

## C. Bankruptcy in Ukraine: A Back Door to Privatization

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## Laws

## Introduction

As a newly independent state, Ukraine attracts the attention of international and local investors as an interesting candidate for business development. To facilitate the establishment of an open market, the country has been developing its own legislation. Among the new set of laws developed after Ukraine became independent was the Law on Bankruptcy. The analysis of this law, and its application in the country's economy, is a focal point of this paper.

The economic transformation in Ukraine, as with most post-Soviet countries, resulted in the privatization of many state companies. Because the stock market in Ukraine barely exists, privatization there essentially means the change of ownership of company's physical assets. However, the privatization process, by its very essence, requires not only the change of ownership of physical property but, even more importantly, a change in the approach to doing business. The process is undertaken in order to lead to the formation of a market economy and to the establishment of appropriate market economy institutions.

If the privatization process is not transparent and not organized to be fair and accessible for all interested and legitimate parties, bankruptcy of state enterprises can become an alternative to privatization. Bankruptcy is, however, an institution inherent to a market economy. It is, or should be, designed to protect the rights of market players (creditors and debtors). This institution is rarely utilized in planned economies. Once a country decides to change its economic system, it takes time and effort, not only at all government levels (legislative, judicial, and executive) but also in the entrepreneurial community, for bankruptcy to become a legitimate process and be used for its intended purposes. This is the case in Ukraine.

The Ukrainian economy depends to a considerable degree on coal and iron ore mining companies. These companies have not been particularly efficient, at least in part because they belonged to the state and have been receiving preferential treatment from the government. The bankruptcy of all such enterprises could lead to a depression of that important industry and instability in the whole economy. Coupled with a not very transparent and essentially weak court system where courts "are exposed to political influence and are involved in misconduct that leads to state loss of attractive assets,"<sup>2</sup> the bankruptcy process potentially becomes an instrument of acquiring state property.

Countries with developed economies took years to develop efficient bankruptcy laws and regulations. Those laws are still being revisited to reflect changing economic conditions and to close possible legislative holes. Ukraine has thus far enjoyed little more than a decade of inde-

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<sup>2</sup>"Privatization and bankruptcies of state-owned enterprises in Ukraine," Discussion Paper, German Advisory Project on Privatization in Ukraine, P.2, Kyiv, July 2003.

pendent years. Twelve years is too short of a period to build a stable market economy and the institutions inherent in it. The country is still in the early stages of developing its political and judicial system and building its capital markets. In such an environment, bankruptcy plays a different role from that in a developed market economy.

Herein we explore a process in a state of flux. Ukraine is trying to develop its economy and the institutions to facilitate its new market economy all at once. It is a daunting task for any country, particularly for the one that is not especially wealthy.

This paper will introduce readers to Ukraine and overview its bankruptcy laws and practices. As a basis for this article, the authors have analyzed the bankruptcy laws of 1992 and 1999 and recent amendments to the bankruptcy regulations as well as manuscripts and cases studies available for public access online.

The paper includes five parts. The first part provides a brief overview of Ukraine and its bankruptcy developments prior to 1992. The second part discusses the bankruptcy law of 1992. In the third part, we review bankruptcy procedures as they are outlined in the current bankruptcy law enacted in 1999. The fourth part analyzes the current practices of the bankruptcy law. A real life case will be considered in order to illustrate the room for further improvement in the Ukrainian legislation. The fifth part concludes.

### Part I. About Ukraine

Ukraine is located in the southeastern part of Central Europe and positioned strategically at the crossroads between Europe and Asia. Ukraine has the second-largest territory in Europe. It has a population of 48 million people (by comparison, Spain has 40.2 million people).<sup>3</sup>

With a favorable climate, Ukraine traditionally has been an agricultural country. It is rich in natural resources: iron ore, coal, nonferrous metal, oil, gas, and mineral salt. Its primary industries are in mining, particularly coal mining.

Ukraine was part of the Soviet Union during 1921 to 1991. In 1991, following the collapse of the USSR, Ukraine proclaimed independence. It became a founding member of the Commonwealth of Independent States and adopted its own constitution in 1996.

The first Ukrainian president, Leonid Kravchuk, concentrated on building the national identity. Political and economic reforms took a back seat with Kravchuk. Leonid Kuchma, second and current president as this article is being written, became Ukrainian president in 1994 and was re-elected in 1999. During his presidency, Kuchma began actively engaging the country with European economic integration and leading it toward a more market-oriented economy. Ukraine has experienced steady GDP growth since 2000. Nonetheless, during Kuchma's presidency, international observers have often complained

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<sup>3</sup>The World Fact Book; <http://www.cia.gov/cia/publications/factbook/geos/up.html>

about the slow pace of economic restructuring.<sup>4</sup>

In its recent report, "Doing Business," the World Bank analyzed 130 countries with regard to how receptive each is to doing business. The analysis indicated that the US, Australia, and Canada are among countries with the most favorable environments for doing business, while many former Soviet countries have not yet created a favorable basis for doing business. According to this report, in Ukraine, it takes 14 procedures, 40 days, and over \$210 to start a business; it takes 20 procedures, 223 days, and \$80 (or 27.3% of the average annual income per capita) to make a contract, and it takes up to three years to finalize a bankruptcy case once it begins. In comparison, a bankrupt Russian business takes an average of a year and a half to go through this process.

Even with a lack of business receptiveness on a regulatory level, Ukraine is still attractive to foreign investors. It has a high potential based on its natural resources and well educated population. Hundreds of U.S. and other foreign companies conduct business there. The present economic outlook in Ukraine is positive. Based on a revised government forecast, GDP grew by 8.5% during 2003. From January-September of 2003, the direct foreign investments in Ukraine increased by \$700 million, and the monetary reserves increased by \$2,280 million to \$6,680 million.

**Table 1. Important Macroeconomic Indicators, 1998-2002<sup>1</sup> :**

	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
GDP per head (\$ at PPP)	2,193	2,391	2,690	2,870
GDP (% real change pa)	-0.2	5.9	9.1	4.59
Government consumption (% of GDP)	18.48	17.8	17	13.5
Budget balance (% of GDP)	-1.49	0.57	-0.29	0.7
Consumer prices (% change pa; av)	22.68	28.2	11.96	0.76
Public debt (% of GDP)	60.03	44.38	35.96	28.5
Labour costs per hour (USD)	0.33	0.32	0.44	0.54
Recorded unemployment (%)	4.06	4.31	3.86	3.76
Current-account balance/GDP	5.25	4.74	3.69	6.3
Foreign-exchange reserves (m\$)	1,046	1,352	2,955	4,241

## Historical Development of Bankruptcy Law in Ukraine

### Bankruptcy Developments Prior to Independence

Until 1991, when Ukraine became an independent state, the development of its bankruptcy institution was closely interconnected with prac-

<sup>4</sup>The Economist; <http://www.economist.com/countries/Ukraine/>

<sup>1</sup>Copyright © 1995-2001. The Economist Newspaper Group Ltd. All rights reserved, Economist.Com Country Briefings, Ukraine: Economic Data, <http://www.economist.com/countries>.

tices in Russia and the USSR. Ukraine had been one of the republics making up the USSR and, prior to that, a part of Russia. The history of the Ukrainian bankruptcy law is, in fact, the history of the Russian law. In the preceding edition of *Annual Survey of Bankruptcy Law*, we reviewed the development of the bankruptcy law in Russia and detailed the stages leading to its current state<sup>6</sup>. Here, we will just highlight some major historical milestones in the development of the Ukrainian bankruptcy institute.

