



LEGISLATION MONITORING: BANKRUPTCY

December 29, 2010

News Flash

On December 23, 2010, the Draft Law “On Improvement of Current Bankruptcy Procedure” (hereinafter referred to as “**Draft # 7329**”) passed the first reading in the Verkhovna Rada. Draft # 7329 was prepared by the working group set up under the Ministry of Economy to improve bankruptcy legislation.

Also, on October 25, 2010, the Draft Law of Ukraine “On Restoring Solvency or Declaring Debtor Bankrupt” (hereinafter referred to as “**New Bankruptcy Law**”) was posted for public discussion on the Ministry of Economy web-site. The Draft Law was elaborated to replace the current version of the same law (hereinafter referred to as “**Current Bankruptcy Law**”). The draft has not been registered with the Verkhovna Rada yet.

Therefore, as for now two laws have been elaborated under the Ministry of Economy: New Bankruptcy Law is supposed to replace Current Bankruptcy Law completely, whereas Draft # 7329 is aimed at improvement of only certain provisions of the Current Bankruptcy Law.

Draft # 7329 seems to be a quick tool aimed at bringing Ukrainian bankruptcy legislation into compliance with IMF requirements to expedite insolvency proceedings and to facilitate out-of-court settlement. However, analysis of the Draft # 7329 shows that the lawmakers concentrated on resolving of the first problem mostly, and failed to enhance possibilities of out-of-court settlement.

New Bankruptcy Law was publicly presented by Deputy Head of State Department on Bankruptcy Mr. Olexander Zavadiak on November 11, 2010 at AmCham’s Legal Committee meeting. According to Mr. Zavadiak, they are now considering any suggestions to the New Bankruptcy Law, including those from WB, deputies, arbitral managers etc. By December 29, 2010 it is planned to have this Draft registered with the Verkhovna Rada. However, the work on the Draft will not be completed this year and it is planned to consider a lot of important issues in 2011.

Presented below is a brief overview of these two pieces of legislation. One can go back to the history and process of bankruptcy legislation improvement in Ukraine by referring to the corresponding chapter of this memo.

Brief Overview of Recent Developments

Draft # 7329 repeats majority of provisions of the earlier Draft # 5281 elaborated by a working group under the MoE comprising Investors Council, Commercial Law Center, AmCham, EBA, Clifford Chance law firm and Baker&McKenzie law firm. Draft # 5281 was registered with the Verkhovna Rada on January 21, 2010 and was recommended to be adopted in the first reading. However, it was withdrawn from the Verkhovna Rada on March 11, 2010 due to the change of government (*for more information see History and Process*). Now it has been resubmitted by a new government and renumbered from # 5281 to # 7329.

As previously, Draft # 7329 is aimed at:

- Shortening duration of bankruptcy procedures by establishing clear timeframes for the court’s and all the parties’ actions, as well as for appealing court decisions;
- Improvement of procedure for informing the creditors of the bankruptcy proceeding initiation (via Internet, on the State Department on Bankruptcy web-site);
- Improvement of rehabilitation procedures (prohibition to enter rehabilitation stage if there is no rehabilitation plan approved);
- Improvement of debt collection by way of optimization of creditors' claims register maintenance, putting a requirement that once the bankruptcy proceeding has started, all creditors must file their claims only in bankruptcy proceeding and may not initiate foreclosure under Judicial Enforcement Law etc.

In addition, the Draft # 7329 contains certain measures to prevent fraudulent bankruptcy in cases when liquidation is initiated by the company’s owner or rehabilitation is initiated by the company’s chief of party. The court has to oblige the above persons to provide the court with an audit conclusion confirming the amount of indebtedness of the company. This might not be enough to prevent fraudulent bankruptcy but it is a positive step forward.

