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Bankruptcy of Natural Persons in Lithuania: Reasons and Problems

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Abstract

In the context of the research and practice The Law of Bankruptcy of the Natural Persons in Lithuania is a relatively new subject and scientifically very fragmentally analysed. The bill of Bankruptcy of Natural Persons in Lithuania was proposed in 2009 (No. XIP-450, 24.03.2009), but met with a considerable amount of criticism and was delayed for further improvements. However, the Law of Bankruptcy of the Natural Persons in Lithuania has come into force on the March 1, 2013. The article aims to identify the main reasons that cause bankruptcy of natural persons in Lithuania as well as to figure out some problems related with it. Through the systematic and comparative analysis there are presented the concept of bankruptcy of natural persons, models, advantages and disadvantages together with reasons and problems. The paper also presents the results of the semi-structured interview with two expert groups.

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Introduction

Bankruptcy of natural persons and its' consequences is particularly relevant topic in Lithuania. The law is applicable to natural persons that are not able to fulfil their financial obligations to respective institutions and the sum of the financial obligations exceeds 25 minimum monthly wages approved by the Government of the Republic of Lithuania. First scientific publications where personal bankruptcy topic was analysed in Lithuania appeared in 2010. There was examined problems and legal aspects of bankruptcy of natural persons (Grudytė, Kiršienė, & Astromskis, 2010); regulations and problems of bankruptcy of natural persons (Bazylienė, Žuk-Butkuvienė, &

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Novickytė, 2013); procedures of bankruptcy of natural persons (Aitis, 2013). Meanwhile, in other countries the topic of personal bankruptcy has been corroborated by the number and variety of scientific publications analyzing different aspects of bankruptcy of natural persons: models of bankruptcy of natural persons (Porter & Thorne, 2006), the advantages and disadvantages of the institute of bankruptcy of natural persons (Jackson, 1998; Mankart & Rodano, 2012; Han & Li, 2011), reasons causing bankruptcy of natural persons (Arnst, 2009; Fan & Yavuzoglu, 2013; Skiba & Tobacman, 2009; Niemi, Ramsay, William & Whitford, 2009; Berthoud & Kempson, 1992; Mangan, 2013; Himmelstein, Warren, Thorne & Woolhadler, 2004; Boardman & Perry, 2007;), the problems of the institute of bankruptcy of natural persons (Clancy, 2007).

The process of analysis of scientific researches on the subject of bankruptcy of natural persons has established the fact of insufficient attention to the subject of bankruptcy of natural persons in Lithuania. For this reason, the aim of the research is to 1) *identify the main reasons that cause bankruptcy of natural persons in Lithuania* and 2) *to figure out the problems related with bankruptcy of natural persons in Lithuania*. Systematic and comparative scientific literature analysis together with the semi-structured interview with two expert groups will help to supplement in scientific literature rather randomly analyzed reasons and problems as well as to achieve practical and more profound results of the application of this law.

1. The concept and peculiarities of bankruptcy of natural persons

Scientifically, the term “bankruptcy” with its pejorative connotation can be replaced by the terms “rehabilitation”, “exemption from debts”, or “fresh start” (Gruodytė, Kiršienė & Astromskis, 2010). According to Aitis (2013), bankruptcy is a legal procedure beginning with the declaration of a debtor about their incapability to fulfil their financial obligations while the obligatory reason to declare bankrupt is the insolvency of a natural person.

There are two models of bankruptcy of natural persons. The first is a so-called Anglo-American “fresh start” model which gives the opportunity to go bankrupt whenever one wishes (Porter & Thorne, 2006). The “fresh start” model has originated in Great Britain and the United States of America as an automatic right to be exempt from debts promptly while observing formal legal procedures of bankruptcy (Gruodytė & Kiršienė, 2010). The second model is a so-called European “earned fresh start” model which gives the possibility to declare bankruptcy only in those cases when responsible debtors get into hopeless situations at somebody else’s fault (Paukštė & Streckytė, 2012).

Lithuanian Free Market Institute (2009), Gruodytė, Kiršienė, & Astromskis (2010), underlined that the Law of Bankruptcy of Natural Persons protects natural persons against impoverishment and could promote more active business development by encouraging enterprising to assume higher risks, which in its turn influences the growth of economy in the country. The research of Mankart and Rodano (2012) has shown that optimal regulation of bankruptcy of persons in the country can increase entrepreneurship by 4 percent.