In the 12th-15th centuries, what was at different times during that period called Kiev Russia<sup>7</sup> had bankruptcy regulations differentiating bankruptcies due to misfortune, negligence, and forgery. Those regulations also defined the priority order of debt repayment, with the Grand Duke being first in line, then foreign creditors, and only then local creditors. Between that time and the 1917 Revolutions, the bankruptcy law gradually developed. Several significant regulations were enacted: the Bankruptcy Statute in 1740, the Statute on Bankrupts in 1800, and the Statute on Insolvency in 1832. All of these pre-revolutionary bankruptcy regulations focused primarily on insolvency of individuals rather than legal entities. Russian or Ukrainian bankruptcy legislation of that time reflected the goals and objectives of bankruptcy as one of the main institutions of the market economy.

During the Soviet Era, the bankruptcy legislation was designed to protect working people and the state, in contrast to the pre-revolutionary goals of protecting creditors. Immediately after Ukraine became a part of the Soviet Union in 1921, several regulations, including the Ukrainian Civil Judicial Code, were enacted to regulate bankruptcy relationships in the republic. However, due to the economic setup of the planned economy with a strong state planning center and no private property, the role of the bankruptcy institution diminished. By the late 1980s, bankruptcy regulations had been revised to reflect the economic developments of the country, and yet they were rarely applied in practice. Ukraine did not have real bankruptcy institutions at that time. The state budget subsidized unprofitable and technically insolvent state-owned enterprises. No legal procedure was practiced to withdraw insolvent companies from the economy.

After a long period without an effective bankruptcy system to facilitate competition and credit relationships, this situation started changing in the early 1990s. The dissolution of the Soviet Union prompted the creation of newly independent states that began to move towards market economies. The establishment of effective bankruptcy institutions was important for the new countries in order to create a more transparent and favorable environment for investors.

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<sup>6</sup>Annual Survey of Bankruptcy Law, 2003 ed., *The New Bankruptcy Law in Russia*, B. Branch, N. Goncharova, K. Sonin. (Thomson West, 2003).

<sup>7</sup>Kiev Russia (Kievkaya Rus') was the feudal Russian state existing in the 9th-12th centuries. In 1132, it became Kiev Knyajestvo, and in 1471 it became Kiev Voevodstvo. Through all those times, Kiev remained the center of these states. Kiev became the capital of Ukraine in 1934.

## Part II. The Bankruptcy Law of 1992

After becoming independent, Ukraine began developing the legal basis to facilitate privatization and private property relations peculiar to a market economy. The bankruptcy law, “On Restoration of Debtor’s Solvency or Declaration of Its Bankruptcy,” enacted in 1992<sup>8</sup> (hereinafter referred to as ‘the 1992 Law’) became one of the first regulations issued by the Ukrainian government whose purpose was to promote business relations in the country. Both the 1992 Law and the 1999 Law have been analyzed in detail by Alexander Biryukov<sup>9</sup>. This article reflects some elements of his analysis.

In the 1992 Law, bankruptcy was defined as the inability of a legal entity engaged in commercial activities to satisfy creditors’ claims or to fulfill its obligations to the fiscal authorities by its assets within one month after the due date<sup>10</sup>. The meaning of “debtor’s assets” was not defined by the law, and no explanation was given in judicial practice. From time to time, this lack of clarity has resulted in problems in the practical application of the law.

In its very preamble, the 1992 Law revealed one of its important limitations. Its preamble stated “this law determines terms and conditions, and procedures to recognize a legal entity, subject of business activities, as a bankrupt for the purposes of meeting creditors’ claims.” The law had a pro-creditor nature. The subjects of the law were narrowed to legal entities carrying out entrepreneurial activities. Neither individuals nor non-profit organizations were subject to the law.

The creditors defined by the 1992 Law included state authorities, legal entities, and individuals.<sup>11</sup> To qualify for protection under the 1992 Law, creditors needed to have documents confirming their property claims. State authorities could file a bankruptcy petition with regard to debtors defaulting on tax obligations or other obligations to the state budget.

At that time, most Ukrainian companies belonged to the state and owed significant amounts to the state budget. Accordingly, had the state authorities fully acted on this provision by filing bankruptcy petitions on those debtors owing back taxes, substantial instability in the country’s economy could have resulted. At the initiative of state tax organs, by September 1995, a total of 330,712 bankruptcy cases had been instituted in relation to legal entities or taxpayers.<sup>12</sup> This total comprised 59.5% of all tax-paying legal entities — subjects of entrepreneurial activity in Ukraine.

When the 1992 Law was enacted, Ukraine had a system of separate

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<sup>8</sup>Law “On Recovery of Debtor’s Solvency or Declaration of Its Bankruptcy,” May 14, 1992 (No. 2343-XII), *Vedomosti Verkhovnoi Rady Ukrainy*, No. 31 item 440, 1992.

<sup>9</sup>See *Bankruptcy and Legislative Reform In Ukraine*, Alexander Biryukov, 27 *Rev. of Central and East European Law*, 2001 No.4, 581-600, (2002, Kluwer Academic Publishers).

<sup>10</sup>Article 1, 1992 Law.

<sup>11</sup>Article 3, the 1992 Law.

<sup>12</sup>*Finansovaia Ukraina*, 1/26/1995.

judicial bodies resolving disputes arising from property relations. Such cases were considered by arbitration courts, and, in the examination of such cases, the legal procedures of the Arbitration Procedure Code of Ukraine were applied.

Under the 1992 Law, the proceeds received from the sale of the bankrupt's property were applied toward satisfying claims of five categories of creditors. Priority was given to expenses related to carrying out a case in an arbitration court, work of the liquidation committee and the activities of the manager of the debtor's property as well as property claims of creditors whose obligations were secured by a pledge. Claims to tax and similar payment obligations were satisfied in second order. All other claims were then to be satisfied to the extent that funds were available.

The principal judicial proceeding established by the 1992 Law was the debtor's liquidation. The liquidation began with a declaration by the arbitration court that the debtor was bankrupt. The law also stipulated the procedural possibility of preventing the debtor's liquidation by means of reorganization — Sanation (or Sanatsia as it is called in Russian and Ukrainian). Sanation refers to the satisfaction of creditors' claims and the debtor's fulfillment of its obligations to the budget with the transfer of its debts to a sanation manager (sanator) for a workout.