Draft # 7329 also contains certain provisions to enhance the state's control over the process of bankruptcy of enterprises in which the state owns 25% or more (hereinafter referred to as "state-owned enterprise"). In fact, a separate Draft Law # 6612 devoted to state's control over state enterprises' bankruptcy has already passed the first reading in the Verkhovna Rada (*for more information see History and Process, October 19, 2010*). Since the Draft # 7329 repeats some of the Draft # 6612, it seems that the Cabinet of Ministers incorporates similar norms into different pieces of legislation to make sure they will be adopted in either case. In particular, Draft # 7329 requires that:

- State Department on Bankruptcy has to be involved when inspecting a state-owned enterprise in bankruptcy proceeding;
- rehabilitation plan and any amendments hereto of a state-owned enterprise have to be approved with State Department on Bankruptcy, State Property Fund and a state body managing state property before it is submitted to the court;
- report of a rehabilitation manager approved by the creditors committee has to be submitted to the State Department on Bankruptcy and a state body managing state property.

To the extent described, suggested amendments with respect to state-owned enterprise are not so bad unless state agencies abuse their rights. Of greater concern is a provision that a State Department of Bankruptcy shall establish the procedure for preparation of rehabilitation plans regardless of ownership of the enterprise. This might cause deviation from procedures envisaged by the law and intrusion into activities of privately owned enterprises.

In general, Draft # 7329 is an ad-hoc response to the most burning problems in bankruptcy proceedings. The draft fills in many legislative gaps and is a positive step forward. However, the draft is not sufficient to bring regulation of bankruptcy proceedings to its higher level. For instance, the draft law does not regulate out-of-court settlements, as required by IMF, nor does it provide for new restructuring mechanisms. The draft law also does not address the issue of protection of secured creditors (including creditors whose claims are secured with pledge). The draft does not prevent natural persons-entrepreneurs from including their liabilities that are not entrepreneurship-related into the whole set of liabilities. It means that, due to current gaps in the law, a natural person can cease his/her liabilities under consumer loan by going bankrupt as an entrepreneur, and the bank will have no possibility to foreclose.

Talking about the **draft New Bankruptcy Law**, it should be noted that Ukraine needs a new version of the law, not merely repairs of the current law. However, New Bankruptcy Law posted on the Ministry of Economy web-site on October 25, 2010 does not satisfy all current needs of bankruptcy regulation. In general, New Bankruptcy Law contains some new positive movements, as well as negative changes, both listed above for the Draft # 7329 and new ones.

The positive changes are:

- Detailed regulation of out-of court settlement, in particular out-of court rehabilitation of a company;
- New restructuring mechanisms (exchange of debts to shares in a newly created company which will afterwards be sold through an auction or tender);
- Clear shortened timeframes and optimization of bankruptcy proceedings;
- Dynamic creditors committee which changes in the course of proceeding: creditors whose claims have been satisfied do not continue participating in the committee;
- Enhanced protection of creditors' rights (informing of the creditors via Internet on Highest Commercial Court web-site, increased role of the creditors committee, requirement for the debtor going bankrupt to have only one bank account into which all receipts are included; procedure for acknowledgement of debtor's transactions aimed at assets stripping void etc.).

The drawbacks of the New Bankruptcy Law are:

- Strongly enhanced state control over the process of bankruptcy of enterprises in which the state owns 25% or more percent, far more than envisaged by the Draft # 7329. In fact, the State Department on Bankruptcy will have the right not only to approve rehabilitation plans, amicable agreements of state-owned enterprises (the court will not be able to approve them without the Department's preliminary approval), but it will also take away much of the court's authority, such as to appoint and dismiss rehabilitation managers, property disposal managers and liquidators. In cases where enterprises are not totally state owned but, for example 25% state owned, this can lead to violation of other creditors' rights and their inability to influence the process;
- Additional powers of the Cabinet of Ministers to approve the procedures for property sales in rehabilitation and bankruptcy proceedings regardless of the ownership of a company, state or private;
- Possibility for the disposal manager to request from the court removal of any encumbrances on the debtor's property (pledge, mortgage) if such encumbrances hinder the activities of the debtor or prevent him from rehabilitation. This might be a threat for banks whose claims are secured with pledges, mortgages because they might not be able to have their claims satisfied. Nor do they have any influence on the process because they are not included into the creditors committee;

- Problems of fraudulent natural persons-entrepreneurs' bankruptcy have not been resolved;
- Cross-boarder bankruptcy regulation is not acceptable since it mandates Ukraine to recognize not only foreign courts' resolutions, which is an intergovernmental "mutuality principle" and has been generally implemented in Ukraine, but also foreign arbitral managers' authority, which is not internationally acceptable practice.

