

Debt restructuring and insolvency: Ukrainian trends

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During the period of financial crisis in Ukraine, debt restructuring became a question of great importance which is being broadly discussed and implemented by banks, other financial institutions and corporate borrowers with significant debt portfolio. In the new financial reality all interested parties realised that, in most cases related to the debtor's insolvency, better results could be achieved outside any formal insolvency (bankruptcy) proceedings. This often requires implementation of certain restructuring arrangements aimed at the improvement of the debtor's financial position and its rehabilitation.

Out-of-court debt restructuring trends

Typically, corporate debt restructurings, also known as workouts, are implemented outside any formal insolvency (bankruptcy) procedures. Out-of-court debt restructuring procedures in Ukraine are usually less expensive and represent a preferable alternative to bankruptcy. The main costs associated with such procedures are time and effort to negotiate restructuring arrangements with the lenders or their representatives. Debt restructurings typically involve a reduction of debt and an extension of payment terms.

Debt restructuring instruments used by corporate borrowers

Except for plain vanilla restructuring arrangements usually implemented to either extend payment terms, change a debt's currency or to set forth a grace period for a debt's repayment, the following instruments (either separately or in a combination) are often utilised by Ukrainian corporate borrowers within the process of their negotiations with the lenders to implement efficient restructuring arrangements.

Debt-to-equity conversion. Some restructurings could be done through debt-to-equity conversion whereby a creditor or a group of creditors agree to release the company from its debt claim in exchange for the issue of new shares in the company. A debt-to-equity conversion usually requires cooperation of existing shareholders with the lenders who become new shareholders of the debtor once the restructuring mechanism is implemented. Special attention in this respect should be given to the legal structure of a debt-to-equity conversion transaction, considering peculiarities of each specific deal (including parties thereto, terms for implementation of restructuring and, and other conditions for capital increase), as such a mechanism is not directly prescribed by the Ukrainian law. It should, however, be taken into account that

direct debt-to equity conversion for limited liability companies is prohibited by Ukrainian law.

Set-off. Set-off requires the parties to the transaction to have single-currency mutual and matured contractual obligations.

Given that a set-off under Ukrainian law could be implemented through submission of the respective application by one of the parties to the transaction only (e.g. application of the debtor), it has been widely used to terminate mutual obligations under loans and deposits since early 2009. Besides, set-off is often used by debtors to terminate their obligations under loans through acquiring Eurobonds (including loan participation notes) in the international capital markets with a substantial discount (due to the issuer's rating downgrade and/or the issuer's country rating downgrade). Such Eurobonds are further used by a debtor to set-off its obligations under the loan previously granted by the issuer to such a debtor, being a bondholder as a result of acquiring the bonds.

However, implementation of both of the above instruments (i.e. debt-to-equity conversion, as well as set-off) became more complicated in late 2009 due to temporary prohibition for premature repayment of loans borrowed from non-residents of Ukraine, imposed by the Law of Ukraine N1533-VI "On Amendments to Certain Laws of Ukraine to Overcome Consequences of Financial Crisis". Such prohibition is expected to remain valid until January 1, 2011.

Subordination. Subordination is a sort of intercreditor arrangement whereby one creditor (the junior creditor) agrees with another creditor (the senior creditor) that it will not receive a repayment of its debt unless and until the senior creditor has been repaid its debt in full. Ukrainian law allows implementation of two types of subordination: (a) contractual subordination; and (b) structural subordination.

In the case of contractual subordination, two loans are granted to the same company, but the junior creditor and the senior creditor agree the priority of payments by the deed of subordination, i.e. a special intercreditor agreement.

Structural subordination arises where the senior creditor lends to a company (Holdco 2) which is lower in the group structure than the company (Holdco 1) into which the junior creditor lends.

In the case of winding-up of Holdco 2 due to insolvency of the latter, Holdco 1, as its shareholder, will not receive dividends in a liquidation procedure and if Holdco 1 has no assets, the junior debt will not be repaid to the junior creditor.

Subordination, however, is a less common restructuring instrument in Ukraine compared to the abovementioned debt-to-equity conversion and set-off, since a number of creditors are not usually willing to be in a position of junior creditors, whose claims are to be satisfied in the last turn. Therefore, this instrument is mostly implemented in a case where a debtor's majority shareholder agrees to subordinate its debt and to make it junior due to a lack of any other options to get comfortable restructuring conditions for its subsidiary, having indebtedness split towards several creditors.

Debt restructuring instruments of Ukrainian banks

Ukrainian banks within the period of financial crisis started the implementation of various SPV structures, allowing them to sell non-performing loan portfolios and to release provisions as a result of such a sale. Given the above, distressed debts trading quickly became a very popular trend in the Ukrainian financial market.

