Debt enforcement in times of uncertainty
The EBRD is an international financial institution that supports projects from central Europe to central Asia. Investing primarily in private sector clients whose needs cannot be fully met by the market, the bank fosters transition towards open and democratic market economies. In all its operations the EBRD follows the highest standards of corporate governance and sustainable development.

**About this report**

Legal reform is a unique dimension of the EBRD’s work. Legal reform activities focus on the development of the legal rules, institutions and culture on which a vibrant market-oriented economy depends. Published twice a year by the Legal Transition Programme, *Law in transition* provides extensive coverage of legal developments in the region, and by sharing lessons learned aims to stimulate debate on legal reform in transition economies.
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The global financial and economic crisis that has engulfed the world since 2008 continues to present an enormous challenge. In line with the severity of the situation, international financial institutions such as the World Bank, the International Monetary Fund (IMF) and the EBRD have made great strides to assist their member countries. These institutions have responded to large funding demands from developing, transition and some advanced economies and heightened their engagement in policy advice. At the same time, the crisis has forced many policy-makers to reassess their understanding of the world economy and the forces that drive it. What could have been done to prevent or at least lessen the economic distress that we witness today? What needs to be done now to help economies avoid a deep and prolonged recession?

From early on in the crisis, the EBRD, the IMF and others have, for example, worked together to contain severe financial strain in central and eastern Europe through the European Bank Coordination Initiative, also known as the “Vienna Initiative”. The Initiative was launched in late 2008 in response to growing fears about the vulnerability of emerging economies in Europe to withdrawals by foreign-owned banks, caused by high levels of private debt to such banks and increased foreign-currency exposure. Experience has shown that the unwillingness (or inability) of foreign banks to roll over loans and maintain trade and other credits can precipitate debtor defaults and currency runs. In the face of these risks, the European Commission, the EBRD, the IMF and other international financial institutions engaged policy-makers from home and host countries and commercial banks to reaffirm their presence in the region and to promote coordination within the banking sector itself. So far these efforts have been promising.

The IMF, like the EBRD, understands that restoring financial stability also requires a legal and regulatory response. Decisions are required to address issues such as: new financial supervision structures for banks and non-bank financial institutions; the regulation of complex financial products and the credit rating agencies; along with new rules on capital adequacy and corporate governance.
Debt restructuring and enforcement in the corporate and household sectors is also a key issue, which requires much thought and debate. While the IMF has a track record of active involvement in the corporate debt restructuring,\(^1\) our recent attention to household debt restructuring is informed by the fact that household debt has reached macroeconomic proportions in a number of countries. IMF staff has recently published studies on *Approaches to corporate debt restructuring in the wake of financial crises*\(^2\) and *Principles of household debt restructuring*\(^3\) which assess the case for government intervention in debt restructuring, especially when it appears that the legal and institutional framework will not be able to deal effectively with the scale or severity of the problem on a case-by-case basis.

For the EBRD Legal Transition Programme, assessing the strength of secured transactions and insolvency regimes in central and eastern Europe and assisting governments in reforming these is nothing new. As the EBRD’s countries of operations have been affected by recent financial upheavals, it is more crucial than ever to give experts a voice to inform the process of legal reforms on which these countries have embarked. This is the objective of the current issue of *Law in transition*. The legal dimension is an integral part of the dialogue. The more we share our knowledge and experience, the more we can collectively learn from the current global difficulties and reduce the risks of future turmoil in the international markets.

Sean Hagan
General Counsel
International Monetary Fund

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\(^1\) See (1999), *Orderly and effective insolvency procedures*, IMF Legal Department, Washington, D.C.


Authorities in the EBRD’s countries of operations are increasingly taking steps to open their electricity and gas sectors to competition and trade, promote renewable energy sources and improve energy efficiency. These sectors are transforming in response to concerns about supply and demand, energy security and environmental sustainability. As a consequence, policies and regulatory frameworks in the EBRD region are evolving, although at different speeds and with varying degrees of success. To measure the transformation of the sector and the evolution of regulatory practices the EBRD recently published the results of its first in-depth assessment of the electricity and gas sectors in its countries of operations, conducted during 2009. This article summarises the findings of that assessment.
Since the EBRD’s establishment in 1991, power and energy sector operations have been a key constituent of the Bank’s portfolio. Energy is an essential commodity that holds the key to economic development in the EBRD’s countries of operations. As both a significant investor and provider of technical assistance in the sector (and indeed in overall economic development), the EBRD is an avid observer of the status and development of the energy sector throughout its countries of operations. More particularly, the Bank is concerned as to the extensiveness and effectiveness of sector reform and the implications thereof for both its investment and technical cooperation activities. On the investment side, the Bank wishes to be in a position to more accurately assess the regulatory risks inherent in a given investment opportunity. While on the reform side, the Bank endeavours to assess the effectiveness of its technical cooperation efforts as well as to pinpoint elements the Bank could assist with in furtherance of its mandate.

Accordingly, the EBRD conducted its first in-depth assessment of the electricity and gas sectors in its countries of operations in 2009, publishing the results of the assessment in 2010. The assessment aims to encourage continued reform and liberalisation of the electricity and gas sectors, as well as improvements in the security of supply and promotion of the use of renewable energy sources (RES) and energy efficiency (EE) in the participating countries.

**Assessment model and methodology**

The assessment was conducted through questionnaires and supplemented with research and analysis. Three questionnaires were developed, one each for: (i) electricity; (ii) gas; and (iii) environmental energy issues related to promoting renewable energy sources and energy efficiency. Because the assessment focuses on energy regulation, the questionnaires were sent first to the regulators.
The assessment model was designed to apply across the wide range of political, economic and regulatory environments in the EBRD region. This model is based on those best practices that have achieved a high degree of broad-based support over the years. These are drawn from international and regional agreements, treaties and papers by international financial institutions (IFIs), aid organisations, leading sector experts and regional regulatory groups. These general principles form the EBRD core principles by which we measure energy regulatory development.

Indicators

Drawn from the core principles, eight indicators were each assigned a points value and combined to form a score (up to 100), which results from the composition of a number of weighted subcomponents. The most fundamental criteria (regulatory authority and independence) received the greatest weight.

1. Regulatory independence (maximum score 15 points) This indicator measures the regulatory authority’s degree of freedom from industry, governmental and other interests. Such freedom enables the regulatory authority to act in ways that develop and guide market competition and restrict market distortion (either existing or attempted).

EBRD core principles for effective energy sector regulation

- clear, coherent and targeted policy, supported by primary legislation that sets out the rights and obligations of different sector participants and is supplemented by consistent secondary legislation (all publicly accessible)
- solid institutional framework for regulation in the form of an energy regulator, ideally independent but at a minimum sufficiently separated from industry actors and the policy-making authority
- liberalised electricity market, or a framework that supports a steady movement towards such a market, and a framework in the gas sector that supports a wholesale market
- non-discriminatory, third-party access to existing network elements
- effective separation of the network business from (commercial) generation and supply activities
- elimination of cross-subsidies and promotion of cost-reflective tariffs
- fair, equitable and transparent licensing procedure
- dispute resolution and appeal process that is efficient and accessible
- transparent framework that holds the regulatory authority accountable
- public service obligations that are carefully targeted to support vulnerable customers, rural or outlying customers, environmental protection and security of supply, while not impeding liberalisation.

For the analysis, the assessment divides the EBRD’s countries of operations into three separate groups based on their commitment to existing regional agreements and ensuing obligations affecting the power sector.

2. Regulatory authority (maximum score 15 points) This indicator considers the degree of division of responsibility between policy-making, industry and regulation to avoid overlap. The more autonomy the regulatory authority has to decide the framework tariffs, the higher the level of development of a market economy that supports competition and cost-reflective prices.

3. Market framework (maximum score 14 points) This indicator assesses the degree to which competition is possible, as well as the actual level of competition. This indicator includes a number of subcomponents such as the type of market model, the eligibility thresholds for operators to enter the market, the level of unbundling in the industry, and the retail options accessible to customers who wish to switch suppliers.

4. Network access (maximum score 12 points) This indicator assesses the network options available to new market entrants. Without access to a stable network that is able to handle increases in capacity, new producers cannot sell their product (within or beyond a country’s borders) and new customers may be restricted.

5. Tariff structure (maximum score 12 points) A liberalised market entails that the energy enterprises receive a fair price for the energy produced, distributed and supplied. International best practices, including *ex ante* publication of and public consultation on the regulated tariffs, elimination of cross-subsidies and introduction of incentive components to regulated tariffs have been taken into account in assessing the tariff structure.

6. Public service obligations (maximum score 10 points) It is widely accepted that some energy services (particularly transmission) are monopolies and therefore require regulation that includes public service and public protection components. For this indicator, the specific focus areas are provisions relating to supplier of last resort, quality of service, network maintenance and protection of vulnerable customers.

7. Transparency and accountability (maximum score 12 points) Without transparency and accountability, any regulatory and policy framework can be abused, misinterpreted or disregarded. This indicator is composed of subcomponents that consider the level at which the legal and regulatory framework is publicly available and accessible and subject to public consultation and comment.

8. Private sector participation (maximum score 10 points) This indicator is concerned with the viability of the existing framework for attracting investment in the form of:

- incentives for new investment
- provisions that facilitate cross-border trade
- third-party access exemptions for new investment
- framework to monitor market abuses that allows new entrants to the market and reduces incumbent priorities or manipulation of the market.

Although these eight indicators are the same for electricity and gas, several subcomponents are varied to accurately reflect the differences between the two sectors.

**Country/regional groupings**

For the analysis, the assessment divides the EBRD’s countries of operations into three separate groups based on their commitment to existing regional agreements and ensuing obligations affecting the power sector.

Group A – the EBRD’s countries of operations that are member states of the European Union (EU).  

Group B – the Energy Community Treaty (EnC Treaty) signatories, which include the south-eastern European (SEE) countries (with the exception of Bulgaria and Romania, which are included in Group A), along with the observers to the Energy Community Treaty, that is Georgia, Moldova, Turkey and Ukraine. These countries are grouped together to reflect the common rules under which each of the signatories to the EnC Treaty is bound and the common objectives to which each of the observers has committed.

Group C – the remaining EBRD countries in eastern Europe, the Caucasus and Central Asia: Armenia, Azerbaijan, Belarus, Kazakhstan, the Kyrgyz Republic, Mongolia, Russia, Tajikistan, Turkmenistan and Uzbekistan.
The energy regulatory regime’s strengths and weaknesses vary from country to country – there is no path of development uniformly followed by the new EU member states.

Results – the electricity sector

Analysis of the results

For the purposes of the charts, “institutional framework” represents indicators 1 and 2 and comprises 30 per cent of the point-scoring potential; “market structure and access” represents indicators 3 and 4 and comprises 26 per cent; “tariffs and public service obligations” represents indicators 5 and 6 and comprises 22 per cent; and “transparency and private sector participation” represents indicators 7 and 8 and comprises 22 per cent.

Group A: EBRD countries of operations that are EU member states

For the EBRD’s countries of operations that are EU member states, compliance with energy market liberalisation requirements and the EU acquis communautaire is mandatory and has been so for many years. The result is that certain core best practices, such as an independent regulatory authority, a transmission service operator and related market unbundling, non-discriminatory network access and a published, transparent tariff structure, are required; thus, compliance in these areas is, as expected, extremely high. Each country achieved a score of more than 90 per cent, which is the minimum level of performance expected for this group, although room for improvement remains, particularly in the Baltic countries which lag behind the other of the EBRD’s EU member states (see Chart 1).

It is interesting to note that the energy regulatory regime’s strengths and weaknesses vary from country to country – there is no path of development uniformly followed by the new EU member states. The institutional framework in Hungary, for example, appears relatively weak and lacks independence and autonomy, particularly in its pricing authority. In practice, however, the Hungarian Energy Office: benefits from a market structure and network access conditions that are consistent with best practices; has greater enforcement powers than most regulators; and is a very active and knowledgeable agency. Bulgaria, one of the newer entrants to the European Union, suffers from some limitations with respect to tariffs and public service obligations, a weakness shared, to a somewhat lesser extent by the Czech Republic, Poland, the Slovak Republic and Slovenia.

Group B: Energy Community Treaty signatories and observers

Obligations of the Energy Community Treaty contracting parties are less demanding than those imposed by EU membership (for example, the environmental and competition requirements), and for observer countries, commitment is entirely voluntary. Nonetheless, the Energy Community Treaty draws on the principles embodied in the EU legal framework, which justifies the 80 per cent score that the assessment has set as a minimum performance bar for the member countries (see Chart 2). Observer countries, which are not bound but are voluntarily moving towards implementation of the Treaty obligations, show more diversity, with Turkey scoring on a par with the contracting parties and Georgia and Moldova falling short. Ukraine is the only country that falls below the 70 per cent mark.

Chart 1

Quality of electricity regulatory frameworks, by indicator group

(Group A. EBRD countries of operations that are EU member states)

<table>
<thead>
<tr>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>High performance</td>
</tr>
<tr>
<td>100</td>
</tr>
<tr>
<td>80</td>
</tr>
<tr>
<td>60</td>
</tr>
<tr>
<td>40</td>
</tr>
<tr>
<td>20</td>
</tr>
<tr>
<td>Low performance</td>
</tr>
</tbody>
</table>

Note: The chart shows the score for each country in the region for quality of institutional framework, market structure and access, tariffs and public service obligations and transparency and private sector participation. Combined scores are presented as a percentage, with 100 per cent representing optimum quality.

In the Energy Community – contracting parties and even more so for the observers – training as to regulatory development and best practices is relatively recent.

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largely due to the low independence of its regulatory authority and the limited openness of the market. However, a reform to set up a liquid wholesale market based on bilateral contracts and balancing services to help open the market is under way (the Ukrainian government has estimated completion for 2014).

In the Energy Community – contracting parties and even more so for the observers – training as to regulatory development and best practices is relatively recent, with many regulatory agencies and accompanying frameworks formed (or significantly reformed) in the last five to 10 years. Moreover, most members of the Energy Community are smaller countries, with limited national market potential, and are primarily concerned about security of supply and the impact of new players on their economies. Thus, many of these countries protect state energy companies, creating some barriers for new entrants in the overall context of progress towards liberalisation. The situation in observer countries varies widely. Although Georgia, Turkey and Ukraine are noteworthy for their relatively larger size and energy strategic positions, Moldova has limited indigenous supply.14 The findings reflect this difference and also the varied obligations within the group.

Looking at the climate for private sector investment, Albania suffers some limitations, although the country will soon privatise distribution. In addition, Albania has the advantage of strong transparency and accountability frameworks and thus less regulatory risk for the investor. FYR Macedonia has had recent privatisation success, due in no small part to concerted reform of its energy sector framework directed at reducing regulatory risk. Turkey offers a favourable environment for foreign investment, most notably in the distribution sector. As of 2000, regional divisions of TEDAS, the former Turkish distribution monopoly, have been progressively privatised, such that the private sector’s share in distribution is now around 25 per cent, with large participation of foreign capital.

In contrast, Georgia and Ukraine suffer from less transparent application of regulations, and less reliable, available information for potential investors (and banks) regarding the predictability of the regulatory regime. In Georgia, the market rules (which are adopted by the Ministry of Energy, not the energy regulator) have undergone numerous revisions in the past several years, which makes keeping pace with the changes challenging for a new entrant to the market and particularly for one with language barriers. Georgia and Ukraine require additional attention to improve the non-discriminatory and transparent allocation of capacity at borders and procedures for cross-border exchanges. This is of particular consequence for both countries, which have significant strategic importance and unrealised renewable energy source potential.

Group C: Armenia, Azerbaijan, Belarus, Mongolia, Russia and the Central Asian republics

Unlike Groups A and B above, the Group C countries have no external pressure towards the modernisation and liberalisation of their energy regulatory sector. It is thus particularly interesting to observe the progress they may
Group A comprises the EBRD’s countries of operations which are also EU member states, plus the Czech Republic. These countries must comply with energy market liberalisation requirements and the EU acquis communautaire.

Group B comprises Energy Community Treaty signatories and observers.

Group C comprises the remaining countries of operations: Armenia, Azerbaijan, Belarus, Mongolia, Russia and the Central Asian republics.
Note: The diagrams present the electricity sector results of the assessment, in accordance with the benchmarks and indicators identified in the assessment model. Each extremity of each axis represents an optimum score of 1.0, that is, full compliance with international best practices. The fuller the “web”, the closer the overall electricity regulatory framework approximates international best practices.

Recognising the importance of regional energy market trade to its security of supply, FYR Macedonia has taken an active role in the Energy Community.

FYR Macedonia was part of the former Yugoslav energy system until 1991. Since then, it has worked steadily to develop a national energy policy and regulatory framework and to liberalise its sector, including the privatisation of distribution companies. The country suffers from limited energy resources; only about 75 per cent of its electricity consumption is produced domestically (the majority from inefficient low-caloric lignite resources and the remainder from hydropower) and its gas supply is imported from Russia. Demand and import prices are increasing while domestic supply is not.

To address these issues, the country has taken steps to reform its institutional, market and investment environment, unbundling its electricity sector and privatising distribution in 2005. It has a regulated market and a wholesale market for eligible customers, with a phased market liberalisation plan (with 42 per cent opening up on 1 January 2008 and staggered thereafter until full liberalisation in 2015). A gas law was passed in 2006, introducing a similar timetable for market opening. There has been some history of political pressure with regard to end-user pricing, and investors have balked at inadequate tariff levels and the absence of institutional policing and legal assistance to address commercial losses. However, a credible regulator has been in place since 2004, with an independent structure and financing and a commitment to adopting and implementing a clear, predictable and cost-reflective regulatory framework.

Recognising the importance of regional energy market trade to its security of supply, FYR Macedonia has taken an active role in the Energy Community. In 2009 the country signed with the Energy Community a Memorandum of Understanding on the establishment of the Coordinated Auction Office, which is intended to function as a supranational auction office for capacity allocation on interconnections in the south-east European region.

Additional institutional reform, particularly on the policy side, is still needed. This includes the creation of a separate energy ministry (rather than – as is the case in much of south-eastern Europe – diluted responsibility within the Ministry of Economy). A dedicated ministry could develop greater domestic resources, including improvements to the gas infrastructure (and particularly the development of gas-fired power plants) and a more investment-friendly environment for new renewable energy source producers, such as favourable licensing conditions and priority access to the grid. Although it passed an Energy Efficiency Strategy in 2004, FYR Macedonia still uses electricity for heating (a downfall in the energy efficiency efforts, also observed in Albania and Montenegro).

Critically, FYR Macedonia’s energy sector would benefit from broad legislative reform that distances parliamentary rule-making from political upheaval; such reform would prevent the delays and deadlocks that have plagued otherwise laudable legislative efforts in support of energy reform over the last decade.

Case study FYR Macedonia

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The institutional frameworks are weaker in this region, with lower levels of independence and scope of authority among regulators (or their ministry equivalents) than in Groups A and B. Armenia stands out for the breadth of power and independence of its energy authority, the Public Services Regulatory Commission of the Republic of Armenia (PSRC). The PSRC, established in April 1997, is responsible for

have accomplished in this area. The three highest-performing countries in this group – Armenia, Mongolia and Russia – have made significant efforts over the last five to 10 years to reform their energy markets and regulatory frameworks. Russia is the best performer by a considerable margin (see Chart 4).

In the six lowest-performing countries, the least-developed indicator is the absence (or low level) of a wholesale market, while limited transparency and the absence or limited independence of the regulator are other critical factors. There are, however, exceptions: in Kazakhstan, for instance, a wholesale market has been active since 1996, an electric power exchange has been in place

since 2001 and a grid code was adopted in the same year. In addition, wholesale market participants have established the Pool of Electric Capacity Reserves (Pool ECR), which supports a reservation mechanism to cover emergency deficiencies in contributors’ contractual obligations.

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Russia’s efforts in the last decade to reform its electricity market offer a useful model for its neighbours. The monopoly RAO UES (Unified Energy System of Russia) has been unbundled, and 20 of the resulting companies were privatised in 2008 – several with foreign investor participation. The reforms created six wholesale thermal power-generating companies (OGKs – which remain separate from hydro and nuclear assets) and 14 territorial generating companies (TGKs – which provide district heating as well as power). Foreign investors include E.ON and RWE of Germany (in OGK 4 and TGK 2, respectively), ENEL of Italy (in OGK 5) and Fortum of Finland (in TGK 10, plus a minority share in TGK 1). The (60 per cent) state-owned RusHydro JSC manages the vast majority of the Russian hydropower plants.

The operation of the country’s transmission grid remains under state control through the Federal Grid Company.

At the wholesale level, a power exchange was established in 2006. The share of electricity that is sold at non-regulated prices is increasing in stages, from 5 per cent of the forecast balance prepared by the Federal Tariffs Service of Russia for 1 January 2007 to full liberalisation of the wholesale electricity (capacity) market in 2011. In the interim phase, the non-liberalised volumes are exchanged and paid for at regulated prices under regulated bilateral contracts.

The power exchange is made up of:

- the day-ahead market (DAM) – based on the mechanism of competitive price formulation or auction of electricity buyers’ and sellers’ bids. Auctioning is conducted daily, one day ahead of real time, and simultaneously for each hour of the day in question. Based on its results, balanced planned hourly output/consumption volumes are formed and equilibrium prices are determined, taking into account system constraints and electricity transmission losses. A major bid selection criterion is the maximisation of total benefit to DAM participants.

- free bilateral contracts – the execution of free bilateral electricity contracts by market participants, offering a complementary trade mechanism (in addition to the auction) by which contractual prices and supply volumes are defined by the parties. For the preservation of the day-ahead market financial balance, the contract parties pay the cost of electricity load losses and system constraints associated with the corresponding contract (that is, the parties pay the nodal price difference).

The power exchange is complemented by a balancing market. Volumes of actual output/consumption deviation from planned amounts for each participant are sold/purchased in the balancing market. The calculations are performed one hour ahead.

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Case study Russia

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Chart 4

Quality of electricity regulatory frameworks, by indicator
(Group C: Armenia, Azerbaijan, Belarus, Mongolia, Russia and the Central Asian republics)

Notes: The chart shows the score for each country in the region for quality of institutional framework, market structure and access, tariffs and public service obligations and transparency and private sector participation. Combined scores are presented as a percentage, with 100 per cent representing optimum quality.

While Mongolian market access is also suffering some limitations, the country should be applauded for efforts by its regulator to institutionalise clarity in the roles and responsibilities of sector participants and introduction of transparent decision-making processes.

Case study **Kazakhstan**

Since gaining independence, Kazakhstan has undergone dramatic economic reform and has some of the largest oil, gas, coal and uranium reserves in the world. It is a partner country of the EU INOGATE programme, which is directed at enhancing energy security, developing state energy markets in line with EU internal energy market principles, supporting sustainable energy development, and attracting investment for energy projects of common and regional interest. On 4 December 2006 Kazakhstan and the European Union signed a Memorandum of Understanding enhancing these commitments.

The Ministry of Energy and Mineral Resources (MEMR) is responsible for energy policy. An anti-monopoly entity was originally established in 1991 but in 2004 its functions and powers were split between the Agency for Protection of Competition (APK) and the Agency for Regulation of the Natural Monopolies (AREM), with primary responsibility for setting tariffs and tariff methodology for gas, electricity, oil products and heat generation. The two agencies are central executive bodies, separate from the government in terms of organisation, personnel and budget; but limited in autonomy, particularly with respect to the ability to dismiss the agencies’ management and overrule regulatory decisions.

The Unified Electric Power System of the Republic of Kazakhstan (UEPS) is a complex that includes 60 power plants, transmission lines and substations that provide energy supply to consumers. A wholesale market, despite its imperfections (most notably in balancing and ancillary services markets) has been operative since 1996. Electric power exchange functions have been in place since 2001 and a grid code was adopted in the same year. The Kazakhstan Wholesale Electric Power Market Operator (KOREM) acts as the operator for centralised trade of electric energy.15

Currently, only traders and consumers with a daily capacity of at least 1 MW have the right to purchase electricity on the wholesale market. An amendment to the Law On Energy Sector adopted in December 2008 provides for a radical change of wholesale price formation. In particular, a price cap for each of the 13 groups of power producers (depending on technology and distance from the source) has been established, marking a shift from a competitive price formation to a regulated one. Competitive retail markets are functioning nominally. Although technically unbundled, the retail markets are affiliated with the regional electricity companies and each has a monopoly over the corresponding retail markets, with the price of electricity approved by AREM.

