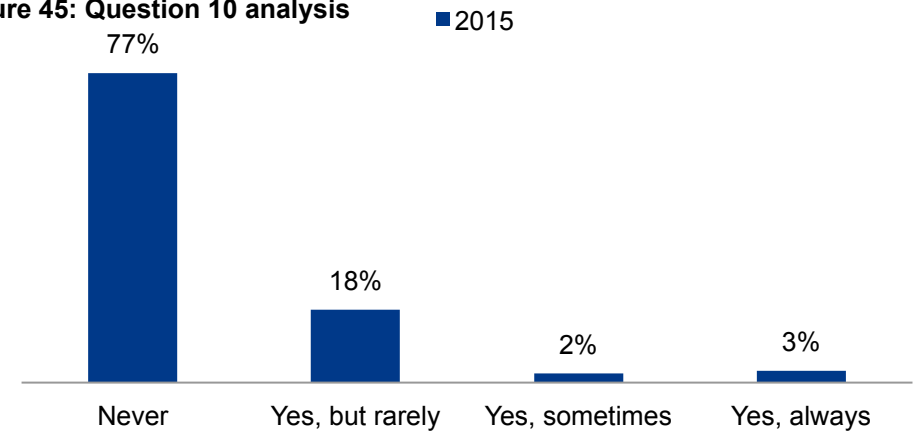
Figure 44: Question 9 analysis



Source: Deloitte analysis based on survey data

10. If your answer was positive, did the offender receive any sanction or has compensated damages?

Figure 45: Question 10 analysis



Source: Deloitte analysis based on survey data

# Annex 4: Behavior of the insolvency administrators (1/2)

Among the identified abuse indicators there are indicators that could be related with the actions of the insolvency administrators.

Upon the request of the Supporting partners, we have analysed the behaviour of the insolvency administrators.

Therefore we analysed involvement of particular administrators into potentially abusive insolvency proceedings.

## 1.1. The indicators connected with the insolvency administrators

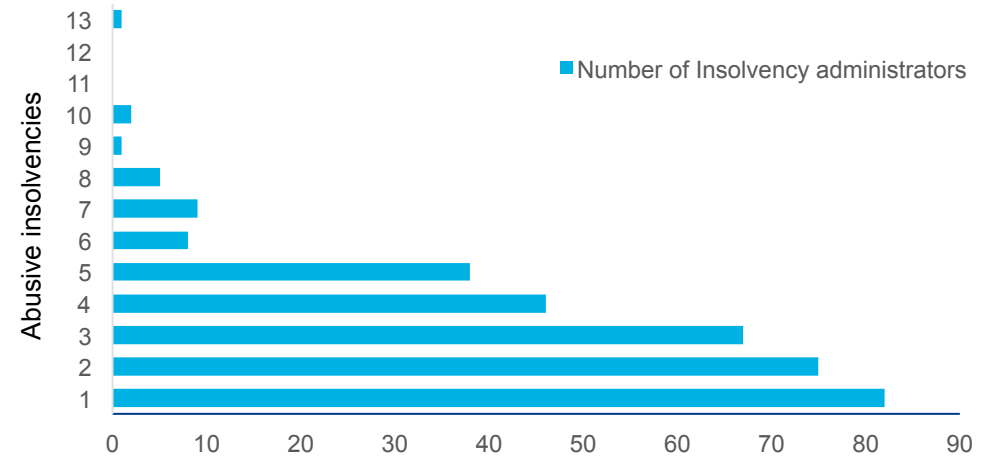
Indicators which indicate potential involvement of an insolvency administrator into abuse are as follows: change of the legal address (without changing the management and the shareholders), terminated legal protection process, fictitious creditors and suspicious behaviour (having the same legal address with the insolvent company or declining the queues for the administration).

## 1.2. Analysis of the insolvency administrators actions connected to abusive insolvency cases

There are 177 insolvency administrators who have administrated at least 3 cases with the defined indicators of the Insolvency abuse. 64 insolvency administrators have worked with at least 5 cases which contained indicators of the insolvency abuse. 17 insolvency administrators have each administrated at least 8 abusive insolvency cases. Finally, there are 4 administrators who have administrated at least 9 cases with the indicators of the insolvency abuse.

155 administrators from 177 which had at least 3 insolvency proceedings with abusive indicators within the observation period were still active on 6 October 2015.

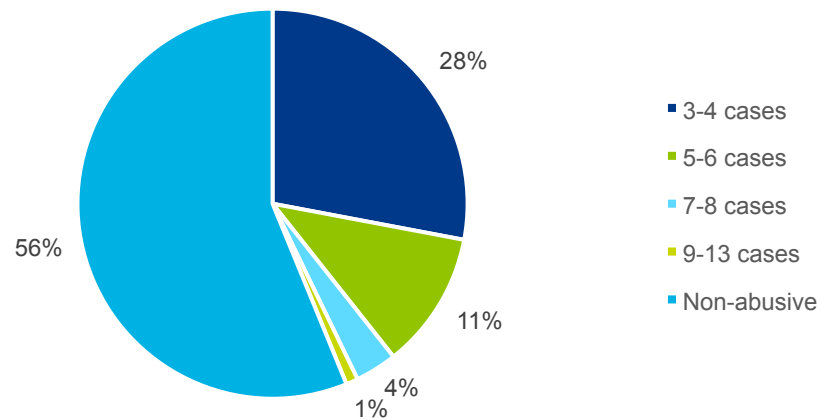
**Figure 46: Connection between the insolvency administrators and abusive insolvencies**



Source: Deloitte analysis based on Lursoft, Insolvency Administration, Financial and Non-financial institutions, SRS data

# Annex 4: Behavior of the insolvency administrators (2/2)

Figure 47: Ratio of the insolvency administrators working with abusive cases



Source: Deloitte analysis based on Lursoft, Insolvency Administration, Financial and Non-financial institutions, SRS data

# 7. Limitations

The Report was drafted in accordance with the Engagement Letter and was performed exclusively for the Client's benefit and use. The Report was prepared according to the directions of our Client and recommendations of the Supporting Partners and may not suit and include procedures or information deemed necessary for the purposes of any other user of this Report. User of the Report accepts that Deloitte, its partners and employees have no obligations towards the user of the Report and Deloitte shall not be liable in respect of any loss, damage or expenses which could be caused by any use of this Report.

Deloitte was limited with the scope of the Engagement Letter and instructions of the Client and the Supporting Partners. For the purposes of the Report Deloitte has used the information, submitted by the Supporting Partners and other sources, but bears no responsibility for the correctness or fullness of information, provided by Supporting Partners and other sources.

The Report contains information about the population of legal entities subject to insolvency proceedings announced during the period of 1 January 2008 to 31 December 2014. The list of cases and Insolvency dates provided by Lursoft is considered to be accurate. The Report contains no analysis on the insolvency of private individuals or insolvency of international companies or financial institutions.

Deloitte notes that the information, other than publicly available sources, based on which the Report was drafted is legally protected and as business secret. Considering the confidential status of this information Deloitte is not allowed to disclose it.

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