EXPERT OPINION

Financial Restructuring

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The dramatic economic situation in Ukraine has put many firms into financial trouble. During times of such hardship, bankruptcy and insolvency law faces a special test. The well-known goals of insolvency law are to help viable businesses survive and facilitate the removal from the market of those that are not viable. Unfortunately, the assessment provided in the 2016 Doing Business report is that the goal of saving a viable business is unlikely to be achieved in Ukraine. Although the *On Restoring the Solvency of a Debtor or Recognising it Bankrupt Act of Ukraine* (Ukrainian generally applicable *Bankruptcy Act*) was restated with effect from 2013, Ukraine is still ranked 141 out of 189 economies in the Resolving Insolvency indicator of the report. It seems further reform is necessary to rise to the challenges of this difficult time.

The Ukrainian Government appears to share this view. In late November 2015, they submitted to the Verkhovna Rada (Ukrainian Parliament) a Draft Act *On Financial Restructuring*, which purports to amend, among other things, the *Bankruptcy Act*. The *Financial Restructuring Act* (sometimes also referred to as the Draft Act below in this article) is sponsored by the World Bank and the European Bank for Reconstruction and Development, and was developed with the participation of the Ukrainian law firm Sayenko Kharenko.

If adopted, the *Financial Restructuring Act* would introduce efficient mechanisms of restructuring the existing exposures of domestic and foreign lenders towards Ukrainian borrowers, which would operate both in and out of court. The Draft Act would be a temporary measure, and is proposed to remain effective for 3 years. During this period, participants in restructurings would enjoy special tax incentives to encourage their use of the proposed mechanisms.

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Below we briefly review the proposed framework and various options available.

Eligibility and participants

The *Financial Restructuring Act* would have a limited scope of application and would specifically target the large volume of bad loans accumulated by the financial sector. Eligible borrowers would be those that meet all of the following requirements:

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— they have a loan from a domestic or foreign bank or another financial institution;

— they cannot make payments under such loan(s) or would not be able to when such payments fall due; and

— their business is potentially viable, which should be agreed by the creditors participating in the restructuring and confirmed by an audit.

State-owned and municipal-owned entities would also be eligible, other than special state enterprises that operate in industries where competition is limited by the state (so-called *kazenni pidpryiemstva*). Several debtors would be able to participate in restructuring as a group. Individuals and financial institutions would not be eligible.

Any of the borrower's creditors would be able to participate in a restructuring as long as at least one of them is a bank, another credit institution, or a leasing or factoring company. Both Ukrainian and foreign creditors, as well as the state fiscal authorities, would be able to join a restructuring. However, specific creditors participating in a restructuring would be determined by the borrower's management. The borrower's related entities would be able to participate in a restructuring but would not be able to vote on the matters requiring approval from creditors.

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Another element of the proposed regime is a Framework Agreement among financial institutions that would be willing to cooperate on restructuring the debts of their clients. Restructuring projects among the creditors that are party to the Framework Agreement would be subject to special voting rules that are further explained below. Accession to the Framework Agreement would be voluntary, and only state-owned banks and the Deposit Guarantee Fund (which would participate in restructurings on behalf of failed banks) would have to execute it.

The new restructuring regime would be administered by a Supervisory Council composed of the representatives of the National Bank (Ukraine's Central Bank), Ministry of Finance, Ministry of Economic Development and Trade and Ministry of Justice, as well as a Secretariat to support the Council's activities.

Features and options available

The main procedure proposed by the Draft Act is voluntary financial restructuring — an out-of-court procedure initiated by the borrower's management. The borrower would have to file an application with the Secretariat, where it would identify the creditors that it believes would be willing to restructure their existing exposure. To make sure that the restructuring is at least remotely realistic, the application should be supported by 3 creditors that are party to the Framework Agreement, or by creditors holding at least 25% of the borrower's financial debt. If the documents meet the requirements of the law, the Secretariat would approve the project and notify the creditors identified in the application.

Generally, the proposed procedure would be highly customisable by the management, who would be able to select liabilities that they would like to restructure and decide on whether a court should be involved. By allowing the management to remain at the helm and negotiate with the creditors and refusing to penalise the management, the Ukrainian law would adopt one of the best practices of modern pragmatic bankruptcy regimes.

The assumption is that the management would only designate significant creditors to participate in the procedure, and would not involve trade or smaller creditors that could be paid in the usual course of business. The specific selection of creditors would ultimately hinge on the management's estimate of the likelihood of approval of the restructuring plan. In particular, the following options would be available to the management under the Draft Act:

— approval of the restructuring by 100% of designated creditors; or

— if all the designated creditors are party to the Framework Agreement, approval of the restructuring by 75% of their votes; or

— if the restructuring is approved by more than 50% but less than 75% of votes of the designated creditors that are party to the Framework Agreement, ratification of the restructuring by a sole arbitrator; or

— prepackaged financial rehabilitation, which is described in the next section.

