

# To sue or not to sue

## A rising wave of disputes in the Ukrainian banking sector mean that banks must strengthen legal departments and assess their non-performing loan portfolio

Just a couple of years ago, Ukraine's economy was in robust shape, and one of the most attractive targets for foreign investors. Political tensions had not affected the highest GDP growth figures in the region, which stand at 7.6% as a yearly average. Rapidly rising standards of living pushed demand for consumer goods, and there is increased global demand for the major Ukrainian export products, such as metals, machinery and chemicals, with expected returns on invested capital higher than anywhere else in Europe.

Taking on a general trend from Central and Eastern Europe, the Ukrainian banking market also experienced an unprecedented boom in 2006 and 2007.

Banks were the fastest growing part of the economy, expanding their assets by over 50% every year. International majors such as BNP Paribas, Reiffeisen, Commerzbank, UniCredit, Intesa, Swedbank, SEB as well as the state-owned Russian giants VTB, Vneshekonombank and Sberbank put Ukraine on their expansion radar as one of the primary targets. In 2007 15 Ukrainian banks were sold to international strategic investors, following another dozen in the preceding years.

The banking boom lasted until mid-2008. The lenders' portfolios, both corporate and retail, were increasing with

impressive dynamics. As one banker joked, 'the bankers were catching people on the street to have them borrow, even if they didn't have an ID on them'.

### The morning after

The global credit crunch hit Ukraine heavily. Immediate withdrawals of deposits and bank liquidity problems were followed not only by the banks' suspension of lending to real economy sectors, but also a huge amount of non-performing loans (NPLs) in 2009. According to the National Bank of Ukraine, the non-performing loans last year exceeded 7.1% of the total loan portfolio. These figures seem too optimistic and might be a case of the banks trying to show the regulator a better picture than reality. Alternative calculations give much higher results: Fitch estimated the NPL ratio as 34%.

Driven by a year-to-year increasing consumer demand, many businesses followed very aggressive development policies. According to analysts, this caused the borrowings-to-net-worth ratio, for instance, in the retail sector to reach 300%. The increasing inflation and the downturn of consumer demand, combined with the fact that a great deal of borrowings were made in US dollars or Euros, made it impossible for many borrowers to service the loans. The collapse of the real estate market and decrease of liquidity of the mortgaged assets added to the escalation of the crisis.

The domino effect affected a range of industries. The state employed a series of efforts in refinancing and recapitalising banks. However, in some cases this did not have much effect, and the National Bank had to institute external administration in a number of banks, including some of the top players. As of February 2010, external administration has been instituted in 12 banks; 15 of about 180 Ukrainian banks have gone into liquidation.

### Lack of compromise

Restructuring the non-performing loans has

been, of course, the first remedy the lenders resorted to: there is no reason to kill the goose laying eggs, even if they are not golden anymore.

But amid the Ukrainian and global financial crisis, many of the borrowers had nothing to lose; sometimes the value of their businesses did not match the borrowed money. Even if the borrowers had additional assets to secure their debt, which was not always the case, they had few reasons to provide them to the lenders.

So many of the debt restructurings failed as no compromise could be reached. On the other hand, even when lenders agreed to restructure without any substantial additional guarantees or sureties from the borrowers, the restructured loan repayment schedules often have not been complied with.

Local borrowers also have realised that they and the lenders are in the same boat; the lenders' legal protection in Ukraine has much room for improvement. Having to form increasing reserves to secure the bad debts and foresee the losses, they also realised that the same losses would probably result from the legal collection procedures.

### A rise in disputes

Though collection actions took place throughout 2008 and 2009, they were not very widespread. The lenders still preferred minimally satisfactory restructuring. However, as the NPL percentage gradually increased, the sitting war could not last forever, and the second half to end of 2009 and the beginning of 2010 saw a rise of disputes in Ukrainian banking sector.

