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The amended Ukrainian insolvency law: key issues

A number of significant amendments, to become effective on 19 January 2013, are being made to Ukraine's insolvency law (the "**Insolvency Law**"). The changes, which are likely to be subject to further amendment prior to becoming effective, are an attempt to create a more streamlined and efficient insolvency process and to remedy some of the real and perceived defects in the current law. In doing so the legislature has implemented some fairly significant changes to the Insolvency Law which will impact both debtors and creditors.

We set out below a summary of the most significant amendments to the Insolvency Law. Our note is divided into three parts, covering (a) some of the most significant amendments, (b) the changes to the insolvency process itself and (c) some of the other amendments which will come into effect.

Key issues

- New concept of hardening periods
- 'Piercing the corporate veil': liability of directors and shareholders
- Changes in the status of secured creditors
- Expedited insolvency restructuring
- Replacement of assets as a new restructuring method
- Insolvency of state and municipal entities

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Part A – the five most significant amendments

We set out below a summary of what we view as the five most significant amendments to the Insolvency Law.

New concept of hardening periods

Currently, due to deficiencies in the drafting of the law, there is in effect no actual period during which transactions entered into by a debtor prior to the commencement of insolvency can be set aside. The amended Insolvency Law remedies this and introduces a new procedure for determining which transactions made before the commencement of insolvency may be set aside.

Under the new rules, a court will be able, following an application from the insolvency manager or any creditor, to invalidate any transactions made by a debtor during the one-year period prior to the date of the commencement of insolvency proceedings, if such transaction resulted in the debtor:

- alienating assets, incurring undertakings or waiving proprietary claim(s) without consideration;

- performing obligations before they became due (this would not include an acceleration or mandatory prepayment of a loan but it would include a voluntary prepayment of a loan);
- entering into obligations as a result of which it became insolvent;
- alienating or acquiring assets not at their market value and as a result of which it became insolvent;
- making any cash payments or receiving payments in kind when the amount of creditors' claims exceeds the value of the debtor's assets (this would mean that repayments or payments under loans and suretyships would potentially be challengeable if the value of the debtor's assets is lower than the aggregate amount of the creditor's claims at the time the payment occurred); or
- granting security.

The amended law does not impose any additional criteria for the invalidation of such transactions. For example, it does not expressly require evidence that the transaction resulted in preferential treatment.

The result of such invalidation will be that the relevant creditor will need to release the security (if any) or return the assets it received from the debtor or compensate the debtor for the market value of such assets (should it be impossible to return them in kind) and, in the case of a loan, the debtor would need to repay the loan to the creditor. We note that if a loan agreement is invalidated on this ground, any Ukrainian law security and/or guarantees/sureties provided in connection with that loan would fall away.

The law does seek to address creditors' concerns in relation to these issues by determining that any creditors who have claims against a debtor as a result of the invalidation of their transaction will rank in the first rank of creditors irrespective of whether or not they had security. This would mean that even though a creditor's security had fallen away, such creditor would rank *pari passu* with other secured creditors.

However, the provisions are poorly drafted in the sense that they do not carve out preferential transactions. For example, if a shareholder has an unsecured loan to the debtor (which would normally qualify for the fourth rank of priority) and such loan is invalidated pursuant to the above provisions, then claims of such shareholders would be elevated to the first rank as well.

A further consequence of this provision is that if a creditor's security has fallen away, even though their claim will rank in the first priority, the law is unclear as to whether such creditor will continue to be treated as a "secured creditor". The most likely scenario is that they would not and as a consequence the creditor would lose its secured creditor status, including the right to block any rehabilitation plan or amicable settlement agreement.

'Piercing the corporate veil': Liability of directors and shareholders and persons with control

The amended law allows both shareholders and directors of the debtor to be liable in certain circumstances to creditors of the insolvent debtor. Accordingly, any director or shareholder of a debtor or any other person which has control over the business or corporate governance of that debtor can be liable in the debtor's bankruptcy if:

- the assets of the debtor are insufficient to satisfy the creditors' claims in full; and
- the actions of such director, shareholder or any other person resulted in the debtor's bankruptcy.