Although Kazakhstan’s proven reserves are the 11th largest in the world, almost all of the gas produced is associated with oil production from the Tengiz and Karachaganak projects in the west of the country and much of it is re-injected in order to maintain reservoir pressure and enhance oil output. Gas-flaring has also been prevalent, although this has decreased since 2005 as a result of government regulation. The relatively slow growth of gas production is caused by a lack of transport infrastructure. The country’s most populous southern region is not connected to the western fields and relies on imports. This is a legacy of the Soviet system, which created links based on proximity and Soviet-defined needs, not internal borders.16
Chart 5
Quality of gas sector regulatory frameworks – selected countries

Results – the gas sector

In addition to the electricity sector, the assessment included a comprehensive analysis of the legal and regulatory regimes of the gas sector across the EBRD region following the same methodology and country groupings (Groups A, B and C). Because of characteristics specific to the gas sector (see below), the results are presented separately from the electricity sector assessment. A number of the EBRD’s countries of operations have a fragmented or undeveloped gas sector, with some countries in the assessment lacking an active gas system (that is, Albania, Mongolia and Montenegro) or a gas system that is not sufficiently developed to allow a full assessment (Bosnia and Herzegovina, FYR Macedonia, the Kyrgyz Republic and Tajikistan); as a consequence gas graphs are not provided for these countries (see Chart 5).

Note: The diagrams present selected results of the gas sector assessment, in accordance with the benchmarks and indicators identified in the assessment model. The extremity of each axis represents an optimum score of 1.0, that is, full compliance with international best practices. The fuller the “web”, the closer the overall gas regulatory framework approximates international best practices. Full results of the gas sector assessment are included in the final report, www.ebrd.com/law/irc/power/assess/report.pdf.

Considerations specific to the gas sector
An important regional consideration for the natural gas sector in the EBRD EU member states is security of supply. The gas supply disruption of January 2009, which resulted from the Russia-Ukraine transit crisis, revealed weaknesses in the existing import arrangements and, in particular, the high level of risk exposure of the eastern part of the internal EU gas market. This disruption of supply has prompted renewed national and internationally coordinated efforts across the region to enhance security of supply. Additional measures that need to be addressed in central and south-eastern Europe are strengthening of interconnections, network harmonisation, reverse-flow capability and market flexibility through storage, liquid natural gas (LNG) and hub trading.

The gas markets across the signatories of the EnC Treaty are small and fractured. Albania and Montenegro lack a gas market, and the gas markets in Bosnia and Herzegovina and most of FYR Macedonia are only at the initial stage of gasification. As a consequence, there is a pressing need for further gasification in much of southern and western Serbia and southern Croatia. The gasification of the region requires large up-front investments, both in the form of new pipelines and construction of new capacity for the markets.

As an observer to the EnC Treaty, Ukraine plays a critical role as an intermediary connecting Russia with eastern European and western European markets. The Ukrainian gas transport is one of the largest in the world: it has an annual nameplate input capacity of 280 bcm (billion cubic metres) and output capacity of 175 bcm. UkrTransGaz, the national gas transmission company, estimates that in 2007 approximately 4.5 Tcf (128.4 bcm) of Russian natural gas transited Ukraine (en route to Europe and for domestic consumption). Currently, the gas sector of Ukraine is dominated by the vertically integrated state-owned Naftogaz which, inter alia, controls UkrTransgaz and the vast majority of distribution companies. Only large and medium-sized industrial consumers can choose their supplier, which is de facto limited to the duopoly Naftogaz-Gazprom-sbyt, while the retail sector (households, district heating, public organisations and small industry) is supplied under monopoly conditions by regional gas companies. At the time of writing no timeframe for gas market opening was formally established. However, the government has recently committed to a full-scale reform of the gas sector, consistent with the objective of membership in the Energy Community, which would require harmonising market rules with the EU Electricity Directive.

The countries belonging to the third group (Group C) have various sources of gas supply and show different levels of development of their gas markets. As a general characteristic, the markets of the region are energy-intensive. While natural gas reserves in Russia and Central Asia are among the largest in the world, at the same time, Russia and Central Asia are also large gas consumers. The aggregate consumption in the CIS and Georgia is greater than that of the European Union. Russia’s exports to Europe are vital energy policy considerations for Europe and influence much of the policy and regulatory framework of neighbouring countries.

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Russia’s exports to Europe are vital energy policy considerations for Europe and influence much of the policy and regulatory framework of neighbouring countries. In addition, Turkmenistan is a major gas exporter with ambitious plans to increase production and exports. Uzbekistan is also a large gas producer but with output dedicated largely to meeting domestic demand and the demand in Azerbaijan and Kazakhstan. The increase in Caspian and Caucasus natural gas production and exports has led to the development of a number of proposals on the international scene to strengthen and expand the existing pipeline network (flowing towards western European and Asian markets). Further development of these networks would be of substantial importance to the western and central European markets.

At the domestic level, the gas sectors in the Group C countries largely consist of vertically integrated monopolies (or near-monopolies). In contrast with the electricity sector, there are few signs of effective market opening and the legislative framework, even at its most developed, provides for limited or no unbundling of the sector. In a few countries though, most notably Russia and Ukraine, market reforms that could substantially transform their respective (and regional) gas sectors are in their infancy.
Since 2006 Russia has had a policy to address price increases and requires that by 2011 domestic prices will be at “parity” with export prices (less transportation and excise duty), resulting in a domestic price that is 60 to 70 per cent of export prices.

In Russia, one state-controlled company, OAO Gazprom, dominates the gas sector, accounting for more than 60 per cent of Russian reserves (almost 30 tcm according to IEA 2008) and almost 85 per cent of Russian production. Gazprom owns the Russian gas transmission system and has a legal monopoly on gas exports. Oil companies and independent gas producers each account for another 20 per cent of Russian gas reserves and produce the balance of the production. Since 2006 Russia has had a policy to address price increases and requires that by 2011 domestic prices will be at “parity” with export prices (less transportation and excise duty), resulting in a domestic price that is 60 to 70 per cent of export prices. This is the culmination of steady progress during the past two to three years to bring domestic gas prices to more cost-reflective levels. In 2008, prices were slightly more than half of the European level. The price reform envisaged by the policy is expected to have a very positive effect on energy efficiency.

In Azerbaijan, a wholesale market exists, organised as a single-buyer model, with wholesale prices determined by the regulator, the Tariff Council of the Azerbaijan Republic. The main sources of gas in Azerbaijan are offshore. The main gas export route is the South Caucasus Pipeline, completed in 2006, which leads from Baku through Tbilisi to join with the Turkish gas grid in Erzurum.

The Kyrgyz Republic is not represented in the spider graphs because its gas sector is limited, with a total consumption of less than 1 bcm, although nascent plans for development are taking hold. Domestic reserves are negligible and the country depends on imports from Uzbekistan. The vertically integrated state-owned companies Kyrgyznetgaz and JSC Kyrgyzgaz are responsible, respectively, for production and transmission and distribution of natural gas. Recently, as a consequence of joining the World Trade Organization (WTO), the Kyrgyz Republic has developed plans to privatise and restructure Kyrgyzgaz JSC and begin sectoral liberalisation. In June 2009 Kyrgyz authorities approved a draft of an intergovernmental agreement with Russia which includes the acquisition by Gazprom of a controlling stake in Kyrgyzgaz.

Renewable energy sources and energy efficiency – status and considerations

Energy efficiency (EE) and renewable energy sources (RES) deserve targeted attention separate from the analysis and approach offered for conventional energy, because they are characterised on a geopolitical level by the need for environmental and supply security, and on an operational and regulatory level by unique characteristics such as grid access and cost. So, for example, the importance of EE and RES has resulted in the development of specific targets regionally in the European Union and the United States, as well as in individual states and countries, along with changes in the governing legal frameworks and guiding principles to remove barriers to EE and RES use. Initial support mechanisms are viewed as spurring technology development and reducing expensive up-front costs that often come with new renewable energy initiatives.

Increased concern about climate change resulting from emissions, growing energy use around the world and energy security, means that any evaluation of electricity and gas sectors must also address whether the existing policy and legal frameworks promote renewable energy sources and energy efficiency. In 2006 the EBRD launched the Sustainable Energy Initiative, focusing on enhancing energy efficiency in the industrial power and municipal infrastructure sectors, promoting RES, and supporting the development of the carbon credit market. In 2008 the EBRD adopted a new Environmental and Social Policy, which articulates its policies on sustainability, emphasising that the EBRD’s mandate to foster transition to market-based economies and promote private entrepreneurship is inextricably linked to its commitment to sustainable development. So too, the European Commission has adopted new directives and regulations to promote sustainable energy initiatives.
Energy efficient measures attempt to reduce energy consumption and conserve energy, while the promotion of RES is directed at reducing carbon emissions and, optimally, finding new, indigenous and sustainable ways to produce energy. For the most part, EE policy is set through national legislation and supported by standards and codes that affect the demand-side (lighting and housing standards, for example). Efficiency standards are also often incorporated into existing regulatory and policy approaches, through tariff structures that credit industry for increasing efficiency, or penalise utilities for failing to do so. RES, on the other hand, is often a separate but additional part of the existing policy and regulatory framework. The regulators are therefore implicated, often because the energy ministries handle RES policy, but also because the regulator may be charged with the responsibility to develop or implement RES policy or rules.

The existing international framework for RES and EE

The World Bank has developed an RES “toolkit” that identifies the importance of overcoming barriers to RES development, including in the legal and regulatory spheres. The World Bank toolkit dovetails with the EBRD’s sustainability policies and initiatives. Its key points are the:

- need for adequate legal frameworks to enable independent power producers to sell to common power grids/networks
- importance of non-discriminatory pricing rules that avoid penalising smaller and/or intermittent renewable energy sources, such that they are de facto discouraged
- significance of minimising restrictions (such as long waiting periods, multiple approvals and hefty fees) and burdensome interconnection requirements, which may exclude new market entrants, in particular those with limited resources.

More than a decade ago, most countries joined an international treaty – the United Nations Framework Convention on Climate Change (UNFCCC) to develop international agreements on steps to reduce global warming (ratified by 192 countries). Following this, a majority of nations adopted the Kyoto Protocol. The major distinction between the Protocol and the Convention is that while the Convention encouraged industrialised countries to stabilise greenhouse gas (GHG) emissions, the Protocol commits the countries (currently 27 of the EBRD’s countries of operations and 37 industrialised countries) to an average of a 5 per cent reduction of GHG emissions, calculated against a 1990 baseline, over a five-year period (2008-2012). Importantly, Kyoto is structured to require a new international framework by the end of 2012. The recent Copenhagen Accord (coming out of the 15th United Nations Climate Change Conference in Copenhagen in December 2009) recognises the need to limit the global temperature increase to no more than two degrees Celsius but does not contain specific commitments to emissions reductions to achieve that goal, putting significant pressure on the 16th United Nations Climate Change Conference, scheduled for the end of 2010. While the struggle to create binding targets continues, increasingly international and regional energy regulatory and policy meetings and strategies are focusing on RES and EE issues, looking in particular at how these intersect with existing sector principles and frameworks, with an objective of addressing climate change.

Regional considerations for RES and EE

In Group A, which comprises those EBRD’s countries of operations which are EU member states and the Czech Republic, the energy frameworks have been recently, or are in the process of being, adjusted to incorporate RES and EE incentive structures. The major forms of RES support are renewable electricity production support via an obligatory feed-in system, investment subsidies for different RES from domestic sources, and EU funds and tax allowances for biofuels. In Hungary, for example, RES policies were established as part of the country’s accession to the...
In Turkey, energy efficiency policy and renewable energy policy are both framed in terms of security of supply, with a sector strategy paper for the electricity market and security of supply recently approved.

European Union in 2004, with significant harmonisation with EU legislation in this area occurring as recently as 2008 (although Hungary, unlike many other countries in Group A, has no specific RES or EE legislation, but instead incorporates incentivising principles into electricity legislation amendments).

For the vast majority of Group A countries, a ministry rather than an energy regulator adopts and implements policy for RES and EE. The incentive structure, subsidy level and national target tend to be policy decisions by ministries. In some instances, however, regulators are responsible for determining the supporting secondary legislation or decisions, such as the quantity of electricity to be produced by specific producers at fixed tariffs to assure return on an RES investment or the implementation of a guarantee of origin system.

Among the EnC Treaty signatories (Group B), RES and EE are receiving policy attention, but supporting secondary frameworks are still limited. In Montenegro, for example, much recent activity has involved the development of policy, strategy and assessments for EE and RES, although in practice implementation is slow, and the legislative framework lags behind. No national laws on energy efficiency and combined heat and power exist. The Energy Law of 2003 covers basic aspects of renewable energy sources, but secondary legislation in the area of efficiency or RES is minimal and the support scheme for renewable energy is limited to the possibility of government incentives, which are not yet in force, and to priority dispatching (that is, the concept that when dispatching installations, transmission system operators shall give priority to generating installations using renewable energy resources insofar as the operation of the national electricity system permits).

Similarly, in Bosnia and Herzegovina, no national policy or law promotes combined heat and power, energy efficiency or renewable energy sources. The Ministry of Foreign and Economic Relations is responsible at the state level, and the energy regulator does not directly address RES or EE issues. On the entity levels (for the Federation of Bosnia and Herzegovina and the Republic of Srpska), renewable energy sources policy is regulated by government decision for both entities. Specifically, public utilities are obliged to off-take all electricity produced from renewable energy sources; the public utilities cover this additional cost and RES generators are not permitted to sell electricity at the wholesale market.

In Turkey, energy efficiency policy and renewable energy policy are both framed in terms of security of supply, with a sector strategy paper for the electricity market and security of supply recently approved by the Higher Planning Council in May 2009. Primary legislation in the area of energy efficiency and a separate law on renewable energy resources were passed in mid-2007. At present, renewable energy sources are supported by feed-in tariffs, for a 10-year term, with a purchasing obligation for retail licensees. The same feed-in price is applied to all renewables, but amendment of this system is pending before Parliament. Moldova enacted a Renewable Energy Law in 2007 and is just defining the secondary legislation required to implement it; although significant work has to be done to bring the law in line with supply and economic conditions. Moldova’s lead in this area is impressive.

The Group C countries have little binding regional stimulus for the development of RES/EE legislation. In the Kyrgyz Republic, Tajikistan and Uzbekistan, hydropower accounts for much of the total generating capacity (in Uzbekistan, it is 13 per cent; in Tajikistan, it is 98 per cent; and in the Kyrgyz Republic it is about 90 per cent) and is the primary renewable energy resource in the region, with some (largely unrealised) potential for wind, particularly in the Kyrgyz Republic. Although some environmentalists argue that large-scale hydropower carries excessive risks to land and biodiversity and should be excluded from classification as renewable energy (and from inclusion in accompanying support schemes), the prevailing view (and practice in the European Union and the United States) is to treat large hydropower as RES. In Central Asia, however, issues surrounding hydropower development are particularly controversial. Most of the water flow in Central Asia comes...
Across all of the EBRD’s countries of operations, the assessment demonstrates that the regulators either lack access to or comfort with renewable energy sources and energy efficiency policies.

In Kazakhstan, RES electricity production (excluding hydropower generation) is minimal, although legislation has recently been enacted to promote RES and energy efficiency technologies. Significant progress in these sectors is expected following the recent passage of the Act “On supporting the use of Renewable Energy Sources” (June 2009) and the amendment of the Act “On Energy Savings” (which is in the process of approval at the writing of this article). The government of Kazakhstan and the EBRD signed a sustainable energy action plan in June 2008, which is a main platform for energy efficiency investments. This plan is part of a wider effort to put the country’s economy on the right path for sustainable growth, economic diversification and competitiveness. In Mongolia, efforts in the RES field have concentrated on providing rural electricity access for those herders and rural communities lacking access to the main power grid. A legal framework to support these efforts is in its infancy, with a new strategy in 2005 and a law on renewable energy passed in 2007, which seeks to eliminate barriers to new investment. In particular, it empowers the regulator to review contracts between new RES power producers and the transmission or distribution company and it sets a feed-in tariff range for different types of renewable energy. Significantly, implementation has begun; the regulator has issued a licence for construction of a 50-MW capacity wind farm and approved a power purchase agreement for the same between the investor and the transmission company.

Across all of the EBRD’s countries of operations, the assessment demonstrates that the regulators either lack access to or comfort with RES and EE policies. Possibly due to the new and evolving nature of these policies, some information is not transferred or gathered easily. In addition, many regulators lack direct competencies in these areas, and thus do not focus on them, despite the important role that regulators always play as leading sector experts. Given the importance of sustainability and the increasing attention being given to international agreements and actions directed at promoting sustainability, the absence of active involvement by many regulators is a cause for concern. Most of the EBRD’s countries of operations have ratified Kyoto, and most have at least national strategies that promote RES and EE and have implications for sector activity. Indeed, as noted above, most regulators do have some form of implementing role with respect to RES (and EE with respect to efficiency incentives as part of the tariff methodologies). It is critical that, as regulators develop their skills and learn new ways to address their tasks to the benefit of the sector, they also develop strategies to promote sustainability, regardless of whether their role is policy-setting, implementation, or indirect and advisory. Additional training of regulators on RES and EE best practices, sector impact and integration, as well as regional harmonisation, is essential.
Part I

The assessment model implies that transition countries are moving towards an internationally agreed set of principles, and its objective is to provide an overview of the energy sector from this perspective.

Conclusion

The assessment’s results contain a good deal of information that is difficult to convey in the context of a short piece. Readers with an interest in the subject are encouraged to refer to the full report for detailed scoring and data. However, a few words may be useful to summarise the assessment’s main findings.

The assessment model implies that transition countries are moving towards an internationally agreed set of principles, and its objective is to provide an overview of the energy sector from this perspective. Concerns about security of energy supply, together with economic pressures, have led various countries to explore regional market frameworks. Such markets require that regulatory environments are somewhat harmonised and that market participants can operate within predictable, transparent and non-discriminatory frameworks.

Across the EBRD’s countries of operations, regulatory progress is visible, although the degree differs greatly among and within the regions. The EU members have achieved a high threshold of compliance with their legal obligations. The Energy Community Treaty countries (the signatories in particular, but increasingly the observers too) are catching up steadily; the adoption of the EU energy *acquis* and the implementation of acknowledged best practices are viewed as a defining step towards EU integration and the greater economic security that comes with EU membership.

Countries outside any international framework have been slower to implement reforms, which largely reflect political, economic and infrastructure limitations (although Russia stands out for its noteworthy reform efforts among the countries in Group C).

The EBRD will support positive regulatory reforms in the transition countries where they are most needed. The target for these countries should be the achievement of greater regulatory independence (or the establishment of an energy regulator in some Central Asian republics), as well as competition safeguards, supported by transparency, non-discrimination and accountability. In RES and EE, future reforms should place priority on raising awareness of the need for promoting sustainable energy at the policy and regulatory level (in particular within Group C countries) and strengthening the local authorities’ knowledge and capacity. The challenges the Group C region faces in this respect are immense, but so is its potential.

Implementation of best practices should lead to greater energy security, access to energy and public confidence in the sector, and in turn promote economic development, growth and long-term sustainability.
Notes and authors

1. The EBRD has 29 countries of operations in which it invests. For a full list of these countries see www.ebrd.com/country/index.htm.

2. The full assessment report, country-by-country analyses and regional comparative assessments for the electricity and gas sectors as well as information about national policy targets for energy efficiency and renewable energy sources can be found at www.ebrd.com/law/irc/power/assess/report.pdf.

3. If the regulatory authority had no competency in renewable energy or energy efficiency issues, the questionnaire was then sent to the governmental institution designated with responsibility.

4. To ensure impartiality and facilitate dialogue between the EBRD and energy sector authorities, all relevant national authorities received a copy of the draft final case summary applying to their country and were provided with the opportunity to comment on that summary before conclusions were drawn therefrom and publication of the final results.

5. For instance, the World Trade Organization Reference Paper on Basic Telecommunications Services defines a set of regulatory principles for the establishment of fair market conditions in the telecommunications sector, and by 2008 around 75 countries had formally accepted the Reference Paper.

6. See the Energy Charter Treaty. Signed in 1994, the Treaty entered into force in 1998. All EBRD countries of operations have signed the Treaty, except for Serbia and Montenegro. Belarus and Russia have signed but have yet to ratify it.

7. These include, inter alia, the EU Electricity and Gas Directives.


12. The EBRD’s countries of operations which are also EU member states are Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia. The Czech Republic is included in Group A, although it graduated from the EBRD’s operations at the end of 2007.

13. Taking into account the fact that the observer countries are not yet members of the binding Energy Community Treaty, the assessment expects them to meet the 75+ per cent target, with rapid progress towards the 80+ per cent mark in the next year or two.

14. Participation of Moldova and Ukraine (and countries to their east) in the energy markets to their west is challenged by infrastructure limitations. Western Moldova borders Romania but Moldova’s network is not synchronous with the European network.

15. The Pool of Electric Capacity Reserves (Pool ECR) is the organisation established by wholesale market participants, supporting a mechanism of reservation of electric capacity, which is necessary in order to cover emergency deficiencies of market participants versus their contractual obligations.

16. The natural gas trunk pipeline system stretches 10,140 kilometres. The major transit pipelines are the Central Asia-Center gas pipeline system and the Bukhara-Urals pipeline, which transport natural gas from Turkmenistan and Uzbekistan to Russia, and the Orenburg-Novoposlov pipeline and Soyuz pipeline from the Orenburg processing plant to Europe.

17. The countries of Group C and the observers of the EnC Treaty (except Turkey) are those for which the differences between the electricity sector and the gas sector, in terms of market structure and regulatory framework, are most noticeable. Thus, those with a sizeable gas sector are represented in this section. The assessment results measuring the level of development of the gas sector for each of the EBRD’s countries of operations are presented in the final report.

18. Europe’s dependency on natural gas exports from Russia drew worldwide attention in January 2006 when a longstanding dispute over price and payment mechanisms in the in-kind agreements caused Gazprom to shut off gas supplies to Ukraine. Supplies to Europe were also affected.

19. The pipeline system built in the Soviet era was intended to take advantage of two sources of natural gas reserves – the major fields of West Siberia and those of the Central Asian states (Kazakhstan, Turkmenistan and Uzbekistan) – and to supply the largely populated European regions of the Union. This structure still affects the international flows of gas, with Russian export pipelines the dominant outlet for Turkmen and Kazakh supplies.


The new RES Directive was published on 26 March 2009. The full text is available at: register.consilium.europa.eu/pdf/en/08/st03/ st03736.en08.pdf. Importantly, it makes clear that the development of renewable energy sources is a core priority for the internal market in the European Union. With this in mind, the new RES Directive creates various legal structures to encourage investment in renewable energy, such as making renewable energy exempt from the existing EU energy acquis requiring non-discriminatory access to the grid and thus prohibiting priority access or reservation of capacity. The RES Directive holds that renewable energy is an exception to the standard rule. Article 16 provides that Member States shall take steps to enhance their networks to accommodate the development of new renewable energy sources and ensure that when dispatching electricity-generating installations, transmission system operators give priority to generating installations using renewable energy sources as permitted by the secure operation of the national electricity system and based on transparent and non-discriminatory criteria. A similar effort underpins energy efficiency measures.


The Kyoto Protocol was adopted in Kyoto, Japan, on 11 December 1997 and entered into force on 16 February 2005. As of writing, 184 parties of the Convention have ratified its Protocol. The detailed rules for the implementation of the Protocol were adopted at COP 7 in Marrakesh in 2001, and are called the “Marrakesh Accords”.

The 2009 World Forum on Energy Regulation, held in Athens in October 2009, which included regulators from around the world, made sustainable energy a focal point for discussion. This initiative is the outgrowth of the Heiligendamm G-8 Process of 6-8 June 2007, which launched a dialogue of the G-8 countries with the main emerging economies on energy issues, recognising the importance of secure, stable and competitive energy supplies for achieving sustainable development.

An Energy Efficiency Strategy was adopted in October 2005, a Strategy for Small Hydro Power Plans was adopted in April 2006, an Assessment of Renewable Energy Resources in April 2007 and a National Energy Development Strategy to 2025 was passed in December 2007, including provisions on identifying investment opportunities in Montenegro, and focusing particularly on RES.
The EBRD has remained committed during the crisis to provide equity funds to the region by supporting first closings, high quality fund managers and the development of secondary markets. This article highlights the challenges faced by the investors and fund managers which can become more pronounced in economic crises – withdrawal of co-investors at the fund raising stage and failure of investors to comply with capital calls.
The private equity industry in the region has developed significantly since the early 1990s and has more recently witnessed the emergence of a nascent interest in countries such as Kazakhstan, Turkey and Ukraine. However, despite the constant growth, private equity investment in the region continues to form a comparatively low percentage of GDP. As shown in Chart 1, the region remains under-penetrated by private equity investment even during periods when the markets and the region in particular have been generally bullish and produced higher returns than many of the more mature private equity markets.