On the other hand, The Free Market Institute (2009) has noted that the legalization of the institute of bankruptcy of natural persons could contribute to the formation of incorrect expectations of the people that might encourage natural persons to make more risky decisions. In the worst case scenario this risk would have to be covered by unrelated people – creditors and users of credit services. From the creditors’ side, they would have to adapt to new risks that could eventually lead to the growth of borrowing services costs. From the side of natural persons that suffered bankruptcy, those individuals will have lower possibility to borrow again (Han & Li, 2011).

2. Reasons and problems of bankruptcy of natural persons

The studies of the scientific literature show that there are two groups of the reasons determining bankruptcy of natural persons: economic and social. Among the economic reasons, Arnst (2009) indicated job loss as the most significant reason influencing a person’s insolvency. Approximately 32 percent of the cases of bankruptcy of natural persons occur due to a person’s job loss, the following economic reason is irresponsible, excess usage of credits. The study of Fan and Yavuzoglu (2013) has named job loss and excess arrearage as two main economic reasons making people insolvent. Skiba and Tobacman (2009) have tried to clarify whether fast loans as one of the economic reasons influence bankruptcy of natural persons. The study showed that a fast loan is a repetitive process. Once a person has borrowed, the psychological urge for further borrowing is usually unstoppable and natural

persons are entangled in the web of bankruptcy. Niemi, Ramsay and William, (2009) have given the data of a German research where job loss has been named as number one reason economic reason that cause personal bankruptcy. Analyzing economic reasons that cause bankruptcy, it was found out that in Great Britain the main reason of financial hardships is income-job loss while less influencing reasons were low income and unacceptably increased necessary expenditure (Berthoud & Kempson, 1992).

Bankruptcy of natural persons is determined not only by economic, but also by social reasons that lead individuals to financial problems. Mangan (2013) has given the statistics of insolvency of American citizens where it was found out that many Americans have to deal with huge medical bills although they have health insurance. The research showed that the high percentage (26.4) of bankruptcy cases due to medical expenses can be seen in the age group from 45 to 54. The Himmelstein, Warren, Thorne and Woolhadler (2004) in their research find out that half of the 1771 respondents of the survey named sickness as the main bankruptcy reason due to which they were unable to cover huge debts and were forced to file for bankruptcy. Arnst (2009) discovered that medically related bankruptcy cases have constantly grown in the past decades where bankruptcies were caused by huge medical bills or medical expenses and people were forced to mortgage their homes. Among the social reasons that cause bankruptcy of the natural persons, Arnst (2009) as well indicated divorces. Boardman and Perry (2007) find out that gambling negatively affects a person causing addiction meanwhile this addiction could lead to huge financial problems.

The institute of the personal bankruptcy aims to create conditions and rights for the indebted natural persons to restore their solvency and the right to resume economical activities. However, regardless to the attractiveness of the goals of the institute of personal bankruptcy, it suffers from a certain amount of problems. Clancy and others (2007) have pointed out the problem of dishonesty of natural persons. The US Internal Revenue Service has stated that 10 percent of the cases of personal bankruptcy have been caused by swindle. Gruodytė, Kiršienė and Astromskis, (2010) pointed out that the endorsement of personal bankruptcy usually pursues slightly contradictory goals: on one hand, personal bankruptcy institute aims to maximize the protection of creditors' interests; on the other hand, the law creates some possibilities for a natural person to have a fresh start by being relieved of the majority of debts, accumulated prior to the bankruptcy. Due to this, creditors are not only restricted in their right to get the loaned money back, but also to make profit from the interests.

3. Research on reasons and problems of personal bankruptcy in Lithuania: summary of the results of the interview with two expert groups

In order to figure out the reasons and problems of personal bankruptcy in Lithuania the qualitative research was made. Regarding the methodology of the qualitative research, it involves the survey of experts with the experience in the sphere in question. Experts with valuable experience and knowledge have been divided in two groups: 1) Banking experts (creditors); 2) Personal bankruptcy administrators. First expert group - banking experts (creditors) has played an important role in helping to determine personal bankruptcy problems from the creditors' perspective, i.e. whether bankruptcy of a natural person can influence less responsible decisions in asking for a loan or credit; the other problem is whether the possibility to declare bankruptcy for a natural person will not become the reason of increased credit service costs. Second expert group - administrators of personal bankruptcy. These experts have been chosen for their knowledge of the subject and extensive experience in working with natural persons undergoing bankruptcy.