No guidance is given in the law as to what actions may give rise to such liability. Furthermore, the reference to "any other person" in the category of those who may be liable, arguably extends liability to those acting as "shadow directors".

Creditors will, therefore, need to be very careful that they cannot be deemed to have control over the business of a debtor to avoid being liable to other creditors.

Changes to the '30-day' rule

Currently, unsecured competitive claims must be submitted to the court within 30 days of each of the publication of the commencement of insolvency and the commencement of the liquidation phase of any insolvency, otherwise such claims are automatically discharged.

A positive development under the amended law is that a failure to submit a claim within the 30-day period will no longer result in the claim being discharged, but simply that its ranking will drop from the fourth rank (which is the rank applying to unsecured creditors) to the sixth rank (alongside all other claims not assigned a higher rank).

We note that there is an exception to these rules in where there is ongoing litigation in relation to a claim at the time that the debtor enters insolvency. In this case a court will suspend the litigation and the claimant will need to submit a claim within 30 days after the insolvency announcement is made. Failure to do so will result in the automatic discharge of such creditor's claim.

Secured creditors will be required to submit claims within the above periods in relation to the unsecured portions of their claims.

Changes in the status of secured creditors

The amended Insolvency Law introduces a number of new rules for secured creditors, including the following:

- Secured creditors, if they can obtain the consent of the insolvency court, will be able to enforce their security after the commencement of insolvency proceedings, irrespective of the moratorium contemplated in the law.
- Secured creditors (together with current and preferential creditors) will be explicitly prevented from voting at creditors' meetings.
- Under the amended law, in addition to the currently existing right to veto in respect of any amicable settlement agreement, secured creditors will have the right to veto any rehabilitation plan if it is prepared during the rehabilitation stage.
- Should any secured creditor not agree with a rehabilitation plan or amicable settlement agreement, the other secured creditors will now be able either to sell some of the collateral and satisfy the claim of such dissenting creditor or to buy their claim. The same options will exist for unsecured creditors if a secured creditor does not agree with a rehabilitation plan.

Set-off

Under Ukrainian civil law, a party to a transaction may set off, without the consent of the other party, any claims which are of the same type if both claims are outstanding.

The amendments to the Insolvency Law introduce two additional requirements applicable to set-off during insolvency, namely:

- the relevant creditor will need to consent to such set-off; and
- such set-off should not "breach the rights" of other creditors.

We note that there is no guidance on what "breach the rights" means and as such this may have an impact on netting arrangements in derivative transactions and banks setting-off or combining accounts in the insolvency of a debtor.

Part B – changes to the insolvency process

We set out below a summary of what we see to be the most significant amendments to the Insolvency Law relating to the insolvency process itself.

Commencement of insolvency: the insolvency test

In order to commence insolvency proceedings a number of criteria must first be met. One of these criteria is that the claim is "indisputable". Under the amended Insolvency Law, a claim will only be indisputable if it is confirmed by a court judgment and a creditor initiates enforcement proceedings on the basis of such judgment. The ability to prove that a claim is indisputable by having the debtor confirm the claim will no longer exist.

In view of this, a creditor will only be able to commence insolvency proceedings against a debtor if such creditor has a claim against the debtor which meets the following requirements:

- it is a monetary or tax-related claim;
- it does not consist of a penalty claim, a claim to reimburse injury to health or life, a claim to pay copyright remuneration or a claim by the debtor's shareholder;
- it is not fully secured by a pledge and/or mortgage;
- it is indisputable (see above);
- it remains unsatisfied for three months following the date of commencement of enforcement proceedings; and
- the value of the claim is greater than the equivalent of 300 minimum statutory monthly wages which as of the date of this briefing is equal to UAH 330,600 (approximately USD 41,360).