**Chart 1:**

GLOBAL PRIVATE EQUITY INVESTMENT AS A PER CENT OF GDP IN 2008

<table>
<thead>
<tr>
<th>Region</th>
<th>Private equity investment/GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central and eastern Europe</td>
<td>1.4</td>
</tr>
<tr>
<td>Russia</td>
<td>1.6</td>
</tr>
<tr>
<td>Latin America</td>
<td>1.2</td>
</tr>
<tr>
<td>Emerging Asia</td>
<td>1.0</td>
</tr>
<tr>
<td>Eurolzone</td>
<td>0.8</td>
</tr>
<tr>
<td>India</td>
<td>0.6</td>
</tr>
<tr>
<td>United States</td>
<td>0.4</td>
</tr>
</tbody>
</table>

The recent financial crisis has exacerbated the scarcity of private equity capital in the region. Russia/CIS, for example, has moved from sixth place in 2008 to ninth place in 2009 in the ranking of the most attractive regions for private equity investors and the risk premium in the same period has increased by 1.5 per cent. A number of private investors have reduced allocations to the asset class due to an over-allocation to private equity following historically low public equity valuations, and in the short term fund raising is expected to continue to remain difficult with investors adopting a more cautious approach to alternative asset classes in the region generally.

As a result of these factors, only a handful of new funds were raised in the region during 2009. Some existing funds have also experienced challenges in pursuing their investment strategies in part due to the inability or unwillingness of distressed investors to honour capital calls (or due to a desire by investors to restrict calls on capital in the short term) and an inability to “self-fund” capital calls from profit distributions from the fund in the absence of any credible opportunities to exit from portfolio investments. The resulting inability to mobilise private equity investors has deprived enterprises (and in particular small and medium-sized enterprises which form a substantial part of underlying economic activity in many countries in the region) of a vital source of sophisticated long-term financing.

As a response to the crisis in the region, and as part of its ongoing commitment to the asset class, the EBRD has taken several steps to ensure that funds in which it is participating are able to reach their first closing, to reaffirm its support for high-quality fund managers, and to promote the development of efficient secondary markets.

In this article, we have attempted to describe some of the most common issues that investors and fund managers face when one or more co-investors withdraws from a fund at the fund raising stage or, in the case of a fund which has already been established, one or more investors fail to comply with a capital call.

Investor withdrawal at fund raising stage

Possible legal remedies

At the initial fund raising stage no contractual relationship typically exists between the fund manager and potential investors, despite the considerable time that has been devoted to negotiating the terms of the fund’s constitutional documents and to establishing the investment structure.

Most of the financial risk for the establishment costs at this stage is with the fund manager. Unlike practices in a number of other industries, private equity fund managers and potential investors do not usually sign any preliminary binding document such as a binding term sheet or mandate letter, outlining the recovery of transaction costs of establishing the fund.

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**Chart 2**

Increases in the perception of risk premium by limited partners in emerging market private equity funds

<table>
<thead>
<tr>
<th>Region</th>
<th>2008 Risk Premium</th>
<th>2009 Risk Premium</th>
<th>Increase in Risk Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>4.0</td>
<td>5.0</td>
<td>1.0</td>
</tr>
<tr>
<td>India</td>
<td>3.0</td>
<td>4.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Latin America</td>
<td>2.0</td>
<td>3.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Sub-Saharan Africa (excluding South Africa)</td>
<td>1.0</td>
<td>2.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Other Emerging Asia</td>
<td>0.5</td>
<td>1.0</td>
<td>0.5</td>
</tr>
</tbody>
</table>

An investor typically only becomes legally bound to contribute financially after entering into the subscription agreement (or an equivalent instrument) whereby it accedes to the fund. If an investor withdraws from the negotiations before signing the subscription agreement, the fund manager’s remedies under English law are mainly limited to those based in tort.

Importantly, under English law, no statutory obligation exists on counterparties to negotiate in good faith and courts have been slow to impose such general obligations. In contrast, civil law jurisdictions have more of a tradition of imposing an underlying legal obligation to act in good faith in commercial dealings.

A party negotiating an agreement may in principle possibly have a claim for negligence at common law against another party even though no contract is ever entered into. For a valid cause of action, the claimant must prove a duty of care, a breach of that duty by one party and a loss of the claimant proximately caused by the breach. A fund manager wishing to bring a claim against an investor who walked away from the negotiations before the fund was established must prove each element. We will analyse the elements in turn.

**Duty of care**

Broadly speaking, for a duty of care to arise it is necessary to establish the following:

- the party’s conduct would cause reasonably foreseeable damage to the claimant
- sufficient pre-existing relationship between the parties
- that imposing such a duty would be considered fair and reasonable.

English courts have been prepared to recognise the existence of a duty not to make misleading statements. In the case of an investor in a fund, such a duty would presumably require, among other things, disclosure to the fund manager of any potential reasons (such as internal exposure limits or credit committee or other similar internal approvals) that would prevent the investor from investing in the fund once the commercial terms of the transaction have been agreed. It is, however, difficult to predict how successful such a claim brought by a fund manager might be. English courts have also previously been prepared to recognise the existence of a duty where no other remedies would have been available to the claimant. The courts’ decisions in this respect are, however, tempered by policy considerations which recognise the need to restrict claims based on a duty of care.

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**Chart 3**

**A standard fund structure**

[Diagram showing the structure of a private equity fund with principal, general partner, management company, limited partners, private equity fund, and portfolio companies]
According to data published by the Emerging Markets Private Equity Association, during the first three quarters of 2009, only 11 funds had first closings in the region.

Breach
Where an investor has acted transparently, has clearly communicated that discussions were “subject to contract” and has made the fund manager aware of its internal constraints at all times, the fund manager may find it difficult to establish a breach of any putative duty based on a misleading statement or conduct. However, if an investor fails to sign an agreed subscription agreement after having confirmed to the fund manager that he had obtained all the internal approvals, the fund manager’s position may be different. Proof of a breach of duty will ultimately hinge on the facts of each individual case.

Causation and loss
The final element of the test is satisfied if the fund manager can prove that he would not have suffered a loss but for the fund manager’s reliance on the statements or the conduct of the potential investors. Whether there was a loss is a question of fact and would depend on the particular circumstances of each case. In instances where the majority of the investors remain committed and the fund proceeds with its first closing, the fund manager may not be able to prove that he suffered a loss. The position may potentially be different if a fund cannot reach first closing, and this failure was proximately caused by the withdrawal of one or more investors. The fund manager’s potential claim would be for any foreseeable damage and might include all organisational expenses (such as legal counsel; tax advisers; placement agents; and travel and roadshow expenses).

In addition, there may be costs relating to the establishment of the fund vehicle and warehousing costs (if the fund manager had acquired investments in the expectation of transferring them to the fund once the fund had been established).

Table 1
Fund first closings in 2008-09

<table>
<thead>
<tr>
<th>Region</th>
<th>Q3 YTD 2008 US$ millions (No. of funds with closes)</th>
<th>Q3 YTD 2009 US$ millions (No. of funds with closes)</th>
<th>% change in US$ value</th>
<th>% change in number of funds with closes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Asia</td>
<td>32,972 (120)</td>
<td>13,275 (71)</td>
<td>-60%</td>
<td>-41%</td>
</tr>
<tr>
<td>CEE/CIS</td>
<td>4,169 (16)</td>
<td>2,007 (11)</td>
<td>-52%</td>
<td>-31%</td>
</tr>
<tr>
<td>Latin America/Caribbean</td>
<td>4,376 (18)</td>
<td>1,455 (11)</td>
<td>-67%</td>
<td>-39%</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>1,573 (16)</td>
<td>513 (8)</td>
<td>-67%</td>
<td>-50%</td>
</tr>
</tbody>
</table>

Mobilising sufficient investor interest to enable the fund manager to achieve critical mass and a viable fund size at first closing is critical to the success of the fund raising process and the long-term development of the asset class in the region.

The EBRD’s commitment to fund investment

In the absence of additional economic incentives for first closing investors (for example, a management fee rebate or share of the fund manager’s profit share entitlement), some institutional private sector investors prefer to invest in a fund that has already reached its first closing. This is due to a number of considerations. First, investors may not like being engaged in the protracted negotiations typical of the first closing fund raising period. Second, the presence of investors who have already committed to the fund provides additional credibility to the fund-manager team and its investment strategy (this is particularly important for first-time fund managers).

Therefore, mobilising sufficient investor interest to enable the fund manager to achieve critical mass and a viable fund size at first closing is critical to the success of the fund raising process and the long-term development of the asset class in the region. Due to the difficult fund raising environment worldwide and particularly in the region, international financial institutions such as the EBRD and government institutions have been crucial supporters of the private equity industry. The EBRD has intervened at two crucial levels by:

- confirming its initial commitment despite the withdrawal of other investors, thus contributing to ensuring that some funds could reach first closing
- “front loading” its commitment to the fund by taking a higher percentage of the first closing fund size and then reducing the Bank’s percentage exposure at subsequent closings as additional private sector capital is committed to the fund.

Default of a limited partner

Possible legal remedies

The legal consequences of an investor’s failure to meet a capital call are typically governed by the constitutive documents of the fund. In addition, the law of the country where the fund is located may provide additional remedies. The constitutive documents of a fund generally give investors a grace period following the payment due date (between 10 and 30 business days) within which to still be able to pay a capital call without being in breach. Failure to pay the capital call (plus any default interest accrued up to the date of payment) during the grace period results in the investor becoming a “defaulting partner” (DP). During the period in which private equity markets were bullish, less attention was paid to the detail and negotiation of the defaulting investor provisions of the investment documentation, which were frequently less robust or comprehensive. The most commonly used contractual remedies can include one or a combination of the following.

- Forfeiture of the capital contribution of a defaulting partner by an amount typically between 50 and 100 per cent of the DP’s contribution at the time of the default. From such time the DP ceases to be a partner, loses the right to vote and is no longer included in the calculation of quorums. The repayment of the non-forfeited portion (if any) of the DP’s capital contribution on termination of the fund (calculated based on the realised value or on the amount standing to credit of the DP’s capital account) is subordinated to the full repayment of all other non-defaulting investors (frequently also including the preferred return hurdle in addition to the paid-in amount) and is paid net of any costs and expenses incurred by the fund manager in enforcing the remedies and sometimes any management fee that would have been payable by the investor had it not become a DP. Typically, the DP receives any return on an “on realised” basis as the investments of the fund are sold, rather than being entitled to an immediate payment out of fund assets.
While in western Europe and the United States large private equity portfolios are regularly sold in secondary market transactions (typically by auction), the secondary market in the region is relatively inefficient.

The defaulting partner’s entire interest in the fund is offered for purchase (usually including the obligation to take over the DP’s undrawn commitment to the Fund) to:

- the other partners (including the general partner) in proportion to the other partners’ subscriptions or
- third parties.

The fund manager would typically be appointed under the fund constitutive documents as an agent of the DP for the sale of such interest. Such interest might be expected to be sold at a discount to the fair market value of the interest at the time of the sale immediately before the default to attract an incoming investor and also to reflect that the incoming investor is taking over the obligation to meet future capital calls.

Often, the fund documents will give the fund manager discretion to choose which approach and remedies to pursue. The milder the consequences of a default the more likely it is that an investor with liquidity problems or whose investment strategy has changed due to the global financial crisis will be tempted not to honour a capital call. The option of bringing a separate claim against the DP for breach of contract is certainly available to the fund manager. However, the cost and time involved in pursuing a claim make this solution unattractive, especially for those fund managers concerned about developing a reputation for being overly litigious. The fact that failure by the DP may be due to a shortage of liquidity diminishes the prospects of recovery thus further reducing the appeal of litigation.

Defaulting partners and secondary markets in the region

As discussed in the introduction to this article, the recent crisis has exacerbated the relative under-penetration of private equity capital in the region. A number of investors have been forced to reposition their capital exposure or to modify their liability management strategies and are planning to or have scaled back from the region in the short term.

This has resulted in an increase in the potential for defaults and distressed investors seeking to dispose of positions in funds before triggering the applicable default provisions, although the number of actual defaults in the region to date still appears to be relatively low. Given that the option of litigation is generally not appealing or viable, most defaults have been worked out through either a reduction of the size of the fund, or the sale of the interest of the DP to the existing partners before a default.

While in western Europe and the United States large private equity portfolios are regularly sold in secondary market transactions (typically by auction), the secondary market in the region is relatively inefficient. Secondary opportunities in the region, due to their small size, are not a core focus of the large global secondary funds, although there are indications of a growing appetite for opportunities in the region as competition and prices in Western markets increase. In addition, this class of investment in the region requires specific know-how to effectively evaluate and price the partnership interest.
An alternative to the sale of the interest of a DP is the issuance of loan notes convertible into partnership interests. A third-party investor would acquire such notes (thus providing the fund with short-term liquidity) and receive a fixed rate of interest as well as the option to convert the notes into partnership interests at maturity.

In the short term, secondary sales, with a small number of notable exceptions, have tended to be small parcels sold at significant discounts and purchased from truly distressed investors in critical need of liquidity. Arguably more substantial, however, is the large body of “near distressed” investors who, while not yet in default, may seek to dispose of their positions only because there is little investment activity currently in the market and therefore fewer capital calls being made on investors. Currently, market expectations seem to support the view that once investment activity increases and normalises in 2010, increased capital calls and lower returns of capital from the sale of assets which restrict an investor’s ability to “self-fund” capital calls, may result in a significant increase in the size and volume of secondary sales.

The EBRD: assistance and support for fund managers and secondary markets
In recognition of the difficulties experienced by the private equity industry over the 15 years of private equity asset class development in the region, the EBRD has responded to the crisis with a series of measures to support high-quality fund managers.

First, due to the reduced allocations to the asset class in the region from private investors during the financial crisis and the withdrawal of potential investors, a number of funds which had achieved a first closing, but which were still fund raising, have been adversely impacted and were unable to achieve target fund sizes. This would have had the potential to materially impair the economic viability of the affected funds and the effective implementation of the fund strategy due to insufficient capital. The EBRD has therefore focused on providing very selective ad hoc assistance to quality performing funds in which the EBRD has already invested (or in some instances even to first-time, high-quality fund managers), to ensure the ongoing viability of the fund and thereby preserve the integrity of the fund management team. This has typically meant that where the EBRD had not yet committed its entire approved commitment to a fund due to a cap on the EBRD’s percentage participation, the EBRD has waived that limited cap in order to bring forward additional capital into the fund.

Second, the EBRD has also endeavoured to support the development of the secondary market in the region by attracting funds of funds which are active in the secondary market. Encouraging funds of funds to invest both in the purchase of secondary interests and in the taking up of the unfunded commitments of defaulting or distressed investors is another way to ensure that performing private equity funds and credible and experienced fund management teams active in the region are not deprived of the liquidity needed to continue to function in a cash-starved market.

Lastly, in identifying credible and experienced fund management teams to support and develop the asset class in the region, the EBRD has continued to play a leading role in selectively “front-running” the first closing of certain funds in order to signal to the market the EBRD’s ongoing support for the asset class and its attractiveness for private sector investors.
The region is expected to continue to attract significant and increasing sources of long-term capital for investment into enterprises in the region as economic and legal convergence continues in the medium to longer term.
In the context of this article, the term “region” refers to the EBRD’s 29 countries of operations. See www.ebrd.com/country/index.htm for the full list.


The so-called “denominator effect”.

A very significant proportion of private equity vehicles in the region are established as limited partnerships.

Limited partnership fund documents are typically governed by the law of the jurisdiction in which the limited partnership is established, such as England, the Cayman Islands, British Virgin Islands, Jersey or Guernsey.

See, for example, Section 4 (1) of the Act IV of 1959 of the Civil Code of Hungary.

Box v Midland Bank Ltd [1979] 2 Lloyd’s Rep 391.

Caparo Industries Plc v Dickman [1990] 2 A.C. 617.


Although this in itself under contract law does not mean that no binding agreement can be reached if the conduct of the parties implies otherwise. See Jirehouse Capital v Beller [2009] EWHC 2538 (Ch).


The term “first closing” is used for this purpose to refer to the fund having acquired participation with an aggregate value at least equal to a pre-established target.

For example, multilateral donors and governmental institutions have provided in aggregate 31.4 per cent of capital raised by the funds in which the EBRD has invested and which are active in the Russia/CIS region.

In the United Kingdom, Art 35(d) of the Partnership Act 1890, states that a partner can apply to the court for a dissolution order with respect to a partnership when another partner has committed a persistent breach of the partnership agreement.
The EBRD Legal Transition Programme has always emphasised the importance of legal institutions to the economic environment. Until recently, however, economies were booming, with corporate and consumer lending at unprecedented levels. The financial crisis that started in the United States has translated into a credit crisis throughout the EBRD region, with no country left unaffected. Macroeconomic policies, international coordination and cooperation will be needed – nobody knows for how long – to put the region back onto the path of growth. The importance of legal frameworks is central to this recovery because when contractual relationships break down and companies go under, the law will ultimately decide what happens next.

To explore this issue of debt enforcement in times of uncertainty, specialists in the field have presented their take on the economic situation and whether the law can provide some certainty and efficiency in the process. Two of the EBRD’s economists, Ralph De Haas and Stephan Knobloch, begin by reviewing the crisis in the region with an eye to the role of the rule of law. Veronica Bradautanu of the EBRD gives a comprehensive, if at times worrying, overview of insolvency laws in the Bank’s countries of operations. Despite considerable progress, it is evident that reforms in the area of insolvency law have not always managed to strike an optimal balance and may therefore leave creditors with troubled debt unable to use insolvency law as the exit route they may need.

These views are confirmed by an article from Timothy Stubbs and Mary Faith Higgins of the law firm Salans on Russian enforcement laws, which despite some remarkable
progress recently in strengthening creditors’ rights remain untested. The level of uncertainty, however, is of particular concern in Ukraine where the laws and practices often result in many obscure or inefficient outcomes for creditors and debtors navigating insolvency proceedings, as described by Zoya Mylovanova, Felix Rackwitz and Oksana Volynets of the law firm Beiten Burkhardt, Kiev.

On a policy level, Allen & Overy’s Philip Wood discusses the influence of insolvency laws on the prospect of achieving not only judicially supervised reorganisations but also private work-outs and examines the important policy choices legislators have to make in promoting efficient and flexible regimes. Lastly, encouragement comes from the aviation industry via the Cape Town Convention adopted almost 10 years ago. Freshfields’ Jeffrey Wool, Secretary and General Counsel of the Aviation Working Group (AWG), and Holland & Knight’s John Pritchard, Chairman of the AWG Legal Advisory Panel, discuss the Convention and its global framework for the financing of aircraft and aircraft objects which has paved the way for some innovative (if sector-specific) remedies in case of debtor default.

All crises have a silver lining – and this one will provide a unique opportunity to better understand how market players have used the instruments and procedures provided in the law, and how those laws and decisions fare in times of crisis. As argued by Frédérique Dahan and Elizabeth Kirk of the EBRD, this will allow the process of transition through legal reform to truly deliver what so many rightly expect from it.
The effects of the global economic turmoil are now being felt throughout the EBRD region, as demonstrated through the huge increases in output losses and non-performing loans. This article explains that although the crisis began abroad, the high levels of distressed debt in the region are revealing some home-grown weaknesses. It further gives an overview on the impact the crisis has had on credit quality in the region, and what options governments have to resolve the growing problem of non-performing loans.
It is more than two years since the transition region was first hit by the global financial turmoil. While the US sub-prime crisis spilled over quickly to western European banks, some of which were directly exposed to toxic US mortgages, contagion to emerging markets was delayed. By March 2008 only a few countries were affected: Kazakhstan, the Baltic states and a few south-eastern European countries. After the intensification of the global crisis in September 2008, however, the crisis spread quickly throughout the transition region, leading to the largest output loss since the recession at the start of transition 20 years ago.

In this article, we provide a broad overview of why and how the crisis has affected credit quality across the transition region. We argue that while the crisis was triggered abroad, the current high level of distressed debt in various transition countries mainly reflects home-grown vulnerabilities. Most debt problems in the region are also surprisingly similar to debt problems in Western countries. For both regions, the period from 2001 to 2007 was characterised by abundant liquidity, low interest rates, relaxed lending standards, very rapid credit growth, and, in some cases, asset bubbles. There is not much difference between a financially overstretched suburban borrower in California with a “ninja” mortgage (“no income, no job, no assets”) and an over-indebted herder in rural Mongolia. Both are victims of a period of over-optimism and lax lending standards.

The remainder of this article is structured as follows. In section 2, we review some of the recent literature on the relaxation of lending standards. Section 3 then gives an overview of the development of non-performing loans (NPLs) across the transition region, after which section 4 summarises lessons from earlier crisis periods about effectively and efficiently dealing with NPLs. Section 5 concludes.
The availability of abundant cheap funding from foreign lenders made domestic local banks relax their lending standards. The rapid development of securitisation in the pre-crisis period exacerbated the aforementioned trends. Securitisation has been shown to have reduced the incentives of lenders in the US mortgage market to screen prospective borrowers. Borrowers whose loans were sold in the secondary market were found to under-perform their peers, suggesting that the move to an originate-to-distribute model contributed to a relaxing of credit standards.

Most of these forces were not only at work in the United States – the centre of the sub-prime mess – and western Europe but also to varying degrees in the transition region. First, lending rates charged to borrowers across the transition region had decreased significantly since 2001. The period between 2005 and 2007 in particular was characterised by a boom in cheap credit.

Second, the availability of abundant cheap funding from foreign lenders made domestic local banks relax their lending standards. The EBRD’s Transition Report 2009 describes how collateral ratios for new mortgage lending declined, although this was not the case everywhere; in some countries (Poland, Croatia, and the Baltic states) regulators had started to impose stricter maximum loan-to-value (LTV) ratios. Other components of lending infrastructure were often missing as well, in particular the credit bureaus. This meant that banks found it difficult to check whether loan applicants had defaulted on previous loans or had been refused credit by competitor banks. In some countries customers were able to apply for loans from several banks at the same time, leading to over-indebtedness.

Third, although various transition countries made good progress with upgrading supervisory standards, banking supervisors across the region are still relatively inexperienced. Moreover, in some countries the funding of supervisory authorities was inadequate, making it difficult for the authorities to attract and retain high-quality staff lured by a booming
Part II: Debt enforcement in times of uncertainty

In contrast to the United States and to a lesser extent western Europe, lending standards in the transition region were only to a limited extent eroded further by securitisation.

A final problem more specific to the transition region was the widespread use of lending in foreign currencies (FX), mostly in euros and (in Central Asia) US dollars, but increasingly also Swiss francs and yen. Interest rates on these foreign currency loans were considerably below the rates on local currency loans – reflecting limited macroeconomic stability in a number of transition countries – and thus attractive to those borrowers that did not realise or properly consider the presence of exchange rate risks. Exchange rate risks were in many cases either ignored because of the implicit guarantees that accompanied hard currency pegs or because of expected adoption of the euro in the medium term. By lending in foreign currencies, banks exposed unhedged customers to significant currency risks. Indeed, the presence of foreign banks and the availability of abundant foreign financing appear to have led to more aggressive pricing of loans in foreign currencies.

The high levels of “euro-isation” also reflect the broader development model that many transition countries followed during the last 15 years: importing substantial amounts of foreign capital to fund consumption and investment. This resulted in high cumulative current-account deficits and in some countries in substantial upward pressure on wages and inflation, gradually eroding countries’ competitiveness. Vulnerabilities were thus not only building up at the microeconomic but also at the macroeconomic level.

In contrast to the United States and to a lesser extent western Europe, lending standards in the transition region were only to a limited extent eroded further by securitisation. Securitisation only emerged slowly at the height of the credit boom: after Latvia issued a residential mortgage-backed security (RMBS) in 2004, mortgage-backed securities were also issued in Kazakhstan, Russia and Ukraine in 2006-07. In Kazakhstan, residential mortgages were securitised by BTA Ipoteka, the consumer lending subsidiary of BTA, a bank that would subsequently default on its debt obligations in 2009. Covered bonds – where banks use on-balance sheet mortgages as collateral to issue bonds – were more popular in transition countries than mortgage-backed securities (where the risk of the mortgage is separated from the originating bank). This may have limited the agency problems associated with securitisation that were the undoing of the sub-prime market in the United States.

The development of distressed debt during the financial crisis

During the last quarter of 2008 and the first quarter of 2009 lending flows to the EBRD region contracted significantly. Domestic banks, confronted with less foreign funding, started to reduce their lending as well. This reduced production of “fresh loans” had an immediate impact on banks’ NPL ratios. The outstanding loan stock gradually seasoned and more and more problem loans appeared.