A sanator could be either an individual or a legal entity expressing a desire to satisfy the creditors' claims on behalf of the debtor and to fulfill the debtors' obligations to the budget, upon the condition that the creditors' committee agreed with the timing for fulfillment of such obligations.

In addition to definitions of the creditors' committee and sanator, the 1992 Law provided for the participation in bankruptcy cases of other specially appointed persons or managers of the debtor's property. Such managers could include the debtor's bank, a state organ authorized to manage property of the debtor (state enterprise), or another entity. The shortcomings of participation of such entities in bankruptcy cases were twofold: (1) they would join the bankruptcy case rather late, and (2) their functions were not clearly established.

Sanation could be carried out by means of reorganization or privatization or by the transfer of debtors' debts to its employees by means of factoring, where the debtor is a state enterprise.<sup>13</sup>

The law provided only a general definition of sanation. Five years after the 1992 Law was enacted, sanation was more concretely defined.<sup>14</sup> Sanation was designed to regulate the problem of the debts and financial recovery of a legal entity (the debtor). Such agreements between debtor and sanator, for example, could include an agreement about debts transfer, an agreement on restructuring the charter capital of the debtor (i.e. complete or partial change of ownership of the legal entity in favor

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<sup>13</sup>Articles 1, 4, 12, 13, the 1992 Law.

<sup>14</sup>Paragraph 26 of the Higher Arbitration Court's Explanation, dated November 18, 1997.

of the sanator) or an agreement on the debt payment by sanator within the established period.

To carry out a sanation proceeding, the sanator needed to reach an agreement with the state structure that was authorized to manage state property as well as the Antimonopoly Committee of Ukraine.

Although the 1992 Law did not stipulate any other proceedings to prevent the debtor's liquidation, several scholars argued that the option to withdraw a bankruptcy application served the function of an amicable agreement. More than 60% of bankruptcy cases were terminated upon creditors' applications after debtors found funds to pay back their debts.

In cases where the debtor was a unitary (state-owned) enterprise, one of the conditions of sanation could be the transformation of such an entity to an economic association in which the sanator would have a part of the stock corresponding to the debt; in other words, this was a judicially engineered/sanctioned debt-for-equity swap.

The 1992 Law did refer to a state structure sanctioned to handle bankruptcy matters. Courts enjoyed unlimited power, and a state body called the Agency on Bankruptcy Matters (hereinafter referred to as "the Agency") was created in Ukraine in 1996. The Agency became the central structure of state executive power subordinate to the Cabinet of Ministers of Ukraine. The main task of the Agency was to establish organizational and economic conditions necessary for preventing bankruptcy of state companies and for aiding recovery of insolvent state companies.

The 1992 Law represented an initial attempt to develop a mechanism for liquidating inefficient enterprises and provided opportunities to more capable entrepreneurs. The first years of applying this law revealed its inefficiency. The number of distressed enterprises significantly exceeded the number of bankruptcies filed with the court. The law was not used as a legal means to regulate disputes involving property relations. Most of the bankruptcies were filed by creditors while debtors did not use this law as an instrument to help their businesses recover. The 1992 law was criticized for providing very limited incentives for enterprise restructuring.

To some extent, the 1992 Law became an addendum to the legislation on privatization. Quite often, bankruptcy was used as a means of changing ownership to facilitate the transfer of state property into private hands.

Privatization policy in Ukraine was defined by the end of 1991 with the Parliament's approval of the concepts on denationalization and privatization of state companies' property, housing, and land. The privatization laws were adopted in March 1992: "On Privatization of the State Companies' Property," "On Privatization of Small State Enterprises," and "On Privatization of Securities." In June 1992, the Ukrainian government approved the first State Privatization Program.

The progress of privatization processes was reviewed in detail in the book, "Support for the Ukrainian Government in the Formation of Stra-

tegic Objectives for Privatization and Establishing Priorities for their Implementation.”<sup>15</sup>

The statistics provided in the book indicate that, in 1992, only 43 properties were sold. The mass privatization started in 1993, and tens of thousands of privatized properties have been sold since then. The unclear legislative definition of a ‘privatization object’ led to inconsistent privatization statistics. The data released by the State Statistics Committee of Ukraine indicates 77,800 properties were sold between 1992-2002. The data released by the State Property Fund (SPFU) for the same period indicates 79,300 companies were sold or 102,900 during 1991-2001<sup>16</sup>. Regardless of the exact amount of privatized assets, about 40% of State property was commercially sold during the 10 years after the first privatization initiation.

At the same time we see irregularities in the number of bankruptcy cases initiated during the same period. The following table shows the dramatic increase in bankruptcies beginning particularly from 1994 to 1997.

**Table 2. Bankruptcy cases initiated in 1992 through 1999**

Year	1992	1993	1994	1995	1996	1997	1998	1999
<b>Bankruptcy Cases</b>	20	38	194	2,000	2,800	6,700	7,500	9,539

After the first several years of the 1992 Law’s application, it became evident that the law needed significant improvements. Several attempts were made by different forces and parties (on both governmental and academic levels) to develop a more comprehensive law. The next bankruptcy law was enacted in 1999. Since then, it has undergone several amendments, which will be reviewed further in this paper.

### Part III. The Bankruptcy Law of 1999

The 1999 Law<sup>17</sup> reflected the experience and knowledge gained since 1992. While the 1992 Law aimed to protect creditors’ interests, the 1999 Law also took debtors’ interests into account. The 1999 Law was designed first to help rebuild a troubled company and only if that could not be achieved would a debtor go through bankruptcy proceedings to satisfy its creditors’ claims.

*Bankruptcy Definition.* Under the 1999 Law, bankruptcy proceedings can be initiated by creditors, the debtor, and state authorities. A creditor can initiate bankruptcy proceedings if the debtor’s financial obliga-

<sup>15</sup>Support for the Ukrainian Government in the Formation of Strategic Objectives for Privatization and Establishing Priorities for their Implementation, Heinrich Hoelzler, State Property Administration and Management in Ukraine: Corporate Governance Patterns and Proposals [http://www.privatisation.kiev.ua/Priv\\_Ukr/PubU/Book\\_German.pdf](http://www.privatisation.kiev.ua/Priv_Ukr/PubU/Book_German.pdf).

<sup>16</sup>Ukrainian Privatization in Numbers (1991-2001), SPFU Report.