Commencement of insolvency: other issues

In relation to the commencement of insolvency, the amended Insolvency Law also provides that:

- a debtor may no longer revoke an insolvency petition which it submits against itself;
- insolvency proceedings may only be commenced against entrepreneurial entities and private entrepreneurs. This means that insolvency proceedings against non-profit entities, such as charitable funds, will no longer be possible; and
- the fast-track insolvency procedure for so-called missing debtors (i.e., when such debtor cannot be found at its registered address, or when it does not submit tax reports to the state tax authority, or when it terminated its business without deregistration in the companies' register) will be repealed and the procedure generally applicable to all entities will apply to these entities as well.

Expedited insolvency restructuring

The amendments to the Insolvency Law introduce a new procedure to allow for the expedited restructuring of a debtor. Such procedure will allow the debtor, with the approval of the majority of creditors by value, to reach an expedited restructuring under the authority of the insolvency court, in effect overriding any dissenting minority creditors.

The expedited process would work as follows:

- A debtor or a creditor, acting with the consent of the majority of creditors, can apply for this procedure if (i) both the debtor's shareholder(s) and those creditors controlling at least 50% of the debtor's indebtedness consent and (ii) a restructuring plan is pre-approved by both creditors controlling at least 50% of the entire indebtedness of the debtor and each secured creditor of the debtor.
- After such approval has been obtained the plan is submitted to the court for its approval.
- Upon the approval of such plan by the court (which should occur one month after its submission), a moratorium on satisfaction of creditors' claims will be imposed and the parties involved may immediately start carrying out the restructuring plan.
- The expedited restructuring procedure must be completed within 12 months and there is no ability to extend such period. During this period it will also not be possible for a court to commence any other restructuring proceedings against this debtor.
- A restructuring plan for the expedited insolvency procedure will be able to include a waterfall of claims which is different from the statutory rankings provided in the Insolvency Law.

Speeding up the process

The statutory time periods that certain phases within insolvency must take will be, in a number of cases, reduced. For example:

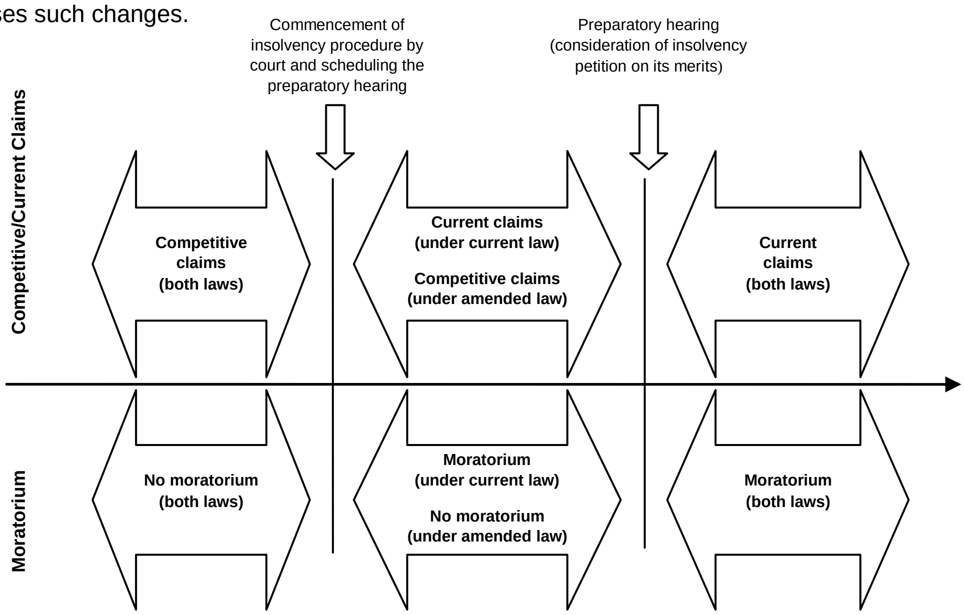
- the preparatory hearing (i.e., the hearing where the court first considers an insolvency petition on its merits and decides whether the insolvency petition can continue) will now need to be held no later than 14 calendar days (as opposed to the current 30 calendar-day period) after the judge commences the procedure;
- property administration (i.e., the initial phase of most insolvency proceedings) may last no longer than 115 days (as opposed to the current six-month period) with the possibility for the court to grant one extension for a further two months;
- rehabilitation (i.e., the phase after property administration if the company is not to be liquidated) may last no longer than six months with a possibility for the court to extend such period in exceptional circumstances for another 12 months (currently, the general term is 12 months with a possibility to extend for another six months); and
- liquidation (i.e., the phase after property administration if the company is not able to be rehabilitated and instead will be liquidated) will continue to last no longer than 12 months (as it is currently), however, with no possibility for the court to extend such period (currently, it is possible to extend such period for a further six months).