Because NPL definitions differ widely, data on NPLs are difficult to compare across countries. We therefore mostly compare changes in NPL levels, rather than the level itself. Moreover, the NPL numbers presented in this paper only present the official picture: rating agencies have repeatedly emphasised that true NPLs may be substantially higher in a number of countries. An important reason for the sometimes diverging official and unofficial statistics is that some banks pre-emptively restructure or roll-over bad loans before they are classified as “non-performing”. In such cases official NPL figures are edging up only slowly.
In turn, the severity of house price collapses that drove the increase in distressed debt can be largely explained by the size of pre-crisis housing price bubbles in various countries.

Mongolia saw a very sharp increase in NPLs from 2.8 per cent in June 2008 to 15.1 per cent in September 2009. The country has been hit by a liquidity and solvency crisis in its banking system in the wake of a protracted period of very high inflation, increasingly over-indebted borrowers, togrog depreciation and a slump in the construction sector. The absence of well-functioning credit bureaus in Mongolia meant that many rural borrowers were able to take out several consumer loans at the same time, leading to over-indebtedness and repayment difficulties when meat and cashmere prices fell during 2008-09. In addition, large-scale fraud and mismanagement in some banks went undetected due to weak supervision, leading to the failure of two banks.

In Kazakhstan, NPL levels increased from 5.1 per cent in June 2008 to 34.7 per cent in September 2009, the highest level across the region. Three factors have contributed to this sharp recent increase. First, some of the large banks have been in debt restructuring talks and therefore had to reveal their portfolio quality. Although Kazakhstan was hit by the crisis as early as August 2007, NPL ratios did not move much for about a year, a period in which some banks rolled over past-due loans to both corporate and retail clients. Second, the February 2009 tenge devaluation has gradually been feeding through the real economy as unhedged foreign currency borrowers had difficulties repaying loans. Third, the increase in NPLs also reflects sharp declines in real estate prices. The real estate sector was characterised by speculative investments in pre-paid apartments (Investquartiras) and left the main Kazakh banks overexposed. The real estate bubble burst in mid-2007, freezing the construction sector and bankrupting some

Note: Ratio of non-performing to total loans, expressed as an index with 100 = NPL ratio in June 2008. Underlying definitions and overdue thresholds for non-performing loans may differ between countries.

Source: National central banks, financial supervision agencies, CEIC Data Company.
In Latvia and in Kazakhstan non-performing loan levels have been driven in particular by a sharp drop in real estate prices, a sector to which banks were heavily exposed.

In Latvia, NPLs increased particularly fast, from 2.1 per cent in June 2008 to 14.5 per cent in September 2009, a level which is still considerably below both Kazakhstan and Ukraine. One reason for this difference in levels is that while the Kazakh tenge and Ukrainian hryvnia depreciated by a considerable amount, the Latvian lat was not devalued. Although this lack of nominal exchange rate flexibility may have increased the adjustment burden in other areas, it has prevented massive distressed debt problems for borrowers with unhedged foreign currency risk exposures (90 per cent of Latvian loans are foreign currency-denominated). The country has nevertheless been hit particularly hard by the crisis and economic output is expected to have dropped 16 per cent in 2009 alone. Parex Bank, one of the largest banks in the country, was nationalised in November 2008.

In Latvia and in Kazakhstan NPL levels have been driven in particular by a sharp drop in real estate prices, a sector to which banks were heavily exposed. More than half of all non-performing loans in Latvia are linked to mortgages, construction or real estate projects. More generally, there is a strong positive correlation between NPL increases and house price collapses in transition countries, as shown in Chart 3.

In turn, the severity of house price collapses that drove the increase in distressed debt can be largely explained by the size of pre-crisis housing price bubbles in various countries, which were fuelled, particularly in the Baltic...

![Chart 2](chart2.png)

**Levels of non-performing loans in selected transition economies**

![Chart 3](chart3.png)

**Correlation between house price collapses and relative change in NPLs**

Note: Real house price change is defined as the nominal price change of dwellings per square metre between the last peak and the latest available data, adjusted by annual average consumer price index. Data for Estonia and Hungary refer to the capital.
The International Monetary Fund estimates that at the end of 2009 non-performing loans amounted to about 30 per cent in Ukraine – close to the level of Kazakhstan.

Rapidly increasing real estate values, which served as collateral for mortgage loans but also for many corporate loans, gave banks a false sense of security and made them rely too much on collateral and not enough on cash flow analysis. In addition, Western banks were willing to provide loans to many banks across the transition region whose risk management systems were not yet on a par with international practice. Faced with a sudden abundance in available funding, local banks were tempted to spend money on seemingly straightforward projects such as large-scale residential real estate developments and office blocks.

Chart 4 shows that the collapse in real estate prices was most severe in countries where real house prices increased much faster than real income levels.

In Ukraine, NPL levels rose quickly from 3.3 per cent in June 2008 to 9.6 per cent in June 2009, according to official statistics. However, banks have been rolling over non-performing loans partly because of negative tax incentives on write-downs and this has kept official NPL statistics relatively low. The International Monetary Fund estimates that at the end of 2009 NPLs amounted to about 30 per cent in Ukraine – close to the level of Kazakhstan (see Chart 2). The high level of Ukrainian NPLs can partly be explained by defaulting unhedged retail clients that were exposed to foreign currency risks after the hryvnia lost almost 40 per cent of its value against the US dollar between September 2008 and June 2009. About 60 per cent of all loans were denominated in foreign currency.

In 2010 regional NPL levels can be expected to rise further, in particular for consumer and mortgage loans, as economic recovery will likely be slow and unemployment levels will continue to rise. Against this background, Chart 5 shows peak values for a number of other countries that experienced severe financial system stress in the past. While NPLs in Kazakhstan and Ukraine are close to the levels that some countries experienced during the 1997-98 crises, a comparison of Charts 2 and 5 shows that there is still a large distance between peak values in earlier crises and current NPL levels in most transition countries. To what extent – and how fast – these countries will reach similar peak levels will not only depend on the swiftness of the economic recovery but also increasingly on the options that are available to banks to efficiently restructure non-performing loans.

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*Note:* Real house price change is defined as the nominal price change of dwellings per square metre between the last peak and the latest available data, adjusted by annual average consumer price index. Data for Armenia, Estonia, Hungary, Romania and Ukraine refer to the capital.

*Source:* National statistical offices and central banks, real estate companies in Armenia, Hungary, Lithuania and Ukraine (and Czech Republic and Poland in 2006).
How to deal with distressed debt

When an economic and financial crisis leads to a sharp increase in distressed debt throughout the economy, governments can choose from three basic policy options: decentralised, semi-centralised and centralised approaches to debt restructuring.

First, in a decentralised approach the ownership and management of bad assets remains completely with the originating banks. This may be beneficial since banks usually possess relationship-specific knowledge which allows them to decide on the optimal strategy to privately restructure loans. Governments may thus take a hands-off approach and let creditors and debtors work out the problems related to defaulting firms on a case-by-case basis, using the existing insolvency legislation and the court system. The government may also take a more activist stance. While still opting for a decentralised approach, it can facilitate a system of large-scale voluntary work-outs between banks and debtors outside of the official court system (the so-called “London approach”). This involves setting up a general framework or template that groups of creditors can use to organise voluntary out-of-court solutions when a firm defaults. Creditors cooperate in steering committees under the guidance of a lead bank to restructure defaulting firms in a coordinated fashion. The majority of the creditors need to agree on the work-out plan and implement it. When it works well, this approach may allow a relatively large proportion of firms that need financial restructuring but are fundamentally sound, to continue as a going concern. Company failures due to excessively costly, burdensome and lengthy court procedures are avoided. However, paradoxically, this approach will only work to the extent that creditors can at least to some extent threaten defaulting firms with more formal liquidation procedures in case of insufficient cooperation. It is thus not a full substitute for imperfect formal insolvency procedures through the court system.

Fully decentralised approaches are only feasible as long as the amount of non-performing assets in the banking system is relatively limited. A financial crisis may, however, lead to such a widespread rise in distressed debt levels that systemic stability is threatened. This will particularly be the case if a high level of NPLs threatens to overwhelm a bank’s normal work-out procedures (or its capital base). Moreover, bankruptcy cases may be so numerous that local courts cannot cope with them in a reasonable amount of time. Even if both the banks and the courts would in principle

Chart 5
Distressed debt: some historical benchmarks from previous crisis episodes

Per cent

Note: Distressed debt is expressed as a share of non-performing loans in total loans. Source: Deutsche Bank, Bank for International Settlements.
Lastly, a third approach governments can follow in the case of widespread distressed debt is to set up a highly centralised and publicly owned asset management corporation.

A second approach the government can follow is therefore a semi-centralised one in which distressed assets of a number of banks are spun off into an equal number of private or semi-private “bad banks”. The Swedish approach in the early 1990s is an example of this. Most of the large Swedish banks set up their own “bad bank”, with suitable names like Securum, Retriva and Diligentia. Securum, the largest of the Swedish “bad banks”, is often cited as a successful example. This state-owned asset management corporation was established in 1992 and took over 21 per cent of the assets of Nordbanken, one of Sweden’s largest banks at the time. The transfer of assets took place at low prices and the resulting gap in Nordbanken’s balance sheet was plugged with equity injections from the Swedish government (which had previously partially owned Nordbanken). Shareholders had to accept substantial losses.

Early interventions such as Sweden’s are desirable because they prevent asset quality from deteriorating. However, “early” usually means that there is still substantial disagreement over the actual value of assets.

This was not the case in Sweden because at the height of the crisis it was possible to transfer assets unusually quickly and possibly at undervalued prices. This process was also helped by the government’s ownership stake in both Securum and Nordbanken. Time-consuming conflicts between the government and the banks were thus minimised. On a more practical level, Securum benefited from the fact that Nordbanken’s bad loans were large and mostly real-estate related. Smaller retail loans would have been administratively much more difficult to deal with.

Lastly, a third approach governments can follow in the case of widespread distressed debt is to set up a highly centralised and publicly owned asset management corporation (AMC). This centralised approach was chosen by many Asian countries in the aftermath of the 1997-98 financial crisis. The main advantage of such a centralised approach lies in its economies of scale. Centralised AMCs are better able to consolidate and securitise similar assets and therefore can translate their size into greater negotiating power against large and politically influential borrowers. The Republic of Korea is a good example because its AMC became heavily involved in the restructuring of the large Daewoo conglomerate. This task would have been difficult to implement with a greater number of smaller institutions. There is also a managerial argument for a centralised approach. Where loan resolution expertise is scarce it might be easier to coordinate the recruitment and training of qualified people in a single institution rather than having several agencies compete for the same small pool of people.
Part II: Debt enforcement in times of uncertainty

Both semi-centralised and centralised solutions...can prevent banks from becoming excessively risk-averse, and improve the environment for new lending.

Both semi-centralised and centralised solutions – if applied transparently and accompanied by an adequate recapitalisation of the banks – can prevent banks from becoming excessively risk-averse, and improve the environment for new lending. Just ring-fencing bad assets on banks’ balance sheets may, in contrast, not be sufficient to regain investors’ confidence and banks may consequently not be able to raise new capital.

Regardless of the level of centralisation, the government can also stimulate restructuring through auxiliary policies. First, liquidity support and deposit guarantees can prevent bank runs and provide distressed banks with the time they need to address elevated levels of non-performing loans. Second, granting tax breaks for write-offs may work as a “carrot” to persuade banks to deal swiftly with non-performing loans. On a more basic level, governments should ensure that incentives are supportive of debt restructuring. The current crisis has shown that this is not necessarily the case. In various transition countries, tax systems – and regulatory measures – have provided disincentives to write-offs. This stimulated banks to keep rolling over bad loans (so-called “ever-greening”). In Kazakhstan, for example, Articles 88 and 90 of the Tax Code impede the adequate provisioning for and writing-off of bad loans because write-offs lead to double taxation: both the creditor and the debtor must pay income tax on the amount that is written-off. Moreover, when the bank actually realises a loss for which it had provisioned, this realisation is treated as “income” and is therefore taxable. Similarly, in Ukraine, Section 12.2 of the Law on Corporate Income Tax stipulated that commercial banks cannot deduct for income tax purposes any provisions created in excess of 10 per cent of the loan portfolio. As in Kazakhstan, this meant that banks ended up paying income tax when writing off provisioned loans.

Third, to let the process of debt restructuring work efficiently, a well-functioning insolvency and secured transactions regime is indispensable. An effective insolvency regime allows banks to recover a higher portion of their exposure to defaulting clients, leading to smaller losses given a certain level of non-performing loans. Swifter insolvency procedures ensure, for instance, that firm owners have less time to strip the firm and move assets abroad (“tunnelling”). A full discussion of insolvency regimes goes beyond the scope of this article, but the example of Kazakhstan is worth mentioning. Before the outbreak of the crisis, the insolvency legislation in Kazakhstan required the consent of all creditors to a restructuring proposal. This meant that each individual creditor was able to block a restructuring even if a majority of creditors agreed with the proposal put forward. A change in the insolvency law effective as of August 2009 removed this obstacle, making restructurings easier from a legal perspective as a majority of the creditors can “cram down” a solution on minority creditors.
During much of 2010 and perhaps 2011, the problem of distressed debt is likely to gain in importance in various countries. This article has provided a broad overview of the genesis of the current distressed debt problem across the transition region, its severity across countries, and some of the policy options available when a case-by-case solution to non-performing loans is not possible or is suboptimal from a system-wide perspective. We argued that, as in the West, the root causes of the current debt problems in the transition region lie in a combination of abundant and cheap funding and a gradual relaxation of banks’ lending standards – in particular an excessive reliance on real estate and the expectation that real estate values would continue to rise rapidly. On top of this, banks across various countries in the transition region have suffered from losses due to customers that defaulted on unhedged foreign currency debt. During much of 2010 and perhaps 2011, the problem of distressed debt is likely to gain in importance in various countries. This is not only the case because NPLs tend to lag behind the onset of economic downturns, but also because in some countries banks have been relatively slow in recognising that large parts of their loan portfolios may ultimately not be performing. This has led to the rolling-over of bad debts and inadequate provisioning – in some cases in response to incentives imparted by tax codes and regulatory authorities – to boost profitability in the short term and postpone the raising of additional capital. Only when banks become sufficiently clear about their loan quality – for instance by publishing the results of stress tests – and take adequate measures to increase provisioning, will they be able to gradually regain market confidence and to access commercial funding sources. Still, even then bank funding will need to be structured in a more sustainable manner – more domestic deposit funding and less wholesale foreign borrowing – than in the previous decade.
There may also be benefits for the risk-taking culture in banks if loan
officers are exposed to the consequences of bad lending decisions
and/or economic downturns.

Notes and authors


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15. There may also be benefits for the risk-taking culture in banks if loan
officers are exposed to the consequences of bad lending decisions
and/or economic downturns.

16. This holds not only for the large-scale sale of houses due to mortgage
defaults. In rural Mongolia, banks are hesitant to realise collateral
from herders (sheep and goats) because selling these animals would
quickly depress their market price, further deepening the crisis.
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22. As of January 2010 this percentage was increased to 80 per cent
for non-bank financial institutions and – for a one-year period only –
to 100 per cent for banks.

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useful comments.
As global economic instability and insolvencies increase, so do the concerns of creditors who may want more information about their rights should their debtors enter insolvency proceedings. This article examines the aspects of the Insolvency Law Assessment 2009 which relate to creditors’ rights, namely issues surrounding: commencement of insolvency proceedings; moratoria on enforcement actions during proceedings; creditors’ claims and participation in the proceedings; priority ranking of creditors’ claims; and creditors’ relationships with insolvency administrators.
Insolvency law is often overlooked during stable economic conditions but is always among the first laws to be tested in times of economic crisis or distress. The importance of effective insolvency laws in emerging markets was highlighted during the financial crisis of 1997-98 in the Asian and European emerging markets. The response of the international community to that crisis continues to be relevant in the aftermath of the current global financial meltdown: “[w]ith credit markets tightening and enterprises struggling to survive, the challenge is to reinvigorate insolvency systems by promoting the restructuring of viable businesses, the efficient closure of failed businesses, and the transfer of their assets to more efficient market users.”

Regardless of the economic situation, an effective insolvency regime lies at the heart of creditors’ rights. Although individual creditors may view their rights in insolvency as a remedy of last resort and will usually go to great lengths to avoid exercising them, the existence of these rights is essential to guarantee that all creditors are treated fairly and transparently, should insolvency be the last chance to recover their claims. Insolvency law also affects creditor behaviour before insolvency proceedings commence. If recovery is too burdensome or uncertain through insolvency, for example, it could affect lending strategies and limit the availability of financing. Conversely, an efficient insolvency law usually provides both creditors and debtors a baseline position to negotiate through private work-outs.

An effective insolvency regime starts with a well-balanced law. Insolvencies involve complex economic and social effects, which require regulations to combine underlying policies which are often in conflict (for example, balancing the protection of employee rights with the contractual rights of creditors). Thus insolvency laws must be careful to strike an appropriate balance and to be flexible. In the last decade international bodies such as the World Bank, UNCITRAL, the Asian Development Bank and the EBRD have developed a number of guidelines and recommendations for approaching insolvency law reform, including identification of key insolvency law objectives.
In these times of economic uncertainty, investors place renewed importance on understanding how the law would treat their claims, should their debtor default or be declared insolvent.

For example, the first of the EBRD Insolvency Core Principles recommends that “an insolvency law regime should at all times promote economy, transparency and speedy resolution” and should provide for both liquidation and reorganisation (including work-outs).

**EBRD insolvency assessments**

Based on these international guidelines, the EBRD has conducted regular assessments of the insolvency laws in its 29 countries of operations and the Czech Republic. The assessments aim to analyse the policy choices embedded in the letter of the laws and compare these results with the recommended approaches put forward in the abovementioned guidelines. The first assessment was carried out in 2003-04 with further updates in 2006 and 2009. The 2009 assessment reviewed all 30 countries’ insolvency laws as of 1 January 2009 and took a deeper look at the regime underpinning the role of insolvency office holders (insolvency administrators, bankruptcy trustee, and so on) in response to the growing recognition of the importance these practitioners have on the efficiency of insolvency regimes.

This article reviews and analyses the aspects of the assessment specifically pertaining to creditors’ rights. In these times of economic uncertainty, investors place renewed importance on understanding how the law would treat their claims should their debtor default or be declared insolvent. The article addresses the following key issues reflected in the assessment that a creditor would look at to determine its strategy towards a defaulting debtor:

- requirements for initiation of proceedings – the speed and straightforwardness of the filing process for a creditor
- the stay on claims enforcement on commencement of insolvency proceedings – to which creditors will the stay apply
- how creditors lodge their claims and participate in the proceedings
- the priority ranking of each class of creditors.

In addition, the article provides an interesting insight into how the regulation of insolvency practitioners may affect creditors’ rights.

To carry out the assessments, the EBRD has created a checklist of key points that form the basis of an insolvency law. The law of each assessed country was evaluated based on the checklist. Generally, the assessment and rating were done in two stages. First, each law was assessed against the checklist and each question received either a full affirmative answer [Y]; a qualified affirmative answer [Y/?], which indicates some doubt or qualification; a negative answer [N], which indicates that either such provision does not exist or is considered inadequate or a qualified negative answer [N/?], which indicates significant doubt or that there may be some mitigating provisions. Second, a scoring system was applied to the answers to all questions for each country. The maximum score possible was 100 per cent and all questions were weighted equally – the purpose of such scoring is to provide a general picture of the quality of the insolvency law in place.

The full results of the assessment are available on the EBRD website.

**Creditors’ rights and the results of the assessment**

Before examining the specific issues involved in the assessment of creditors’ rights, it may be interesting to provide an overview of the results – especially in comparison with the complete survey. In other words, is the treatment of creditors in insolvency in a particular jurisdiction typical of the jurisdiction’s general approach to insolvency law, including other aspects such as court jurisdiction and proceedings, assets of the estate or reorganisation? Broadly, the answer seems to be yes. Jurisdictions which generally reflect well on international best practices also tend to adequately regulate creditors’ rights. There are a few jurisdictions with surprising results, however, such as Latvia, Lithuania, Slovenia and Turkey, where the law’s treatment of creditors better reflects international principles than the overall insolvency law itself. In Mongolia, Turkmenistan (maybe somewhat unsurprisingly), Ukraine and Uzbekistan the opposite can be observed.

This pattern is in contrast with the popular idea that transition economies are across-the-board pro-debtor. In fact, there seems to be little such evidence from the results of the EBRD assessment. On the contrary, those countries that have modernised their insolvency law regime appear to have taken great care to strike a balance where due process, transparency and information are ensured together with protection of creditors’ rights and interests.
Among the most restrictive requirements for entering insolvency are those which force creditors to obtain a judgment recognising the existence of, validity of and default on the unpaid debt before filing for the debtor’s insolvency.

Creditors should be able to initiate insolvency proceedings against a defaulting debtor fairly quickly and via straightforward actions. It is important that the barriers to entry into insolvency proceedings are not too high and provide internal checks against fraudulent filing. The assessment looked at criteria required for creditors to file an insolvency action. In particular we considered (i) the length of time creditors must wait before filing after the debt is past due and (ii) the procedural requirements, such as written documents which must be produced by the creditor or specific procedural steps which must be taken to commence proceedings. Positive marks were given to regimes that do not unduly restrict a good faith action by a creditor to commence insolvency by imposing, for example, long time periods before filing, minimum debt amounts or overly burdensome proofs of existing claims. The assessment shows that most countries have relatively straightforward procedures, with 15 countries receiving a completely positive score. Bosnia and Herzegovina, for example, allows a creditor to file an insolvency action against a debtor who fails to pay a due debt for 30 days or more.

However, there are a number of countries that impose a range of unnecessary restrictions on creditors filing insolvency actions. For example, some insolvency regimes impose an overly long waiting period before creditors may file for bankruptcy. Russia, for example, requires that three months must pass before a creditor is allowed to file. Similar time periods are set by Albania, Kazakhstan and Lithuania.

Indeed, a number of regimes also require that the debt that is due and unpaid must reach a minimum threshold for the creditor to initiate insolvency. Any such limitation appears unnecessary since it is not conclusive: a debtor who owes US$ 10 and cannot pay may possibly be even more insolvent than a debtor who owes US$ 10,000 and cannot pay. Kazakhstan, for example, requires that the claim be equal to or higher than 150 monthly conventional units (approximately €900). The Kyrgyz Republic has a similar requirement. Azerbaijan does not allow insolvency commencement at all unless the overdue claims constitute 10 per cent of the statutory capital of the debtor.

Among the most restrictive requirements for entering insolvency are those which force creditors to obtain a judgment recognising the existence of, validity of and default on the unpaid debt before filing for the debtor’s insolvency. Obtaining such a judgment may take substantial time. The challenge will be particularly acute for foreign creditors who may have to first get a judgment in the jurisdiction governing the contractual relationship with the debtor, or an arbitration award and then get that judgment or award recognised by the local court. Ukraine imposes such a requirement.
A key feature of insolvency proceedings is the stay on individual enforcement actions by creditors on commencement of the proceedings.

It is very encouraging, however, to note that these restrictive initiation criteria tend to be repealed or have been significantly eased over time. The 2003 assessment showed that 13 out of the 27 assessed jurisdictions (48 per cent) were given a negative grade on this issue; in the 2006 assessment, which reviewed 29 systems, this had slightly decreased (13 out of 29 – about 45 per cent). In 2009 the percentage of countries providing overly restrictive entry criteria has fallen to 20 per cent (six countries out of 30).

Many countries have instituted these restrictive measures in an attempt to prevent creditors from using bankruptcy for abusive purposes, such as to eliminate a competitor, to overtake the management of the debtor or to acquire the debtor’s assets at reduced prices. Such fears may well be grounded in the EBRD region. However such limitations seriously hamper the efficiency of the insolvency system by unduly preventing a large number of good-faith creditors from using the insolvency regime in an efficient and legitimate fashion. By the time all criteria are fulfilled, many of the debtor’s assets may have been dissipated, its business sunk, and its chances of recovery close to nil.

Insolvency laws cannot provide the cure for all abuses and misdeeds that it may be used for. Measures to prevent misuse of the system should be the competence of other areas of law and addressed within those areas. Thus, it may be the judge’s role to consider the good faith and validity of a creditor’s claim when evaluating whether to open insolvency proceedings. Similarly, the debtor must be able to challenge the creditors’ claims. Other measures to prevent abuse include harsher civil and criminal liability for creditors and their controlling entities who engage in such actions. Such measures require efficient mechanisms to uncover creditors’ abuse when it occurs.

Stay or moratorium on creditors’ enforcement

A key feature of insolvency proceedings is the stay on individual enforcement actions by creditors on commencement of the proceedings. Ideally the stay should be automatically imposed at the opening of insolvency proceedings and should apply to all creditors. This ensures that all creditors are treated equally and gives the debtor breathing room to assess its financial situation and to make decisions regarding the possibility of a reorganisation or, instead, liquidation. Should the debtor and creditors opt for reorganisation, it is particularly important that all creditors are stayed, including secured creditors, lessors and creditors with retention of title.

