Breakthrough in Ukraine - a Successful Bankruptcy Law in a Post-Socialist Country

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January 1, 2001 marked the first anniversary of an important and progressive new law in Ukraine: "The Law on Restoring the Solvency of the Debtor or Declaring It Bankrupt." Enacted in June 1999, and signed into law six weeks later by President Kuchma, this powerful and flexible legal instrument became effective at the beginning of the calendar year, offering thousands of heavily indebted industrial enterprises an alternative to outright liquidation. In the first year of the new law, more than 20 industrial firms have commenced, with the consent of their creditors, restructuring cases in commercial court, have converted liquidation cases filed by their creditors under Ukraine's old (1992) bankruptcy law to restructuring cases, or have reached amicable settlements with their creditors, establishing a workable schedule of debt forgiveness and repayment. As information about the opportunities available under the new law spreads around the industrial, financial, and legal community, we can safely predict that hundreds of new cases will be filed.

The Ukrainian bankruptcy law draws heavily on the U.S. Bankruptcy Law, but also contains special provisions that adapt it to the realities of Ukrainian politics, culture, and legal system. Under Article 53 of the Ukrainian law, as in Chapter 11 of the U.S. law, debtor enterprise management can petition to reorganize and retain control of the enterprise.

The Ukrainian law, during its brief existence to date, has been far more effective than its post-Soviet contemporaries, with the possible exception of the Russian law, under which a number of amicable settlements have been reached since its enactment in 1998.

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A Haunting Scene in the Industrial Heartland of Southeastern Ukraine – Economic Crisis in the Industrial Sectors

You pass through the iron gate and drive through a tree-lined prospect into an industrial park with factories, machinery, rows of workshops, a garage, an imposing administrative building, medical facilities, kindergartens, a recreation center, dining halls, residential housing, and all the components and amenities of a complete factory town, except that the buildings are dilapidated, freezing cold, and eerily empty, as in a second-rate science fiction movie. All physical infrastructure is in place for production–nothing, however, is being produced. There are almost no people.

The enterprise described above represents an extreme example of the paralysis that has overtaken entire industries in Ukraine, including textile mills, manufacturers of heavy producer goods such as agricultural and construction machinery, and producers of electronic components. Some factories are completely shut down, others operating at five or ten percent of capacity. As bank accounts of heavily indebted enterprises are "frozen" by the state for arrears in tax and pension system payments, transactions are typically all or mostly in barter, with no cash available to pay wages, debt service, or trade payables. Some manufacturers of consumer goods are equally distressed, although certain manufacturers of fast moving consumer goods, such as processed foods, have been able to find cash customers and operate more or less normally.

The current situation began to unfold in the early 1990's, when breakup of the Soviet Union severed trade relations, causing industrial enterprises to lose both customers and suppliers. Conditions worsened in the mid-1990's when the government, under budget pressure, eliminated direct subsidies to the enterprises as well as subsidies for their major inputs, such as energy. By this time, most industrial enterprises were accruing economic losses, although under Soviet tax accounting rules, many of the loss makers were still "profitable" and incurring profits tax liability. Eleven consecutive years of economic decline in Ukraine, through mid-1999, combined with poor enforcement of the rights of shareholders and creditors, shut off the flow of new investment into the industrial sector. Banks, faced with massive loan defaults, stopped making industrial loans.

This story is no doubt familiar to the reader. The same scenario, with some variations, has occurred throughout the former Soviet Union. In very depressed economic environments, it is still possible to revive individual enterprises and begin generating operating profits using a combination of restructuring measures (*e.g.*, cost reduction, product portfolio adjustment, strengthening of marketing and sales functions, etc.) The necessary pre-conditions include at least the following: a good product, a good market for that product, and progressive enterprise management. Even in the presence of these conditions, however, restoration of solvency and financial health of an enterprise will not be achieved if debt service require-

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ments exceed operating profits, causing continuing negative cash flow. Tax penalties for late payment will generate new losses and exacerbate the cash flow problem. The enterprise management, constantly short of cash, will be forced to make second-best decisions. Heavy debt burdens will discourage potential investors and lenders. Without new investment, aging production equipment will fail or become obsolete, and the enterprise will eventually lose its entire market share to domestic or, more often, foreign competitors.