<sup>17</sup>The Law of Ukraine #784-XIV “On Bankruptcy,” dated June 30, 1999.

tions are past due for at least three months, and if the total undisputed claims of one or more creditors against the debtor are greater than or equal to 300 minimum monthly wage units (approximately \$5,000 as of 01/2004).<sup>18</sup> Bankruptcy cases can be instituted by an economic court.<sup>19</sup> The debtor may submit a petition to an economic court if it has sufficient property to cover the court expenses.<sup>20</sup>

*Debtors.* In addition to bankruptcies of legal entities, the 1999 Law was extended to include bankruptcies of both individuals and non profit organizations. The Law differentiates state enterprises (kazenni pidpryemstva<sup>21</sup>). It is not applicable to legal entities operating as state-aided [military] enterprises and those state legal entities which constitute communal property.<sup>22</sup> The 1999 Law gave rights to local state authorities independently to exempt state enterprises from bankruptcy proceedings if such enterprises are located in the area under such state authorities' supervision. As a follow up to the law, the President of Ukraine issued several regulations exempting certain state enterprises from bankruptcy proceedings. This matter will be reviewed in greater detail in a later part of the paper.

*Creditors.* Like the 1992 Law, the 1999 Law defines creditors as legal entities and/or individuals entitled to monetary claims against the debtor.<sup>23</sup> Employees of the debtor are also considered among its creditors. The 1999 Law improves on the 1992 Law by regulating non-resident creditors in a fashion similar to local creditors except when Ukraine's international agreements contain a contrary stipulation.

*Participants in Bankruptcy Cases.* The 1999 Law has a new feature that clearly defines who can take part in a bankruptcy case. This includes the basic parties, the debtor and creditor(s), who are often represented by a creditors' committee. In addition to basic parties, the law defines an arbitration manager and the owner of the debtor's property as well as other participants in bankruptcy proceedings. Such persons could include, for example, representatives of the employees of the enterprise whose procedural rights have been established by the 1999 Law.

*Arbitration Managers.* The 1999 Law has expanded the number of professional participants in bankruptcy cases who are appointed by economic courts and who have been given the general title of arbitration managers.<sup>24</sup> As part of the newly defined proceeding, the law has added an important provision that one person — Arbitration Manager — can fulfill the function of the Trustee (manager of the debtor's property), Sanation Manager (the reorganization administrator), and the Liquida-

<sup>18</sup>Article 1, 1999 Law.

<sup>19</sup>Para 3, Article 6, 1999 Law.

<sup>20</sup>Para 4, Article 6, 1999 Law.

<sup>21</sup>The term 'kazenni pidpryemstva' appeared in Ukrainian legislation in 1998 with enactment of amendments to the 1991 Law of Ukraine on Enterprises.

<sup>22</sup>Para 6, 7, Article 5, 1999 Law.

<sup>23</sup>Para 5, Article 1, 1999 Law.

<sup>24</sup>Article 1, 1999 Law.

tor in all stages of the case proceedings. The law requires that such a professional specialist must be trained and licensed by the Agency for Bankruptcy to be allowed to participate in bankruptcy cases. This provision was designed to increase the accountability and transparency of bankruptcy cases.

*Bankruptcy Court.* As in the 1992 Law, the 1999 Law placed the jurisdiction for bankruptcy proceedings under the arbitration (now “economic”) courts<sup>25</sup> with the same procedural rules. Ukraine has followed the current legal direction and created separate judicial chambers to specialize in bankruptcy cases.

During the last several years of the judicial reforms, Ukraine considered two approaches to facilitate the processing of bankruptcy cases. One was to have a separate system of state arbitration (economic) courts that would function in parallel with courts of general jurisdiction. For this task, 56 arbitration chambers were created to work exclusively with bankruptcy cases. This system was established in order to allow for judges to be educated specifically to consider only bankruptcy cases and make better informed and qualified decisions. The second approach, which finally has been chosen over the first one, was to create a unified judicial system with the Supreme Court of Ukraine on the top of the hierarchy. This unified system now has a branch called “economic” (khoziaistvennyi) courts in place of “arbitration” courts.

Upon the request of the parties or by its own initiative, the economic court is entitled to take measures to secure satisfaction of creditors’ claims, including the arrest of the debtor’s property and prohibition of certain transactions.<sup>26</sup>

*State Agency on Bankruptcy Matters.* The 1999 Law introduces a special state agency with respect to bankruptcy cases and outlines its duties. Its responsibilities are to develop and execute state policies with regard to bankruptcies, how they impact the general economic environment in the country, and specifically how they relate to state enterprises. The Agency on Bankruptcy Matters has been merged and restructured as a new subdivision of the Economy Ministry of Ukraine as the result of the administrative reforms in Ukraine in late 1999 and early 2000.

*Bankruptcy Proceedings.* The 1999 Law defines a number of bankruptcy proceedings, both judicial and non-judicial.<sup>27</sup> The law provides creditors with options to satisfy their claims and, at the same time, stipulates an option for debtors to resolve their financial problems.

The Law obligates the owner to take any and all measures necessary to prevent the bankruptcy of the company/debtor. The owner can execute its responsibility via the enterprise’s managers, state bodies, and persons authorized to manage the property.

The 1999 Law defines a non-judicial proceeding (Article 3): prejudicial

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<sup>25</sup>Article 6, 1999 Law.

<sup>26</sup>Article 12, 1999 Law.

<sup>27</sup>Section II, 1999 Law.

sanation (pretrial readjustment or reorganization of the debtor); and the judicial proceedings (Article 4): judicial sanation, liquidation, disposal of the debtor's property, and an amicable settlement.

The 1999 Law provides for debt forgiveness, including tax forgiveness, that gives the parties the ability to negotiate amicable settlement agreements that permit the debtor to reorganize and potentially provide greater payments to creditors than would be the case in a liquidation.

*Court Procedure.* The 1999 Law defines a number of quite complicated proceedings for a bankruptcy process including several court steps —

— A bankruptcy case begins with the acceptance by the court of either a creditor's or a debtor's application for consideration. Such application must be filled out in accordance with the requirements of the Economic Procedural Code of Ukraine.

— Within a period of not more than 30 days, a preparatory court hearing of the case is scheduled, and a moratorium is placed on auctions to resolve property claims against the debtor.

— Within a period of three months after the preparatory hearing, a preliminary hearing must be conducted. At this hearing, a pretrial sanation administrator(s) is appointed and a creditors' committee is established.

— During this same period, a petition of the creditors' committee may cause the proceeding of judicial sanation, in which case the sanation administration will be appointed. Sanation is normally set for a period of 12 months, although it may range from a shorter time up to 18 months.

— If the applied measures do not result in rejuvenation of the debtor, then liquidation will follow, and liquidators will be appointed.

— An amicable settlement may be reached at any stage during the bankruptcy proceeding. It must be reached in an agreement with creditors. Other creditors must be notified about the agreement in order to forgive or defer debt payments or restructure debts into scheduled installment payments.

The following chart presents the definitions of pre-trial and juridical bankruptcy proceedings stipulated in Article 1 of the 1999 Law:

### **Bankruptcy Process**

#### Pre-trial Sanation

A system of measures to restore the debtor's solvency, taken by the owner of the debtor ([or] the agency authorized to manage the debtor's property), [or by] an investor in order to prevent the debtor's liquidation through carrying out reorganization, organizational, economic, managerial, investment, technological, financial, and legal measures consistent with the legislation in effect, before the bankruptcy proceedings are commenced.