In terms of distressed debts sale and implementation of SPV structures by Ukrainian banks the following should be observed.

Legal structure of distressed debts sale transactions.

Ukrainian legislation provides for two possible options of loan claims' sale: through entry into either factoring or an assignment agreement (both are governed by the Civil Code of Ukraine). The main difference between the following options is described in Figure 1.

In the case of loan claims' sale through either factoring or an assignment, pledge claims will be automatically transferred to the factor (the assignee) by operation of law. However, to enhance security, certain additional contractual arrangements in respect of pledge claims could also be made.

Besides, in the case of both scenarios/options of loan claims' sale to the SPV, re-registration of contractual encumbrances in the State Register of Encumbrances of Movable Property will be required.

Banking secrecy issues. No complications with disclosure of banking secrecy information will arise if the loan agreements with the banks' clients envisage the banks' rights to make the respective disclosure of banking secrecy information in the case of loan claims' sale (either through assignment or factoring). Should no such clauses be contained in the loan agreements, a prior written consent from the client would be required to observe banking secrecy rules prescribed by Ukrainian law.

Foreign currency control implications. Given that Ukrainian foreign currency control regulations prohibit settlements between Ukrainian residents in any currency other than Ukrainian hryvnias ("UAH"), assignment of foreign currency loan claims will require:

Figure 1: Loan claims' sale

	Factoring agreement	Assignment agreement
1. Loan claims value	Discounted value of the loan to be paid by the assignee (the factor).	No less than the par value of the loan to be paid by the assignee.
2. Acquirer of loan claims	The assignee (the factor) should be established as a bank, or a non-banking financial institution (registered by the State Commission for Regulation of Financial Services Markets).	No special requirements to the assignee are envisaged by the Ukrainian law.
3. Consent of the debtor/ restrictions envisaged by the loan agreement	No consent of the debtor is required. Restrictions for an assignment stipulated by loan agreements (if any) are not applicable to the given case, therefore, factoring could be made even in case of the said contractual restrictions.	The debtor's consent is not required, unless otherwise stipulated by the loan agreement.
4. Further (secondary) assignment	Can be performed through further factoring agreement only.	Can be performed through further assignment or factoring agreement.

(i) an individual licence (permit) from the National Bank of Ukraine for settlements between Ukrainian residents in a foreign currency; or (ii) special contractual arrangements – to allow the foreign currency loan claims to be paid in UAH.

Transfer of overdue loans together with the underlying security to solvent borrowers with sound financial reputation is also currently being used by certain Ukrainian banks as part of their strategy to deal with distressed loan portfolios. Such a transfer is always done under the consent of the lender and its borrower, being in default.

Insolvency (bankruptcy) trends

At least one of the current trends in bankruptcy proceedings in Ukraine is of immediate interest: the world economic crisis has given rise to a movement towards reforms of bankruptcy proceedings in Ukraine.

One of the main reasons for the Ukrainian legal community to start seriously discussing the issue of bankruptcy proceeding reforms is the fact that debtors in Ukraine recently started using and often abusing bankruptcy proceedings as a way of getting rid of their debts.

As in the rest of the world, the global economic crisis caused many defaults under loan agreements in Ukraine. As a result, a number of bankruptcy proceedings were initiated by creditors and debtors. Usually, bankruptcy proceedings result in the following consequences: (i) a bank or another creditor gets partial repayment of the debt through the procedure of the sale of debtor's assets held within the bankruptcy proceedings; (ii) a debtor gets rid of its debts and gets a chance to "restart with a clean conscience"; or (iii) the state gets a solvent taxpayer, i.e. the debtor which passed through bankruptcy proceedings.

However, it became quite popular in Ukraine for bad faith debtors to initiate bankruptcy proceedings in respect of themselves after they were willfully stripped off their valuable assets. In such cases banks or any other creditors "fight for nothing".

Bankruptcy proceedings in Ukraine are hardly advisable to be entered into by creditors because: (i) Ukrainian legislation does not prescribe any special out-of-court procedures, therefore they are always used at the discretion of the parties thereto; and (ii) bankruptcy proceedings are usually multistage, time and cost consuming.

However, as a matter of practice, bankruptcy proceedings could be an efficient instrument available to creditors for the recovery of debts, subject to thorough control of the whole procedure from the creditors' side.

The following key issues are to be noted prior to commencement of bankruptcy proceedings in Ukraine.

Procedures to be applied within a bankruptcy proceeding

According to Ukrainian insolvency legislation, the court is entitled to apply the following procedures to the debtor within bankruptcy proceedings:

- administration of assets;
- amicable agreement;
- financial rehabilitation; and
- liquidation.

Terms

The Ukrainian Bankruptcy Act provides for specific terms for the procedures defined in p. (A) hereinabove to be applied within Ukrainian insolvency proceedings.

