Lithuania: New definition of insolvency

> IT IS NOW SUFFICIENT FOR A COMPANY TO BE REGARDED AS INSOLVENT IF IT FAILS TO MEET EITHER THE LIQUIDITY TEST OR THE BALANCE SHEET TEST

As explained in previous editions[1], a new Insolvency Law has come into force in Lithuania since 1 January 2020.[2] This article looks at one of the law's most essential changes, i.e. the new definition of insolvency.

Under the new law, a company is insolvent if (i) it is unable to fulfil its proprietary obligations in due time or (ii) its liabilities exceed the value of its assets. In contrast to this, the definition of insolvency under the previous Enterprise Bankruptcy Law required that a company had (i) defaulted on its obligations *and* (ii) the value of overdue liabilities of the company had exceeded half the value of the assets included in the company's balance sheet.

The new definition of insolvency is notably broader than the old one. Whereas previously the requirements of a combined liquidity and balance sheet test had to be met, it is now sufficient for a company to be regarded as insolvent if it fails to meet either the liquidity test or the balance sheet test. The latter test threatens a company with insolvency because of its liabilities exceeding their assets, even if it has no overdue liabilities at all. This concept is completely new to Lithuanian businesses.

The legislative aim of the broader definition has been to prompt managers and other responsible persons to initiate insolvency proceedings at an earlier stage than before and thus to improve the chances for rescuing businesses and increasing satisfaction rates for creditors in restructuring and insolvency proceedings. The broader definition of insolvency might indeed achieve this goal. First, it extends the scope of financial distress situations that would qualify as insolvency and would justify the opening of insolvency proceedings. Second, it has a direct impact on managers and other persons entitled to file for insolvency, as the broader definition of insolvency increases the risk of personal civil and administrative liability for failing to file in due time.

Some criticism has been levelled against the new definition of insolvency. One fear is that it might affect companies with only temporary liquidity problems. Another concern is that it might inadequately disadvantage start-ups, balance sheets of which usually show few assets but heavy indebtedness. Against this background some critics are afraid that that new definition might lead to an increase in insolvency cases and potentially have an effect detrimental to the general purpose of rescue and of granting of a second chance as expressed i.a. in the Restructuring and Insolvency Directive.

Managers will have to come to terms with the broader concept of insolvency, not least in order to avoid personal liability. For this, they should look attentively at how courts will interpret the new definition. We can expect courts to apply the new statutory criteria for insolvency not just formally but also looking at the facts of the case at hand and continuing to apply and further develop additional criteria, such as: is the company continuing its business operations? How do the current and future profitability figures look? What is the real value of the assets (as compared to the book value? What is the chance to recover trade receivables? ■

Footnotes:

1 See Heemann/Zabulionytė, *The new corporate insolvency law*, in Eurofenix No. 77 (Autumn 2019) and *Change in organisation of the profession of the insolvency practitioners: Chamber of Insolvency Administrators established*, in Eurofenix No. 78 (Winter 2019/20).

2 Law on the Insolvency of Legal Entities ("Insolvency Law"); *Lietuvos Respublikos juridinių asmenų nemokumo įstatymas, No. XIII-2221.*