Before the new bankruptcy law was enacted, it was virtually impossible for a Ukrainian enterprise to reach a global debt settlement with its creditors and avoid liquidation. As a result, heavily indebted but potentially viable enterprises continued to deteriorate with little or no hope of recovery.

As part of the initial privatization process, Ukraine, like most of the other post-Soviet republics, enacted a basic bankruptcy law facilitating the liquidation of insolvent enterprises. In healthy economies, liquidation of insolvent enterprises serves to redeploy idle and under-used assets into more productive uses, as well as to provide at least partial compensation to creditors while there is still some residual value left. In such moribund economies as Ukraine's during the 1990's, liquidation must contend with the failure of markets for used assets, *i.e.*, plants and machinery, which exist in abundance. The 1992 law was used primarily by the tax authority for "housekeeping," to rid the tax rolls of completely defunct enterprises, most of which had already been stripped of all assets. The law did not provide any useful mechanism to revive the industrial sector and put people back to work. Instead, the government addressed this problem by creating a government agency charged with restructuring enterprises. Needless to say, this agency failed in its mission, as did its counterparts elsewhere in the Region.

In 1997, an initial attempt failed to enact a new law that would facilitate restructuring enterprises by commercial entities. The law was opposed by the Communist Party, then dominant in the Rada (legislature), largely because it was viewed primarily as a law that would only make liquidation procedures more efficient. In 1998, proponents of the law worked with the Communist Party to create a new law that would allow enterprises to be restructured as going concerns. Although liquidation procedures were also improved and the rights of creditors strengthened, the Communist faction in the legislature actually sponsored the law because of its potential to restore employment in the industrial sectors.

Major Features of the Ukraine Law on Restoring Solvency

The bankruptcy law defines a set of "sanation" procedures that govern the financial restructuring of a debtor enterprise as a going concern. Under Article 53, with the consent of a majority of its creditors, the debtor enterprise itself takes the initial step by submitting a restructuring petition. After claims are filed and the court approves the claims register, creditors with approved claims meet and elect a committee on the basis of debt-weighted voting. The debtor enterprise nominates a

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"Sanation Manager," who must be approved by the creditors' committee and the Court, and then assumes responsibility for the day-to-day operation of the enterprise, under the supervision of a Trustee, who is nominated by the creditors' committee and approved by the Court. The Sanation Manager is required to prepare and submit a sanation plan, which must be approved by the creditors' committee and the Court. At any time during the proceedings, an amicable settlement agreement can be negotiated with the creditors' committee. The agreement includes a debt repayment schedule and, once approved by a majority of creditors, is binding on each and every creditor, whether or not the individual creditor voted for the sanation plan or the agreement.

The presence of a trustee, representing the interests of the creditors, in a debtor-managed restructuring provides a mechanism of control to the creditors' committee that is usually absent, for example, in Chapter 11 of the U.S. Bankruptcy Code. The Ukrainian law is thus more balanced between creditors and debtors than Chapter 11, which is generally considered by insolvency experts in this respect to be rather lenient on debtors.

The most important features of the new law that provide financial benefit to the debtor enterprise are discussed below. In the successful restructuring cases we have seen to date under this law, all except the last two of these provisions have constituted significant sources of "internal capital generation," making it possible, in combination with various operational restructuring measures, to convert from negative to positive cash flow in a relatively short period of time.

