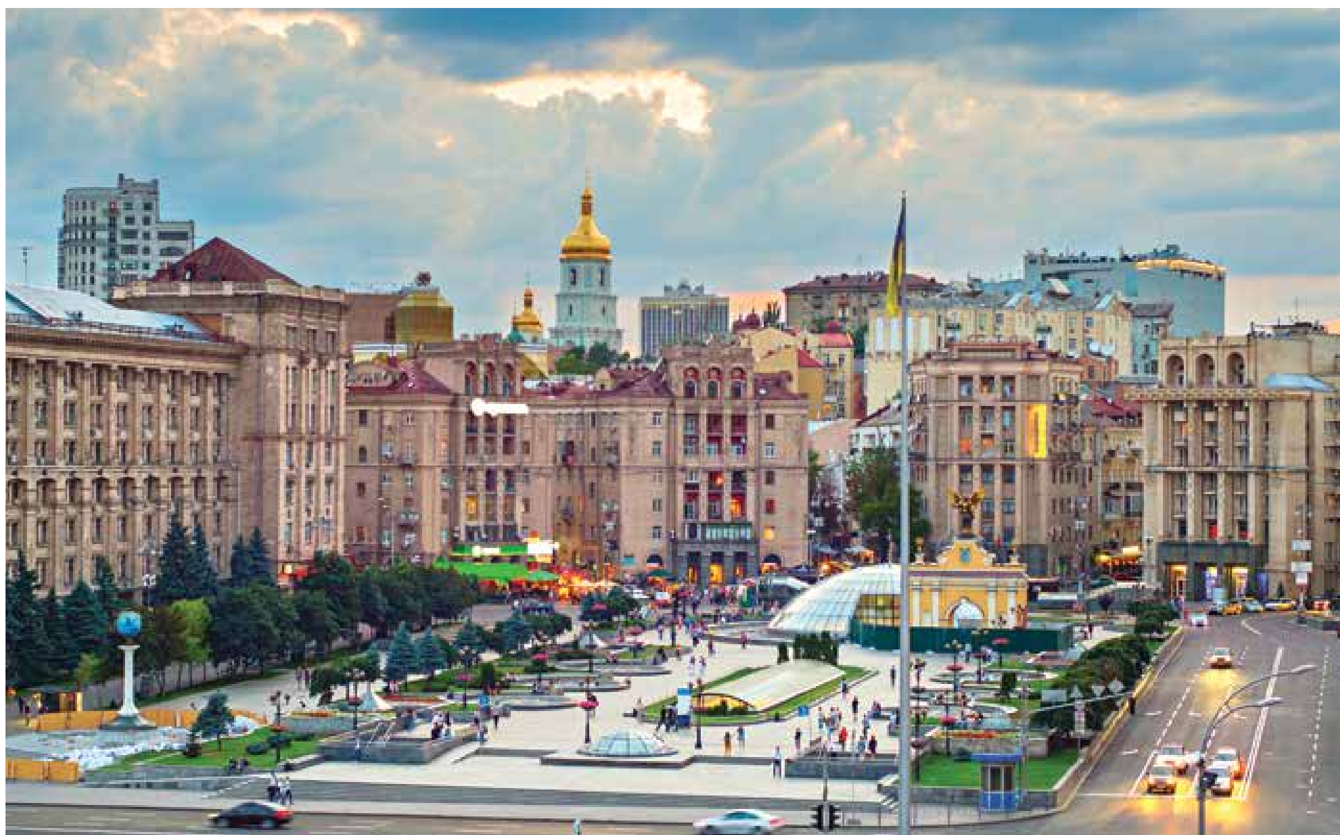
New Ukrainian Debt Restructuring Law: Upgrading the Parties' Pre-Insolvency Toolkits

By **ANDRIY NIKIFOROV** *and* **SERHIY MYKHAYLYK**



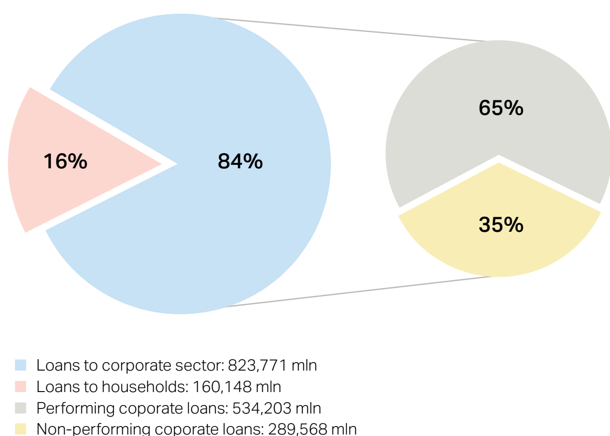
Background to the Financial Restructuring Law