The qualitative research has surveyed 6 experts all together, three in each group. The selection of the qualitative research informants has been made by method of purposive samples. The results achieved in the course of qualitative research have been analyzed on the principle of the paradigm of phenomenology which helps to conduct comparative analysis and generalize the received data. The answers of the two expert groups have been grouped by spheres and divided into categories and subcategories. The interview guidelines fall into two blocks: *3.1 Reasons of personal bankruptcy* and *3.2. Problems related to personal bankruptcy institute*.

3.1 The block of personal bankruptcy reasons

Analysis of the expert interview have distinguished two categories of personal bankruptcy reasons in Lithuania: economic reasons and social reasons. The results of the expert interview on this block are presented in Table 1.

Table 1. Personal bankruptcy determining reasons in Lithuania

Categories	Subcategories
Economic reasons	- Loss of job and income related with it causes the risk of failing to return loans
Social reasons	- Low overall financial understanding leads to overestimation of future possibilities to return loans (irresponsible borrowing)

Experts' evaluation of bankruptcy reasons revealed that job loss was indicated as the main economic reason. This tendency also has been reflected in scientific literature analysis when job or business loss has been pointed out as the main insolvency reason. Results of the interview with two expert groups showed that the main social reason of insolvency can be considered low overall financial understanding, when persons having overestimated their future loan return capacity are forcibly and publicly announced as insolvent.

3.2 The block of problems related to personal bankruptcy institute

Table 2. Problems of Personal Bankruptcy in Lithuania (results of expert survey)

Categories	Subcategories
Inadequacies of law conditions	- Law and legal acts do not define the legal procedure of salary calculation for administrators; - Complicated bankruptcy procedures; - Mandatory sale of the only dwelling (even with minor children, adopted children or persons under guardianship); - Administrator cost is additional burden for the person under bankruptcy; - Many inconsistencies arise: regarding creditors; conditions under which bankruptcy cannot be filed for; legal acts without the definition of the unprofitable activities; unclear motives to replace the bankruptcy administrator; creditors' rights to demand the coverage of losses; procedure on disagreement to sell assets for lower price than is stated in the plan.
Inadequacies of solvency restoration plan	- 5 year insolvency restoration plan; - Mandatory sale of assets – dwelling.
Private credit history	- Former personal bankruptcy may reduce possibilities to get a loan.
Irresponsible borrowing	- The risk of more risky, less economically grounded decisions arises.
Credit service cost	- With the considerable increase of bankrupt bank clients, credit service costs may grow.

The attitude towards personal bankruptcy in Lithuania of the two expert groups has revealed multiple inadequacies of personal bankruptcy institute in Lithuania. Five key qualitative categories help us to understand and evaluate the problems of personal bankruptcy in Lithuania: law condition inadequacies; solvency restoration plan inadequacies; personal credit history, irresponsible borrowing, and credit service cost (Table 2). According to the experts, the analysis of law conditions shows quite a number of obscurities in its provisions. Experts as well agreed that the five year period for solvency restoration is too long. The shorter procedure is more attractive and approachable in solving problems among creditors and debtors. The plan's requirement of mandatory sale of the only dwelling causes another inadequacy in this category. The experts, having evaluated the problems in the context of personal credit history, have stated that a former personal bankruptcy can reduce the possibility of receiving loans in the future. According to the Personal Data Legal Protection Law (Seimas of the Republic of Lithuania, Personal Data Legal Protection Law), data on unfulfilled personal financial obligations shall be stored for the period of 10 years.

All experts have agreed that natural persons, being aware of the possibility of bankruptcy, allegedly can be partially encouraged to make more risky, less logically and economically grounded borrowing decisions, because they know that in case of failure they can initiate self-bankruptcy. This attitude is considered to be directly related to irresponsible lending and borrowing practices in Lithuania.

4. Tendencies of personal bankruptcy procedure improvement

The analyses of the problems of personal bankruptcy institute as well as the interview with the expert of personal bankruptcy institute have revealed inadequacies in both the personal bankruptcy institute itself and in the law provisions. Table 3 is designed not only to show the shortcomings of the personal bankruptcy law provisions but also to give recommendations for the improvement of legal regulations.

