

IP appointment lottery: Experiences in Lithuania, Slovakia and Hungary with random IP selection systems

How does the new Lithuanian system compare to those in Slovakia and Hungary?



THE MAIN AIM OF LAWMAKERS WHEN INTRODUCING RANDOM IP SELECTION SYSTEMS WAS TO TACKLE THE LACK OF TRANSPARENCY



Three years ago, Lithuania introduced a new system for the appointment of insolvency practitioners ('IP') in certain insolvency proceedings. The basics of this new system were already described in Eurofenix.¹

The aim of this article is to provide a first assessment and to compare this system to similar random selection systems in Slovakia and Hungary.

Legal frameworks

Which types of insolvency proceedings exist?

All three jurisdictions have three general categories of insolvency proceedings: bankruptcy and restructuring proceedings for legal persons, as well as insolvency proceedings for natural persons. Variations exist. Noteworthy are the out-of-court bankruptcy proceedings under Lithuanian law.²

When were the random selection systems introduced?

Slovakia started to introduce random IP selection systems already in 2005.³ Hungary followed in 2009, Lithuania in 2015.

What were the aims?

The main aim of lawmakers when introducing random IP selection systems was to tackle the lack of transparency (perceived or real) attached to the previous rules



of selecting and appointing IPs. These rules had allowed stakeholders to propose 'their' IPs, and/or permitted judges to appoint IPs with little transparency or real oversight.⁴

The previous appointment systems did therefore not strengthen the trust in the impartiality and functioning of the insolvency systems and IPs were frequently regarded as running a shady but often lucrative business.

How does random IP selection work and which proceedings does it apply to?

In **Lithuania**, the random selection of IPs is restricted to in-court bankruptcy proceedings of companies on the basis of the Enterprise Bankruptcy Law No IX-216, 20 March 2001 (EBL) and the Selection Rules for Bankruptcy Administrators as approved by Government Order

No 647 of 9 July 2014.

Therefore, it does not apply to insolvencies of natural persons, at least not if the filing natural person uses the right to propose a specific administrator according to the Law on Bankruptcies of Natural Persons (cf. Art. 4 paras 5-7). Neither does it apply to restructurings of companies (cf. Art. 6 Enterprise Restructuring Law No IX-218, 20 March 2001) and to out-of-court bankruptcy proceedings, (cf. Art. 13 para. 2 EBL) in which the filing party proposes the IP to be appointed by the court (in restructurings) or by the creditors' assembly (in out-of-court proceedings). The 'lottery' system is based on a categorisation of insolvent companies (three groups based on size: small, medium, large) and IPs (three groups based on criteria supposedly showing the experience of an IP).

The computer-run system used by the judge randomly selects the IP for the case at hand from the IP-categorised pool of registered IPs. The general idea is to get the most experienced IPs for big cases, less experienced ones for medium-sized cases and the least experienced IPs for small cases (while also considering the workflow of the registered IPs).

The **Hungarian** random selection system applies to bankruptcy and restructuring proceedings of companies, not to insolvencies of natural persons.⁶ There are, however, certain exceptions. A special legal regime applies to insolvencies of financial institutions or insurance companies and to so-called major economic operators of preferential status for strategic purposes. In case of the former group of companies, the debtor's business activity triggers the application of special provisions for the appointment of the IP. In case of the latter, a company might qualify for such a status by governmental decision.

In both cases the random selection system does not apply and a state-owned company is appointed as IP. In standard cases, in which the random selection

applies, IP selection is performed with a special software with access to the register of IPs and certain data, such as the seat or branch of IPs and the number of past and current cases handled by them. The software scales the IPs based on such information and suggests the IP to be appointed in the case at hand.⁷

Different from Lithuania and Hungary, in **Slovakia** the random selection applies to all categories of insolvency proceedings.⁸ The court appoints the IP randomly selected from the pool of registered IPs. The Register of IPs has three sections: IPs for restructuring, for bankruptcies of legal persons and for bankruptcies of natural persons. IPs may register in all three sections. The main criteria used by the random selection programme is the location of the IP, i.e. the IP must have an office in the district of the competent court. In contrast, the Slovakian random selection system does not take into count other criteria, such as the number of employees working for the respective IP and the previous insolvency cases dealt with.

Experiences

Lithuania

During the first three years of its existence, the Lithuanian random selection system faced several challenges, some of which were successfully addressed, but others remain, some appearing to be inherent in the random selection system.

Initial problems were caused by unforeseen possibilities of abuse. As mentioned, the overall number of administered insolvency procedures affects the IPs' priorities in the appointment system. Initially, this number was calculated separately for natural person IPs and (additional) companies established by them.⁹ Some persons used this leverage and established many companies using their personal IP certificate, in order to increase the chances of getting an appointment.¹⁰

Other issues were caused by insufficient planning. Many



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THE EXISTENCE OF A RANDOMISED SELECTION SYSTEM HAS NOT COMPLETELY ELIMINATED THE POSSIBILITY TO APPOINT A ‘DESIRED’ IP



debtors in Lithuania are small companies. The randomised selection rules prioritise less experienced IPs to be selected for such small companies. This prioritisation left the more experienced practitioners without work for several months until some bigger companies went bankrupt, while the ‘rookies’ were overloaded. Though these issues were promptly addressed, others remain. As explained, the system is not fully automatic. Thus, it leaves room for the court to decide in which category the debtor should be placed: big, medium or small. This discretion for judges with usually little or no expertise in insolvency and economic matters produces unexpected and sometimes detrimental results.¹¹ Also, the assessment of an IP’s experience for categorisation purposes is based on rather formal criteria, i.e. type and number of past cases. These do not necessarily reflect the required competence.