Not surprisingly, it was not only the banks that initiated legal procedures. The borrowers often attacked first, claiming, on the basis of some loopholes in the banking and currency legislation, whole or partial invalidation of the loan agreement. Sometimes the borrowers aimed to avoid paying interest or the currency rate difference (as many of the loans were granted in foreign currency) using some imperfections of the laws; in other cases litigation was used just to protract loan enforcement.

Some judgments in those cases shocked the market, like the one in the \$20 million Hotel Central v VTB Bank case. Here, the court of first instance and the court of appeals held invalid a loan agreement covering a facility in foreign currency, as the payments in Ukraine should be made in local currency only. This was made possible due to the ambiguous interpretation of various laws, until the Superior

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Commercial Court supported the bank in the dispute.

Bankruptcy has also become a viable solution for many of the borrowers. In 2009, more than 14,500 companies were in pending bankruptcy proceedings, but a far greater number of borrowers were either experiencing difficulties with loan servicing or were in fact insolvent, but had not yet been put into any formal proceedings in that regard.

Often the borrowers or their affiliates have been those to initiate the bankruptcy. Unlike many other countries, in Ukraine the inter-group or affiliate claims are treated equally with any others for the purposes of bankruptcy. As a result, sometimes the banks have not even been allowed on the creditors' committees.

This situation encouraged the lenders to behave more actively; in a number of banks special NPL divisions have been created or strengthened, legal teams expanded, and a more proactive approach to NPL has been employed. However, the lenders have faced a number of problems on their way, not only in the complicated management of the NPL portfolio, but also in a number of legal matters in the way of collections related to both procedural and material laws.

Despite being foreseeable, this seriously complicated the collection activities of a number of lenders, especially those where the decision-making was concentrated abroad.

### A choice to make: jurisdiction

The main parts of the disputes between lenders and borrowers are considered by national Ukrainian courts. By default, the Ukrainian court at the location of the defendant has jurisdiction over a dispute between a lender and a borrower.

Foreign courts jurisdiction choice is possible, but this option is limited and rarely applicable. Generally, local courts respect the choice of jurisdiction in civil proceedings only. However, certain disputes, such as those regarding immovable property, securities issues in Ukraine, or bankruptcy, shall be considered exclusively by domestic courts.

In commercial proceedings only the choice of arbitration as alternative jurisdiction is respected, also subject to some exceptions. International arbitration is available for the disputes with an international element, such as those arising out of cross-border transactions or from transactions with a foreign-owned entity.

Even when domestic courts have jurisdiction, there are still some options to

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Oleksiy Filatov is a partner and chair of Vasil Kisil & Partners litigation practice group. He specialises in international and domestic dispute resolution, including complex commercial, corporate, and competition disputes, as well as intellectual property matters. His experience also includes numerous disputes in the banking and financial sector.

Filatov represents Ukrainian and international clients and leads litigation teams at Ukrainian courts, as well as partici-

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Filatov has been recognised as a litigation professional by a number of international and local legal market researches, including Chambers Global, Chambers Europe, PLC Which Lawyer?, PLC Dispute Resolution, and Ukrainian Law Firms.

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Yaroslav Teklyuk is a counsel at Vasil Kisil & Partners and focuses on corporate and commercial litigation as well as bankruptcy proceedings. He is recognised as a high-class professional in commercial litigation and is often recommended in this field. Recently he has successfully handled several disputes over real estate property mortgaged in connection with bank loans, represented a foreign bank in a number of collection proceedings against local borrowers in construction and retail

industries, and represented a major foreign creditor in a complex bankruptcy of a shipping company. He is a member of Kiev Region Bar Association and the Ukrainian Bar Association.

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choose from: a case against a non-performing debtor may be considered by either common courts (civil litigation) or by commercial courts (commercial litigation). Generally, commercial courts consider disputes arising from relations between businesses (entities and private entrepreneurs).

