Debt Restructuring in Ukraine: Legal Perspective

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General

The current economic crisis has had a severe impact on the Ukrainian economy. Many local companies found themselves in financial troubles after they lost the possibility to refinance foreign debts accumulated over recent years. In 2009, a record number of Ukrainian borrowers defaulted on their debt obligations, and in the absence of appropriate treatment of defaults, such companies are likely to face bankruptcy proceedings. According to the available statistics, in 80% of such cases in Ukraine companies end up in liquidation.

Given that financial rehabilitation mechanisms provided for in Ukrainian bankruptcy laws have not proved to be efficient, out-of-court restructuring appears to be the only feasible option to recover solvency of generally viable businesses. Such advantages of out-of-court restructuring as the possibility to keep the process low profile and absence of any rigid procedures, timeframes or necessity to involve state authorities, may result in significant savings of cost and time for all parties and already made informal workouts the preferred model for dealing with distressed debt in many developed economies.

In many countries, including Ukraine, there is no legislative framework specifically governing out-of-court restructuring (while there is a concept of pre-court rehabilitation in the Ukrainian bankruptcy law, in practice it is hardly used). At the same time, there are a number of informal instruments such as the London Approach and INSOL Principles, which are often relied on by foreign creditors in the course of cross-border restructurings, including those in Ukraine.

The process of restructuring

In order for the restructuring to be successful it is important to identify the need for it in a timely manner. Ordinarily, the debtor is in the best position to know this, but our experience with Ukrainian borrowers shows that very few companies think proactively and most often they start negotiations with creditors only after their obligations become due and they cannot pay. Even the fact that the debtor is required to file for bankruptcy under Ukrainian law when it sees that discharge of its obligations to one or several creditors would preclude it from discharging its obligations to other creditors does not change the situation, as there is no sanction for failing to comply with this requirement.

At the same time, we have seen that major Ukrainian companies enjoyed the benefits of initiating a well-planned restructuring process: it gives better control over the timing and cost of restructuring, the possibility to carefully select all advisers involved and, most importantly, it inspires trust in the creditors who see the willingness of the debtor to meet obligations.

Unless the debtor has significant past experience of debt restructuring, staff with relevant training and excellent relationships with all creditors, it is important that the restructuring process is run by professional advisers. It is particularly important in restructurings involving foreign creditors, where the absence of professional advisers may be negatively perceived by the creditors and result in longer and tougher negotiations as it is advisers who should come up with some mutually acceptable solution. It always depends on the particular circumstances whether the company would need both financial and legal advisers, as we have been involved in workouts with mid-size borrowers where, in light of our specific experience in international finance, we acted as the only advisers and were holding all negotiations as well as working with the documents. At the same time, more complex restructuring would usually require participation of financial advisers who would analyze all data and assist with preparing a viable restructuring proposal.

As a rule, after the borrower has presented a restructuring proposal supported by the relevant financial data, the parties sit to negotiate and execute a standstill agreement which establishes a certain period of time during which the creditors agree not to exercise their remedies against the debtor, while the debtor undertakes to provide information to the creditors, refrain from certain actions which may adversely affect the rights of the creditors, and perform other obligations related to the restructuring process. Depending on the timing of execution of

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the standstill agreement, it may also contain the basic terms of the restructuring, and the parties have to complete negotiations on such terms by signing the restructuring agreement during the period provided in the standstill agreement.

Types of restructuring

The types and methods of restructuring may vary greatly depending on the particular case, but generally they can be arranged into the following groups:

— Modification of existing debt instruments

In our view this is the most straightforward and, therefore, the most commonly used restructuring method in Ukraine. In fact, many companies see the essence of restructuring in mere extension of maturity of their indebtedness. However, there have been a number of cases in the past two years where the borrowers did not thoroughly analyze the prospects of their business and failed to repay the debt on the new date. Therefore, this method may generally be used only when the borrower experiences a short-term lack of liquidity, but its business has not been adversely affected and continues to generate profits. In more complex cases, the parties should consider modifying other terms as well, including the interest rate, amortization schedule, financial covenants, etc.

— Consolidation of debt instruments

This method is often used where the amount of indebtedness is high and it exists in various forms and with various creditors (e.g. bilateral and syndicated loans, Eurobond issues, trade credit). The transformation of various instruments into a new one providing for the same terms for all creditors allows the borrower to better plan cash flows required for servicing of the debt and reduce relevant costs. We have seen this approach used by large Ukrainian borrowers, including Naftogas and AlfaBank, each of which restructured its external debt in the amount of over USD 1 billion into a single issue of Eurobonds.

— Complex restructuring of debt and business

Unlike the methods described above, this one should be used when there are fundamental problems with the business of the borrower, and it is necessary to divest some assets in order to reduce debt and reshape the business so that it can service the remaining debt. In addition, this method often provides for a change of control (full or partial) over the borrower. Unfortunately, we have not seen successful examples of this type of restructuring in Ukraine. The restructuring of the USD 175 million Eurobond issue by XXI Century, a leading real estate developer, which provided for the partial exchange of notes for warrants, did not include many other required elements and, as a result, did not dramatically improve the condition of the borrower.

We note that each of the methods described may be used in combination and/or supplemented with additional security or financing. Creditors usually analyze the feasibility of the restructuring independently and may offer their own plan, which better protects their interests or increases the chances of recovery.

Cross-border restructuring

Given that all major restructurings in Ukraine so far have had a cross-border element, it would be appropriate to highlight certain issues which have to be taken into account in that regard. Such issues mostly relate to the fact that foreign-law debt instruments have to be reconciled with Ukrainian laws, including strict currency control rules.

In particular, the National Bank of Ukraine (NBU) plays an important role in any cross-border restructuring because current NBU rules, including those on registration of loan agreements, were not designed to cover debt restructuring situations, and application of certain structures often requires the involvement of the NBU. In addition, the parties should take into account the maximum interest rates re-established by the NBU at the end of 2009, which adversely affects the prospects of restructurings providing for an increase in the interest rate. On top of that, the Ukrainian Parliament has adopted the *Anti-Crisis Act* which came into effect at the end of 2009 and introduced a number of restrictions, including a ban on prepayment of cross-border loans until 1 January 2011.

Apart from having the rules which preclude restructurings, Ukrainian legislation also lacks some rules which are required for certain types of restructuring to take place. In particular, Ukrainian legislation does not provide for a clear mechanism of debt-to-equity swap, and that situation had to be addressed by *ad hoc* decisions adopted by the NBU in the case of Kreditprombank's restructuring. In most of the cases providing for transfer of control to creditors, they would also need to receive various forms of approval from Ukrainian state authorities (e.g. Antimonopoly Committee and/or NBU).

Conclusion

Although there has been some progress in understanding the benefits of out-of-court debt restructuring among Ukrainian companies, the lack of experience in this field and absence of a set framework makes it quite difficult. At the same time, we hope that first successful cases of debt restructuring in Ukraine, as well as problems identified, would set the ground for the future and result in the creation of appropriate practices and rules.

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