Almost all countries in the 2009 assessment provide for an automatic stay on unsecured creditors on the opening of proceedings. Only Latvia requires a separate court order for the moratorium in accordance with its 2007 Insolvency Law. Ukraine, which in the 2003 and 2006 assessments, was criticised for not imposing an automatic stay, has since adopted such a provision.

Most countries also extend the stay to secured creditors, preventing enforcement of secured claims until the observation period ends, but this is not as widely accepted as the stay on actions by unsecured creditors. The number of jurisdictions providing an automatic stay on secured creditors has slightly increased over the years: in the 2003 assessment, 16 out of 27 jurisdictions imposed a stay; in 2006, 20 out of 29 and in 2009, 21 out of 30. In three jurisdictions, secured creditors would be allowed to continue their claims after the commencement of the insolvency proceedings: Albania, Kyrgyz Republic and Turkey. In other systems, the stay on secured creditors is not automatic: the court may impose a stay ex officio or on request. In Croatia, for example, the imposition of a stay is at the discretion of the court. Although the automatic stay on commencement is recommended, it allows for a situation in which if a creditor perceives that the preservation of its collateral is under threat, the court could order a specific protective injunction or lift the stay altogether under certain circumstances.
Part II: Debt enforcement in times of uncertainty

Current developments in technology and increased availability of electronic mail and filing systems should permit the notification process to become much less expensive and more logistically manageable.

Perhaps the most surprising finding of the assessment on this question is that most countries do not extend the stay to creditors with retention of title rights (even if the ownership right serves the function of a security right). The 2009 assessment shows that only four out of 30 countries impose the stay on such creditors – the same number as in 2003 and 2006. Montenegro is one of very few countries that imposes an automatic stay on any and all claims against the debtor from the moment of registration of the insolvency petition.

The problem with singling out categories of creditors for imposing a moratorium is that it permits a potentially very large share of creditors to continue enforcing their rights once bankruptcy has started, thereby considerably reducing the chances of reaching an agreement on a reorganisation plan. Some would also argue that it goes against the very basic philosophy of insolvency law, which is to treat all creditors equally.

Filing of claims and creditors’ participation in the proceedings

Another important issue concerns the creditor notification, filing requirements for creditors’ claims, and the degree of creditors’ participation in the insolvency proceedings. Generally, it is accepted that, as much as possible, all known creditors should be notified as early as possible that insolvency proceedings have been initiated against the debtor and given information about when they may lodge their claims. The timing of filing is often crucial for a creditor’s ability to influence the course of insolvency proceedings and, in some jurisdictions, may even affect its ability to recover a claim at all.

The assessment shows that all jurisdictions have consistently required public notification of commencement of proceedings. The insolvency administrator (as in Moldova) or the court (as in Albania) must issue a notice in one or two national publications. In Poland, the notice must be published in the Economic and Court Gazette and in one daily newspaper. A recent trend, seen in Romania, is to create a special agency to publish such notices in specifically designated publications. The increasing availability of the internet has prompted some laws to require courts (or specifically created registers) to publish such information on their web sites, as for example in Russia – although such a register was still under preparation as of the writing of this article.

Not all legal regimes, however, require individual notifications to all known creditors about the commencement of proceedings and about their right to lodge claims. Based on the 2009 assessment, the jurisdictions that have clear requirements to notify creditors individually are: Albania, Bosnia and Herzegovina, Croatia, Estonia, Kazakhstan, Lithuania, Montenegro, Romania, Russia and Tajikistan. Interestingly, it seems that the number of jurisdictions requiring individual notification has slightly decreased: in 2003 – 13 out of 27 countries assessed such requirement, in 2006 – 13 out of 29, and in 2009, only 10 out of 30.

This trend is to some extent understandable: individual notification of creditors can be very costly, especially for large enterprises, and public notification can fulfil the same purpose at a fraction of the cost to the debtor. Public notification in effect shifts the costs to creditors, who must regularly monitor such public sources. This may be especially difficult for foreign creditors. Current developments in technology and increased availability of electronic mail and filing systems should permit the notification process to become much less expensive and more logistically manageable and thus may prompt lawmakers to begin to require individual notification to creditors.

The issue of notification becomes acute when the law provides a tight deadline to creditors for lodging their claims and also provides that failure to do so would result in the creditor being unable to recover its claim or exercise its rights. All countries set deadlines for submission of claims, ranging from one month to one year. But in seven jurisdictions, with a relatively short filing period of up to two months, failure to file claims in a timely manner results in the creditor losing the right to claim.

Ukraine is a case in point. The 1992 Insolvency Law does not require debtors to notify creditors individually of commencement of insolvency, only public notification via a newspaper.
A creditor then has 30 days to file its claims; failure to do so would result in the claim being forfeited. Other countries, including Czech Republic, FYR Macedonia, Mongolia, Romania, Slovak Republic and Slovenia, have similar consequences for failure to file claims.

Lawmakers’ desire to ensure creditors’ discipline may be laudable but it is too extreme in these cases. Foreign creditors in particular would be seriously affected by cut-off deadlines as they may not have sufficient time to prepare and submit their claims. Timely filing would be ensured just as effectively by providing less drastic disincentives for late filing such as provisions requiring that related expenses (for example for reconvening the court to approve the amendments) be borne by the late filing creditor (as in Moldova); that a creditor may not be allowed to challenge decisions made before filing its claim; or that the distribution of proceeds to such a creditor be calculated as of the date of filing.

The other aspects of creditors’ participation in the insolvency proceedings reveal much less controversy. The 2009 assessment revealed that, except in Mongolia and Turkmenistan, the insolvency laws give creditors the right to appeal if their claim was rejected or only partially accepted. Similarly, all countries provide for the creation of a creditors’ committee to monitor the proceedings. In all jurisdictions the creditors must be kept informed about the progress of the insolvency case and should be able to appeal to a court to review aspects of the case which affect their interests.

In all jurisdictions the creditors must be kept informed about the progress of the insolvency case and should be able to appeal to a court to review aspects of the case which affect their interests.

<table>
<thead>
<tr>
<th>Secured claims satisfied out of proceeds from the collateral first</th>
<th>Secured claims subordinated to other claims</th>
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<tr>
<td>Albania*</td>
<td>Moldova</td>
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<td>Armenia</td>
<td>Mongolia</td>
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<td>Azerbaijan</td>
<td>Montenegro</td>
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<td>Bosnia &amp; Herzegovina</td>
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<td>Bulgaria</td>
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<td>Croatia</td>
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<td>Czech Republic</td>
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<td>Estonia</td>
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<td>FYR Macedonia</td>
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<td>Hungary</td>
<td>Turkmenistan*</td>
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<td>Kyrgyz Republic</td>
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<td>Latvia</td>
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<td>Lithuania</td>
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<td>Belarus*</td>
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<td>Kazakhstan*</td>
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<td>Tajikistan*</td>
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<tr>
<td>Ukraine*</td>
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</table>

Source: EBRD Insolvency Law Assessment, 2009

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a  Although the Insolvency Law 2002 gives priority to the secured claims, the Civil Code of Albania (article 605) contains a number of provisions that may be interpreted to undermine the Insolvency Law provisions.

b  Although the Insolvency Law 2003 gives first priority to the secured claims it also gives first priority to the bankruptcy cost. The law is not clear how this difference is reconciled in practice.

c  The following claims must be paid out before secured claims: severance payments to employees, compensation costs for bodily injury and loss of life, bankruptcy costs and current expenses.

d  The following claims must be paid out before secured claims: bankruptcy procedural costs, current expenses, payments to the insolvency office holder.

e  The following claims must be paid out before secured claims: bankruptcy costs, alimony payments, compensation costs for bodily injury and loss of life, unpaid wages and social security payments.

f  The following claims must be paid out before secured claims: compensation costs for bodily injury and loss of life, severance payments to employees and unpaid wages.

g  Secured claims are ranked on a par and shall be paid out proportionally with three months of unpaid wages, bankruptcy costs and payments to the Deposits Guarantee Fund (in case of banks).
Part II: Debt enforcement in times of uncertainty

The results show that secured creditors do not see severe modification to their rights in the collateral, ranking order in enforcement, or mode of realisation, when their debtor becomes insolvent.

Priority ranking of creditors’ claims

An important rule, which greatly impacts creditors, is the ranking of their claim compared with other claims to the insolvent debtor. Concurrently with the assessment, the EBRD looked at the ranking of creditors’ claims in each of the EBRD’s countries of operations and the Czech Republic. This undertaking was separate from the assessment since it is recognised that the order of priority ranking is a highly political question, which very much depends on the economic and social circumstances of the jurisdiction, rather than serving more generally accepted aspects such as the clarity and predictability of the ranking system.

The results show that secured creditors do not see severe modification to their rights in the collateral, ranking order in enforcement, or mode of realisation, when their debtor becomes insolvent. As EBRD data show, 23 of the 30 countries explicitly provide that claims of secured creditors will be satisfied out of the proceeds of the collateral on which they have a security right, ahead of any other creditors or even in a completely separate process (see Table 1). In the other seven countries different categories of claims could take priority over secured creditors, such as all unpaid employee wages and compensation damages for health injuries in Belarus, Kazakhstan and Tajikistan. In Georgia the costs of the bankruptcy proceedings must be paid out first and these are not capped, nor strictly related to the costs of realisation of the collateral. In Ukraine secured creditors rank on a par with three-months unpaid employees’ wages and all bankruptcy costs. In Turkmenistan, the rules are confusing since both secured creditors’ claims and full bankruptcy costs are given first priority. In Albania too, the situation is confusing because of the lack of coordination between the Insolvency Law and relevant provisions of the Civil Code.

In each of the 23 countries mentioned above, some administrative costs may be repaid out of the proceeds from the secured collateral. Some systems, like Montenegro, limit the costs to the realisation of the specific collateral. Some systems cap the costs which would precede secured claims. It varies from 30 per cent (in Russia) to 10 per cent (in Poland). In some countries, enforcement of collateral is conducted separately from the insolvency proceedings – secured creditors apply for the separation of their encumbered assets from the bankruptcy estate and can realise them individually. This is the case in Bosnia and Herzegovina, Croatia, FYR Macedonia, Kyrgyz Republic and Turkey.

Creditors’ relationship with the insolvency administrator

The regulation of insolvency practitioners (such as insolvency office holder, administrator, trustee, and so on) and their activities is an important ingredient of the efficiency of insolvency regimes because in all of the EBRD’s countries of operations, the insolvency law provides for an insolvency practitioner to be assigned to either supervise or replace the management of the debtor on the commencement of the insolvency proceeding. The creditor-practitioner relationship during the proceedings is thus particularly important for the preservation of creditors’ rights.

The assessment shows that creditors in 15 out of 30 jurisdictions have little or no say in the appointment of the insolvency administrator, and in 10 countries creditors could not challenge the appointment. In contrast, some countries allow creditors to take an active role; in Croatia, Estonia and Romania, creditors may replace the court-appointed practitioner with a practitioner of their choice for preliminary proceedings.

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Most countries appear to prefer that courts make the appointment with little participation from the debtor or creditor and, to avoid any abuse, require that practitioners be chosen from a pre-set list in a consecutive manner, as in Kazakhstan. Some countries go so far as to require random selection from a list or an appointment by lottery as in Hungary. Under an effective insolvency regime, creditors should be able to challenge the appointment of the insolvency practitioner based on several grounds, including conflicts of interest or other questions of independence or the inability to properly administer the case (by reference to expertise, experience and resources).\textsuperscript{18}

The assessment provides considerable insight as to the limitations of many legal regimes in ensuring the quality of the insolvency practitioner’s profession, and thus sometimes the mistrust that creditors may harbour against them. This article does not provide the space to go further into the subject – suffice to say that efficient insolvency proceedings in the assessed region are inconceivable without a good insolvency practitioner, and that further work will be required in many of the EBRD’s countries of operations in the future.

Conclusion

Should creditors worry? This was the starting point of this article. On the one hand, it is fair to say that the picture is encouraging but also mixed. In many jurisdictions, some issues such as the automatic stay on creditors’ claims and ranking order are fairly settled. On the other hand, commencement criteria, notification process, lodging of claims, and the creditors’ ability to act as a check on insolvency administrators continue to raise concerns.

Finding ways to use technology more advantageously and ways to prevent abusive use of insolvency law may help further strengthen creditors’ rights. However, in other areas, legislative improvement will not be enough: regulatory measures, such as the development of the insolvency practitioners’ profession towards a highly qualified, accountable, and ethically sound professional body will be essential.
Notes and author

1 The three EBRD insolvency law assessments have been prepared by EBRD consultants Neil Cooper and Ronald Harmer, with the participation of Mahesh Uttamchandani, Melissa Burgess and Michel Nussbaumer. This article does not necessarily represent the opinion of the EBRD, nor does it constitute legal advice in any way. The author would like to thank Frédérique Dahan and Elizabeth Kirk for their very useful advice on the draft article. All mistakes or errors are the author’s only.


3 G. Johnson, supra note 2, page 14.


6 The Czech Republic graduated from the EBRD’s operations as of the end of 2007, but was included in the 2009 assessment for the sake of consistency.


9 See for example, EBRD Core Principles for an Insolvency Law Regime, Principle 1 states: “The ILR should at all times promote economy, transparency and speedy resolution. (All insolvency processes are inherently disruptive to the community and should, therefore, be resolved as quickly as possible. A lengthy process is almost always consistent with a deterioration in the value of the debtor’s assets…)”; World Bank Principles for Effective Creditor Rights and Insolvency Systems (revised 2005), C4.2 states: “Commencement criteria and presumptions about insolvency should be clearly defined in the law. The preferred test to commence an insolvency proceeding should be the debtor’s inability to pay debts as they mature,…” and C4.3 – “Debtors should have easy access to the insolvency system on showing proof of basic criteria (insolvency or financial difficulty)” at: www.worldbank.org/ifa/FINAL-ICRPrinciples-March2009.pdf.

10 One monthly conventional unit (MCU) equals 1273 tenge, see Law on National Budget for 2009-11, dated 4 December 2008, Nr. 96-IV.


12 See, for example, EBRD Core Principles for an Insolvency Law Regime, Principle 4 states: “The ILR should provide for immediate interim conservatory and protective measures (Often there is a time gap between the initiation of the insolvency proceeding [such as the filing of a petition] and the administration of the insolvent estate. While this time gap should be kept as small as possible, the ILR should provide interim protection, for the benefit of the debtor and the creditors, to ensure that the assets of the debtor are safeguarded during this period. Where reorganisation is appropriate, interim protective measures will permit the debtor reasonable time to restructure its affairs and protect its assets from being stripped away by anxious creditors)”.

13 World Bank Principles for Effective Creditor Rights and Insolvency Systems (revised 2005), C5.2 states “…The injunctive relief (stay) should be as wide and all-encompassing as possible, extending to an interest in assets used, occupied, or in the possession of the debtor”.

14 See, for example, EBRD Core Principles for an Insolvency Law Regime, Principle 2 states: “The ILR should provide clear tests for the initiation of an insolvency proceeding and should require notice to be given to all known creditors of such proceeding”.

15 See bankruptcy.interfax-aki.ru.

16 Based entirely on the results of the EBRD Insolvency Law Assessment 2009.

17 These are: Albania, Armenia, Azerbaijan, Georgia, Hungary, Kazakhstan, Latvia, Montenegro, Turkmenistan and Tajikistan.


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Debt enforcement is an issue where the legal framework plays an immensely important role for both creditors (secured and unsecured) and debtors. Whereas much reform has taken place in the areas of secured transactions and insolvency laws, too little still is known about how these laws are used by lenders and borrowers when structuring transactions, when the debtor shows signs of financial distress and finally when the loan becomes “non-performing”. The global crisis has brought this question into focus and presents an opportunity for the EBRD to try to discover these essential links between what the legal framework allows for debt enforcement and the real outcomes and recovery rates for lenders.
The mission statement of the EBRD’s Legal Transition Programme is to “help create an investor-friendly, transparent and predictable legal environment to improve the investment climate in the Bank’s countries of operations”. In times of economic distress, where the return on the investment becomes highly doubtful, such a mission concentrates on providing investors with greater certainty of their rights.

Debt enforcement remains one of the most severe flaws in transition economies. Not surprisingly, untested laws, weak institutions and a radical change in the business culture come to the fore when there is a breakdown in the contractual relationships. This does not mean that no progress has been made.

In 2003 the EBRD ran an extensive survey focusing on the practical results of the enforcement of a hypothetical secured debt.1 Respondents were asked to assess a secured creditor’s ability to initiate an enforcement procedure and recover its loan from the charged assets, giving an indication of the amount of any likely recovery and the time it would take to complete the enforcement procedure. The survey also requested additional information on various aspects of enforcing a security right, such as the effect on the procedure should the debtor be declared insolvent; the risk of competing claims (priority creditors such as tax claims or employees, judgment creditors, statutory liens, and so on); and the recovery procedure, in particular the scope for debtor obstruction.

The results confirmed that, in broad terms, countries that had reformed their secured transactions legal framework provided better outcomes on the enforcement side too. The laws had been amended and the enforcement provisions revised and strengthened, and the perception of domestic practising lawyers...
The reforms that have taken place in the last 15 years in transition economies have demonstrated that it is possible for an emerging market to create almost from scratch a legal regime that provides efficient ways to enforce debt, and specifically secured debt.

was that these would withstand the practical test. However, in some countries where the secured transactions law had been reformed, enforcement remained a serious problem. This was the case at the time in Albania, the Kyrgyz Republic, Moldova, Poland and Romania where institutional weaknesses were clearly evident in the results of the survey (for example, the ability of the court system to support the enforcement process).²

The survey did not quite fully address the situation of a debtor’s insolvency, which dramatically increases the magnitude of the problems because “[i]nsolvency law is the root of commercial and financial law because it obliges the law to choose. There is not enough money to go round and so the law must choose who to pay. […] In ordinary commercial dealings, black letter law in the books often does not matter much: relationships matter more. On bankruptcy where competition is at its sharpest, black letter law decides negotiating position and outcomes.”³ The current financial crisis has highlighted this in a painful manner. For institutions such as the EBRD and the World Bank which have a mission to try and assist transition economies and developing markets, the challenge is to advise on what legal provisions transition countries should adopt to ease the problems and on how transition countries can ensure that such rules are effectively implemented and operate as intended.

Naturally, countries are not facing this crisis in a vacuum. All have adopted (and sometimes several times reformed) corporate insolvency legal regimes, which provide a structure of rights and duties, most often guided by foreign assistance.⁴ Are they thus well equipped? Will these systems reassure investors and borrowers and provide a general legal framework against which private renegotiations and debt restructuring may take place? We know that the “quality” of the insolvency and secured transactions laws in the region is very mixed, but how these laws will perform is not clear. Most importantly, we may not understand why they perform as they do.

The answer to this question requires that institutions have a deeper understanding of the key ingredients for efficient and successful debt enforcement in transition economies, including in insolvency, and how these ingredients operate when combined. However, in our view, the current knowledge is still too piecemeal to provide such an answer. What is needed is to fill the gap in knowledge between, on the one hand, the known key ingredients and policy options of secured transactions, debt enforcement and insolvency law, and on the other hand, the economic data on outcomes and economic efficiency.

Efficient debt enforcement in insolvency: key ingredients of a legal regime

The reforms that have taken place in the last 15 years in transition economies have demonstrated that it is possible for an emerging market to create almost from scratch a legal regime that provides efficient ways to enforce debt, and specifically secured debt. A good deal of progress has been made and this should be acknowledged.⁵ The reforms are, of course, all country-specific, however there are some common trends.⁶

There is a consensus that enforcement procedures should enable prompt realisation at market value of the assets given as security. If the value received on realisation is expected to be only half the market value, the creditor will require more assets to be given as security. If it is expected that enforcement will take two years, similarly the creditor will give less favourable credit terms to the debtor.

The security right should continue to be effective and enforceable after the insolvency of the person who has given it. The position against which the creditor most wants protection is the insolvency of the debtor. Any reduction of rights or dilution of priority on insolvency will reduce the value of security.

It has been recognised that parties should have contractual freedom to provide the terms of their agreement, and that such freedom should extend to the means of enforcement of the secured debt, unless such means are deemed to be against public policy. Such clauses which give creditors the ability, on default of a debtor, to start enforcement of their security rights and realise the collateral are now widely permitted.
The current crisis has also reminded us of the importance for secured creditors to have an insolvency legal regime in place, which will act as the baseline for parties’ private negotiations and debt restructuring.

It is now widely accepted that courts do not necessarily need to be involved in enforcement but could be circumvented or replaced by quasi-public institutions, such as notaries, to supervise and organise the enforcement process and realisation of the collateral. The role of the court becomes that of a safety net, only called on when there is a dispute between parties or third parties as to the legality of the process.

Changes to secured transactions law have not happened in isolation. Insolvency laws have also undergone dramatic changes. The two areas of law have often been depicted as being at odds – secured credit was the realm of creditors that should be protected at all costs because credit is the life blood of any economy; insolvency was the realm of debtors, who needed a system to allow their survival and to protect themselves and their employees. In fact, in insolvency, all parties – the banks, the employees, the tax authorities and the shareholders – are actually creditors; all parties benefit from the debtor surviving the bad spell and being able to carry on doing business if its business is economically viable, or from liquidation of the business if it is not. The current crisis has also reminded us of the importance for secured creditors to have an insolvency legal regime in place, which will act as the baseline for parties’ private negotiations and debt restructuring.

Corporate insolvency laws are typically meant to serve two principal objectives:

- to provide fair and predictable treatment of creditors
- to assist in maximising the assets of the debtor in the general interests of creditors.

Developed economies’ laws have widely different ways of achieving these objectives and the particular economic (“how to save jobs?”) and social (“what is fair?”) circumstances influence the policy choices. However, in all developed economies, provisions exist which would, in case of a debtor’s default, prevent a race among creditors to enforce individually their rights against a common debtor and facilitate the reorganisation of viable business enterprises and the liquidation of those that are not viable. As M. Uttamchandani writes, “the designations of ‘debtor-friendly’ or ‘creditor-friendly’, while potentially useful in the broad sense of understanding a system, obscures the importance of a system that provides stakeholders with the tools and incentives to achieve a variety of outcomes that are appropriate within the specific regulatory and institutional environment of that country.”

Here again, the reform trends show some basic, yet fundamental goals to be achieved.

- The regime should promote economy, transparency and speedy resolution. All insolvency processes are inherently disruptive to the community and should, therefore, be resolved as quickly as possible. A lengthy process is almost always consistent with a deterioration in the value of the debtor’s assets. In addition, for the process to be acceptable to as wide a group of stakeholders as possible, it should be seen to be public in nature.

- The law should provide clear tests for the initiation of an insolvency proceeding and should require notice to be given to all known creditors of such proceeding.

- The regime should permit both bankruptcy (liquidation/wind-up) and restructuring (reorganisation/work-outs). Liquidations are necessary to cull inefficient or unprofitable business from the marketplace and redistribute resources to more efficient or profitable ones. A modern insolvency law, however, must permit reorganisation or private work-outs, where appropriate, as a way of preserving the going-concern value of a debtor’s assets, enhancing stability within the debtor’s community and encouraging debtors and creditors to work towards amicable resolutions.

- The law should provide for immediate interim conservatory and protective measures for the benefit of the debtor and the creditors to ensure that the assets of the debtor are safeguarded during the entire proceeding. Where reorganisation is appropriate, interim protective measures will permit the debtor reasonable time to restructure their affairs.

- Where liquidation is appropriate, the law should strive to interfere as little as possible with the efficient realisation by secured creditors of their security. Where no going-concern value is to be preserved, the insolvency law should limit its conflict with the existing contractual rights of secured creditors.
It is now widely accepted that reducing credit risk benefits the economy as a whole by promoting access to credit and that the legal framework for credit (in particular secured credit) should be enabling and facilitative, while taking into account the specific contextual concerns.

**Economic impact of insolvency law and creditors’ protection: does it matter?**

It is now widely accepted that reducing credit risk benefits the economy as a whole by promoting access to credit and that the legal framework for credit (in particular secured credit) should be enabling and facilitative, while taking into account the specific contextual concerns. Legal regimes allow market players to enter into transactions efficiently, enforce contracts when necessary, and liquidate businesses if they fail, and work best when there is confidence in the process, it is speedy and inexpensive, and confers a reasonably predictable outcome.