#### Judicial procedures of the debtor's property administration

A system of measures to ensure proper supervision and control over the management of the debtor's property and assets, for the purpose of securing the preservation and effective use of the debtor's property assets and making the analysis of the debtor's financial situation

*Sanation:* A system of measures taken in the course of bankruptcy proceedings to prevent liquidation of the debtor, rehabilitate its financial and economic state, and satisfy, fully or partially, creditors' claims, by means of lending, restructuring the enterprise, its debts and/or capital, and/or changing organizational, legal, and production structure of the debtor.

*Liquidation:* Termination of operations of a subject of business activities that has been declared bankrupt by a court of arbitration, for the purpose of carrying out measures to satisfy indisputable claims of the creditors through selling the bankrupt's property.

*Amicable settlement agreement:* Agreement between the debtor, creditor/group of creditors about the deferral of payments and/or payment by installments, or termination of an obligation, based on the relevant agreement by the parties.

*The Priority of Claims:* The 1999 Law defines the priority of property claims by creditors. Claims are to be satisfied in the order of priority class of the creditor to the extent of available assets.<sup>28</sup>

*First priority:* Those creditors who have a debt secured by a pledge have the highest priority. This category also includes claims for vacation benefits and payroll by those employees who are being laid off. Any expenses directly attributable to the bankruptcy case are in this category. Such expenses include publication of required notices, expenses related to payment of state duties, work of liquidators or a liquidation commission, or other required appraisals and audits.

*Second priority:* For financial management organizations (trusts), claims of those whose money was managed are given second priority. Industrial accident claims from employees of the bankrupt enterprise are in this category.

*Third priority:* Tax obligations and required payments to the budget.

*Fourth priority:* Claims not secured by a pledge.

*Fifth priority:* Claims of workers who have contributed to the charter capital of the bankrupt enterprise.

*Sixth priority:* Any remaining claims.

In addition to the 1999 Law, bankruptcy proceedings are subject to the Code of Arbitration Procedures of Ukraine and other legislative acts of Ukraine. Bankruptcy proceedings against banks are subject to the law on banks and banking activity.

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<sup>28</sup>Article 31, 1999 Law.

Overall, the 1999 Law was a considerable improvement compared to the five-page 1992 Law. The 1999 Law defined proceedings in greater detail, provided for creditors' and debtors' rights, and outlined responsibilities of parties initiating and participating in bankruptcies. Still, the 1999 Law left room for further developments and improvements, especially in light of fast-changing economic conditions.

Since 1999, several changes have been made to improve the Bankruptcy Law.<sup>29</sup> Amendments have been added as practice identifies missing points in the law. During the end of 2003 and beginning of 2004, a new set of suggestions developed by the deputy groups of the Supreme Rada<sup>30</sup> (Parliament) is being considered by Rada.

#### Model Legislation and Bankruptcy Reform in Ukraine

Scholars note that Ukrainian Bankruptcy Reform has been partly guided by Commonwealth of Independent States (CIS) Model Legislation. In December 1997, the CIS Antiparliamentary Assembly adopted the Model Law "On Insolvency (Bankruptcy)" developed by the CIS Scientific Consultative Center of Private Law, with the active assistance of law specialists from the Netherlands, Germany, and the United Kingdom.<sup>31</sup>

While the 1999 Law includes many of the features of the CIS Model Law, it does so in ways that often have different legal interpretations. As a result, the new law has opened many areas of variant reading in its application and left many questions that the courts are having problems resolving. Some aspects of the differences cause significant differentiation in how the bankruptcy procedure impacts the economic system and leaves open areas of uncertainty, thereby retarding the expansion of the market economy.

This situation has forced the judges of the Higher Economic Court of Ukraine to concentrate on resolving the inconsistencies in the Ukrainian legislation. The lack of clarity in how the sections of the law interrelate has left much confusion in the procedural application of the law.

A key structural difference between the Model Law and the 1999 Law is the concept of "bankruptcy" versus "insolvency" or "inability to pay." Generally, both in the Model Law and other established bankruptcy laws, bankruptcy is a legal state that establishes legal requirements and responsibilities. Insolvency or inability to pay are economic terms

<sup>29</sup>The Law No. 2181-III, December 21, 2000; the Law No. 2238-III, January 18, 2001; the Law No. 2341-III, April 5, 2001; the Law No. 2740-III, September 20, 2001; the Law No. 2922-III, January 10, 2002; the Law No. 594-IV, March 6, 2003; the Law No. 597-IV, March 6, 2003; the Law No. 3088-III, March 7, 2002; and probably several other changes and amendments including the Law No. 672-IV, April 3, 2003 and the Law No. 762-IV, May 15, 2003.

<sup>30</sup>The Supreme Rada (Verkhovnaya Rada) is Ukraine's Parliament or national legislative body. The Constitution of Ukraine imitates the American presidential system of government with three government branches.

<sup>31</sup>See *Bankruptcy and Legislative Reform In Ukraine*, Alexander Biryukov, 27 *Rev. of Central and East European Law*, 2001 No.4, 581-600, (2002, Kluwer Academic Publishers).

used to determine insolvency but provide only part of the picture. The 1999 Law primarily refers to insolvency and thereby loses a key part of the structure that is basic to other, more experienced bankruptcy schemes.

Overall, the issues with the 1999 Law and its conceptual differences indicate a real need for a further revision of the Ukrainian Bankruptcy codes, not just in themselves but in relation to the wider civil codes.

#### Bankruptcy-related Infrastructure

Since 1992, when the first bankruptcy law came into force in Ukraine, the country's government and business society have been gradually developing an infrastructure to support the country's incipient bankruptcy institutions. Many organizations participate in and/or relate to a bankruptcy process in one way or another.

In addition to creditors and a debtor, the organizations related to the development of the bankruptcy institution in the country include: the Supreme Commercial Court (namely the arbitration courts system), the Agency on Bankruptcy Matters, the National Professional Association of Arbitrary Managers (trustees, sanation managers, liquidators), State Tax Inspection, the Ministry of Economy and European Integration, the State Property Fund, the Ukrainian Association of Industrialists and Entrepreneurs, the Union of Anti-crisis Managers of Ukraine, and others. We shall review the most relevant ones; however, many more organizations affect bankruptcy proceedings in Ukraine.

#### Bankruptcy Specialists

At the end of the 1990s, a program was started for preparing bankruptcy specialists who are trained in the roles of manager of the debtor's property, sanation administrator, or liquidator. This program has thus far produced over 3,000 trained bankruptcy specialists who are licensed to appear in court proceedings.

The bankruptcy problem in Ukraine is being researched by many State Central and Regional Departments of the Agency on Bankruptcy Matters. Many consulting companies also provide consulting services on financial and legal analysis during bankruptcy proceedings.