On June 14, 2016, the Ukrainian Parliament adopted the long-awaited Law of Ukraine "On Financial Restructuring" (the "**Restructuring Law**") that introduced an out-of-court procedure for the restructuring of liabilities of Ukrainian debtors other than banks or other financial institutions.[1] This procedure will complement the long-established Ukrainian insolvency process and the court administered pre-insolvency procedure under Article 6 of the Law of Ukraine "On Restoration of Debtor's Solvency and Declaration it Bankrupt," dated May 14, 1992 (the "**Insolvency Law**"). The Restructuring Law came into force on October 19, 2016 and will continue in effect for the next three years when it will terminate in accordance with its terms. According to the Restructuring Law drafters, three year period should suffice to assess whether the law has made a difference. Thereafter, the Restructuring Law will be amended to continue to apply or the Article 6 process will be brought up to speed with the existing restructuring practices.

Although the Restructuring Law has been criticised for being somewhat limited in the scope of its application, there are two key features about the law that are worth highlighting. First, the Restructuring Law allows the debtor company to include in the process not only credits of commercial creditors, but also the credits owed to state-owned banks as well as the Ukrainian tax and other state authorities. Second, Ukrainian debtors may also benefit from the tax incentives set out under the Law of Ukraine "On Amendments to the Tax Code of Ukraine and Other Laws of Ukraine On Ensuring Balance of Budget Revenues in 2016," dated December 24, 2015, which applies exclusively to restructurings under the Restructuring Law.

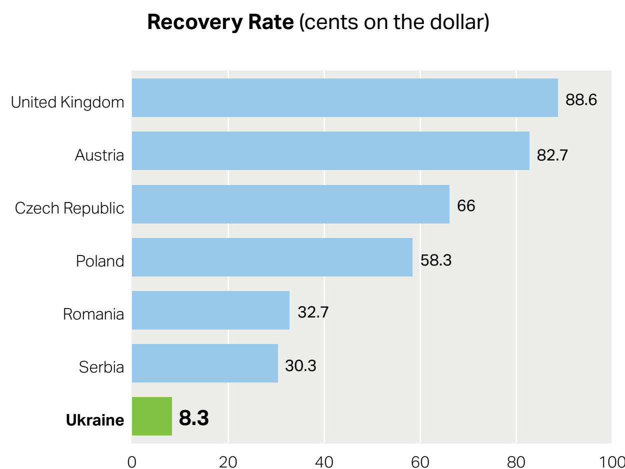
The introduction of the Restructuring Law is one of the policy responses to address the problem of non-performing corporate loans on the balance sheets of Ukrainian banks according to the National Bank of Ukraine. As of August 2016, such non-performing corporate loans amounted to almost 30% of the total bank credit portfolios of Ukrainian banks.[2] In its letter of intent to the IMF dated April 22, 2014 and the accompanying Memorandum of Economic and Financial Policies, Ukraine committed to take steps to facilitate the restructuring of non-performing loans in the banking sector, thereby boosting depositor confidence and promoting healthy credit growth. This commitment eventually took the shape of the Restructuring Law, the development of which was sponsored by the European Bank for Reconstruction and Development and the World Bank.

Loans to Ukranian Residents, UAH 985,970 mln
(as of 31 August 2016)



The other reason for the adoption of the Restructuring Law is the historically low rate of creditor recoveries in Ukrainian insolvency proceedings compared to other jurisdictions. The chart below shows how the insolvency recovery rate in Ukraine compares to recovery rates in other European economies, including Ukraine's neighbouring countries.[3]

Recovery Rate (cents on the dollar)



Where Article 6 Pre-Insolvency Process Failed

The adoption of the Restructuring Law is also an acknowledgement that Article 6 of the Insolvency Law establishing the pre-insolvency court-managed debtor financial rehabilitation procedure, which was introduced in 2013, failed to achieve the desired goal of facilitating restructuring of Ukrainian non-performing loans. When compared, for example, to the UK scheme of arrangement to which a multitude of corporates worldwide have turned in recent years, the Article 6 procedure requires the consent of all secured creditors and the majority in value of unsecured creditors where the UK scheme simply needs the approval of a majority of creditors holding at least 75% by value. The requirement of unanimous consent of secured creditors is an unrealistically high threshold for many restructurings and is ultimately the Achilles heel of the Article 6 procedure. Also, although the Article 6 procedure may at first appear to provide for an immediate moratorium on creditor claims, this moratorium will only come into effect after the restructuring plan has been approved by the requisite majority of creditors and therefore is perceived to be too late.