There have been attempts to try to measure the impact of those different legal regimes across the world. The seminal article “Law and finance” began the study of the relationship between legal frameworks and economic outcomes. Initially, scholars focused on whether the origin of the legal framework (and, by extension, its major features) was correlated with economic development, as measured by GDP or per capita income. The analysis of creditors’ rights in “Law and finance” concluded that legal origin (common law or French, German or Scandinavian civil law) is of significance for many creditor rights, with common law offering stronger creditor protection than civil law, and French civil law jurisdictions offering the lowest level of protection. This legal origins hypothesis is taken up by Djankov et al, in their ongoing study “Debt enforcement around the world”. The study surveyed local lawyers on how the laws in their countries would work in practice in the case of a hypothetical senior secured debt with a debtor on the brink of default. The authors then rated each jurisdiction on whether it could achieve the most “efficient” outcome – the continuation of the debtor as a going concern. Such an outcome may not be the most efficient in all cases. Their conclusions were that, although the features of the law (and therefore its legal origin) have some bearing, the general economic development of the jurisdiction (as measured by the per capita income) is a closer determinant of the likelihood of reaching the efficient outcome in the jurisdiction.

Where does this leave emerging markets? Must they ignore the calls for reform of their insolvency regimes and focus on improving general macroeconomics? There is certainly much more they can do, and Djankov, in “Bankruptcy regimes during financial distress”, suggests a number of possible options to improve the efficiency of the process, especially in times of systemic distress such as the world is experiencing now. These are: minimising dependence on the courts for debt enforcement; establishing specialised courts to deal with commercial or bankruptcy issues; reducing the time that court proceedings take by limiting appeals and introducing statutory limits; and publicising decisions and auctions on the internet.

An empirical study by Davydenko and Franks on the issue of debt enforcement examines actual recovery rates and outcomes for loans in France, Germany and the United Kingdom. Using historical data on borrowers and banks, the study concluded that lenders make significant changes in their lending practices (namely, changes in the amount and type of collateral required) based on the level of creditors’ rights in their jurisdiction, and that in general, the level of recovery varies with the level of creditor protection. This, like legal origin, relies on macro-level differences among developed countries. However, this study does not explain how or why lending practices were shaped by the legal framework. It thus leaves emerging markets with some uncertainty about the choice they need to make, especially in times of crisis if it transpires that the system in place is not coping well.

We believe that existing research has thus not yet captured how particular features of insolvency law actually drive creditors’ (and debtors’) actions in enforcement. The differences in creditor protection among the different jurisdictions are clear. But the conclusions do not provide those emerging
Part II: Debt enforcement in times of uncertainty

A legal framework which allows creditors ample room to restructure and renegotiate debts with defaulting debtors will likely lead to fewer insolvency proceedings and higher recovery rates for creditors.

To adequately advise on reforms in emerging economies, and incidentally include them in the research debate around these issues, we need to explore “the bit in the middle”: namely, how the features contained in the secured transactions and banking laws are used by lenders; what measures they take to protect themselves against their debtor’s default; what incentives or concerns drive creditor and debtor behaviour when the debtor’s financial situation becomes difficult; and how they finally use all the features of the legal framework for debt enforcement and insolvency combined. The next section will briefly develop how we intend to undertake such research.

The “bit in the middle”: exploring how debt enforcement and insolvency legal frameworks are used and why they operate the way they do

We hereby suggest undertaking empirical research in a selected number of the EBRD’s countries of operations to fill the gap mentioned above. Such research would consist of studying selected financial institutions in a given country and the policies and practices in relation to non-performing loans and other delinquent corporate debts (secured and unsecured). Such research would need to capture institutions’ expectations of their position in the legal framework and how those expectations influence decision-making regarding debtor defaults; the measures financial institutions take to limit the potential losses as a result of such distressed loans and their expectations of how the loan will perform – especially whether the debtor should file for insolvency or be declared insolvent. Comparing this information with recorded defaults and proceeds collected on enforcement in the same institutions should give a clearer picture of how creditors navigate these issues.

The objective of such work should be to discover how lenders’ expectations of their position in the legal framework influence their decision-making regarding debtor defaults, especially in insolvency. A few examples illustrate the concept.

Prior to commencement of insolvency

Before a debtor enters into insolvency proceedings, secured creditors have many more choices for dealing with defaulting debtors and preserving the value of the encumbered property. Many of these are contractual, but the availability and use of certain legal provisions will have an impact on what decisions creditors make. For example, if the secured transactions law provides creditors with the ability to take a security interest over the entire enterprise of the debtor, such security will presumably put him in a special position (akin to administrative receivership in the United Kingdom) in which the creditor, and not the debtor’s management or the judicial authorities, is in control of proceedings. This could make creditors more likely to delay enforcement because they have the safety net of control due to the wide scope of their security interest. By looking at the terms of the financial institutions’ loan agreements, the scope and type of collateral taken and their experience with such proceedings, we will examine the impact of this feature of the law.

A legal framework which allows creditors ample room to restructure and renegotiate debts with defaulting debtors will likely lead to fewer insolvency proceedings and higher recovery rates for creditors. But work-outs could be discouraged by, for example, exposing directors of a debtor company to liability for failure to file for insolvency. Although such a provision could be intended to protect shareholders and creditors from directors who act in bad faith, it would certainly have a chilling effect on work-outs which could rescue the company and prevent an economically inefficient liquidation. Not much data is available on the prevalence of work-outs or how successful they are and this research, we hope, should contribute to compiling such information to determine what drives lenders to seek private renegotiations.

Post commencement of insolvency

Creditors in almost all jurisdictions can put the debtor into insolvency proceedings and would likely do so only as a last resort. Features of insolvency law will affect the willingness of creditors to voluntarily enter the debtor into insolvency proceedings, but will also drive creditor actions during the proceedings.
The most important of these insolvency law features is whether the legal framework provides an automatic stay (or moratorium) on separate enforcement actions by creditors, in effect “stopping the music” and forcing all creditors to participate in a unified proceeding. If creditors perceive the stay as a threat to the value of their collateral (either due to debtor’s misuse or to the rights of other creditors), they would be inclined to try to enforce before commencement of insolvency. Such fear would probably be lessened if the creditor had been able to take and perfect an enterprise charge as mentioned above – but only if such charge is believed to be efficiently enforceable.

Tunnelling of the firm by the controlling shareholder has been presented as a major problem for creditors in transition economies, creating pressure for a quick piecemeal sale (and presumably full control by the secured creditor), and certainly an incentive for shutting down the firm during insolvency proceedings. Information from the loan file combined with interviews with loan officers will help determine whether this hypothesis is well-founded and whether this concern influences the creditor’s behaviour at the first sign of a debtor’s financial difficulties.

The issue of priority is particularly topical: it is often not so much what the rules provide rather whether the priority ranking of the secured creditor in insolvency is negatively affected by the existence of insolvency proceedings (compared with the secured creditors’ rights before insolvency was declared). Does such change in priority ranking in insolvency affect the strategy of secured creditors? How do the rights of other actors affect secured creditors’ decisions to enter insolvency proceedings?

Another important question concerns reorganisation and the availability of post-commencement financing. In reorganisation, insolvency administrators may need to borrow to carry out their duties. In some jurisdictions creditors who provide new money to finance the rescue are given priority over the debtor’s existing creditors and this priority may be “super-priority” if financing was secured over already encumbered assets. This may affect the recovery rate of existing creditors or induce them to offer such financing to obtain super-priority. Very little is known about the approach of financial institutions to such financing. Moreover, prediction of future enforcement outcomes and good knowledge of the market and market value, are necessary for informed re-financing decisions to be taken; yet such mechanisms are often not well developed in transition economies.

By collecting this information, we believe that the EBRD will be able to contribute significantly to the debate by filling in the knowledge gap between the law and its intended operation on the one hand, and the final outcome of an enforcement procedure on the other. By examining these issues at all levels – the legal rules; policy implications and hypotheses; how market players use the legal rules in their business model and strategies in vivo (that is to say, when all rules combine together); and the outcome (whether formal via enforcement or informal via private work-outs) – the EBRD should be able to present a more refined picture of the impact of legal provisions and of the policy choices underpinning them.
Notes and authors


2. On Poland, see further analysis in EBRD/National Bank of Poland (2005), The impact of the legal framework on secured credit market in Poland, at www.ebrd.com/country/sector/law/st/facts/nbpeng.pdf. Conversely, the survey revealed that in other countries, such as Croatia, where there were limitations or inadequacies in the secured transactions law, there nonetheless existed a basis for effective enforcement. In other words, the market had nonetheless found a relatively successful way of realising value out of charged assets. Practical adaptation to a deficient legal framework has its limits, however: it is unlikely that such systems would prove sufficiently flexible for many modern financing techniques.


4. See this issue of Law in transition, namely Veronica Bradautanu’s article “Aspects of the EBRD’s insolvency law assessment 2009: should creditors worry about their rights in a growing number of insolvencies?”

5. For example, since 2003 the World Bank has published the Doing Business survey, which attempts a global survey of lawyers in many areas of law, including “Getting Credit” and “Closing a Business”. See also the EBRD’s own assessments at www.ebrd.com/law.


7. There is some debate, too, about whether changes in secured transactions law or insolvency law have a greater effect on lending. Some evidence has determined that lending volume responds positively to legal change and that a change in the ability of individual creditors to enforce their claims has a more positive response than changes in the bankruptcy law treatment of multiple creditors. R. Haselmann, K. Pistor, and V. Vig (2008), “How law affects lending”, American Law and Economics Review, Vol. 10, p. 303.


10. F. Dahan and J. Simpson (2008), Secured transactions reform and access to credit.


15. These issues do not concern all types of lending. Lending to large listed companies is sometimes unsecured, including only a negative pledge clause; secured lending could take place if the company were in financial difficulties, when existing creditors demand security as a condition for survival or of the injection of fresh money. When lending to special-purpose vehicles, all assets are used as security for the benefit of financing creditors so there is no competition because there are no general creditors and running a private work-out is a purely contractual undertaking with the involved stakeholders. The same applies to asset-based finance (often title finance). In wholesale financial markets, the security is mostly in the form of set-off and a netting arrangement, and collateral for over-the-counter derivative transactions. Financial market security interests are considered fundamental as a protection against systemic risk; these markets require no interference with the security agreement. In contrast, small and medium-sized enterprises lending is usually dominated by a single lender (bank). This is when the conflict on insolvency tends to be most dominant and policy-driven. See further in Wood, supra note 3.

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As the number of insolvencies across the world continues to increase, countries might re-examine their insolvency laws to ensure that judicial reorganisations and private work-outs are a viable and efficient alternative to liquidation for companies in distress. This article explores the relevant policy issues, which are sometimes ignored or misunderstood, and recommends a number of solutions.
This article examines the merits of judicial reorganisations and private work-outs as methods of dealing with corporations' financial difficulties. It notes some of the policy factors which may lead to one method being more prevalent than the other and puts forward a number of recommendations as to how countries can reform their insolvency laws.

Methods of dealing with corporate insolvencies

There are three main methods of dealing with a corporate insolvency.

- **A privately agreed reorganisation** occurs without any judicial intervention. The market vernacular for this is a "work-out". The reorganisation plan is a private contract between the company and its main creditors, typically banks and bondholders.

- **A judicial reorganisation** typically involves a judicial order imposing stays on creditor executions, liquidation petitions and other creditor actions, followed by a reorganisation plan which is typically confirmed by the court.

- **A final liquidation** is initiated by a court order and generally involves disposal of the company's assets, distribution of the proceeds to creditors and dissolution of the company.

Work-outs and judicial reorganisations are intended to rescue the company and its creditors. In contrast, a final liquidation kills the company and hence is a last resort.

Virtually all advanced countries' insolvency regimes provide for judicial reorganisation. The main exceptions are Hong Kong (which relies largely on receiverships of universal security interests), Luxembourg and Switzerland. The latter two countries have the "compositions" instrument, but it is only marginally a judicial reorganisation proceeding as understood along modern lines and is used rarely. In addition, a great many emerging countries, together with middle-income countries, have judicial reorganisation.
Most practitioners believe that a private work-out is by far the most favourable method of resolving financial difficulties if possible.

Notwithstanding the availability of judicial reorganisation, its use in most jurisdictions is apparently infrequent – often fewer than 5 per cent of cases outside the United States – and most often it is just a slow-motion liquidation. Most proceedings are actually liquidations.

No one knows the prevalence of private work-outs, but it is believed that a very high proportion of financial problems are resolved in this way.

Other methods of dealing with financial difficulties
It is worth mentioning various hybrids of judicial reorganisations and work-outs. These include the following:

- The main example is the pre-packaged judicial reorganisation (“pre-pack” as it is often called). In the case of a pre-pack, the main creditors, usually led by bank and bondholder committees, agree on a reorganisation plan with the debtor privately and commit to vote in favour of the plan. If agreement cannot be reached, the debtor applies to the court for a judicial reorganisation, which imposes stays on creditors, allows the creditors to vote, and leads to a court confirmation of the plan to bind dissenting creditors. The court may possibly validate other aspects of the plan, such as the granting of security interests or transfers which might otherwise be deemed preferential. Hence, a work-out is combined with a judicial reorganisation and has the force of the latter. In other words, the pre-pack is a work-out with a court stamp on it.

The entry into and exit from the proceedings can be extremely quick – as little as a few days or a month. As mentioned, the main purpose of a pre-pack is to bind hold-out creditors to the plan.

It is useful for insolvency statutes to facilitate pre-packs. This generally means that it must be possible to complete the disclosure and voting quickly and with minimum formality, even though this may give rise to risks for creditors.

- A further hybrid combining the features of work-outs and judicial reorganisations is the Australian voluntary arrangement, which does not require any court intervention, but provides stays and the force of law.

- Another example is the French idea of a court appointing a sort of official umpire, or juge-commissaire, to facilitate negotiations.

- There are also various “voluntary” codes of conduct for work-outs agreed on by officials and domestic banks. These work-out codes were often originally inspired by the so-called London Approach and can be found in Hong Kong, Indonesia, Japan, Thailand, Turkey and elsewhere.

The pros and cons of work-outs and judicial reorganisations
Most practitioners believe that a private work-out is by far the most favourable method of resolving financial difficulties if possible. It is probably true to say that most cases concerning the financial problems of large corporations are resolved out of court.

The overriding advantage of the private work-out compared with a judicial reorganisation is the ability to avoid the trauma and stigma of insolvency. However, confidentiality may be impeded by stock exchange rules that require the public disclosure of facts necessary to avoid a “false market” in the shares.

Creditors generally prefer work-outs because they can control the process and the negotiations without yielding control to the court. There is more freedom of negotiation.
The main disadvantage of a work-out compared with a judicial reorganisation is the need for near-unanimity among participating creditors. The costs and number of delays are generally lower in work-outs because the process is not tied to the speed of the courts or to the confrontations which a formal process engenders. Interest does not stop accruing and there are no stays which would interfere with creditor rights. The participants do not fragment into competing legal entities. The existing management can remain, subject to any changes which they may be pressured to accept.

The main disadvantage of a work-out compared with a judicial reorganisation is the need for near-unanimity among participating creditors. A class of creditors will not in practice agree to postpone or reduce their debts unless materially all creditors of that class agree likewise and also agree not to liquidate the company. The problem of obtaining unanimity is rendered more difficult because of the diversity of creditors in relation to large modern corporations, such as senior and junior creditors, and hedge funds. An interesting case is that of creditors with the protection of credit default swaps (similar to a guarantee) which may crystallise only on restructuring proceedings. These creditors tend to favour forcing a judicial reorganisation proceeding instead of participating in a work-out.

Nevertheless, a judicial reorganisation is an insolvency proceeding, even if it lasts a month and is framed as a pre-pack. Hence the proceeding may give rise to the stigma of insolvency and also provoke cancellation clauses in leases and contracts.

Other disadvantages of work-outs are the comparative weakness of international recognition compared with that of judicial proceedings and the vulnerability of restructuring sales and security interests to being set aside as preferences in a subsequent insolvency proceeding.

One of the main policy issues therefore is whether insolvency laws should or should not encourage work-outs as opposed to judicial reorganisations.

Policy incentives driving one method or the other

The main factors involved in this balancing act are the incentives given to management and traditional creditors, such as banks and bondholders, to favour one method or the other. For example, a jurisdiction would tend to encourage judicial reorganisation if it:

- imposes penalties on directors who do not petition for insolvency when insolvency is looming
- makes directors personally liable
- does not permit bondholders to bind dissenting bondholders by a majority vote outside a judicial reorganisation (as is the case in the United States)
- permits management to stay in place
- provides major extensive stays on creditors
- contains harsh avoidance provisions in the case of security taken before a proceeding in the twilight period (that is the period during which transactions conducted by the debtor are automatically suspect).

However, the impact of such incentives, one way or the other, can be unexpected. For example, France has a draconian reorganisation law which is highly protective of debtors as opposed to creditors. Use of reorganisation proceedings in that country has historically been very low, however. Directors probably were discouraged from entering into such proceedings because they often faced personal liability as a result (so the penalties on directors for failing to file had completely the opposite result from that which was intended).
Modern reorganisation laws can be graded according to a number of criteria. The result of this classification or grading is that there are huge disparities among jurisdictions in their approaches to judicial reorganisation.

Bank creditors also were reluctant to use the proceedings because they lost a large amount of control to the courts, which themselves are quite dominant in French insolvencies.

By contrast, the use of the US Chapter 11 reorganisation in the case of public companies appears much more common than elsewhere, partly because, outside Chapter 11, public bondholders cannot bind dissenting bondholders to a restructuring plan which affects payments – individual bondholders have an absolute veto. But voting is allowed in the case of Chapter 11. This may explain in part why large car companies eventually had to undergo what was effectively a pre-packaged judicial reorganisation.

Beyond that the various versions differ greatly on key crucial features.

- **Impact on security interests**: the issue here is about the treatment of creditors who have been granted a security interest on the debtor’s assets. The impact of reorganisation on these interests is especially pronounced where there is a stay on enforcement of the security interests; a right of the administrator to use the collateral or income of the collateral; substitution of security by the administrator; stretching of the secured debt by creditor voting; trumping of the security by the administrator’s costs or super-priority moratorium loans; or exclusion of after-acquired property from the security. The scope of adequate protection of the secured creditor and the extent of carve-outs from the stay are also essential.

- **Impact on insolvency set-off**: the issue here is whether set-off is permitted in the case of a judicial reorganisation. Countries – mainly those with a civil law background influenced strongly by the Napoleonic Civil Code, such as Belgium, France and Latin American countries – which prohibit a set-off in bankruptcy also typically prevent it in the case of judicial reorganisation. On the other hand, countries which allow insolvency set-off, such as Australia, Singapore and the United Kingdom, generally allow the ordinary solvent set-offs to continue running in relation to a reorganisation.

- **Impact on contract cancellations and lease forfeitures**: the question here is whether the reorganisation imposes a major stay or freeze on the termination of contracts and leases by counterparties in the case of the insolvency of one of the parties.
Policies in favour of the nullification of termination clauses operating on the insolvency of a party are based on the fact that the debtor would otherwise be deprived of a profitable contract necessary for a rescue. The policies against argue that the freeze results in a massive interference in the fabric of the contract which is crucial to commercial life; that in most cases the insolvent party would not be able to perform; that the creditor should not be exposed to unpredictability and volatile markets; that the freeze results in the debtor being able to “cherry-pick” contracts (abandoning the unprofitable contracts but keeping the profitable ones); and that the doctrine prevents netting and results in complicated carve-outs and exemptions for financial markets in order to contain systemic risks.

A stay on contract terminations is a particularly pro-debtor measure and probably is not espoused by the majority of jurisdictions. It is a feature of the insolvency laws of Belgium, France, Spain and the United States, but not Japan, the Netherlands, Switzerland or the United Kingdom.

- **Creditor control**: for example, the right of the debtor’s management to stay in power and to initiate a plan; the extent of the supervisory powers of the court; creditor’s committees and the insolvency administrator; and the degree to which the creditors can otherwise control the proceedings and the terms of the plan.

There is much division on whether management can stay in charge and the degree of court control. As a general rule, the tendency is that if there are very extensive interferences with creditor rights, such as stays on security and contracts, then there usually must either be extensive carve-outs or detailed discretions given to the court, thereby complicating and slowing the procedure. Hence, the choice is often between simplicity and cheapness, compared with debtor protection and complexity.

- **Ease of entry**: entry is encouraged if there need be no proof of actual or potential insolvency; no court approval of the opening; no proof of the likelihood of success; and a unilateral application by the debtor. A few countries have all of these together but generally there are some restrictions on entry by a debtor in order to prevent abuse of the process and protectionism.

- **Director liabilities for deepening the insolvency**: apart from failure to account for collected taxes and social security payments, the main categories of director liability for deepening the insolvency include:
  - fraudulent trading, which is where a company incurs debts with the certain knowledge that the company will not be able to pay them
  - wrongful trading, which is where a company incurs debts and the directors should have reasonably foreseen that they would not be paid or where the directors failed to take whatever steps were necessary to mitigate the risk of insolvency
  - duties to file on insolvency, typically where the company is insolvent in terms of being unable to pay its debts as they fall due or on a balance-sheet basis
  - negligent management resulting in the insolvency, effectively overriding the business judgement rule.

The huge range of policies on director liability is shown by the fact that in the United States, personal liability of directors for deepening the insolvency is extremely rare, if not non-existent (protecting management), whereas in countries such as Spain and France the liability risk appears to be quite high. England has a standard of “wrongful trading”, which also can be found in Australia, Ireland and Singapore. English case law shows that the liability is tolerant in the sense that the business judgement of the directors is largely protected.
The advantage of novation is that a portion of a business can be transferred as a whole instead of having to negotiate the transfer of obligations with each creditor.

- **Compulsory novations of contracts and leases:** an important issue—which has been made particularly visible by the recent financial crisis—is the ability of the administrator, with or without court approval, to transfer both rights and liabilities under contracts and leases to a buyer, that is, to novate the whole relationship. The advantage of novation is that a portion of a business can be transferred as a whole instead of having to negotiate the transfer of obligations with each creditor. On the other hand, counterparties can find themselves left with a lease or contract with a completely different entity whose credit and status they have not approved. In addition, if partial transfers are allowed, then credit analysis can become impossible since assets can be separated from liabilities. Hence, novations are very controversial and are usually hedged about with protections. These novations are possible, subject to conditions, in both France and the United States.

- **Disclaimer and abandonment powers:** the issue is whether the administrator is entitled to either disclaim or abandon contracts, leases and onerous property. Most judicial reorganisation statutes give the administrator these powers since one of the objects of the rescue is the transformation of liabilities into claims for damages, which can be dealt with in a plan.

- **Avoidance of pre-commencement preferences:** the issue is whether, as with liquidation, the administrator in a judicial reorganisation has the power to avoid transactions, prejudicial to creditors, which take place in the “suspect” period, that is, the twilight period between when the company is actually insolvent and when proceedings begin. Again the tendency is to permit the administrator to avoid these transfers.

- **New money:** the question here is whether the regime facilitates the priority for new loans after the commencement of the insolvency proceedings. Often a super-priority loan is vital to keep the company going, but if a judicial reorganisation fails (as they often do) then existing creditors are subordinated to the new money. Key questions are creditor control of the new money decision; adequate protection of secured creditors; and whether existing creditors can or should be overridden without their consent. In practice these new money financings are often provided by existing bank creditors.

Some countries, such as China, England (in the case of “schemes of arrangement”), Germany and the United States provide what is known as a “cram-down.” A cram-down is the overriding of the votes of a dissenting class of claimants who voted against the plan. The effect is to disenfranchise claimants who would get nothing if the plan failed and the company went into liquidation. Dissenters may be overridden if they get more under the plan than they would on liquidation. A court in this case overrides voting on the basis that the blocking vote is unreasonable.
Policy factors and judicial reorganisations

The overall policy approach to judicial reorganisations involves a complex policy judgement. The argument is not whether judicial reorganisations are useful – they are considered to be so – but how draconian their impact is on creditor rights and transactions generally. This involves a consideration of the main criteria discussed in the list above.

On the one hand there are policies of rescuing businesses and a possible maximisation of recoveries for creditors. The wider economic advantages often cited are that jobs are saved and the economy can be protected from a short-lived depression. Judicial rescues are now a more orderly liquidation since, and unlike most liquidations, the business can be kept going to preserve its going concern value.

On the other hand, policy disadvantages of very tough reorganisations include transaction disruption, legal complexity, cost and delay resulting from the complicated carve-outs and exemptions which are necessitated by debtor-friendly statutes. Other problems include: the laddering or layering of the legal system internally, protectionism of “zombie” industries, international conflicts and collisions between jurisdictions with different ideas about rescue statutes; and insolvency redistribution, that is, improving the overall lot of one set of creditors by taking away from another.

The comparative use of reorganisations is difficult to quantify meaningfully because, although governments may keep raw statistics of the number of proceedings, these statistics usually do not show the amounts involved or distinguish between small and large insolvency or among the sectors involved, nor do they show the rate of success in terms of the real costs and savings, either to creditors or in terms of businesses kept alive. The statistics also tend not to show how many businesses
Both government statistics and anecdotal evidence seem to show that in many countries reorganisations are not in the mainstream but work-outs are.