The existence of a randomised selection system has not completely eliminated the possibility to appoint a ‘desired’ IP. As indicated, the ‘lottery’ is only applicable for in-court bankruptcy cases. It is therefore not mandatory for out-of-court bankruptcy proceedings, where

the IP is still proposed by the filing party. Statistics¹² show that the number of out-of-court proceedings has mushroomed after the introduction of the randomised selection system: during 2015 such proceedings more than doubled, reaching 103 (compared to 48 in 2014) and continued to increase to 175 (in 2016) and 235 (in 2017).

Even though the absolute number of extrajudicial bankruptcy procedures remains rather low (about 8% of all proceedings in 2017), the tendency is clear. Creditors and other stakeholders might feel a need to entrust the administration of more complex proceedings to an IP of their choice, having the required expertise and resources. However, one cannot rule out that for certain cases out-of-court proceedings are used, in order to circumvent the random selection and to bring in an IP who would give priority to the filing party’s particular interests to the detriment of the other stakeholders.

Hungary

The main reason for introducing the lottery system in Hungary was to address a lack of transparency. At first, however, random selection could easily be avoided

by a reasoned decision of the court. Such deviation from the electronic appointment occurred most often in cases of debtors active in special branches of economy, such as agriculture or construction. The possibility of deviation by court decision was abolished in 2014.

A still existing method for avoiding the general appointment provisions is the awarding of a preferential status to the debtor by the government, for strategic purposes. In some cases this status might be justified due to a special economic role of the debtor in the Hungarian economy (e.g. national air carriers, public utility suppliers). In other cases, however, awarding such a status might seem to be a political tool. Since its introduction in 2012, more than 100 companies were able gain this status.

The consensus amongst IPs is that the introduction of the lottery system clearly led to a more equal distribution of insolvency cases. The current regulation leaves less space for deviation from the random selection method. The system, however, is criticised because the court has no option to deviate from the random appointment in proceedings requiring special experience or knowledge.

Slovakia

As the random selection system in Slovakia is applicable to all types of insolvency proceedings, it may seem to be a mighty tool against corruption, as well as a means to strengthen the trust in the impartiality of the courts with regard to the appointment of IPs. But assigning cases randomly causes problems of ensuring professional administration of insolvencies, since many IPs are registered in all sections of the IP register and because the system does not take into consideration important factors, such as the IPs’ resources and experience. Thus, bigger and more complex cases can be entrusted to a randomly selected IP who has no sufficient skills or resources to successfully handle the case.

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Conclusion

Experiences in Lithuania, Slovakia and Hungary show that randomised IP selection might further transparency and impartiality of the IP selection process and thus strengthen the general trust in this profession and in the functioning of the insolvency system as a whole.

This is certainly to be welcomed, in particular in central and eastern Europe, i.e. a region that to a certain extent still faces allegations of corruption. However, impartiality and transparency of such lottery systems come at a price: even the comparably complex Lithuanian categorisation and selection system has, at the end of the day, similar drawbacks as the Hungarian and Slovakian ones, that is the elimination of the human error also eliminates or severely restricts the possibilities to have a fitting individual solution (IP) for the particular case (debtor).

Moreover, taking into account the trend towards restructuring, there is an increased need for individual solutions, including IPs, tailored to the particular case. This begs the question to what extent standardised random selection processes will ever be able to address this need.

Finally, the trust gained by a transparent and impartial selection through 'lottery' might very well be outbalanced if society and stakeholders do not trust the outcome of insolvency proceedings, i.e. the best possible satisfaction of creditors and/or the rescue of viable businesses. ■

Footnotes

- 1 Cf. Heemann/Gasparké 'Lottery and liability', Eurofenix 2015, Spring Edition.
- 2 Others examples include certain simplified forms of bankruptcy and restructuring proceedings in Lithuania.
- 3 Since 2005 for bankruptcy proceedings; since 2017 also for restructuring proceedings.
- 4 Other goals include protection of small creditors, ensuring equal distribution of work among IPs, helping new IPs to enter the market.
- 5 For more details see Heemann/Gasparké 'Lottery and liability', Eurofenix 2015, Spring Edition.
- 6 In private persons' insolvencies another selection method applies. Basically one of

the major creditors acts as IP.

- 7 The legal basis is Act XLIX of 1991 on Restructuring and Bankruptcy Proceedings.
- 8 The legal basis is Act 7/2005 Coll. on Bankruptcy and Restructuring.
- 9 Legal and natural persons may be certified as IPs and there is no limit on how many IP license holding companies one natural person may establish using his/her personal certificate as an IP.
- 10 From January 2015 till October 2015 114 licenses were issued to new companies, while the overall number of licensed companies before the system implementation was 522. (<http://www.bankrotodep.lt/vciklos-sritys/nemokumas-2/administratoriai/bankroto-administratoriai/#Juridiniai>)
- 11 Lithuania does not have specialised courts or judges for insolvencies.
- 12 p. 5 in the 7 Feb 2018 Survey for 2017 of Enterprise Bankruptcy and Restructuring Proceedings et al, prepared by the Department of Audit, Accounting, Property Valuation and Insolvency Management under the Ministry of Finance,



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