Changes to dates for determining creditors' status

Currently there is a distinction made between competitive creditors (i.e., creditors whose claims have become due and payable before the commencement of insolvency proceedings) and current creditors (i.e., those creditors whose claims become due and payable after the commencement of insolvency proceedings). Under the amended law this distinction will remain. However, the cut-off date for determining whether a creditor's claim is a competitive claim or a current claim will change. From 19 January 2013, unsecured creditors whose claims become due and payable before the date of the preparatory hearing (as opposed to the commencement of insolvency, which is normally several weeks earlier) will now be considered as competitive creditors. Other unsecured creditors will qualify as current creditors.

Moratorium

Currently, a moratorium on the satisfaction of creditors' claims arises from the moment that the court accepts the insolvency application by commencing insolvency proceedings and sets a date for the preparatory hearing. Under the amended law, this will change and the moratorium will only commence on and from the date of the preparatory hearing itself. The chart below summarises such changes.



The effect of this change will be to significantly limit the ability of debtors to instigate so-called "defensive insolvency proceedings" (where debtors initiate insolvency proceedings with "friendly" related parties to get the benefit of the moratorium and stop other people commencing proceedings and then withdrawing the proceedings before the preparatory hearing) as the benefit of the moratorium will only commence once the preparatory hearing occurs, after which it will be very difficult for the insolvency process to be halted.

A further amendment to the Insolvency Law provides that current claims fall outside of the moratorium. Therefore, a debtor will be able to satisfy its obligations to current creditors irrespective of the moratorium. Further, the law will expressly provide that the moratorium will not prevent a current creditor from enforcing its claim at any time. However, according to the amended law, enforcement against any non-monetary assets of the debtor initiated by the current creditor during insolvency will be possible only with the consent of the insolvency court.

The amendments to the Insolvency Law also expand the list of claims which will be outside of the scope of the moratorium. These include pension and social tax claims in addition to the existing list which includes salary claims, alimony claims, claims to reimburse injury to health and life and claims to pay copyright remuneration.

Register of creditors' claims

Under the amended law the insolvency manager will, for the purposes of compiling the register of creditors' claims, be the only person responsible for initial consideration of creditors' claims during insolvency. Currently this is done by the insolvency manager in consultation with the debtor. As before, the court will approve such claims.

Insolvency publications

From 19 January 2014, all official insolvency publications will be posted on the web-site of the High Commercial Court of Ukraine. Currently there is no official online publication. Official insolvency publications must, until 29 January 2014, still be published in certain specified forms of print media.

Creditors' meetings

The amended law introduces a quorum for creditors' meetings. For the first meeting, creditors which have two thirds of the total value of claims entitled to vote must be present and, for subsequent meetings, creditors which have half of the total value of claims must be present. Currently there are no quorum requirements and the only thing that makes a meeting valid is that all creditors are properly notified of the meeting.

Further, under the amended law, any creditor which holds 25% or more of the entire value of any competitive claims will automatically be included in the creditors' committee.

The maximum number of members of the creditors' committee will continue to be seven.

Rehabilitation phase

Currently, once a debtor enters the liquidation phase of its insolvency, it is not possible for the debtor to have its insolvency transferred to the rehabilitation phase. The amended Insolvency Law changes this and will permit a court to commence rehabilitation, even after the commencement of the liquidation phase, provided that a rehabilitation plan is prepared and the sale of the debtors' assets has not begun.