If a restructuring is approved by less than 100% of votes, the decision would, nevertheless, be binding on dissenting creditors. The Draft Act, therefore, ensures that a small number of holdout creditors (holding 25% or less of the liabilities) could not jeopardise the rehabilitation of a company that is supported by the majority of its creditors. If holdout creditors are not party to the Framework Agreement, the management could either remove such

creditors from the restructuring plan or switch to a prepackaged rehabilitation.

Unlike the existing court-administered proceedings governed by the *Bankruptcy Act*, the *Financial Restructuring Act* would allow the borrower and its creditors to customise other elements of their arrangement, including on an individual basis. For example:

— although the Draft Act provides for a moratorium on payments to the designated creditors during 120 days from the commencement of a procedure, the creditors would be able to waive it — such an option is not available under the existing *Bankruptcy Act*;

— if the moratorium is waived, the borrower and any number of the designated creditors would, nevertheless, be able to agree to a standstill, which may be subject to a number of conditions and undertakings, such as a prohibition on disposals — currently the law does not prohibit conclusion of such arrangements but neither does it specifically address them;

— a restructuring plan may contemplate a number of solutions, including additional funding and security to be provided by the borrower, in which case such security would not be subject to the generally applicable hardening period — while the existing *Bankruptcy Act* does not have any carve-outs from the hardening period for the new money;

— after the plan is approved, the borrower and any participating creditor would still be able to modify the arrangements between them as long as the creditor does not receive better terms compared to what was initially agreed — at the same time, under the existing *Bankruptcy Act* any change in a financial rehabilitation plan must be approved by a court.

The resulting procedure would be much more flexible compared to the regime of the *Bankruptcy Act*, which is expected to improve the chances of viable businesses reaching an agreement with their creditors. Ultimately, it is a "win-win" situation for all the stakeholders, including creditors, borrower's management, its employees and state fiscal authorities.

The Financial Restructuring Act is expected to become a widely used instrument for turning around viable Ukrainian businesses

Prepackaged rehabilitation plan

In addition to the new voluntary restructuring regime, the Draft Act purports to modify one of the existing procedures provided for by the *Bankruptcy Act*. In particular, the management may apply to a court on behalf of a borrower with a draft plan of financial rehabilitation. Prior to application, the plan would have to be approved by creditors holding 75% of secured claims and more than 50% of unsecured claims that are subject to the plan. The *Bankruptcy Act* currently provides that a prepackaged rehabilitation plan should be approved by the creditors holding 100% of all secured claims and more than 50% of all unsecured claims.

Similarly to the financial restructuring regime, the borrower would be able to designate creditors for purposes of the prepackaged rehabilitation procedure. In particular, it should not include in the plan the liabilities that it intends to pay as originally scheduled. However, the prepackaged rehabilitation procedure would not be subject to the eligibility requirements established by the Draft Act (unless the borrower switches to it from the out-of-court financial restructuring procedure), in particular, that at least one of the participating creditors should be a financial institution. In other words, any debts may be restructured through the prepackaged rehabilitation procedure.

It is expected that this procedure would be used by borrowers (i) whose creditors are not financial institutions and/or party to the Framework Agreement, and (ii) that do not expect unanimous approval of the plan. Therefore, it is possible that the financial restructuring provided for by the Draft Act would turn into a prepackaged rehabilitation procedure under the *Bankruptcy Act* if the borrower realises that it cannot secure the necessary vote. In such case, the proceedings would be brought before the commercial court of appeals in Kiev, bypassing local commercial courts that would normally be considering prepackaged rehabilitation plans.

Further steps

The Draft Act has not passed its first reading yet, but given the interest of international financial institutions and the Ukrainian state authorities, it is expected to move through Parliament relatively quickly. There will likely be changes in the final text, but the main approaches should remain the same.

Although, as with other pieces of legislation, there is concern that certain borrowers might try to manipulate the procedure to the detriment of some of their creditors, the Draft Act provides for various mechanisms to protect creditors' rights. These include strict sanctions applicable to the participants of a restructuring, restrictions on voting by the borrower's related parties, extensive disclosure requirements applicable to the borrower, possibility for the majority creditors to opt out of the moratorium, confirmation of the viability of the borrower's business by an independent expert, protections given to existing secured creditors, as well as the rule prohibiting the borrower from initiating new restructurings within one year from the date of commencement of the previous restructuring project.

Following adoption, the *Financial Restructuring Act* is expected to become a widely used instrument for turning around viable Ukrainian businesses. Allowing management more control over what is essentially a quasi-bankruptcy procedure should ensure that companies enter the procedure at an earlier stage, before the debts snowball and make rehabilitation impossible. Full customisation should help to take into account the interests of all participating creditors and facilitate agreement among them. The end result should be the improved efficiency of the Ukrainian insolvency law and higher creditor recovery rates.

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