Subject to certain exceptions, disputes of the same nature involving at least one natural person as a party are considered by local general courts. The right domestic jurisdiction choice is important as many of the loan transactions were structured to engage ultimate beneficial owners of the borrowers as guarantors and their personal assets as additional security.

### Litigation: the long and winding road

Any case is primarily considered by the courts of first instance under different rules for civil and commercial proceedings.

The general term for a case consideration at the court of first instance shall not exceed two months; however, the law allows this to be prolonged up to three months. There are specific rules setting shortened periods for consideration of special case types, but there is no expedited procedure except for the civil cases where the defendants do not appear. The two-month periods are applicable also at the appellate and cassation courts.

Nevertheless, the terms of consideration of the case are rarely kept at first instance, while the appellate courts comply better. This problem is especially serious in civil procedure, where a case may be considered for years at the court of first instance only. Also, at almost any stage the consideration of the case may be suspended for a number of reasons, like pending proceedings in another connected case, request for an expert opinion, or (in civil proceedings) a legal assistance request to a foreign court.

## “Sometimes it is not easy to have an interim attachment granted even in a relatively straightforward case”

Importantly, the court of appeals in civil cases and the cassation courts in civil and commercial cases may, for certain reasons, remand a case for reconsideration to a lower court. Given that the number of times the case may be reconsidered is not limited, this sometimes causes the case to wander through the courts for several years.

### Appeals

The decision of the court of first instance in both civil and commercial procedures may be appealed to a court of appeals on the grounds of both matters of law and fact.

In civil procedures, the decisions of the court of appeals may be appealed to the Supreme Court of Ukraine by filing of a cassation complaint grounded on the matter of law only. The decision of the Supreme Court may be revised only by the Supreme Court itself on a limited number of exceptional grounds.

In commercial proceedings, the cassation complaint against the decision of the court of appeals may be filed with the Superior Commercial Court. According to the effective procedural rules, the decision of the Superior Commercial Court may be challenged at the Supreme Court – theoretically, also on limited grounds and with limited rights of the Supreme Court as to the measures to take upon consideration of the complaint.

### Cassation

The existence of four levels of court proceedings raised a broad discussion among law practitioners, scholars, judges, and lawmakers. The subject of the discussion is mainly the existence of the so-called second cassation in the commercial proceedings. This is the right of a party to challenge the decision of the Superior Commercial Court at the Supreme Court.

Second cassation abolitionists argue that the existing number of possibilities to reverse a judgment gives the parties little

legal certainty and contradicts their right to have the case considered within a reasonable time. This point of view has recently been supported by the Constitutional Court of Ukraine in one of its decisions.

However, the Constitutional Court has not formally recognised the second cassation rules as unconstitutional, limiting with just a general opinion. Using the latter fact, the Supreme Court has already declared that it remains competent to consider second cassation complaints until the procedural rules are amended by the Parliament. Thus the question of legality of the second cassation remains open, which does not help the disputing parties to be certain of their litigation perspectives.

### The final injunction

A judgement becomes enforceable if not appealed against or if confirmed by the court of appeals. The Supreme Court (in civil proceedings) and the Superior Commercial Court (in commercial proceedings) may suspend enforcement of the judgement upon the motion by the defendant filed along with the cassation complaint, if any.

However, even if a judgement has been through all the appeal and cassation levels, you cannot be totally sure of its final nature. The Ukrainian procedural rules envisage that a judgement can be reviewed and possibly overturned upon a party's motion based on so-called newly discovered circumstances (the facts existing before the judgement which the party could not have reasonably known at that time).

The only deadline to bring such a motion is two months after the motioning party learned of these facts. In practice, this means that the judgement may be revised with no time limit.

### A shortcut to success?

Given the timing of litigation, the outcome of the collection proceedings depends not

only on the standing of the debtor at the time of filing of the case, but also on the changes of his standing while the case is pending. In the current economic climate when the borrowers suffer from money disappearing from their bank accounts and other assets from their books, the interim injunctions become a vital element of any successful dispute resolution strategy.