Under the amended law, if a property administrator believes that it is possible for a debtor to trade its way out of insolvency, he or she will be responsible for the preparation, together with the debtor, of a rehabilitation plan and to submit it to the creditors' meeting no later than two months following the date of the preparatory hearing. This changes the current law which provides that only the rehabilitation manager can prepare such plan. The effect of this is that the process for agreeing the method by which a company can trade its way out of insolvency may be significantly quicker.

As mentioned above, secured creditors will have the right to veto the rehabilitation plan. The amended law also contemplates certain mechanisms to overcome the veto of any dissenting secured creditors.

Debt-into-equity swaps and bonds issuances

Under the amended Insolvency Law, a debtor's share capital may be increased in accordance with a rehabilitation plan. In this case, the debtor's shareholders will have the right of first refusal for the purchase of such newly issued shares.

This will potentially allow debt-into-equity swaps during insolvency, although it is unclear if this would work in practice unless it forms part of the rehabilitation plan. Also, the National Securities Commission will need to adopt a specific procedure allowing exchange of shares for debt before this would be possible.

In addition, the new law will allow joint-stock companies to issue bonds during insolvency to either bring in additional money or to restructure existing indebtedness.

Liquidation

The amended law makes it clear that, during the liquidation phase:

- no new liabilities may arise in relation to the debtor (including tax liabilities), except for those which are closely connected to the liquidation procedure; and
- the conditions of any asset sale may not include any deferral of payments or payments by instalments.

Satisfaction of claims

The amendments to the Insolvency Law provide that:

- claims for fines and other payment sanctions (which may potentially include default interest) cannot be claimed or satisfied during insolvency proceedings, unless the insolvency proceedings were voluntarily commenced by the debtor. Currently, such claims are able to be satisfied but are not taken into account when calculating the number of votes of creditors at the creditors' meeting;
- any failure to satisfy a current claim by the debtor during the rehabilitation stage, if not cured, will allow the court to instigate liquidation procedures in respect of the debtor; and
- during the rehabilitation phase or liquidation phase, the debtor's shareholder(s) may satisfy the claims of all competitive creditors included in the register of creditors' claims in accordance with a specific procedure contemplated in the amended law, as a result of which the insolvency will be terminated.

Changes in the status of the insolvency manager

The amendments to the Insolvency Law introduce changes aimed at improving the professionalism of insolvency managers, increasing their liability for wrongful actions during insolvency and ensuring the independence of insolvency managers in the process. In particular:

- a completely new licensing procedure for insolvency managers and their activities will be introduced; and
- the person who brings an insolvency petition will no longer be able to influence the decision as to who the insolvency manager will be. Instead, the insolvency manager for the property administration stage will be chosen randomly by a computer database (and if such person refuses to act then the court will make the determination). The court will still appoint the insolvency manager to act during the rehabilitation or liquidation stages and we expect that, as is the case now, the court may be influenced by the views of the creditors' committee.

Rankings

In general, the statutory rankings in insolvency remain the same, namely:

- **Rank 1**: secured claims, salary claims and expenses incurred in connection with insolvency proceedings;
- **Rank 2**: other payments due to employees, pension and social insurance tax claims;
- **Rank 3:** other claims for taxes;
- **Rank 4:** unsecured creditors' claims;
- **Rank 5:** claims of employees to receive distribution from the share capital of the debtor; and
- **Rank 6:** other claims.

Part C – other amendments

We set out below a summary of some of the other changes which the amended Insolvency Law introduces.

Replacement of assets as a new restructuring method

The amended law introduces a procedure for the replacement of a debtor's assets as one of the rehabilitation options. In order to be able to implement the replacement of assets, the creditors must ensure that such arrangement is included in the rehabilitation plan which is approved by the court.

This would work by permitting a debtor, during the rehabilitation phase, to incorporate a subsidiary and become its sole shareholder. In return for the shares in such entity, the debtor will be able to contribute all its assets and liabilities (save for any liabilities to competitive creditors) to the share capital of such entity. Subsequently, these shares may be sold and the proceeds received from such sale used for the satisfaction of claims of any competitive creditors.

While this procedure may ease the process of realising proceeds from the sale of assets and satisfying creditors' claims, it is likely to require significant work to be carried out.