1. *Moratorium (Article 12.2–12.5).* Introduced upon acceptance by the Court of the debtor's petition, the moratorium prohibits the debtor enterprise from paying any pre-petition creditors, including the tax and pension authorities and secured claims (except wages, alimony and child support, claims for injury to life or health, and royalties), and conversely prohibits creditors from taking any measures to secure payment. The moratorium remains in force for 12 months, plus an additional six months at the discretion of the Court. Imposition of new fines and penalties (*e.g.*, for late tax and pension payments) is also suspended during the moratorium. The amount of the debt is fixed as of the moment of filing, and penalties are suspended for the duration of the sanation.
2. *Elimination of Claims Not Filed Before the Deadline.* After acceptance of the petition, notice of insolvency proceedings must be published, after which claims must be filed by creditors within a specified time period. Claims that are not filed on time (Article 31.5), or that are successfully contested by the debtor (Article 14.5) are eliminated.
3. *Automatic Tax Forgiveness (Article 36.2).* Under the Amicable Settlement provisions of the law, debtor enterprises concluding such an agreement, by majority vote of the creditors' committee, receive automatic forgiveness of all tax and pension debts (including interest and penalties) that are more than two years old, and the opportunity to pay the remaining tax and pension debt over a six year period, providing that the enterprise remains current on new tax obligations. This provision is loosely based on U.S. bankruptcy law.

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4. *Debt Forgiveness by Commercial Creditors.* Commercial creditors may forgive debt or agree to a deferred repayment schedule (Article 18.2.4). Under Ukrainian tax law, the amount of forgiven debt will be deductible to the creditor, and unfortunately, taxable to the debtor. (Under the U.S. law the forgiven debt is deductible to the creditor, but is not taxable to the debtor.)
5. *Transfer of Social Assets (Article 18.2.12).* Worker housing, kindergartens, and other facilities inherited by enterprises from Soviet times, all of which represent sources of financial loss to enterprises, may be transferred to local governments quickly and without cost to the enterprise as part of a Court-approved sanation plan.
6. *Debt to Equity Swaps (Articles 18.2.12: 37.4).* Under a consensual, Court-approved plan, the enterprise may issue additional stock to convey to creditors in satisfaction of debts.
7. *Rejection of Contracts (Article 17.10).* Although not much used yet, the new law includes a provision allowing a sanation manager within 3 months of sanation to reject economically burdensome contracts that have not been fully performed. As under the comparable provision of the U.S. Bankruptcy Code, the other party to the rejected contract may file an unsecured claim for damages.
8. *Preferences and Fraudulent Transfers.* Also as yet untested under the law, voidable preferences and fraudulent transfers represent an additional potential source of internal capital generation. The sanation manager may pursue payments made to unsecured creditors at the expense of the remaining pool of creditors within 6 months of filing or conveyances to "insiders" (defined by Article 1) for less than equivalent value. These provisions, modeled on U.S. law, not only forestall the dismemberment of the debtor as it slides into bankruptcy, ensure equality of distribution, and combat corruption, but also can provide sources of funding for the debtor.

We are not aware of any other law in the Region that contains this potent combination of tools for sanation. Most of the laws we have reviewed contain provisions for a moratorium and a claims register similar to the Ukrainian law. We did not, however, find any other law in the Region containing automatic tax forgiveness or voidable preferences. Some laws (*e.g.*, the Croatian law) do not bind dissenting creditors to the plan or agreement.

Successful Restructuring of Enterprises During the First Year of the New Law – Different Routes to Restoration of Solvency

Effective bankruptcy laws are characterized by a high degree of flexibility. No two insolvency cases are exactly like, and different circumstances require different solutions. The diverse paths that the enterprise restructuring cases have followed under the new law in Ukraine demonstrate its flexibility. To date, we have seen five major variants, each of which we illustrate below with a case example. We also discuss a sixth variation that is allowed under the law but as yet untested.