Interim injunctions are permitted in both civil and commercial proceedings. Strictly speaking, these are mostly not interim injunctions but rather interim attachments granted when otherwise the final injunction may become non-enforceable, or its enforcement complicated.

The most widespread interim measure is attachment of money on the defendant's assets and money on his bank accounts. However, sometimes it is not easy to have an interim attachment granted even in a relatively straightforward case. Also, no interim measures are available to secure the enforcement of a future arbitration award.

### Arbitration looks attractive

Arbitration still seems an attractive option and a number of lenders include arbitration clauses (either local or international) into the loan agreements. The final nature of the award that may be challenged on formal grounds only, the relatively short timing and simplified procedure, expectedly lower costs and freedom from political and other influences alike makes many foreign lenders stick to this option.

However, a number of problems still exist. The non-availability of the interim measures at local courts is one of them. Advantage such as cheaper procedure are usually arguable: in Ukraine the filing fees are limited at about \$3,500 at the first instance court, with the appeal filing fee being the half of the paid at the previous instance. While the experts' fees are comparable in both arbitration and litigation, the attorneys' fees may be seemingly higher in litigation due to the number of stages and lengthy procedures. However, in arbitration the same fees may be accrued within the exequatur proceedings, which also may include appellate stages.

The exequatur is granted under the rules of civil procedure, with all their time-consuming peculiarities to be considered. Thus, instead of the expected simple procedure one may get three cases: arbitration, challenge of the arbitral award, and recognition and enforcement of the award. Nevertheless, in a particular case there are still reasons for which you would

prefer arbitration to litigation at national courts.

### **Enforcement**

Getting an enforceable judgment is not the end but rather a good start; it does not mean you get the money next day. The judgments are enforced through the bodies of the State Enforcement Service (bailiffs' office) following a special court order confirming that the judgment is enforceable. It is the bailiff who finally gets the money from the debtor's bank account, sells his assets and pays the creditor. The enforcement procedure at the state enforcement office is also very formal, contains various stages, and entails possibilities to challenge the actions of the bailiff either through the administrative levels of the Enforcement Service or at court.

Foreign judgments may be enforced through Ukrainian courts on the basis of the international treaties of Ukraine (and there are not many in that regard), or on the assumed reciprocity principle. The arbitration awards are enforceable in Ukraine generally on the basis of the 1958 New York Convention or other international treaties of Ukraine. After a court ruling on recognition and enforcement of the foreign judgment or award is granted, they should be submitted to the bodies of Enforcement Service in the same way as Ukrainian court orders.

### **Non-litigation enforcement**

The pleasures of dispute resolution and enforcement procedures made many lenders try to use non-litigation enforcement procedures. Indeed, subject to the availability of relevant clauses in the loan and ensuring (such as mortgage) agreements, Ukrainian law in some cases allows the collection of money and mortgaged assets through an out-of-court procedure. However, a number of traps may also wait for the creditor in that way.

For instance, non-litigation collection of the mortgage on the basis of a so-called creditor's claims satisfaction clause in the mortgage agreement is available. This clause usually says that in case of default under the secured obligation the creditor can either assume the title over the mortgage or sell it to a third party.

However, the lenders often oversee that to register the title to their name or to sell the mortgage they need the original title documents (which are often retained by the borrower) and a special notice from the real estate registration authorities (granted only at the request of the current owner). Therefore, non-litigation enforcement of

mortgage may not be available without the borrower's consent.

Moreover, whenever banks recur to non-litigation enforcement, they should be ready for the borrowers challenging their actions at court. As litigation proceedings are not costly in Ukraine, the chances of ending up in court are very high, irrespective of the strategy chosen by the bank. Thus, the current priorities of the banks include, more than ever, strengthening their legal teams, improving NPL division management and assuring smooth cooperation with the outside litigation counsels.