Key Features of Financial Restructuring Procedures under the Restructuring Law Compared to Procedures Under the Insolvency Law

	Article 6 Pre-Insolvency Procedure under the Insolvency Law	Financial Restructuring Procedure under the Restructuring Law
Nature of procedure	Court supervised process	Out-of-court process with the involvement of a specialized body created by the state (secretariat)
Applicability	Applicable to all debtors, regardless of their liability composition	Only applicable to those debtors that owe liabilities to at least one financial institution
Who can initiate the procedure?	Debtor or creditor(s)	Debtor only. Multiple debtors in the same corporate group may have a joint proceeding under the Restructuring Law where they have at least one common financial institution creditor and 2/3 of all participating financial institution creditors by value, in relation to each debtor, have consented to such a joint restructuring.
Commencement of procedure	Court commences procedure and introduces moratorium if the majority of unsecured creditors by value and all secured creditors of debtor approved the restructuring plan	Secretariat resolves on commencement of restructuring procedure, provided that financial institution(s) holding at least 50% of all financial institution claims (excluding the debtor's related parties) have consented to the restructuring. The secretariat's resolution is a basis for automatic introduction of moratorium.
Moratorium	Moratorium binds all creditors	Moratorium binds (i) all participating creditors (including state bodies that are treated as such by operation of law) and (ii) non-participating creditors in relation to the non-current (including fixed) assets of the debtor that are not subject to the non-participating creditors security.
Duration of procedure	Cannot exceed 12 months	Cannot exceed 180 days
Scope of restructuring/ rehabilitation plan	Rehabilitation plan binds all creditors	Restructuring plan binds (i) all creditors that agreed to participate in restructuring, (ii) subject to exceptions, tax, customs, state treasury and enforcement bodies and (iii) related parties of debtor.
Cramdown of minority creditors	Unsecured creditors may be crammed down if the plan has been approved by the majority of unsecured creditors by value and all secured creditors of debtor	The following creditors may be crammed down, if the plan has been approved by more than 2/3 of the participating creditors by value and the arbitration tribunal of the secretariat: (i) other participating creditors (ii) state authorities that are participating creditors by operation of law (iii) related parties of the debtor
Tax incentives	No	Yes

Creditors Eligible to Join in Financial Restructuring Procedure under the Restructuring Law

The Restructuring Law's application is limited to liabilities owed to creditors that agreed to participate in the restructuring by signing consent letters (the so-called "participating creditors"), related parties of the debtor and, subject to some exceptions, tax and other state authorities. It is therefore not possible to impose the restructuring plan under the Restructuring Law on non-participating holdout creditors other than the state authorities and debtor's related parties. Where participating creditors had agreed to the process but then decided to pull out and did not vote for the restructuring plan, the law allows cramming them into the plan if it was supported by more than 2/3 of the total participating creditors by value and approved by the arbitration tribunal of the secretariat. The failure to include a full-scale cramdown mechanism on holdout minority creditors is somewhat of a missed opportunity and would limit the utility of the Restructuring Law in debt restructurings. Ukrainian debtors may need to resort to other procedures if they wish to cram down minority creditors.

The Restructuring Law procedure is commenced only if the debtor's petition is supported by one or more financial institutions holding at least 50% of all financial institutions' claims (excluding claims by the debtor's related parties). The definition of financial institutions under the Restructuring Law includes the financial institutions as determined under Ukrainian law, international financial organizations and non-resident financial institutions that extended loans to the debtor. Therefore, if, for example, all of the creditors are investment funds and none of them meets this financial institution test, the Restructuring Law process may not be used. The Restructuring Law procedure would most likely suit Ukrainian debtors whose pool of creditors is comprised primarily of Ukrainian banks and international financial institutions such as the European Bank for Reconstruction and Development or the International Finance Corporation.

The Restructuring Law expressly provides that it is applicable to the restructuring of liabilities owed to international financial organizations and certain non-resident financial institutions, as well as to the agreements governed by a foreign law. Nevertheless, it may not be possible to restructure liabilities using a Ukrainian restructuring procedure if the debt agreement is not governed by Ukrainian law because of the conflict of laws issues. For example, it is a longstanding principle under English law that English law-governed debt may only be amended using English law procedures. In practice,

non-Ukrainian creditors (and the Ukrainian debtor) may prefer to use, potentially in parallel with a new restructuring regime (as described in more detail below), tried-and-tested restructuring routes such as an English law scheme or a US Chapter 11 procedure to the extent that these are available.