Both Draft # 7329 and New Bankruptcy Law do not deal with a natural person's bankruptcy because, as explained by Mr. Olexander Zavadiak, Deputy Head of State Department on Bankruptcy, there is no necessary infrastructure in Ukraine for such a novelty. We are inclined to support the position that it is not the right time to introduce individual bankruptcy in Ukraine. Ukraine should much rather increase consumer rights' protection in a way which will prohibit unbalanced provisions in consumer agreements and allow consumers clearly understand terms and conditions of each transaction.

Summary of Recent Developments

Although Draft # 7329 registered with the Verkhovna Rada on November 4, 2010 is not sufficient enough to fill in all gaps in regulation of bankruptcy proceedings, it is a timely and positive repair of the Current Bankruptcy Law. It allows expediting insolvency proceedings as required by IMF benchmark. It is desirable that the Verkhovna Rada adopt it.

New version of the Bankruptcy Law, if to be adopted, should be elaborated with great attention. The draft of the New Bankruptcy Law suggested by the Ministry of Economy and posted on its web-site for discussion on October 25, 2010, does not include all the necessary provisions, overestimates the state's role in bankruptcy proceedings and needs further considerable improvement. According to Mr. Olexander Zavadiak, Deputy Head of State Department on Bankruptcy, the Draft might undergo substantial amendments before it is submitted to the Rada. FINREP will continue to monitor the process and make suggestions through AmCham or otherwise, if necessary.

History and Process

The Law of Ukraine "On Restoring Solvency or Declaring Debtor Bankrupt" (hereinafter referred to as "**Bankruptcy Law**") became effective on July 1, 1992 and underwent a great number of amendments. International donor organizations take an active part in the process of improvement bankruptcy legislation in Ukraine.

The lead in bankruptcy drafting legislation was taken by **Commercial Law Center (CLC)**. The Investors Council under the Cabinet of Ministers applied to the Cabinet of Ministers in 2009 with the request to draft legislation improving bankruptcy procedures. Since the Ministry of Economy (MoE) and, in particular, State Department on Bankruptcy are responsible for making policy in this particular area, the Cabinet of Ministers directed the Ministry of Economy to submit for the Cabinet of Ministers' consideration draft legislation aimed at improvement of regulatory environment in Ukraine and rating indicators outlined in the World Bank and IFC "Ukraine in Doing Business" research.. For this particular purpose, the working group comprising members of the Investors Council, CLC, AmCham, EBA, Clifford Chance law firm and Baker&McKenzie law firm was created under the Bankruptcy Department of MoE.

By efforts of CLC and other members of the working group the draft Law "On Amendments to Certain Laws of Ukraine regarding the Improvement of the Bankruptcy Procedures" # 5281 (hereinafter referred to as "**the Draft Law # 5281**") was elaborated. The law went through the broad public discussion and positive feedbacks from WB IFC, Ministry of Finance, State Entrepreneurship Committee, Highest Commercial Court of Ukraine and other state agencies and experts were received.

The Draft Law # 5281 was aimed at improving bankruptcy procedures in terms of the necessity to save the entity which is going bankrupt. A brief look at the draft allows saying that improvements can be arranged into three groups:

1. Shortening duration of bankruptcy procedures.
2. Lowering costs for bankruptcy proceedings.
3. Improving indicators of pay-out index in the bankruptcy procedures.

The Law did not deal with specific issues such as banks' or natural person's bankruptcy.

The Draft Law # 5281 was registered with the Verkhovna Rada on January 21, 2010 and was recommended to be adopted in the first reading. However, it was withdrawn from the Verkhovna Rada on March 11, 2010 due to the change of government.