#### Agency on Bankruptcy Matters

On December 15, 1999, the President of Ukraine issued the Decree, "About alterations in the structure of central bodies of executive power" (N1573/99), which provided for the establishment of the state self-supporting institution Agency on Bankruptcy Matters ("the Agency"). The Agency was designed to implement the state policy as to bankruptcy prevention and securing conditions for the implementation of procedures of restoring the debtor's solvency or declaring it bankrupt, with regard to state enterprises, enterprises with the state-owned stake exceeding 25%, and subjects of business activities of other forms of

ownership.<sup>32</sup>

Later on, the Cabinet of Minister's Resolution<sup>33</sup> defined the Agency's main task as the rendering of services in bankruptcy proceedings. To achieve this task, the structural subdivisions of the Agency were established in all regions of Ukraine - the regional agencies of bankruptcy. They perform their duties together with corresponding subdivisions of the Ministry of Economy and European Integration.

In accordance with the 1999 Law, the Agency on Bankruptcy Matters is entitled to promote establishment of organizational, economic, and other conditions necessary for the implementation of procedures of restoring the debtor's solvency or declaring it bankrupt.<sup>34</sup>

The establishment of the Agency helped bring order to bankruptcy processes in Ukraine. Among other functions, the Agency is authorized to maintain a unified data base on enterprises undergoing bankruptcy proceedings. The Agency has a right to propose candidates for the position of the arbitration manager (trustee, sanation manager, liquidator) for the arbitration court's consideration in case of state companies' bankruptcies. It provides services on assessing the state-owned companies' financial conditions. The Agency also organizes trainings for arbitration managers and issues licenses to individual entrepreneurs acting as arbitration managers.

The work of the Agency helped streamline bankruptcy processes in the country and make them more unified and organized. However, the Agency does not have an exclusive power or right to consolidate all state companies' bankruptcy cases. In the new Privatization Program for 2003-2008 that has been approved by the Ukrainian Government, the role of the Agency is not clearly defined. Significant powers are given to the State Property Fund and some others to the Cabinet of Ministers. The disbursement of responsibilities among different government agencies often brings confusion and leads to overlapping involvement in bankruptcy cases.

#### The State Property Fund of Ukraine

The State Property Fund of Ukraine (SPFU) is a state body created in 1992, initially to carry out state policy in the sphere of privatization of state property and to act as lessor of property complexes that are national property.<sup>35</sup> During a decade of its activities, the role of SPFU evolved, and, in 2003, the President of Ukraine issued an Order transferring of all state corporate rights to SPFU.<sup>36</sup> Prior to 2003, the Cabinet of Ministers delegated the right to manage state corporate

<sup>32</sup>Article 2. Powers of the State Agency on Bankruptcy Matters, 1999 Law.

<sup>33</sup>Resolution #691 dated 04/24/2000.

<sup>34</sup>See the 1999 Law translation by Deloitte & Touche Emerging Markets.

<sup>35</sup>Resolution No 2558-XII of the Supreme Rada of Ukraine, 06/07/1992, PROVISIONAL ORDINANCE on the State Property Fund of Ukraine.

<sup>36</sup>Order of the President "On the Transfer of All State Shareholdings to the SPFU," #1-1/72, 01/26/2003.

rights either to corresponding branch ministries or to local power bodies.<sup>37</sup>

Creating a state agency to manage state corporate rights was undertaken to protect the assets of state companies. The concentration of state corporate rights within one body was a positive step. Such concentration centralizes state policies and presumably prevents abuse of state ownership rights by regional government authorities. The implementation of this decision is, however, still in question, like many of the other initiatives discussed in this article. The lack of SPFU expertise in business management is interfering with effective execution of its responsibility. In fact, the head of the SPFU is considering placing the management of the state share of energy companies with the Ministry of Fuel and Energy.

At the same time, the Supreme Rada and other state agencies are searching for other solutions to the shadow privatization methods. The Supreme Rada has placed a block on the sale of enterprises where the state owns over 25% by the adoption of a law, "On moratorium on the compulsory sale of the property." This provision is to remain in effect until the new privatization program improving privatization methods is approved.

The SPFU functions are outlined in the Rada's Resolution.<sup>38</sup> They include organizing and conducting privatization of companies with significant state ownership (25% and more), protecting the Ukraine property rights, managing the state companies' property in the process of privatization or establishing joint ventures, enhancing the process of economic liberalization, and creating conditions for enhancing competition among companies.

To implement these functions, the SPFU is entitled to change the organization form of state-owned companies by transforming their ownership to open joint-stock companies, to sell state-owned property in the process of its privatization including the property of companies under liquidation, to execute agreements with intermediaries on privatization preparation and the sale of privatized objects, to issue licenses to intermediaries, and to represent the interest of Ukraine abroad to protect state property rights.

While the SPFU's role in the privatization process has gradually increased, the requirements for an SPFU specialist have also increased. In addition to understanding the privatization legislation, specialists have to understand the financial intricacies of companies and the peculiarities of bankruptcy proceedings. This definitely introduces a challenge, particularly in light of the volume of legislative changes issued by the Ukrainian government every year.

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<sup>37</sup>For a detailed analysis of the state property administration, see *Support for the Ukrainian Government in the Formation of Strategic Objectives for Privatization and Establishing Priorities for their Implementation*, Heinrich Hoelzler, State Property Administration and Management in Ukraine: Corporate Governance Patterns and Proposals [http://www.privatisation.kiev.ua/Priv\\_Ukr/PubU/Book\\_German.pdf](http://www.privatisation.kiev.ua/Priv_Ukr/PubU/Book_German.pdf).

<sup>38</sup>Section II, 1999 Law.

## International Help

Since proclaiming its independence, Ukraine has been receiving international aid for its legislative initiatives. Many countries have provided funding and expertise to help the country streamline its privatization processes, improve bankruptcy legislation, and monitor its economic developments in general. The following projects have provided significant help to the Ukrainian government.

*World Bank Project* — The bankruptcy program supported by the World Bank since 1998 consisted of seven primary actions: (1) improve existing court procedures to facilitate restructuring of financially viable enterprises; (2) clarify and streamline procedures for initiating bankruptcy proceedings and for ensuring notice to all creditors at the initial filing of a bankruptcy petition; (3) clarify procedures for writing off debt; (4) clarify procedures that would provide for a court-enforced moratorium on payments to creditors for pre-petition debts; (5) clarify conflicting rules relating to bankruptcy laws; (6) develop a training program and professional standards; and (7) identify additional problems remaining in the bankruptcy system for further reform.<sup>39</sup>

*German Advisory Project on Privatization in Ukraine* (“the GAPP”) - This project was implemented within the framework of cooperation between the Government of Ukraine and the Federal Government of Germany and involved sharing expertise in the privatization area, conducting research of the bankruptcies of state enterprises, and providing recommendations with the implementation of the new Privatization Program 2003-2008.<sup>40</sup>

*Center for Social and Economic Research* — CASE Ukraine is a nongovernment, nonprofit organization founded by the Polish CASE Foundation in early 1999. The Center is aimed to promote research in the economic, political, and social spheres and to contribute to the process of development of civil society in Ukraine.<sup>41</sup> Many other European and American agencies, including USAID, contributed to the development of the bankruptcy institution in Ukraine.