Nevertheless both government statistics and anecdotal evidence seem to show that in many countries reorganisations are not in the mainsteam but work-outs are. However, reorganisations appear to be widely used for a few large-scale cases. This is an area where better statistics are essential as a check on the reality that practically everybody has their own agenda on insolvency.

The author notes that the judicial reorganisation of banks is a completely separate topic. The current tendency is for “strong-arm” resolution powers although these need to be approached with caution.

Specific recommendations

Practically everything in insolvency is controversial, but the following are some specific points which the author would recommend.

- **Work-outs**: insolvency law should encourage out-of-court work-outs and reduce the incentives to enter into judicial proceedings.
- **Directors’ duties**: company directors should not have mandatory duties to file for insolvency proceedings when the company is insolvent or in financial difficulties. Any penalties or liability on directors for deepening the insolvency should be cautious and should give primacy to the business judgement rule.
- **Preferences**: the policy of avoiding transactions entered into in the suspect period should be curtailed. For example, the grant of security for existing debt should not be automatically void if the company is insolvent and proceedings are commenced within the suspect period and where the security was granted as part of a rescue. In this case, there is a real bargain in return for the security. There should be a high threshold protecting payments made by the debtor in the suspect period. The object is to allow the company to continue to do business and to protect private restructuring plans.
- **Pre-packagings**: the insolvency law should contemplate rapid and flexible procedures to allow quick court or creditor approval of private plans agreed before the commencement of proceedings.
- **Security interests**: the object of security interests is to protect creditors on insolvency. Security interests play a major role in modern societies and any restrictions on enforcement or other interferences on security interests in rescue proceedings should only be allowed if the administrator grants the secured creditor adequate protection.
- **Set-off**: is a major risk mitigant on insolvency. It should be allowed on both liquidation and rescue proceedings.
- **New money**: the lending of post-commencement new money to finance the rescue should be subject to creditors’ approval in the plan or the court’s approval. If secured creditors are trumped, they should be entitled to adequate protection.
- **Contract terminations**: contractual termination clauses should be effective in the case of rescue and liquidation proceedings. There could be an exception for utilities and qualifications for leases of land.
Contract novations: the ability of the administrator to transfer both the rights and the liabilities under contracts and leases should either not be permitted at all or should be highly conditional so as to protect counterparties.

Voting: financial democracies are property democracies. Shareholders and junior creditors should not be entitled to vote on restructuring plans when they would receive nothing on liquidation. There should be provision in listing rules for publicly listed companies which would exclude the right of shareholders to veto, for example, a debt-to-equity conversion, or a large disposal if their shares are worthless.

Simplicity: insolvency law should be kept as simple and as flexible as possible, with the minimum number of compromises.

Insolvency is a destroyer and a spoliator of companies, jobs and even economies. It is therefore not surprising that insolvency law is the main driver of market practice and the legal regime in terms of business law.

Whether insolvency law can have a major impact on economic progress and economic development is an issue for further discussion. This author believes that the law is generally relevant to economic development and this is particularly true of insolvency law.
CREDITORS’ RIGHTS: THE RUSSIAN REVOLUTION

Legal reforms in Russia in response to the global financial crisis have been considerable and somewhat unexpected. They have strengthened creditors’ rights inside and outside of bankruptcy through the introduction of out-of-court enforcement and the priority ranking of secured creditors, among other features. The effectiveness of the reforms, however, will continue to depend on the judicial system.
The onset of the global financial crisis in September 2008 caught many financial institutions and their borrowers by surprise. The shock was felt severely in Russia, where high commodities prices had fuelled a decade of growth accelerated by heavy borrowing. In the aftermath of the 1998 Russian financial crisis, financial institutions – both foreign and domestic – had gradually expanded their lending activities. Russian companies had access for the first time to previously unavailable credit. Like “kids in a candy store” many went on a borrowing spree, in particular those in the extractive industries and in commercial real estate development. When the crisis hit, asset prices and revenue streams fell severely, triggering margin calls, covenant breaches and payment defaults on a widespread basis. Russian borrowers became unable to meet their obligations, despite previous financial projections and relatively sound financial models.

Until the crisis hit, the standard warnings from Russian counsel in the qualification sections of their legal opinions had attracted scant attention from the banks to which they were addressed:

“[t]he enforcement of rights and obligations under the Transaction Documents may be affected...by laws relating to bankruptcy, insolvency...and defences generally affecting creditors…”

Suddenly these words took on significance. What did these laws provide? And how would they treat the banks’ security?

With an understanding of the role Russia’s insolvency laws and procedures would play in this economic turmoil, in early December 2008 Russian legislators rushed through a major reform of laws protecting creditors’ rights, including bankruptcy and enforcement of security. The first wave of reforms was then followed by two subsequent reforms in April and July 2009.
The cumulative effect of the reforms has been to increase creditors’ rights in the areas of insolvency and security enforcement, at least on the books. Whether these reforms will achieve their intended effect in practice will depend on other factors, not the least of which is the ability of the Russian judicial system to interpret and apply the reformed laws fairly and impartially. We outline below the main import of the reforms and the additional factors likely to affect creditors’ rights in Russia.

Summary of main reforms to the Bankruptcy Law in 2008-09

On 30 December 2008 the Russian Duma adopted major amendments to Russia’s Bankruptcy Law No. 127-FZ of 26 October 2002 (the Bankruptcy Law) and security (pledge and mortgage) laws. These were included in two new laws: RF Law No. 296-FZ and RF Law No. 306-FZ. The main elements of the bankruptcy law reform included:

- creation of a National Association of Self-Regulating Organisations of Professional Administrators – a non-profit organisation – and adoption of the requirement that all administrators be members of such an organisation
- elaboration of qualifications and standards for administrators, their rights, obligations, liability, compensation, insurance, disclosure and funding of indemnification obligations
- creation of additional powers for the creditors’ meeting (which now has the exclusive power to set the size and order of an administrator’s compensation)
- greater public information requirements on bankruptcies, including the planned creation of a new Unified Federal Register on Bankruptcy Proceedings
- clarification of so-called “super-priority” claims and their priority, including claims based on funding provided to the company after the opening of insolvency proceedings that is deemed essential by the insolvency administrator for the business’s survival
- simplification of the criteria that must be met for creditors to file for the debtor’s insolvency (in particular, elimination of the requirement that the first creditor to file for involuntary bankruptcy must have first secured a writ of execution of its claim against the debtor through the courts)
- granting third parties the express right to settle the debtor’s mandatory payment obligations (including taxes).

The reforms also included major changes to Russian pledge legislation both in the bankruptcy and non-bankruptcy context.

- Secured lenders (in the bankruptcy context, only holders of a mortgage or pledge) may now exercise out-of-court self-help measures for enforcement of their security. In particular, the pledgor can now agree on non-judicial foreclosure at any time, not just after an event of default has occurred. This arrangement may be incorporated directly into a pledge or mortgage agreement. If the pledgor is an individual, or where the collateral is real estate, the arrangement must be notarised. The pledgeholder may also now take title to or sell the collateral on enforcement, without having to go to a public auction as was the case before the reforms.
- Secured creditors’ claims are now satisfied before claims of first- and second-ranking creditors (such as personal injury, wrongful death and punitive damages claimants and employees). This substantially improves the position of secured lenders in non-bankruptcy foreclosures.
- An independent appraiser must now be retained to determine the collateral’s market value if it exceeds the equivalent of Rb 500,000 (about US$ 16,750). This affects most secured loans given the low threshold.
- Secured creditors’ claims in insolvency are now entitled to a minimum percentage of funds received from the sale of collateral (this will depend on the nature of the underlying obligation – whether it is a loan by a “bank or other credit organisation” (at least 80 per cent) or other obligation (at least 70 per cent)). It remains to be seen how the courts will interpret these provisions regarding loan agreements of foreign lenders and international financial institutions (IFIs).
- Foreclosure on security during bankruptcy can only happen after passing the “observation” period, and only then with the court’s consent.
- It has been clarified that creditors taking security from a debtor for a third-party’s obligation will be treated as a secured creditor in such a debtor’s own bankruptcy. Previously, the courts had not been uniform in their approach here: some of them allowing third-party security takers to enforce outside of ongoing bankruptcies.
In April 2009 the Duma further amended the Bankruptcy Law (RF Law No. 73-FZ of 28 April 2009). These changes introduced more detailed rules on major areas of significance in a bankruptcy proceeding.

The reforms introduced detailed rules for third-party (vicarious) liability in a bankruptcy (that is, persons who may, by virtue of their control of the debtor, be held liable for its debts). In particular, the earlier required element of culpability (in Russian, вина) was dropped. Moreover, the law’s previous vague provisions were supplemented with a list of “controlling persons” who may be held vicariously liable (including members of the debtor’s liquidation commission, persons acting under powers of attorney or statutorily authorised to conclude transactions on the debtor’s behalf, and 50-per-cent-or-more shareholders of the debtor).

The reforms had a direct impact on voluntary bankruptcy filing requirements, lowering the bar for the statutory filing obligations of CEOs and liquidation commissions. In particular, a company’s CEO must file for bankruptcy where the company meets financial insolvency criteria and/or has insufficient assets. The reform provided definitions of the terms “insufficient assets” and “financial insolvency”. The former arises when a debtor’s debts exceed the value of its assets. The latter arises when a debtor stops satisfying its monetary obligations due to insufficiency of funds (which is presumed unless proven otherwise).

The reforms expanded the class of “interested persons” for the purposes of bankruptcy filing requirements, lowering the bar for the statutory filing obligations of CEOs and liquidation commissions. In particular, a company’s CEO must file for bankruptcy where the company meets financial insolvency criteria and/or has insufficient assets. The reform provided definitions of the terms “insufficient assets” and “financial insolvency”. The former arises when a debtor’s debts exceed the value of its assets. The latter arises when a debtor stops satisfying its monetary obligations due to insufficiency of funds (which is presumed unless proven otherwise).

The reforms also substantially expanded rules on suspect transactions (fraudulent conveyances) and preferences (that is, certain types of transactions preceding or following bankruptcy which may be avoided by the administrator). Generally, these categories can now be challenged as follows.

Suspect transactions include “undervalue” transactions, which can be challenged if concluded within one year preceding bankruptcy; and transactions “aimed at causing harm to creditors’ proprietary rights”, which can be challenged if concluded during a period of up to three years preceding bankruptcy.

Preferential transactions include those where creditors take security for old loans, prepayments (while other creditors are not being paid) or a change in priority of a creditor. These can generally be challenged if concluded during a period of one to six months preceding bankruptcy, depending on the circumstances. The consequences of a successful challenge of a transaction as a preference or a transaction “aimed at causing harm to creditors’ proprietary rights” can be very serious for the creditor, who might in certain circumstances be relegated to a position below the lowest priority group in the bankruptcy distribution.1

Lastly, in July 2009 the Duma adopted a third reform to the Bankruptcy Law (RF Law No. 195-FZ of 19 July 2009), introducing further (albeit more modest) changes. These included:

- rules on auctions of pledged property during bankruptcy proceedings
- more detailed rules on compensation of bankruptcy administrators and their advisers, as well as insurance requirements and technical candidature requirements.

In the aggregate, the reforms represent substantial improvements to Russian bankruptcy and secured transactions laws. However, major problems in the Russian judicial system will most likely frustrate protection of creditors’ rights. This is because the quality of protection depends not only on the law as it appears on the books, but also on its application.

Current enforcement problems

As seen above, several of the changes in this year’s reforms were very positive for creditors. One major step forward in the non-bankruptcy enforcement context, is that “self-help” measures for creditors have been introduced. Previously, these had been severely restricted. As a rule, creditors virtually always had to enforce pledges and mortgages through judicial proceedings, and sell collateral at auction. The ability to seize and realise on a borrower’s assets by self-help measures substantially strengthens the creditor’s position.
The central issue for creditors involved in bankruptcies in Russia is that the general problems plaguing Russia's judiciary continue to prove a significant obstacle for the efficient protection of creditors' rights in the bankruptcy setting.

A note of caution is necessary, however, as the question remains as to whether these measures may (by way of amendment) be applied to security instruments already in existence at the time the reform came into effect (11 January 2009). The relevant enabling provisions state that the reform may apply only to “legal relations between parties that arise as from the date of [its] entry into force” (after 11 January 2009). This leaves it unclear as to whether pre-existing pledge agreements can be amended without a risk of being held unenforceable. This is obviously a critical issue for lenders who may wish to take advantage of the reforms and improve the quality of their existing security.

In a second major step forward, the reforms have generally enhanced creditors’ rights in the bankruptcy process. In particular, the provisions on suspect transactions, preferences and vicarious liability have been substantially clarified. In a business culture where asset-stripping has sometimes been described as a sport, this marks a major improvement.

However we need to sound another note of caution: under the reforms, creditors must now rely solely on a bankruptcy administrator to bring an action to unwind a suspect transaction or preferences. This actually constitutes a step backwards, as previously individual creditors could attack such transactions without depending on the administrator to do so. The effect of this change is somewhat reduced by the law’s apparent requirement that the administrator file such an action where directed to do so by the creditors’ meeting or creditors’ committee.

Despite the foregoing and other improvements, the central issue for creditors involved in bankruptcies in Russia is that the general problems plaguing Russia’s judiciary continue to prove a significant obstacle for the efficient protection of creditors’ rights in the bankruptcy setting. Once a bankruptcy occurs, creditors must always rely on the judicial system to protect their interests. They may no longer rely on arbitration clauses in their transaction documents, nor may they pursue independent enforcement of security. (The Bankruptcy Law imposes an automatic stay on all enforcement actions once the court accepts a bankruptcy petition.)

Some of the problems faced by creditors in the Russian judicial system include the following.

- Russian judges continue to receive extremely low salaries compared with their Western counterparts. The perception of judicial corruption (including bribery) continues to persist at a high level in Russia. The trend does not appear to be improving. Out of some 180 countries listed in Transparency International’s Corruption Perceptions Index, Russia fell from 143rd place in 2007 to 147th place in 2008, with a slight improvement to 146th place in late 2009. Abuse of the judicial system by private parties for the purposes of pursuing private commercial agendas (sometimes referred to in Russia as “corporate raiding”), including through bankruptcies, is unfortunately perceived to be the norm, rather than the exception.2

- The court system is not only perceived to be abused by private parties, but also by the executive branch of the Russian government. Commentators continue to note a high level of interference by executive bodies of the Russian government at federal, regional and local levels, including in the bankruptcy context. On 23 June 2009 the Council of Europe Committee on Legal Affairs and Human Rights adopted a report outlining a variety of allegations of judicial abuse.3 That report was followed by a subsequent report from the Committee on Economic Affairs and Development condemning the Russian government’s actions in the Yukos bankruptcy case and related criminal proceedings.4 Where strong governmental interests arise (such as a case where a major state-owned company is involved or a case which concerns a strategic industry such as hydrocarbons), a strong perception persists that Russian courts will not act impartially, including within the bankruptcy context.

- In addition to the above problems, commentators see a lack of experience and specialisation in bankruptcy as common among many Russian judges; a lack of commerciality in interpreting and applying laws generally; and a tendency towards formalism within Russian juridical doctrine.
Part II: Debt enforcement in times of uncertainty

Due to these persistent issues, the balance of power between Russian borrowers and their lenders is still skewed heavily in favour of borrowers. Lenders face serious difficulties in exercising their rights, both before and during bankruptcy.

This has resulted in a situation where many lenders in Russia, in lieu of speedily enforcing their rights against security and/or filing involuntary insolvency petitions, have instead hesitated, becoming caught up in protracted restructuring negotiations with borrowers without the necessary bargaining power of a clear and certain legal backdrop. Lenders generally have been reluctant to put their borrowers into bankruptcy for fear of not being treated fairly by the courts.

Those lenders with offshore security have generally found themselves in a more favourable enforcement position, including when negotiating restructurings. As a result, many major limited recourse projects (for example, in real estate development) have an element of offshore security (for example, a share pledge over an offshore holding company) and are often structured using offshore vehicles. Although the lender will have taken security at the project company level onshore (both over the project company’s assets and contractual rights as well as over its shares), the lender will usually find that its ability to enforce offshore provides an equally important protection (and indeed sometimes the most effective bargaining tool). The presence of substantial shareholder and/or affiliate recourse (including personal guarantees from ultimate beneficial owners), as well as the possibility to trigger cross-defaults with affiliates, have also proven effective bargaining tools.

In summary, while the reforms to the Bankruptcy Law have been generally positive and should be applauded, until major reforms are carried out within the judicial system itself (to create a skilled, impartial and independent judiciary) most creditors will continue to believe that in the midst of a crisis the Russian bankruptcy system will not provide them with the protections they would enjoy in more developed market economies. In addition, the qualification in the legal opinion will remain.

Notes and authors

1 This situation merits serious attention by lenders and their counsel. Many legal systems include built-in deterrents against preferences for the debtor and/or its management. But it is unusual to see creditors themselves penalised, absent fraudulent or dishonest collusion. See P. Wood (2007), Principles of international insolvency. On this basis, creditors seeking to take security for existing debt in Russia should exercise extreme caution and make a careful analysis of the risks before proceeding.

2 See “Criminal corporate raiding in Russia”, Thomas Firestone, Resident Legal Advisor, US Department of Justice, US Embassy, Moscow (report delivered at the American Bar Association conference on Russian dispute resolution, Moscow, Russia, 21 September 2009).


4 Council of Europe, Committee on Economic Affairs and Development (29 September 2009), “Allegations of politically-motivated abuses of the criminal justice system in Council of Europe member states” (K. Sasi, rapporteur), Doc. No. 12038, www.assembly.coe.int/Documents/WorkingDocs/Doc09/EDOC12038.htm: “Bankrupting private companies via legal means and then buying them up via state-owned companies and taking disproportionate legal action against company executives, claiming that they have committed tax offences, as in the Yukos affair, is something that must be condemned by the Parliamentary Assembly in the strongest possible terms.”

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DEBT ENFORCEMENT AND INSOLVENCY IN UKRAINE

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The current financial crisis has become one of the most significant tests for Ukraine’s legal system. Never before have various legal instruments been invoked so creatively and aggressively by debtors seeking to be released from their obligations, or by creditors trying to enforce their rights.
This article aims to address some of the debt enforcement issues in Ukraine that have been exacerbated by the global financial crisis and to examine some of the reforms recently enacted to deal with the impact of the crisis. We will analyse trends and problems in the development of Ukraine’s legal system and practices – focusing on the particular problems of mortgage law and unfinished construction projects.

Commercial law in Ukraine

Commercial law reform in Ukraine has typically been undertaken within a context of rushed drafting and few necessary consultations. This has frequently led to inadvertent errors in the law itself, which can frustrate even the most experienced practitioners. In addition, much legislation presents as overly complicated – making full compliance with the encyclopaedic multitude of regulations nearly impossible and requiring that documents include provisions that may be irrelevant to the deal.

Simultaneously, the absence of certain standard legal instruments (such as irrevocable powers of attorney, debt-to-equity swaps, or escrow accounts) from the law can lead to uncertainty, especially for foreign parties. Similarly, even when legal instruments are provided by the statutes, the failure of Ukrainian authorities to issue required implementing regulations prevents parties from drafting and executing documents appropriately.

Parties with valid contracts may face difficulty in performing their obligations due to legal requirements ancillary to the deal, such as the recently amended controls on foreign currency. Under general rules, debtors can only purchase foreign currency in limited situations, which may lead to defaults under their loan agreements. In addition to preventing parties from obtaining foreign currency, under Ukraine’s regulations parties making payments abroad might be required to obtain a special licence. As a further example, Ukraine has recently prohibited sending pre-payments to foreign lenders.
The introduction of such restrictions on foreign currency payments demonstrates the strict scrutiny the National Bank of Ukraine attaches to cross-border transactions and investments.

Debt enforcement in general

The difficulties faced by unsecured creditors have been exacerbated by the current crisis. First, the time involved in litigation or arbitration proceedings increases the risk that debtors will “tunnel” all assets before the unsecured creditors can seize and realise them. The financial crisis is sure to increase the number of these proceedings, slowing down an already tedious process and increasing the time debtors have to strip their companies of assets. In addition, even assets that debtors may not dispose of or can dispose of only with difficulty (such as licences, construction permits, agricultural land, land lease rights, long-term contracts with unrelated parties, goodwill) may be encumbered with interests unknown to unsecured creditors, and thereby prevent realisation.

Although pre-emptive measures, such as a prohibition on disposal of assets, are available to creditors in theory, they may be difficult to invoke in Ukrainian courts. Similarly, in the insolvency context, illegal transfers by the debtor aimed at asset stripping are difficult to invalidate retroactively.

The insolvency law also exposes creditors to excessive risks that they will forfeit their claims if they fail to become aware of the debtor’s insolvency filing. Because the insolvency administrator appointed to manage the debtor’s case may fail to notify creditors of the filing, creditors must expend company resources to make monitoring a priority. Failure to file a creditor’s claim within 30 days of the opening of insolvency proceedings results in dismissal of the claim.

Furthermore, because insolvency laws are so debtor-friendly in Ukraine, creditors rarely initiate the proceedings when they are not affiliated with the debtor, instead preferring foreclosure. In this time of financial crisis, non-traditional methods of dealing with debtor defaults are gaining in popularity, and creditors will often engage in such methods as debt-to-equity swaps or discounted sales of their claims.

Enforcement of secured debt

New regulations enacted to deal with the financial crisis have largely ignored the secured transactions framework, despite the existence of inefficiency in the system. However, not all inefficiency is due to the law.

Some of the problems in the practice of secured transactions law can be avoided through careful drafting of security agreements. For example, many security agreements contain only the minimum provisions required by law and are not carefully tailored to the particular transaction. In transactions between unrelated parties, this can be fatal, when, for example, due care is not given to amending the security agreement and to updating the registration when the collateral or debt changes. In these situations, it is likely that the parties with payment obligations will exploit these failures to avoid performance.

Another difficulty with the secured transactions regime is the limited forms of collateral it encompasses. It is still unclear, for example, whether the law permits security to be taken on a participation interest in a limited liability company. The same effect can be achieved by using a conditional assignment of the participation interest. In practice, security interests in corporate rights are not commonly used because of the onerous requirements to enforce those rights through re-registration of the new owner, which involves the close cooperation of the debtor. Thus, it is generally recommended to have all the documents required for state registration of the transfer (including the corporate decision authorising transfer of shares to a new owner and the power of attorney for registration of amendments to the charter) upfront. However, parties rarely go to the trouble of executing these documents, preferring instead to rely more on other security granted by the debtor, and using the pledge over corporate rights as an enhancement only.

New regulations enacted to deal with the financial crisis have largely ignored the secured transactions framework, despite the existence of inefficiency in the system.
One change since the start of the financial crisis has affected the purchase of foreign currency. Some Ukrainian entities are no longer allowed to purchase foreign currency required for payment to a foreign counterparty under suretyship agreements at the inter-bank exchange rate. As a result, if the surety must perform its obligations on behalf of the debtor, it must use its own foreign currency reserves, if it has any, or negotiate an alternative settlement. Absent available reserves of the debtor or surety, a court proceeding is virtually guaranteed.

**Insolvency in Ukraine**

As previously mentioned, Ukrainian insolvency law functions mainly to protect the debtor, and does not often result in prompt or full satisfaction of creditors’ claims. Creditors use insolvency only as a last resort and only when their economic interest gives them virtual control over the creditors’ committee, and through that committee, the insolvency proceedings. In contrast, a debtor with liquidity problems is likely to file for insolvency to benefit from the stay on enforcement, which is introduced at the commencement of insolvency proceedings.

Entry into insolvency is also easier for debtors than creditors. Creditors must have obtained a court award against the debtor to prove their claim and must initiate enforcement proceedings against the debtor’s assets. If the amount awarded by the court has remained unpaid for three months following the commencement of enforcement proceedings, the creditor may then file for the debtor’s insolvency. Once insolvency has commenced, assignment of claims and set-off are not expressly allowed and are thus subject to challenges on the basis of discrimination against other creditors.

Troubled banks have special insolvency procedures under the banking law. The provisions allow for the National Bank of Ukraine to place the insolvent bank into an administrative receivership and act as the receiver. During this temporary administration, a moratorium on full or partial satisfaction of creditors’ claims is introduced. Recently, such moratoria have been limited to three months.

**The specific case of real estate in Ukraine**

The real estate industry has been hit hardest by the financial crisis in Ukraine. The appreciation of real estate values over the last decade is seen to have contributed to the deepening of the crisis because it encouraged companies to use reserve cash or borrowed funds to invest in immovable property. This introduced cross-collateralisation and diversity into many businesses, which are now overburdened by servicing their real estate debt. Problems in this area have been especially pronounced through the problems with enforcement of mortgages and unfinished construction projects.