March 30, 2010. The Draft Law "On Amendments to Certain Laws of Ukraine regarding the Improvement of the Bankruptcy Procedures" initiated by Foundation for Effective Governance (**FEG**) (hereinafter referred to as "**FEG**")

Draft Law”) was posted on the Ministry of Economy web-site for discussion. The Draft Law seemed to be the same as the draft Law # 5281 elaborated by CLC and withdrawn from the Verkhovna Rada. According to FEG web-site, a task group consisting of practicing experts developed a draft law to bring the bankruptcy procedure in Ukraine to the best global practice. The task group included state officials, WB IFC representatives and legal experts.

The following new features of the FEG Draft Law were outlined:

- Specifically determined legal status of secured creditors (in particular, concept of “property surety provider” is introduced);
- Specified procedure for initiation of insolvency proceedings;
- Optimized procedure for formation of creditors' claims register and minimized possibilities to change the register (firstly, through minimization of opportunities for other proceedings in parallel with the insolvency case);
- Major powers of creditors transferred to creditors' meetings (with the decisions to be approved by secured creditors);
- Conceptually improved procedure for declaring certain agreements of a debtor invalid within an insolvency case;
- Cancelled right of the rehabilitation manager to waive the money obligations of a debtor;
- Improved rehabilitation/restructuring procedure;
- Ensured control of creditors over current expenses of a debtor.

IFC project Investment Climate in Ukraine was also involved in improvement current Bankruptcy Law since the project’s representatives are members of the task group which developed the FEG Draft Law as indicated above. IFC identified three activity areas where the existing standards can be quickly bettered:

- Improving professionalism of court-appointed trustees – IFC plans to hold a number of workshops and training courses to share the best global practices in the area of reorganizing businesses and restoring their solvency;
- Improving license conditions so that the license would guarantee the proper level of knowledge and professionalism;
- Introducing the code of conduct for court-appointed trustees; this will help improve the quality of all insolvency/bankruptcy-related procedures done by the trustees.

Besides, IFC has launched **Ukraine Corporate Governance Mediation Pilot Project** in 2008. The project is designed to achieve cost and time savings for small, medium, and other enterprises by providing them with an opportunity to resolve their disputes effectively through mediation, and is implemented in cooperation with Kyiv-Mohyla Academy Business School (kmb). Ukrainian Mediation Center was set up under the auspices of the Kyiv-Mohyla Academy Business School to be the driving force behind the development of alternative dispute resolution in Ukraine, by providing training and making available the services of independent mediators. However, it should be noted that alternative dispute resolution, being an out-of-court (extra-judicial) method of settlement, is not well regulated in Ukrainian legislation and is beyond the scope of bankruptcy proceedings.

June 29, 2010. NGO Public Finance¹ together with International Institute of Business organized a roundtable discussion on problems of Ukrainian bankruptcy law and reforms prospective. The event was attended by Parliamentary members, officials from ministries and entrepreneurship committee, representatives of international donor organizations and professional arbitral managers.

The discussion covered three main issues:

1. Draft Law “On Amendments to Certain Laws of Ukraine regarding the Improvement of the Bankruptcy Procedures” (Draft Law #5281);
2. Necessity to implement procedure of individual bankruptcy.

1. Draft Law “On Amendments to Certain Laws of Ukraine regarding the Improvement of the Bankruptcy Procedures” (#5281).

The Draft Law #5281 was represented by Head of Entrepreneurship Committee Mr. Mykhaylo Brodsky and by World Bank projects coordinator Mr. Marius Vismontas. According to Mr. Vismontas, World Bank experts took an active part in drafting this law aiming to provide its compliance to WB Principles of efficient creditors’ rights protection and Principles of doing business. He also mentioned that adoption of this law would be only the first step in a general Program of the bankruptcy procedure reform, the next step should be adoption of another law which is prepared by

¹ Public Finance is a non-governmental organization, which protects rights of private individuals and companies by initiating amendments to the Constitutions of Ukraine, laws of Ukraine and regulations approved by the Cabinet of Ministers and other central public authorities of Ukraine.

the Foundation for Effective Governance and provides for more comprehensive amendments to the current bankruptcy procedure aiming at increasing of its transparency, clearness and compliance with international best practice in relevant area.

