Insolvency and bankruptcy in Ukraine: the history and current state of regulation, international aspects.

1. Ukraine as a subject of international private law and investment activity.

Ukraine gained independence in 1991 as a result of the break-up of the USSR. At that time it was one of the most developed Soviet republics. The basis of its economy was not just well known highly productive agriculture, but a powerful military-industrial complex producing missiles, weapons, tanks, space technology and the world's largest cargo plane which included many of the largest enterprises in the USSR and worldwide. Ukrainian educational institutions were of a fairly high level which provided the required number of engineers and managers and it had a well-developed network of research institutions. Consequently, when becoming an independent subject of international law and having declared the intention to build a market economy, Ukraine began to be considered as an attractive place for investments by foreign investors. Economic and regulatory reform processes started, which in 1992 resulted in a complex quasi-market environment.

Given that the reforms were isolated and not holistic and were not implemented by experts in these fields, but by the Ukrainian political elite, this soon led to a general economic crisis. In 1992, the economy and society at all levels was struck with a "non-payments crisis" that resulted in the insolvency or bankruptcy of many businesses.

The situation was aggravated by the fact that the legal system of Ukraine, as a former part of the Soviet socialist "planned" economy, had not needed and therefore had no legal mechanism for resolving insolvency or bankruptcy.

2. The history of the development and the main factors of Ukraine’s current reformation of its bankruptcy legislation

This situation forced the government to resort the introduction of a system of insolvency legislation in Ukraine. This process was also facilitated by the desires of the authorities to use the institution as a tool of guided privatization for their own profit.

The first attempt to lawfully regulate the legal relationships of insolvency was made by the Law "On Bankruptcy" (became effective on 01/07/1992). The Law was rather poor and had only 22 articles which did not provide the necessary detailed regulatory requirements. The declared goal of the law was to regulate the judicial procedure of the bankruptcy (liquidation) of legal entities in order to satisfy creditors' claims.

The main drawback of the law was that it did not provide specific mechanisms for stoppage of the fulfillment of monetary obligations and tax obligations (mandatory payments) by a debtor, as well as the stoppage of legal measures to enforce these obligations. Since, at that time, the institute of professional insolvency practitioners (asset managers) did not exist, their functions were performed by creditors (who usually do not have the knowledge needed to carry out liquidation procedures).

Technical and legal flaws of this Law were exclusively resolved by legal practice and relevant interpretations of the Supreme Economic Court of Ukraine.

The said Law also contained provisions on reorganization, but the mentioned flaws prevented their use. And the unfavorable investment climate in Ukraine combined with the procedures of restoring solvency inhibited foreign investors from participating in the process.

In 1994, the Agreement on Partnership and Cooperation (hereinafter - PCA) was signed between Ukraine and the European Community and its Member States. Ukraine began the process of bringing national legislation up to EU standards, especially in certain priority areas (Article 51 of the PCA), including bankruptcy of companies.

In particular, it was the improvement of bankruptcy law in order to bring its provisions to EU norms and standards, in particular, to Council Regulation 1346/2000/EC of 29 May 2000 on insolvency proceedings.

But, the main factor in reforming Ukrainian legislation to bring it to international standards, was, and still is, the influence (requirements) of major donors, in particular, the IMF and the World Bank. Specifically, in 1999, the International Monetary Fund issued its vision of Ukrainian bankruptcy proceedings and offered measures to create effective regulation of corporate insolvency: Orderly & Effective Insolvency Procedures. Key Issues. Based on the above, an American consulting company prepared the second edition of the Law "On restoring the debtor's solvency or bankruptcy" which was adopted on 30/06/1999 and became effective on 01.01.2000.

Unlike previous versions of the law, the mechanism of the proceedings in bankruptcy cases was built on the principles of competition of creditors as the orderly collective satisfaction of creditors' claims. This version remained very far from perfect but eliminated many of the shortcomings of its predecessor. Specifically, a moratorium on the satisfaction of creditors' claims, a bankruptcy law sub-institute, was founded. Creditors were divided into two groups, long-term and current ones. Creditor’s status (rights and obligations) in the bankruptcy case was determined by the nature of its claims against the debtor, its security, the time the commitment was incurred and its social significance. The particular emphasis of the Law was solvency restoration procedures. Accordingly, the debtor was granted more rights and preferences.

The adoption, in 2004, of the Commercial Code, which provided clarification of substantive norms in insolvency procedures, became an important development in the reform of bankruptcy law.

But as the law was developed by foreign advisers, it was not duly mesh with the existing legislative system, containing legal constructions which had been unknown in Ukrainian legislation and did not take into account the legal practice. Accordingly, many gaps and inconsistencies of the Law were settled by case-law, and with information letters and interpretations of higher courts. This state of the regulation, coupled with the significant growth of corruption in the judiciary of Ukraine led to that the proceedings in the bankruptcy cases in

fact became a procedure for legitimizing crimes in the economic sphere and a tool for dispossession of participants in economic relations.