**Enforcement**

Ukraine’s registry of mortgages, the Unified Register of Prohibitions of Disposal of Immovable Property Objects and the State Register of Mortgages, is reliable and effective in ensuring that title to a property is not transferred without the consent of secured creditors. However, enforcement of those rights through foreclosure is often time-consuming and problematic and leads many creditors to seek negotiated solutions instead.

Foreclosure of a mortgage may be pursued through several methods:

- a court enforcement
- an execution writ issued by a notary
- a claim satisfaction clause, which provides a clause in the mortgage agreement that, on default, gives consent for the asset title being transferred to the mortgagee or sold to a third party.
Investments and security interests in unfinished construction projects pose a complicated problem for creditors seeking to enforce their rights.

Title transfer as a means of mortgage enforcement is risky for creditors because even the most carefully worded claim satisfaction clause in a mortgage agreement will only rarely be treated by registration authorities as sufficient for title re-registration. It is also very expensive, with the state and state pension fund each collecting 1 per cent of the value of the collateral at the time of transfer. A smooth title transfer also relies heavily on the debtor, whose cooperation is required. In practice, this usually means that the creditor is forced to bring court action to compel registration authorities to register the title transfer.

Sale of the collateral to third parties is also problematic. Sale agreements must be notarised, which also means that they must include an excerpt from the title register – only available to the owner and its representative. To avoid this issue, creditors usually insist on a power of attorney from the debtor at the time of loan disbursement to obtain the title register excerpt, but because Ukrainian powers of attorney are always revocable, the position of the creditor is very tenuous. In many cases, this necessitates an additional court action brought by the creditor to compel registration authorities to provide the excerpt. Lastly, the reforms brought by the financial crisis have also complicated mortgage enforcement, especially in the residential sector, by prohibiting residential evictions when the property is the mortgagor’s only residence.

Enforcement may be complicated by construction projects lacking permits (common in complex commercial properties) or unlawful remodelling projects (common in residential or office properties). Debtors often deliberately inform authorities of the non-compliance with these laws of their construction project and use the investigation to complicate enforcement of payment obligations.

Unfinished construction

Investments and security interests in unfinished construction projects pose a complicated problem for creditors seeking to enforce their rights. The most common issue is that the multitude of legal and commercial structures used in the construction industry can make seemingly valid and perfected security interests worthless in enforcement. Construction projects often involve a host of participants including: developers; general contractors; lenders; construction investment funds; individual investors; direct agreement financing; municipalities; and parties to joint venture agreement, each entitled to a share of the project based on entirely separate and valid legal grounds. This conflict creates a situation in which the same assets may be rightfully claimed by different parties.

Property rights and their derivatives (such as mortgages) have general priority over contractual obligations (such as joint venture agreements), but this rule may not always apply, especially when municipalities have rights in the assets which are subsequently encumbered by mortgages. Because these other interests are not registered in the mortgage register, they remain unknown to the mortgagees, who cannot establish with certainty which parties involved in the development and life of the project have an interest in the relevant parcels of land and property under construction.

Construction projects can cause additional problems when completed, at which time secured parties with an interest in the construction must re-register their interests to attach to the finished property, and many permits and other agreements must be re-issued or re-executed. Where the security documents for the construction project do not provide for assignment to the mortgagee of the rights of the mortgagor, the transition from construction to completion is difficult.
Alternatives to enforcement

The complexity of the enforcement and insolvency regimes in Ukraine provide strong incentives for creditors to negotiate alternative solutions to enforcement in debtor defaults. The global financial crisis has made this incentive even stronger. Private work-outs and other value-enhancing agreements were already commonplace, but the financial crisis has opened the door to new options for creditors. Among these are debt-to-equity swaps, repo deals, novations, sale or assignment of claims or indebtedness, contractual replacement of management, and non-consensual set-offs of mutual obligations. These options are gaining in popularity alongside the more traditional options of adjusting payment schedules; changing collateral structure; and debt currency conversion, and could prove a more effective long-term solution to problems with debt enforcement in Ukraine than law reform alone.
This article discusses how the Cape Town Convention and its Aircraft Protocol are a significant part of an international trend towards enforcing creditors’ rights and remedies in secured and leasing transactions, including in insolvency.
Part II: Debt enforcement in times of uncertainty

Where the combined Cape Town Convention on International Interests in Mobile Equipment¹ and Protocol thereto on Matters Specific to Aircraft Equipment² (hereinafter referred to as the “Cape Town Convention” or the “Convention”) is applicable, it mainly impacts the legal framework in two ways. First, it provides a system for registering all interests in aircraft equipment that were created by leasing and asset-based financing transactions, sale transactions and other interests in such aircraft equipment. The order in which interests are registered establishes the ranking of creditors and their rights against the aircraft object. Second, the Convention provides several remedies, including repossession of aircraft equipment after default under mortgages, title reservation agreements or leases; special country-optional provisions for repossession when the debtor is in an insolvency proceeding; remedies outside of court; and deregistration and export of aircraft. The Convention includes basic principles that protect the debtor and creditor from uncertainty about the process and outcomes. For many countries, adopting the Convention, and thus incorporating its remedies into domestic law for applicable transactions, has been groundbreaking.

This article summarises what the Convention is, when it applies and how the remedies work and are adopted by each country making recommended elections at ratification.

What is the Cape Town Convention?

The Cape Town Convention, signed in November 2001 in Cape Town, South Africa, was developed under the auspices of the International Institute for the Unification of Private Law (UNIDROIT) and the International Civil Aviation Organisation (ICAO) and was aimed at three kinds of high-value mobile equipment assets: aviation, rail and space objects. Whereas the Convention sets out international standards for registration of international interests, priority of registration and remedies available to the holders of such interest, it also provides that asset-specific regulations and remedies available to the holders of such interest in a particular type of asset should be regulated by an independent protocol.
The Convention's overall objective is to contribute to the efficient financing of transportation equipment, which in turn leads to the development of cost-effective modes of transport using modern technologies.

This article solely concerns the Convention as modified by the Aircraft Protocol, which became effective in March 2006. With the strong support of the aviation industry, 29 countries plus the European Commission have ratified the Aircraft Protocol as of writing. The Convention's overall objective is to contribute to the efficient financing of transportation equipment, which in turn leads to the development of cost-effective modes of transport using modern technologies. The huge outlays involved in the financing of objects of these kinds make it essential for the creditor (the financier, seller or lessor) to have confidence that if the debtor defaults, the relevant legal regime will respect the creditor's contractual and proprietary rights and provide efficient and effective means to enforce those rights. Traditional conflict of laws rules apply lex rei sitae (law of the state where the asset is located at a given time) as the law governing certain property rights. Such a principle is unsuited to items of mobile equipment, which are constantly moving from one country to another. Dependence on national laws is disadvantageous because they vary widely. Some jurisdictions are highly supportive of security interests, while others are more hostile or restrictive. This uncertainty may discourage potential financiers from extending credit or may lead to substantially increased credit costs. Hence the need for an international set of substantive rules governing security, title retention and leasing interests in such equipment which will provide creditors with the necessary safeguards to make financing more available and on better terms.

The Convention lays down rules on four main topics:

- international recognition of the interests of creditors under security agreements, conditional sale agreements and leasing agreements with respect to high-value, uniquely identifiable mobile equipment
- default remedies of the holders of such interests, that can be expeditiously exercised
- perfection regimes by registration, thereby enabling third parties to discover the existence of security interests
- recognition and priority of those interests, both within and outside the debtor's bankruptcy.

When do the Convention and Protocol apply?

The goal of the Convention is to apply as widely as possible to situations involving mobile equipment. The Convention and Protocol apply to an “international interest” with respect to or to a “sale” of a relevant aircraft object. An international interest is constituted (if it meets the minimal formalities) when a debtor under a security agreement; a buyer under a title reservation agreement; or a lessee under a lease agreement is situated in a contracting state at the time the agreement or contract creating or providing for the interest is concluded. The location of the “creditor” is irrelevant. Although the Convention only applies to international situations, this criterion is considered satisfied by the mere mobile character of the equipment and a connecting factor to one of the contracting states by virtue of aircraft registration or the location of a debtor or lessee in a contracting state, and not on its actual use. Hence the Convention and the Aircraft Protocol can potentially apply to all transactions involving the financing of aircraft, regardless of the nationality of the parties and the use of the aircraft. For example, if an aircraft were registered in Ireland, the Convention could be applicable to a Ukrainian leasing company financing the purchase of that aircraft for a Ukrainian airline serving the domestic market only.

How do the remedies work if the Convention and the Protocol apply?

The approach taken by the Cape Town Convention is to provide a basic set of remedies under the Convention and Protocol and to provide a more advanced set of remedies that contracting states opt in or out of by declaration at the time of ratification or thereafter. This optionality reflects the trend towards developing new and better remedies and the need for certainty, but also reflects the fact that such a trend is still developing. Hence, contracting states need some latitude in initially considering whether to adopt the Convention.
Part II: Debt enforcement in times of uncertainty

All remedies included in the Convention work within certain general principles that apply without regard to declarations or elections.

General principles of all remedies

All remedies included in the Convention work within certain general principles that apply without regard to declarations or elections, and which are intended either to clarify potential gaps or conflicts that may arise with the existing law in a contracting state, or to protect the debtor.

First, any remedy provided by the Convention is to be exercised in conformity with the procedure prescribed by the applicable domestic law of the jurisdiction where the remedy is to be exercised.7

Second, party autonomy is one of the key tenets of the Convention and asset-based financing and leasing, so any additional remedies agreed by the parties and permitted by the applicable law, can also be exercised to the extent they are not inconsistent with the mandatory provisions of Article 15 of the Convention and the mandatory provision of Article IV(3) of the Protocol.8

Third, any remedy provided by the Convention must be exercised by the creditor or lessor in a commercially reasonable manner.9 A remedy is deemed to be exercised in a “commercially reasonable” manner where it is exercised in conformity with the provisions of the parties’ agreement except where such provision is “manifestly unreasonable”.10

Fourth, the general principle of a chosen forum is a key to enforcement of the rights recognised by the Convention. The courts chosen by the parties in the relevant agreement creating the international interest will have exclusive jurisdiction (unless expressly non-exclusive) over claims brought under the Convention11 except for any additional jurisdiction which is available for advance relief. There will also be jurisdiction in the courts of a contracting state where the aircraft object is situated at the time when the remedy is exercised or where the aircraft object is registered with the Civil Aviation Authority of such contracting state, and in certain circumstances in the courts of a jurisdiction where the debtor is situated.12

Lastly, the Convention provides for the priority ranking of competing interests and makes the registration of interests at the International Registry critical to parties’ protection of their interests in any kind of dispute or enforcement. All international interests must be registered on the International Registry in order to be effective against any third party in a contracting state.13 Article 30 provides that a registered interest is effective if it was registered before the commencement of insolvency proceedings.

Basic remedies

Basic remedies, which become available to all transactions subject to the Convention, are slightly different when they arise under lease agreements and title reservation agreements, or under security agreements (mortgages).

Article 10 of the Convention provides that in the event of a default under the lease agreement or title reservation agreement, the lessor or title holder may terminate the lease agreement or title reservation agreement with respect to any aircraft object to which such agreement relates or apply for a court order to authorise or direct such termination.14 Article 10 also provides that the lessor or title holder may take possession or control of any aircraft object to which such agreement relates, or apply for a court order to authorise or direct such possession or control.15

When security agreements have been entered into (in the form of a mortgage, for instance), article 8 provides that, to the extent agreed by the parties, the creditor can in an event of default take possession or control of any object charged to it and sell or grant a lease of any object on reasonable notice to applicable interested persons.16 Article 8 of the Convention provides that all sums collected or received by the creditor as a result of the exercise of the remedies mentioned shall be applied towards discharge of the amount of the secured obligations. The creditor is obliged to distribute any remaining surplus among holders of subsequently ranking interests which have been registered or of which the creditor has been given notice, in order of priority. If there is still a surplus available to the creditor after such distributions, then such surplus must be paid to the debtor.
The truly revolutionary aspects of the Convention, as far as remedies are concerned, are found in the elective remedies that contracting states can choose to opt into.

The basic remedies are to a large extent fairly standard and established for the large majority of the countries where the EBRD operates. The truly revolutionary aspects of the Convention, as far as remedies are concerned, are found in the elective remedies that contracting states can choose to opt into.

Contracting state elective remedies

Described above are the basic remedies that every contracting state automatically adopts when ratifying the Cape Town Convention. However, as mentioned above, the Convention also offers a number of remedies in the form of key declarations that a contracting state can make. These declarations critically enhance the economic benefits of the Convention, as Professor Vadim Linetsky of Northwestern University has conclusively demonstrated in a recently published study, which modelled the economic benefits of a contracting state electing the Convention’s insolvency “Alternative A” declaration, including the benefits of the “Cape Town discount” described under the “Insolvency” section below.

The first elective remedy concerns the important mandatory declaration, if made under the Convention by a contracting state, that any remedy available to the creditor under any provision of the Convention, unless such remedy requires application to the court, may be exercised by the creditor without leave of the court. This, if adopted, would be quite a departure for many jurisdictions in central and eastern Europe, which have tended (but not consistently) to maintain the role of the courts on enforcement of security rights.

However, the most critical declaration or remedy is the insolvency remedy.

Insolvency. The Convention does not require contracting states to make an insolvency declaration. This in practice will mean that the contracting state retains its national insolvency law. If it chooses, however, a contracting state may elect between “Alternative A” and “Alternative B”, which deal with remedies in the event of insolvency of the debtor. Alternative A is the recommended option and indeed the option included in the “qualifying declarations” set out in the new Aircraft Sector Understanding (ASU) to the Organisation for Economic Co-operation and Development (OECD) Arrangement on Officially Supported Export Credits, a strict condition to the receipt of the “Cape Town discount” on the export credit exposure premium under the ASU.

Alternative A. Of the 23 contracting states that have made an election, 22 have chosen Alternative A. It is the preferred option because it requires the debtor to give possession of the aircraft object to the creditor under the security agreement, title reservation agreement or lease no later than:

- the end of the waiting period specified by the contracting state that is the primary insolvency jurisdiction and that has adopted Alternative A or
- the date on which the creditor would be entitled to possession if the Convention and Aircraft Protocol did not apply.

Furthermore, the remedies of de-registration and export of the aircraft (see below) are made available on an expedited basis by the aircraft registry authority of a contracting state if it chooses Alternative A.

Alternative B. Alternative B has been elected by only one country, Mexico, and is considered much less useful than Alternative A because it does not provide the same level of certainty in insolvency. Alternative B provides that the obligation of the insolvent debtor is to give notice that it will either cure the applicable defaults or give the creditor the opportunity to take possession of the aircraft object in
Part II: Debt enforcement in times of uncertainty

Where a country makes the declaration under the Aircraft Protocol that Article XIII shall apply, it commits to introduce an irrevocable de-registration and export authorisation.

Alternative A is not an isolated proposition of how legal regimes should treat secured creditors in the event of insolvency, but rather part of the development of legal thought on insolvency as described in a recent article by Jeffrey Wool and Andrew Littlejohns. The article examines how insolvency law has begun to reflect contextual considerations and policies and is not simply a one-size-fits-all entitlement of a debtor in bankruptcy to hold all parties in limbo. According to this approach, the analysis of appropriate insolvency law “requires an assessment of economic considerations, in light of the practical realities of aircraft financing and airline insolvency proceedings, and balanced against other interests, assessed in concrete terms.”

The explicit inclusion of Alternative A in the OECD ASU confirms this.

Other elective remedies

Cooperation of foreign courts in carrying out Alternatives A and B. If elected, Article XII provides that the courts of the contracting state where the aircraft is located will cooperate to the maximum extent possible with foreign courts and insolvency administrators in carrying out the provisions of Article XI Alternatives A or B.

Use of IDERA in aircraft registry of contracting states. Where a country makes the declaration under the Aircraft Protocol that Article XIII shall apply, it commits to introduce an irrevocable de-registration and export authorisation (“IDERA”). An IDERA is a specific instrument defined by the Convention (which also includes a sample form) which may be obtained by the creditor from the debtor. The creditor will then submit it at the closing of the financing to the relevant aircraft registry where the airframe or helicopter (but not an engine) is registered. The IDERA will be used, in case of default, to de-register and export the aircraft. Certain protections are built into this provision. Any second-ranking creditor may not exercise this remedy without the prior written consent of the holder of any registered interest ranking in priority to that of the second-ranking creditor.

Like any other remedy, it must be exercised in a commercially reasonable manner. Lastly, the exercise of the authorisation must be taken in accordance with the applicable safety laws and regulations of the jurisdiction where the aircraft object is registered.

Speedy court relief pending final determination.

The provisions for “speedy court relief pending final determination” require that a contracting state declares such provisions to be applicable in its jurisdiction and set up time periods after which a court would grant the relief to the creditor. Article 13 of the Convention (as modified slightly by Article X of the Aircraft Protocol), unless a contracting state opts out of it, provides for what is called “speedy court relief”, which allows the creditor, including a lessor or a title holder, to obtain the following court orders before judgment “to the extent that the debtor has at any time so agreed”, which means that the relevant agreement should cover the following remedies:

- preservation of the object and its value
- possession, control or custody of the object
- immobilisation of the object
- lease or, except where covered by subparagraphs (a) to (c), management of the object and the income therefrom
- sale and application of proceeds

Article 13 does not limit the availability of other forms of advance relief at law.
The Cape Town Convention is rightly seen as reflecting trends in international secured transactions and leasing law and as providing a significant example of an agent for accelerated development in the field of enforcement remedies, including in insolvency.

Mandatory election. Article 54(2) requires that every contracting state makes an election declaring whether it will require that any remedies under the Convention or Protocol must be taken only with the leave of court. This election was described earlier in this article and would permit non-judicial remedies by creditors under the Convention.

Contractual choice of law. Lastly, Article XXX(1) permits a contracting state to opt into the provisions for the parties to choose the law applicable to their contractual rights and obligations under Article VIII of the protocol.

Conclusion

The Cape Town Convention is rightly seen as reflecting trends in international secured transactions and leasing law and as providing a significant example of an agent for accelerated development in the field of enforcement remedies, including in insolvency. It builds on the EBRD Model Law on Secured Transactions and other work undertaken by UNIDROIT, UNCITRAL, and the Hague Conference on Private International Law, but it pushes law reform to a new, very promising dimension.

The Cape Town Convention directly addresses insolvency, the core risk in commercial transactions, and creates an international electronic registry to objectively determine priorities, a highly efficient and innovative feature. The Convention will be the starting point for all bold initiatives in this field, or at least will be a reference point when only incremental change in the law is possible.

Resources

The Official Commentary on the Cape Town Convention by Roy Goode is a critical companion for the Cape Town practitioner because it explains and analyses all provisions of the Convention and Aircraft Protocol and was authorised by the original diplomatic conference. Purchase details are available on the UNIDROIT web site: www.unidroit.org, and on the web site of the Aviation Working Group (AWG): www.awg.aero.

The AWG web site is an excellent source of material and resources on the Cape Town Convention and links to other web sites, including the International Registry where the Cape Town Convention “international interests” and all other interests thereunder are registered online to be effective against third parties in any contracting state. The web site also provides information about Cape Town seminars being held around the world under its sponsorship to help the legal and aircraft finance industries understand and work with the treaty. The AWG Legal Advisory Panel has published two booklets regarding application of the Convention to transactions. These booklets are available for purchase as described on the AWG web site.
Notes and authors


3 One exception is in those countries that ratified the Geneva Convention on the International Recognition of Rights in Aircraft, where the law of the country of aircraft registry at the time of the formation of the applicable security or lease agreement would apply to the rights against third parties. The Cape Town Convention supersedes the Geneva Convention except to the extent of rights or interests not covered or affected by the Cape Town Convention. Protocol art. XXIV.

4 Aircraft objects include airframes capable of carrying eight persons, including flight crew, or larger; helicopters capable of carrying five persons, including flight crew, or larger; and similar cargo aircraft and helicopter and aircraft engines of specified size if the connecting factors of the Convention exist, see Protocol art. I; R. Goode (rev. ed. 2008), Official Commentary on the Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific to Aircraft Equipment, para. 5.3.

5 Conv. art. 2(2), art. 3(1). Such an entity is “situated” in a contracting state when it is incorporated, formed in, or has its registered office, centre of administration or principal place of business in such contracting state. The Convention also applies when an airframe or helicopter is registered in a contracting state at the time of conclusion of such agreement.

6 However, it would be possible for contracting states to declare that the Convention would not apply in relation to a purely domestic transaction. Conv. Art. 50; Protocol Art. XIV(2).

7 Conv. art. 14.

8 Conv. art. 12.

9 Protocol art. IX(3).

10 Id.

11 Conv. art. 42.

12 Conv. art. 43; Protocol art. XXI.

13 Article 29 of the Convention provides that, unless varied by the parties in a registered subordination, a registered interest has priority over any other interest subsequently registered and over an un-registered interest regardless of whether or not the first-mentioned registered interest was acquired or registered with actual knowledge of any other interest that has not been registered. The Convention recognises the priority of the interests and rights pre-existing the effective date of the Convention under applicable law, unless a contracting state has elected to require pre-existing interests to be registered. No contracting state has made such an election.

14 Conv. art. 10(a).

15 Protocol art. IX(3).

16 If a contracting state declaration supports it, the creditor could also collect or receive any income or profits from the management or use of any such object. See Conv. art. 8(1).

17 Conv. art. 9(1)-(2).


19 Conv. art. 54(1).

20 Protocol art. XI.

21 See www.oecd.org.


23 Id. at 2.

24 Another key example is the Directive 2002/47/EC of 6 June 2002 on Financial Collateral (amended in 2009), which aims to assist integration, cost efficiency and stability of the financial markets and the financial system in the European Community by permitting enforcement of financial collateral against institutions regardless of otherwise applicable insolvency laws.

25 Protocol art. IX(2).

26 Protocol art. IX(3).

27 Protocol art. XIII (3).

28 Conv. art. 55.

29 Conv. art. 13(1)(a).

30 Conv. art. 13(1)(b).

31 Conv. art. 13(1)(c).

32 Conv. art. 13(1)(d).

33 Protocol art. X(3).

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**Legal transition developments**

Information on legal developments in the EBRD’s countries of operations can be found on the EBRD web site at www.ebrd.com/law.

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**Law in transition online**

*Law in transition* online is published in the autumn of each year. It is available in both English and Russian at www.ebrd.com/pubs/legal/series/lit.
## Abbreviations

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<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AMC</td>
<td>Asset management corporation</td>
</tr>
<tr>
<td>ASU</td>
<td>Aircraft Sector Understanding</td>
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<tr>
<td>AWG</td>
<td>Aviation Working Group</td>
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<tr>
<td>bcm</td>
<td>billion cubic metres</td>
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<tr>
<td>CEE</td>
<td>Central and eastern Europe</td>
</tr>
<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>DAM</td>
<td>Day-ahead market</td>
</tr>
<tr>
<td>DP</td>
<td>Defaulting partner</td>
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<tr>
<td>EBRD, the Bank</td>
<td>European Bank for Reconstruction and Development</td>
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<tr>
<td>ECR</td>
<td>Electric capacity reserves</td>
</tr>
<tr>
<td>EE</td>
<td>Energy efficiency</td>
</tr>
<tr>
<td>EMPEA</td>
<td>Emerging Markets Private Equity Association</td>
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<tr>
<td>EnC Treaty</td>
<td>Energy Community Treaty</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>FX</td>
<td>Foreign currency</td>
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<tr>
<td>FYR Macedonia</td>
<td>Former Yugoslav Republic of Macedonia</td>
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<tr>
<td>GHG</td>
<td>Greenhouse gas</td>
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<tr>
<td>ICAO</td>
<td>International Civil Aviation Organisation</td>
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<tr>
<td>IDERA</td>
<td>Irrevocable de-registration and export authorisation</td>
</tr>
<tr>
<td>IFI</td>
<td>International financial institution</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>LTV</td>
<td>Loan-to-value ratio</td>
</tr>
<tr>
<td>NPL</td>
<td>Non-performing loan</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>RES</td>
<td>Renewable energy sources</td>
</tr>
<tr>
<td>RMBS</td>
<td>Residential mortgage-backed security</td>
</tr>
<tr>
<td>SEE</td>
<td>South-eastern Europe</td>
</tr>
<tr>
<td>SME</td>
<td>Small and medium-sized enterprise</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
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<tr>
<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
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<tr>
<td>UNFCCC</td>
<td>United Nations Framework Convention on Climate Change</td>
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<tr>
<td>UNIDROIT</td>
<td>International Institute for the Unification of Private Law</td>
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</tbody>
</table>