Insolvency of state and municipal entities

Currently there is a moratorium on enforcement against real estate and other key fixed assets of any entity in which the State of Ukraine has an interest of 25% or more. The amended law lifts this moratorium in respect of all state owned companies, unless a state-owned company is included within the list of entities which may not be privatised (as published by the government from time to time).

Under the amended law a new procedure will be introduced in relation to the insolvency of entities where the State of Ukraine owns more than 50% of the share capital. The key features of this procedure will be that the court will not be able to approve a rehabilitation plan or amicable settlement agreement, and the assets of the debtor may not be sold during any liquidation procedure, without the prior consent of the public authority which acts as the shareholder of such state entity.

Municipal authorities will no longer be able to decide whether insolvency procedures can or cannot be taken against their subsidiaries.

Changes in the concept of "interested parties"

The definition of "interested party" will be amended under the amended law. Currently it includes:

- subsidiaries of the debtor;
- directors of the debtor;
- accountants of the debtor; and
- close relatives of the above persons which include their children, parents, brothers, sisters and grandchildren.

Under the amended law the list will be expanded to include:

- any legal entity which controls the debtor;
- any legal entity which is controlled by a third party, if such third party controls the debtor;
- any shareholders of the debtor; and
- any other persons which may reasonably be considered as interested parties in relation to the debtor.

The insolvency law provides for a number of restrictions and limitations in relation to the status of an interested party. In particular:

- the debtor's transactions with interested parties during the rehabilitation phase will be subject to the prior approval of the creditors' committee;
- in any public sale of the debtor's assets, an interested party cannot be an auction organiser; and

- an interested party cannot act as an insolvency manager.

However, a debtor's agreement with another person may not be invalidated solely on the ground that such person qualifies as an interested party in relation to that debtor.

Directors

During the property administration phase, not only the creditors' committee (as it is currently) but also any creditor or other participant of the insolvency proceedings will be entitled to apply to the court for termination of the powers of the debtor's directors in the event that they are:

- breaching the law; or
- obstructing the insolvency manager from performing its powers and duties.

Once terminated, the court will temporarily grant to the insolvency manager the powers and authorities of the directors until new directors are appointed in accordance with the constitutional documents of the debtor (i.e., the shareholders of the insolvent company will need to appoint new directors).

Currencies

Under the amended law, if a creditor's claim is denominated in a currency other than UAH, then, for the purposes of the inclusion of such claim to the register of creditors' claims, it will be re-calculated in UAH based on the official exchange rate of the National Bank of Ukraine as of the date of submission of such creditor's claim to the court. Currently, the law is silent as to what the insolvency manager should do.

However, in amending the law, the legislature did not take the opportunity to clarify the issue of whether the satisfaction of a claim denominated in a foreign currency can be satisfied in that currency. The law on this point therefore remains unclear.

Insolvency of individual entrepreneurs

The amended law provides that if an individual entrepreneur is declared bankrupt and it is impossible to satisfy all creditors' claims in full during the insolvency, such individual will lose his or her entrepreneurial licence and, for a period of three years, will not be able to be registered as an entrepreneur, borrow money, purchase assets using borrowed funds or provide suretyships or security.

Detailed procedure for the sale of the debtor's assets during insolvency

The amended law introduces a detailed new procedure for the sale of a debtor's assets during insolvency. This procedure is aimed at bringing more transparency to the process and maximising the proceeds which the debtor may potentially receive out of such sale. The creditors will not be able to use their existing debt as consideration at any auction to buy the assets of the debtor given that payments will need to be made in cash.

Implementation of the UNCITRAL Model Law on Cross-Border Insolvency

The amended law implements the provisions of the 1997 UNCITRAL Model Law on Cross-Border Insolvency. Subject to the existence of a relevant treaty between Ukraine and an applicable country, this will, among other things, allow foreign insolvency practitioners to apply to Ukrainian courts for freezing orders and for the recognition of foreign insolvency proceedings in Ukraine. Additionally, Ukrainian courts will be obliged to cooperate with foreign insolvency courts and provide relevant legal assistance in relation to any foreign insolvency proceedings.

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