Use in Cross-Border Restructuring Context

It remains to be seen if the restructuring agreements implemented under the Restructuring Law will gain traction in the context of a purely domestic Ukrainian restructuring. This said, some of the process features such as the moratorium, the Ukrainian law-governed standstill agreement and the ability to stay the bankruptcy proceedings may come handy in cross-border restructurings as well. It may be worth considering whether the Restructuring Law procedure may apply in parallel with other non-Ukrainian procedures in the context of a cross-border restructuring in order to benefit from the following procedural advantages under Ukrainian law.

Moratorium. The moratorium under the Restructuring Law is imposed automatically for a 90-day period upon commencement of the restructuring proceeding by the secretariat (which, as noted above, is a specialized body created by the state). As long as the moratorium is in place, the debtor may not:

— discharge its obligations to any creditors, except when approved by 2/3 of the participating creditors by value and is done in the ordinary course of business;

— dispose of its property, other than in the ordinary course of business, except when approved by 2/3 of the participating creditors by value;

— be the subject of any corporate reorganization, except when approved by 2/3 of the participating creditors by value; and

— enter into agreements with a view to granting a pledge or mortgage over the debtor's property, except when it secures new money financing within the financial restructuring procedure. The debtor may borrow new money from any funding source, provided that the transaction has been approved by the 2/3 of the participating creditors by value. Under the Restructuring Law, the security granted in respect of such new money financing must be, in the first place, over the assets that have not been previously encumbered and, if these are not sufficient, over the already encumbered assets upon the consent of the respective creditors.

The moratorium primarily concerns the claims of the participating creditors (including state authorities that may be treated as participating creditors by operation of law) and the related parties of the debtor. The moratorium also prohibits the participating creditors from:

— enforcing against the collateral provided by the debtor or a third party, in each case to secure the debtor's obligations to those creditors;

— enforcing against non-current unencumbered assets of the debtor;

— taking any action to obtain possession of or control over the debtor's property, including by entering into any contract; and

— offsetting their claims against the debtor's counterclaims.

The moratorium provisions of the Restructuring Law target primarily the debtor company and its participating creditors, but they also provide a stay of some proceedings commenced by non-participating creditors. Non-participating creditors may not enforce over non-current unencumbered assets of the debtor, although the law does not limit such creditors' rights to enforce against collateral created for their benefit or to offset their claims.

Notwithstanding the moratorium, any creditor has the right to commence or continue legal proceedings to seek a court judgment against the debtor company with a view to recovering the debt or enforcing over the debtor's property. However, if successful, such creditor would need to wait for the expiry of the moratorium to proceed to the enforcement of the court judgment. Finally, the Restructuring Law prohibits any creditors from charging any late payment interest or other monetary penalty in respect of any debtor's obligation subject to the moratorium. The moratorium also suspends limitation period under the statute of limitations and any other similar time period within which creditors may seek remedies, whether established by law or contract.

Standstill Agreement. Under the Ukrainian Code of Commercial Procedure applicable to disputes between legal entities and insolvency cases, an agreement of the parties to refrain from bringing a lawsuit in court is invalid. Prior to the Restructuring Law, the invalidity of such agreements discouraged the parties from entering into any kind of standstill agreement governed by Ukrainian law. Now, the Restructuring Law expressly allows a debtor company to lock its creditors into a standstill and contains an express provision that makes it clear that the Restructuring Law overrides all other Ukrainian legislation.

As described above, once the debtor's application for the Restructuring Law procedure has been filed and accepted by the secretariat, the statutory moratorium will automatically take effect. Going forward, the participating creditors may enter into a standstill agreement to change the scope of the moratorium, to replace the general ban on the disposal of assets by the debtor company with a set of affirmative or negative covenants tailored to the debtor's business as well as to formalize the intercreditor relations. Participating creditors that failed to enter into the standstill agreement will continue to be subject to the process in all respects, other than with respect to the terms of the standstill agreement.

Effect on Bankruptcy Proceedings. The process under the Restructuring Law is also helpful in circumstances where the debtor is aware that a rogue creditor may file (or even has already filed) for the debtor's bankruptcy. Under the Insolvency Law, the court must commence the insolvency proceedings, subject to some exceptions, within nineteen days following the date of receipt of the insolvency claim. If the debtor company has the requisite support of the majority of financial institutions, it may apply for the financial restructuring process under the Restructuring Law prior to the court's ruling on commencement of the insolvency proceedings. In this case, the insolvency proceedings will be suspended for a period of at least 90 days or indefinitely if the debtor and its creditors agree on a restructuring plan to which the dissenting creditor's liabilities are subject (i.e., if the dissenting creditor ultimately becomes a participating creditor). However, given that the Restructuring Law procedure essentially does not contain a cramdown

procedure on minority creditors, the suspension of the insolvency proceeding may only be temporary and the debtor company may still need to find an alternative solution to the holdout problem.