The partner of a law firm Ms. Anna Vronska made a presentation on key elements of the Draft Law #5281, which are:

1. amending the procedure of the dispute settlement through the amicable agreement;
2. providing for the opportunity to offset uniform claims;
3. increasing requirements to licensing of arbitral managers;
4. limitation of the bankruptcy procedure duration by 12 months for liquidation and 18 months for rehabilitation of an enterprise, without an opportunity for prolongation.

2. Individual bankruptcy procedure.

Chairman of the Entrepreneurship Committee Mr. Brodsky informed the round table attendees of preparation of the draft law on individual bankruptcy. According to Mr. Brodsky, this draft law was prepared by the Committee and was submitted to the Ministry of Economy in fall 2009, with no continuation of its consideration in other governmental authorities due to absence of reaction from the Ministry of Economy. According to Mr. Brodsky, this draft law included international best standards in resolving issues of individual bankruptcy, and was aimed at implementation of an efficient mechanism of recognizing person as a bankrupt instead of turning him or her into a "lifelong debtor of the bank".

However, this document was not commented by the World Bank or any other international donor organization so far, thus it was agreed that it would need additional expert analysis and comments, including from international donor organizations in case the Committee would decide to continue with the draft law resubmission to the Cabinet of Ministers and to the Rada.

Mentioned draft law was neither distributed at the roundtable discussion, nor any reference was provided as to where it may be obtained.

The Deputy Head of the State Tax Administration Mr. Sergiy Lekar did not express support for individual bankruptcy since, in his view, the concept is not well elaborated and could be used as the way to escape tax liabilities in the conditions of unclear legislative provisions.

July 1, 2010. The meeting was held at the Cabinet of Ministers of Ukraine. Its purpose was to discuss the Government's initiative to amend the bankruptcy legislation. Mr. Tyhipko chaired at the meeting. The Government was represented by Mr. H.Stadnyk (the Ministry of Justice), Mr. M.Brodsky (the State Committee for the Issues of Entrepreneurship), Mrs.I.Cherepovska (the Ministry of Economy Department for the Issues of Bankruptcy). Mr. Tyhipko started the meeting with the clarification that the Government's position consisted in promoting the prepared amendments, including reconciliation between judicial enforcement and bankruptcy procedures. As for the finalizing of a new version of the draft Law, Mr. Tyhipko said that it could be done but later, when the Government's vision of the content of further reforms in this area had been formed. The Government officials agreed with this approach.

July 15, 2010. The Draft Law "On Amendments to Certain Laws of Ukraine regarding the Improvement of Bankruptcy Procedures" was placed at the official website of the Ministry of Economy of Ukraine for public consideration. This Draft Law is mainly the same as the Draft Law # 5281 discussed at the round table on bankruptcy issues on June 29, 2010 (see above).

October 19, 2010. Draft Law # 6612 elaborated by the Cabinet of Ministers of Ukraine was adopted by the Verkhovna Rada in the first reading. The draft has to be further elaborated before the second reading. The law was drafted to execute protocol # 10 of the Cabinet of Ministers meeting dated April 12, 2010 on prevention of illegal disposal and unreasonable usage of state property.

The Draft Law is aimed at enhancement of the state's control over the process of bankruptcy of enterprises in which the state owns 25% or more percent. In particular, under the Draft Law the State Department on Bankruptcy shall appoint arbitral managers, rehabilitation managers and property disposal managers, as well as approve rehabilitation plans and amicable agreements for enterprises which are the 25% or more percent state-owned. In addition, criminal and administrative sanctions for arbitral managers (rehabilitation managers, property disposal managers and liquidators), similar to sanctions applied to enterprise officials, shall be introduced.