So, according to *Doing Business,* bankruptcy procedure in Ukraine lasts an average of 2.9 years, and the recovery rate is 8.2 cents per 1 dollar. It is among the worst in the region.
Based on these data the IMF required the insolvency procedures to be reformed as one of the basic requirements for continued cooperation with the Government (p. 22 of the Memorandum of 2010). The main goal of the reforms should have been to provide a reliable protection of creditors' interests and to reduce the duration of the procedures in bankruptcy cases and the costs of these procedures. Moreover, the updated regulation should have been based on the proposals of the experts and consultants of the WB and the IMF. In particular, the need to reform the bankruptcy system in the context of improving other areas of legislation was emphasized, including adapting the juridical system to the needs of effective bankruptcy proceedings through the implementation of appropriate corporate governance and institutional support for the effectiveness of the bankruptcy system and appropriate state and non-state regulation. In accordance with the latest version of the Principles for Effective Insolvency and Creditor Rights Systems (2011), the developers suggested the use of advanced mechanisms as a means to maximum protection of the interests of the participants of bankruptcy proceedings, a new system of monitoring, diagnosing and protecting businesses from financial problems and crises and finding optimal ways to overcome insolvency. In particular, an attempt was made to improve bankruptcy proceedings; new ways of protecting the rights and legitimate interests of both debtors and creditors, as well as employees and the state were introduced; for the purpose of economy and efficiency a procedure for pre-trial rehabilitation of debtors was introduced, and the jurisdiction of all matters in dispute with the debtor was given to the commercial court which considered the bankruptcy case of the debtor.

As the Government of Ukraine is in constant need of external borrowing, a new phase of reform was started.

3. The current state of the regulation of insolvency and bankruptcy

The new version of the Law "On Restoring the Debtor's Solvency or Recognizing it Bankrupt" came into force on 01/19/2013, in Ukraine. This Law was the third attempt by the Ukrainian parliament to build a legal basis of restructuring and insolvency on the European model. The latest draft law on bankruptcy was submitted by its developers to the Verkhovna Rada of Ukraine for adoption as a draft law built on a new concept. However, after the MPs' "improvements" to this version of the law, there were no conceptual innovations remaining in it. In reality, the structure of the text was slightly changed and the number of articles was increased by reducing their size, but without significant change of the main provisions of the law. In addition, some new provisions worsen the regulating of insolvency relationships when compared to the previous version of the law.

To be fair, it should be noted that the law has increased by a section devoted to the so-called cross-border insolvency, which was an IMF requirement. Nevertheless, there are no grounds to assert that the concept of the national bankruptcy system has changed.

As Chairman of the Committee on Insolvency and Bankruptcy of Ukrainian Bar Association, this author was a member of the working group which developed the draft of this law. Representing the community of practitioners, we tried to draw the attention of legislators primarily to procedural flaws of the draft, which would prevent its proper application in practice. Unfortunately, most of the proposals were not taken into account. All the main ideas that had been declared at the beginning of the reformation process were not dealt with in the new version, and sometimes greatly worsened the situation.

For example, the draft law was ideologically directed towards reducing the corruption component in bankruptcy proceedings, particularly in the area of regulation concerning the provision of professional services by insolvency practitioners. As one of the safeguards in the Law was the establishment of provisions that all appropriate payments to the asset manager were required to be made through notary deposit. But, to implement these provisions of the Law on Bankruptcy it was necessary to pass amendments to the regulations governing the activities of notaries. As for today, these have not even been developed and therefore, for more than a year, in bankruptcy proceedings which have been undertaken under the new Law, asset managers have no legal ability to obtain compensation and pay their costs. Obviously, it is easy to see how this affects the level of corruption.

At the same time, there are procedural problems. For example, there was a paradox situation, where, under the transitional provisions of the Law, two versions of the Law ("new" and “old”) were implemented simultaneously. Although, formally the order of their implementation is settled, it is impossible to clearly define the scope of the application of each of these acts.

4. Participation in the bankruptcy of a foreign debtor: typical problems and dangers for non-residents in bankruptcy proceedings in Ukraine.

Ukraine is the largest country in Europe and has unique natural resources and human potential. That is why, despite the current negative political and social factors, Ukraine continues to attract foreign investors. A contributing factor is the lack of information from trustworthy sources. There is a lack of understanding of the actual processes which take place in Ukraine, by foreign "experts", and therefore, they are unable to objectively evaluate the legislation associated with the regulation of businesses, and especially its use, which sometimes misleads the international community. For example, the most recent review of the IFC project *Doing Business* shows that Ukraine has improved its ranking in business activity by 28 points!!! Obviously, this is not true. Investors, who are not associated with the government by corrupt connections, are fleeing Ukraine and their assets are taken via formally legitimate court proceedings.

When representing a client in Ukraine, one should keep in mind that the system of bankruptcy in Ukraine is often used not for the purposes for which the relevant legal procedures were developed. There are numerous examples where bankruptcy has been used for the purpose of assigning low prices, or even no remuneration, to the assets of the company brought to insolvency.

Often, debtors use bankruptcy to avoid fulfilling their financial obligations.

The global financial crisis and the new insolvency cases associated with it are a new type of crime for Ukraine. Foreign companies use Ukraine as a place to hide assets and launder money derived from the jurisdiction of the creditors in their countries. As a good example of the above, we have a cross-border insolvency case. During the investigation we have established that the debtor, a resident of the Czech Republic, transferred 8 million dollars borrowed from a number of Czech banks to Ukraine and laundered it through the bankruptcy proceeding of a Ukrainian company. Unfortunately, so far our attempts to return the stolen money to the creditors using criminal proceedings in Ukraine and the Czech Republic have failed. Primarily, due to the inactivity of Czech law-enforcement agencies.

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