In particular, the term for administration of assets must not exceed seven months, the term of financial rehabilitation – 12 months, and liquidation procedure – 12 months.

Although the terms for the above procedures are determined by the Bankruptcy Act, the same Act also entitles the court to extend such a term.

Moratorium

According to Article 12 of the Bankruptcy Act, a court after opening a bankruptcy proceeding imposes a moratorium for satisfaction of creditors' claims in respect of any and all creditors' claims before commencement of the bankruptcy proceedings.

During the moratorium period, the creditors are not allowed to recover their debts under enforcement documents, as well as under any other documents, granting creditors the rights to recover debts. Penalties are not charged during the moratorium period.

One shall bear in mind that the moratorium covers only pre-bankruptcy claims (i.e. the claims which arose before commencement of bankruptcy proceedings).

The moratorium lasts until the date of termination of bankruptcy proceedings.

Insolvency administrator

In accordance with the Bankruptcy Act, the insolvency administrator is a general definition for a person who is properly licensed to provide the insolvency administration procedure and is one of the key players in it.

According to Article 31 of the Bankruptcy Act, the insolvency administrator is empowered:

- to convene creditors' meetings and sessions of the creditors' committee;
- to participate in the creditors' meetings and sessions of the creditors' committee with an advisory vote;
- to take measures in order to protect assets of the debtor (i.e. to file with the court an action claiming invalidation or termination of some contracts of the debtor affecting its financial standing, etc.); and

- to prepare and keep the creditors' claims register; etc.

At the stage of administration of assets, the insolvency administrator acts as the administrator of assets along with the management of the debtor. At the stages of financial rehabilitation and liquidation, the insolvency administrator substitutes the debtor's management and exercises all respective powers and authorities.

Therefore, it is critical to pay special attention to the process of appointment of the insolvency administrator.

Creditors' claims

A court shall start bankruptcy proceedings in respect of the debtor; if the amount of indisputable claims of creditors to such a debtor equals 300 minimal wages, and such claims have not been satisfied within three months from the maturity date.

The Bankruptcy Act differentiates pre-bankruptcy creditors' claims and current creditors' claims.

An initiating creditor is always obliged by the respective court ruling to publish in the official media a notice regarding commencement of bankruptcy proceedings. Such a notice is to be published to identify all debtor's creditors, having pre-bankruptcy claims against it. Such creditors have to file their applications, describing the claims against the debtor; within 30 days from the date of the above publication, with the commercial court which is considering the case in order to be able to participate in the bankruptcy proceedings.

Pre-bankruptcy claims of the creditors not filed with the commercial court within such a 30-day period will be dismissed by the court.

Creditor's committee

Creditors' committee is supposed to be one of the key bodies in the bankruptcy proceeding.

Members of the creditors' committee are elected and appointed by the creditors' meeting.

Creditors' committee shall convene creditors' meetings, file a motion on opening of financial rehabilitation procedure and/or liquidation procedure with the respective commercial court, approve an amicable agreement (as the case may be), file a motion on extension or reduction of the terms for special procedures within bankruptcy proceedings with the court, etc.

Considering the above powers and authorities, and the fact that not all creditors are usually represented in the creditor's committee, it is recommended to use all available efforts to be elected to the creditors' committee.

Amicable agreement

According to Article 35(2) of the Bankruptcy Act, an amicable agreement may be entered into at any stage of the bankruptcy proceedings.

On the creditors' side, a decision on entering into the amicable agreement must be taken by the creditors' committee. To take such a decision no less than 50% of the creditors' committee members have to vote for entering into the amicable agreement, provided however that all creditors having secured claims agreed to enter into the amicable agreement.

From the debtor's side, a decision on entering into the amicable agreement should be taken by the debtor's management or its insolvency administrator.

The amicable agreement entered into by the creditors and the debtor needs to be approved by the commercial court considering the case.

It should also be noted that the Ukrainian Government has recently initiated amendments to the effective Bankruptcy Act aimed at (i) facilitation of terms for bankruptcy proceedings which are currently prescribed by the law; and (ii) establishment of bankruptcy proceedings for individuals. Those amendments are expected to be adopted by Ukrainian Parliament by the end of 2010 and most probably will introduce (i) a reduction of bankruptcy proceeding's terms; (ii) certain measures to prevent abuse of rights through challenging of court's rulings to delay and postpone court proceedings and hearings; and (iii) new solutions of some existing legislative discrepancies.

Notes:

¹ The Law of Ukraine "On Financial Rehabilitation of a Debtor or Bankruptcy", dated from September 14, 1992 No. 2343-XII.

² Currently bankruptcy proceedings can be applied to legal entities and individuals – private entrepreneurs (i.e. sole traders) only.

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