Timeline and Important Deadlines

The Restructuring Law provides for a number of strict deadlines that are aimed at preventing any abuse by the debtor and the participating creditors of the benefits granted by the law. In particular, once the financial restructuring procedure has been initiated, it must be completed within 180 days and may not be extended further. If the financial restructuring fails, the debtor and creditors will not be able to resort to the Restructuring Law nor the Article 6 proceedings for the next 18 months excluding the time that lapsed from the commencement of the earlier process and up to its termination.

Day 1	The debtor submits a written application for restructuring to the secretariat accompanied by consent(s) of financial institution(s) holding in aggregate at least 50% of total claims of all financial institutions (excluding claims of the debtor's related parties).
Day 2—Not later than on the next business day after Day 1	The secretariat resolves on the commencement of the restructuring process and notifies the creditors indicated in the debtor's application of the date of the first creditors meeting. The moratorium on the creditors' claims is imposed automatically for the initial 90-day period.
Within 10 business days, but not earlier than 7 business days, after Day 2	The first creditors meeting must be held.
7 business days prior to the date of the first creditors' meeting	The debtor must provide the participating creditors with, in particular, (1) the background for restructuring, (2) information on overdue debt, (3) information on creditors' contractual rights to accelerate any loans, (4) information on any breaches of the security agreements, (5) the debtor's 12-month financial forecast and (6) list of existing court and enforcement proceedings.
2 business days prior to the date of the first creditors' meeting	The debtor may supplement the list of the participating creditors.
Within 30 days after Day 1	The debtor may recall its application for restructuring.
Within initial 90 days after Day 2 (that may be extended up to 180 days)	The restructuring plan must be approved in respect of the debtor.
Within 18 months from the date of commencement of the previous restructuring procedure or Article 6 rehabilitation procedure	The debtor may not again file for restructuring under the Restructuring Law.

Conclusion

Despite the mixed reception it received in the Ukrainian restructuring professionals' community, the Restructuring Law is not without merit. Although the financial restructuring procedure does not allow the debtor company to impose a restructuring plan supported by the majority creditors on the minority holdouts, the Restructuring Law procedure does come with certain procedural advantages such as the statutory moratorium and the suspension of any Ukrainian insolvency proceedings. In a cross-border restructuring context, it may be desirable in the right circumstances to pair the Ukrainian Restructuring Law mechanism with a foreign procedure such as a UK scheme of arrangement or a US Chapter 11 process in order to construct a debt restructuring procedure that is less vulnerable to attack by rogue creditors. ■

1. The matters related to insolvency of Ukrainian banks are regulated by the Law of Ukraine "On the Deposits Guarantee System", dated February 23, 2012. Other Ukrainian financial institutions are subject to the Insolvency Law, including the Article 6 process.
2. Source: Report on monetary and financial statistics, https://bank.gov.ua/control/uk/publish/article?art_id=27843415&cat_id=44578#1
3. Source: Doing Business survey of the World Bank dated June 2015, http://www.doingbusiness.org/data/exploretopics/resolving-insolvency

▼ **Andriy Nikiforov** is a counsel at Kinstellar based in the firm's Kyiv office and the Head of the local Banking, Finance & Capital Markets as well as Restructuring & Insolvency practices. Mr. Nikiforov has broad experience in the areas of capital markets, finance, debt restructuring, financial regulation, derivatives as well as M&A. Andriy acted on some of the most visible transactions in the Ukrainian market, including establishment of the majority of Ukrainian MTN programmes and drawdowns thereunder, and the debt restructuring of Metinvest, the largest Ukrainian private business. He received a law degree with distinction from the Kyiv Taras Shevchenko National University and LL.M degree with honours in Corporate Finance and Securities from the University of California, Berkeley School of Law.

▼ **Serhiy Mykhaylyk** is an associate at Kinstellar based in the firm's Kyiv office. He received a law degree with distinction from the Kyiv Mohyla Academy National University and LL.M in Commercial Law from the University of Cambridge. Mr. Mykhaylyk's practice areas include finance, capital markets, debt restructuring and insolvency, M&A and financial regulation.