1. *Article 53 plans.* The standard route under the new law begins with submission of a petition with the support of a majority of creditors, proceeds through submission

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and approval of a sanation plan by the creditors and the Arbitration Court, and concludes with a negotiated amicable settlement. The first case successfully completed under the new law, involving a furniture factory in Western Ukraine, proceeded along this path, requiring less than 6 months from the filing of the petition to conclusion of the amicable settlement. An export customer agreed to provide needed investment for retooling upon approval of a plan including some debt reduction and rescheduling of the remaining debt. Creditors agreed to a two-year grace period without any debt repayment. The portion of the debt that was not forgiven is to be paid in equal quarterly installments over the next four years.

2. *"Pre-packaged" Article 53 plans.* A significant variation on the foregoing involves not only an agreement to the sanation plan, but also an agreement in principle to an amicable settlement even before the petition is filed with the Court. The amicable settlement, however, cannot actually be approved until the claims register is established, a prerequisite to constituting the creditors' committee. A meat factory from Eastern Ukraine followed this path, taking about eight months from commencement under Article 53 to the conclusion of an amicable settlement. The cornerstone of this amicable settlement was a conversion of all the factory's commercial debt to equity with no future cash payments. Commercial creditors accounted for 93% of the debt. The official debt-for-equity swap was hitherto unprecedented in bankruptcy in Ukraine.
3. *Sanation.* The new law also contemplates cases under Article 53 or otherwise where a sanation plan is negotiated with the committee and approved by the Court, but no amicable settlement is reached. In those cases where an enterprise can be operationally restructured, taking advantage of the moratorium and the reduction of the creditor pool confirmed in the claims register only, such sanation without an amicable settlement may be enough to turn the debtor around. We assisted a bakery in Southeastern Ukraine whose cash flow would support its existing debt service requirements under these circumstances.
4. *Creditor-filed case concluded with amicable settlement.* A case originally initiated to liquidate the debtor can with the consent of the creditors' committee change course and conclude in an amicable settlement. Such a case involving a sugar mill in Western Ukraine, initially brought by a minor creditor under the old bankruptcy law, was converted in March 2000. After conversion, the case proceeded along customary lines, with the moratorium, a redetermination of the creditors' claims register, and the formation of a creditors' committee. The ability under the new law to make important decisions and bind dissenting creditors with a simple majority of creditors (50% +)—a substantial difference from the old Law—enabled the case to reach a successful conclusion ten months later in an amicable settlement. In this case, the creditors forgave 90 percent of the debt.
5. *Case filed by a friendly creditor.* In some situations, it is virtually impossible to use Article 53, although the management of the enterprise would like to conduct a restructuring. For example, the shareholders cannot be mobilized to file a petition. This situation sometimes occurs when the state owns a majority of the shares of the enterprise. Similarly, if a majority of the debt is held by the state, it can be difficult to obtain consent of a majority of the creditors to file a petition (especially if it is non-tax debt, such as a loan). Article 53 can be circumvented by persuading

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a friendly creditor to file a petition against the enterprise. The creditors' committee can then vote for sanation (rather than liquidation) and approve the debtor enterprise's current manager as sanation manager. Because the procedure ostensibly continues to be creditor-filed, it is not necessary to appoint a trustee. A textile mill in Southeastern Ukraine, owned mostly by the state, followed this path. The friendly creditor who filed at the request of the enterprise management was the pension fund.

6. *Conversion of creditor-filed to debtor-led case.* Pursuant to Article 53.8, the law allows for cases that were initially brought by a creditor to be converted to a debtor-led case with the approval of the creditors' committee. To our knowledge, no such cases have occurred to date.

We anticipate that, as use of the law develops further and the various provisions of the law are tested, additional variations will arise. A set of amendments that should improve the efficiency of the law is now awaiting debate in the Parliamentary session that begins in the winter/spring session of the Parliament. The bankruptcy law has now become a cornerstone of the commercial law system in Ukraine, and will undoubtedly assist in Ukraine's transition to a vibrant and successful free market economy.

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