## Part IV. Practices of 1999 Law Application

## Discussion of Issues

## Use of Bankruptcy Law in Privatization of State-owned Companies

In the discussion paper, “Privatization and Bankruptcies of State-

<sup>39</sup>News Release No:99/1931/ECA, World Bank to Assist Ukraine’s Enterprise and Financial Sectors.

<sup>40</sup>See “Privatization and bankruptcies of state-owned enterprises in Ukraine,” Discussion Paper, German Advisory Project on Privatization in Ukraine, P.2, Kyiv, July 2003. Also see *Support for the Ukrainian Government in the Formation of Strategic Objectives for Privatization and Establishing Priorities for Their Implementation*, Heinrich Hoelzler, State Property Administration and Management in Ukraine: Corporate Governance Patterns and Proposals [http://www.privatisation.kiev.ua/Priv\\_Ukr/PubU/Book\\_German.pdf](http://www.privatisation.kiev.ua/Priv_Ukr/PubU/Book_German.pdf).

<sup>41</sup><http://www.case-ukraine.kiev.ua>.

owned Enterprises in Ukraine,” the GAPP provides a decade long analysis of statistics of bankruptcy filings. In comparison with the filings for state-owned enterprises, this shows some interesting characteristics.

**Table 3. Dynamics of bankruptcy cases with state-owned enterprises**

Bankruptcy Cases/Years	1996-97	1998	1999	2000	2001	2002-03
<b>Total bankruptcy Cases</b>	<b>17</b>	<b>20</b>	<b>30</b>	<b>35</b>	<b>113</b>	<b>118</b>
Liquidation	9	6	13	15	38	23
In-court procedure	8	14	15	14	50	71
Sanation			2	6	24	24
Amicable agreement					1	
In % of total:						
Liquidation	53%	30%	43%	34%	19%	
In-court procedure	47%	70%	50%	40%	44%	60%
Sanation			7%	17%	21%	20%
Amicable agreement					1%	

While the overall rate of bankruptcies declined after the implementation of the 1999 Law, the rate of bankruptcies for state-owned enterprises experienced a steep climb. The analysis of the value of the state ownership in these enterprises against the receipts from privatization leads to an important observation. As an alternative to official privatization, bankruptcy is being used to convert state-owned enterprises into privately held enterprises. This observation is further reinforced by observing the decline in the receipts from formal privatization.

Table 4 indicates that receipts from bankruptcies of state companies in 2002 were four times higher than receipts from privatization. This statistic would lead one to suspect that bankruptcy became a tool in changing ownership of state companies. This supposition is confirmed through empirical research conducted by GAPP.

**Table 4. Estimated value of the state-owned stakes in the enterprises in bankruptcy<sup>2</sup>**

Year	Value of the state stakes by statutory fund for the enterprises in bankruptcy	Actual privatisation receipts
1996	0.0	0.0
1997	13.5	78.1
1998	40.7	360.8
1999	33.2	694.6

<sup>2</sup>GAPP report, SPFU data

Year	Value of the state stakes by statutory fund for the enterprises in bankruptcy	Actual privatisation receipts
2000	46.0	2075.5
2001	1131.8	2132.0
2002	2686.0	576.1

The original administrative structure of the Ukrainian judicial system authorities left the courts and agencies that were responsible for maintaining the state’s interests open to political an/or financial insider influence. The overall effect has been the creation of a shadow path to privatization that has been available to those able to invoke the bankruptcy proceeding on state-owned enterprises. This problem has been partly resolved by a presidential order that transferred management of state corporate rights to the SPFU (see above the responsibilities of the SPFU).

A study<sup>43</sup> of the state businesses driven into bankruptcy shows a clear focus on taking over industries related to metals and chemicals. The law has an approach to restructuring that freezes pre-filing debt, thereby blocking those pre-bankruptcy creditors’ collection efforts, in favor of continuing operations after the filings. This procedure allows a new creditor to come in and gain control of the reorganization. This practice does require support from the government administrations or ministries responsible for the enterprises.

According to the SPFU data, about 400 state-owned companies had a bankruptcy procedure initiated from 1996 to 2003. In approximately 190 of these 400 enterprises, the state stakes exceeded 25%, including about 100 enterprises where the state share exceeded 50%.

**Table 5. Bankruptcy cases of State Enterprises<sup>3</sup>**

State Enterprise in Bankruptcy	400	
Those with stake > 25%	190	48%
Those with stake > 50%	100	25%

Modeling of the enterprises being affected by bankruptcy proceedings<sup>45</sup> has led to a hypothesis about which enterprises are affected. Larger enterprises appear to be less likely to be liquidated via the bankruptcy process, and larger reductions in employment as part of the restructuring are actually more likely to lead to liquidation than the survival of the enterprise.

The use of bankruptcy as an alternative to privatization can be seen

<sup>43</sup>The German Advisory Project on Privatization.

<sup>3</sup>GAPP report, SPFU data

<sup>45</sup>GAPP report.

in a number of ways. In the 2000-2004 period, the courts reorganized a total of 10.3 billion Hryvnia<sup>46</sup> while only 5.8 billion Hryvnia have been involved in privatization. While not a direct relationship, this comparison provides a good indicator of the nature of the activity. Also, of 3.3 billion Hryvnia in tax debt in companies under bankruptcy from 2002 through 2004, only 252 million Hryvnia have been repaid, another indicator of how the bankruptcy system is used to circumvent state interests.

**Table 6. Bankruptcy Cases of Companies with state stake over 50%**

<b>Total number of companies with a state stake of over 50%</b>	<b>294</b>
Of that, under bankruptcy proceedings	100
Of that,	
- being liquidated	22
- under sanation (reorganization)	34
- under asset management by PFU	39

During 2000-2004, the SPFU participated in the restructuring of 50 joint stock companies with a state stake. Twenty-eight of 50 companies were among the most strategically important companies for the Ukrainian economy. The restructuring of 15 out of 50 has been completed by 2004, and the companies have continued to operate in the market. As of January 1, 2004, 80 coal mining companies were proclaimed bankrupt; during 2004, six mines are to be closed.

On April 2, 2003, the President of Ukraine enacted a law, "On Changes to Certain Laws of Ukraine [related to bankruptcies of mining companies]." This law prohibited the filing of bankruptcy petitions against mining companies (mines, open-cast mines, concentrating mills, coal producers) that receive state support where the state stake is at least 25%. The bankruptcy petitions against such companies can not be filed once the privatization of such enterprises begins. In addition, the law on Bankruptcy was amended by the statement that the bankruptcies of such enterprises can be filed only after January 1, 2004. The bankruptcy cases of such companies started after January 1, 2000 are to be terminated.

