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 reform 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.
New regulations enacted to deal with the financial crisis have largely ignored the secured transactions framework, despite the existence of inefficiency in the system.

**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 creditor, 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.
Part II: Debt enforcement in times of uncertainty

Ukrainian insolvency law functions mainly to protect the debtor, and does not often result in prompt or full satisfaction of creditors’ claims. 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.
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.

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