Table 3. Inadequacies of personal bankruptcy legal regulation and recommendations for its improvement

Inadequacies of Personal Bankruptcy Law Provisions	Recommendations for legal regulation improvement of Personal Bankruptcy Law
Art. 4. 1. A natural person shall file his bankruptcy petition with a district court having jurisdiction over his place of residence according to the procedure established by the Code of Civil Procedure of the Republic of Lithuania (there are no legal acts or recommendations with the description of this procedure therefore natural person find it hard to file the bankruptcy petition without the help of a lawyer).	A law enforcing legal act should define recommendations on filing for personal bankruptcy with the district court.
Art. 4. 2. A natural person who has the intention to file a personal bankruptcy petition... shall give a written notice thereof to all his creditors... (a natural person not always can understand who the creditors are therefore a legal act should define the understanding of "other creditors").	A law enforcing legal act should better define the wording "other creditors".
Art. 4. 4. The following shall accompany a bankruptcy petition and be submitted: 2) Documents evidencing income received and/or expected to be received by a natural person (it is hard to understand what documents could evidence expected income).	A law enforcing legal act should define what documents could evidence expected income.
The amount of funds necessary for carrying out bankruptcy procedures should be established by a law enforcing legal act.	A law enforcing legal act should regulate the determination of the amount of funds necessary for carrying out the procedure of bankruptcy.
Art. 6. 3. A court decision to open personal bankruptcy proceedings shall indicate: 4) Amount of funds that the bankruptcy administrator is entitled to use for carrying out bankruptcy procedures, satisfying the basic needs of a natural person. These amounts of funds should be established in a law enforcing act.	A law enforcing legal act should establish the amount of funds that the bankruptcy administrator is entitled to use for carrying out bankruptcy procedures, satisfying the basic needs of a natural person.
Art. 7.1. The plan shall indicate the following: 3) List of the assets of a natural person planned to be sold...	The law should establish that the only dwelling cannot be sold and/or should establish the conditions for future rent.
Art. 27.1. Sale of the assets for a lower price than indicated in the plan shall require a written consent of a natural person. Procedures should be established in cases when a natural person does not consent to sell assets for a lower price than indicated in the plan.	Procedures should be established in cases when a natural person does not consent to sell assets for a lower price than indicated in the plan.
Art. 28.1. Where a natural person lives with his minor children/adopted children and/or persons under his guardianship/care, the only dwelling, including the pledged one, may be sold by a court decision no sooner than after the expiry of the six months' period following the approval of the plan or revised plan. During this period the natural person must find another dwelling for sale or rent.	The law should regulate that a natural person shall not sell the only dwelling and/or should establish the conditions of future rent when the natural person lives with minor children (adopted children) and/or persons under his guardianship/care.

Source: created by the authors based on Personal Bankruptcy Law of the Republic of Lithuania, 2012

Considering the above mentioned inadequacies of legal regulations of personal bankruptcy in Lithuania and recommendations for the law improvement, it becomes obvious that the personal bankruptcy law has to be improved by law regulating legal act supplements which would remove all the bankruptcy process regulation inadequacies mentioned in Table 3.

Personal bankruptcy is a costly process. Therefore one of the recommendations for the Department of Enterprise Bankruptcy Management would be to systematically organize seminars in order to consult natural persons who are intending to initiate personal bankruptcy process. In this way, natural persons could more thoroughly get acquainted

with the intricate law provisions and understand whether a natural person is eligible for bankruptcy or not. In this way financial resources of natural persons would be saved as well as the number of ungrounded law suits would be reduced.

Conclusions and recommendations

Interview with two expert groups determined job loss as the main economic reasons due to which the risk of falling to return loans might lead to personal bankruptcy. Meanwhile, low overall financial understanding was indicated as the main social reason when overestimated future possibilities to return loans might lead to insolvency and irresponsible borrowing practice increase.

The research of two expert groups revealed five key problems of personal bankruptcy in Lithuania: law condition inadequacies; solvency restoration plan inadequacies; problems related with personal credit history; irresponsible borrowing; and problems related with the possibility of credit service cost increase.

After the research has been carried out, it is evident that the legal regulation of personal bankruptcy has some problems that in near future have to be eliminated. For this reason, The Seimas committees are recommended to prepare supplements to the law regulating legal acts which would eliminate the process regulation inadequacies shown in Table 3 “Inadequacies of personal bankruptcy legal regulation in Lithuania and recommendations for its improvement”.

As well, it is recommended for The Department of Enterprise Bankruptcy Management to systematically organize seminars to consult natural persons who potentially intend to petition for bankruptcy.

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