Based on the data promulgated by the Property Fund of Ukraine

<sup>46</sup>The Hryvnia, also spelled sometimes as Hryvna or Grivna (UHR) was introduced September 2, 1996 by the National Bank of Ukraine (NBU). It replaces the old 'Coupon' (or 'Karbovanets') which was a temporary currency used in Ukraine during the period of separation from the rouble zone. Coupons were later exchanged at the fixed rate of 100,000 coupons to 1 Hryvnia and as of September 15, 1997 the Hryvnia remains the only legal tender in Ukraine." <http://www.uazone.net/Hryvnia/>

As of March 2004, 1 US Dollar equals 5.33 Ukraine Hryvnia and 1 Ukraine Hryvnia equals 0.19 US Dollar.

(PFU),<sup>47</sup> as of January 1, 2004, more than one third of companies with a state stake of over 50% were going through bankruptcy proceedings. During the winter of 2004, the Supreme Rada considered extending the term of this law until the situation stabilizes through the legislation improvement. The Rada is also considering a law prohibiting the filing of bankruptcy petitions against all mining companies, regardless of whether such companies have a state stake and state support.

There are many cases where companies' managements developed complicated schemes to bring state companies to a bankrupt condition. The schemes quite often are exceedingly tangled. While state authorities suspect this to be the case, they often do not have a solid basis to proceed with an investigation as Ukrainian laws often conflict with each other.

The usual way of capturing assets is the creation of a new clone company, typically in the form of a closed joint stock company to which the interested enterprise transfers its productive assets, leaving debts and non-productive asset to the "old" company. This "old" company is usually the subject of the bankruptcy procedure. Sometimes a new enterprise plays a role of an investor during the sanation procedure. The capturing of attractive assets from the state-owned enterprises requires the support of the regional administrations and/or branch ministries. Regional administrations often use state tax authorities to initiate bankruptcies and then help interested parties acquire companies' assets from current management.

The number of cases of this type of artificial bankruptcy was, in fact, so substantial for the Ukraine economy that the President of the Ukraine issued a decree in 2003 to investigate this misuse of bankruptcy proceedings.

#### Weaknesses in Ukrainian Legislation

The 1999 Bankruptcy Law and the Privatization Law have several weak areas that often lead to a misuse of these laws. While an advance over the 1992 Law, the 1999 Law is more or less a work in progress. Hopefully its major problems can and will be addressed by amendments.

The Bankruptcy Law did not clearly define what was to be considered debtors' assets and what the starting point for evaluating these assets was. This lack of clarity often led to a situation such that, by the time the court issued any ruling, the debtor's asset value would be depleted to be less than sufficient to cover its debts either upon sale or as a result of a sanation. This problem has been addressed by issuing a moratorium on any transaction after the bankruptcy petition has been filed. However, the question of proper debtor's asset evaluation is still an important one to clarify in the law.

The State Privatization Program for 2003-2008 stipulates that the state enterprises under pledge must be sold only by privatization, thus preventing abuse of the bankruptcy process by improper pledges. Nei-

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<sup>47</sup><http://www.bankrut.com.ua/cgi-bin/news/viewnews.cgi?id=EpZyyZyElyiIVWFzHz>

ther of these laws, however, specify who will be the recipient of the sale proceeds if the proceeds exceed the pledged value or who will compensate the lender for the remaining sum if the proceeds are smaller than the pledged value. The lack of clarity on this question may lead to an increase in the interest rate charged to state-owned companies as the probability of full credit recovery from state-owned companies' under question declines.

There are a number of alternative ways of improving the system that are not being taken advantage of, including such business tools as risk insurance or malpractice insurance. Better historical statistics would allow underwriting such insurance products. The head of the Department of Insurance of Nadra, Demitri Tkachev, indicated that banks are covering only 10% of loan risks as of January 2004.

The 1999 Law provides that all actions of the arbitration managers have to be approved by the court before implementation. Quite often, the court judges may not have the knowledge either of the industry the debtor works in and/or of the peculiarities of companies' financial analyses. In such a case, the court hardly can make a reasonable assessment of the restructuring plan developed by the arbitration manager. If the court judges do not have enough expertise to evaluate the essence of the plan, then why would such approval add any assurance that the plan would be implemented? This process might be enhanced if insurance companies could participate and insure the outcome of the plan within reasonable limits.

From 2000 to 2003, the Ukrainian Cabinet of Ministers and the Ministry of Economy issued a number of regulations to support the 1999 Law. Those regulations govern the following issues:

- procedures for the financial rehabilitation of state enterprises
- establishment of a State Register of debtors subject to bankruptcy proceedings
- participation of the state tax authorities in bankruptcy proceedings
- procedures for financial rehabilitation of companies under privatization

The number of regulations governing bankruptcy proceedings is increasing. They are issued by a number of different state bodies. Bankruptcy specialists are expected to keep track of all new regulations, amendments, and additions issued by the government. Quite often these regulations are in conflict with each other and economic courts as well as arbitration managers faced with a need to apply them in practice.

The following case study illustrates some of the current problems.

#### Real-life Example: 'Chemical War'<sup>48</sup>

On October 30, 2001, Victor Kolesnik, the former Board Chairman of

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<sup>48</sup>Translation of an abstract from 'Chemical War' by Inna Alekseenko Business #65 (340), 11/05/2003, <http://www.business.ua/i460/a8227/>

RivneAzot,<sup>49</sup> a chemical enterprise open joint stock company, had called a press conference to allude to the case where RivneAzot, in his opinion, had become the next victim of unlawful privatization.

On October 12, 2001, the shareholders of RivneAzot had called for a special shareholders' meeting. The representatives of the major shareholders took part in the meeting. The major shareholders included Cheminvest Aktiengesellschaft, a Lichtenstein company that owned 12.2% of RivneAzot, and a Rivnensky regional state administration that received 58.36% of RivneAzot stock on September 21, 2001, while the company was in bankruptcy.

At the meeting, shareholders made the decision to re-elect the Board and the Supervisory Council. Vladimir Petrov, the Ukrainian representative of the IBE Trade Corporation, was elected as the Acting Board Chairman, and Anatoly Juhimenko, assistant to the governor of local state administration of Rivnensky region, was elected to be the Chairman of the Supervisory Council. Former Board Chairman Kolesnik did not come to this special shareholders' meeting. Subsequently, the Rivnensky city court recognized this meeting, as well as decisions made at the meeting, as lawful. The new management found the money to pay duties to the state that were agreed to as part of the debt restructuring in order to retain the use of electric power.

Predictably, the new management accused the former board of all sorts of sins. The new management argued that it is beneficial for someone to take hold of the enterprise through the procedure of bankruptcy. Anatoly Juhimenko, the new Chairman of the Supervisory Council, expressed this opinion in the press. Victor Kolesnik, the former Chairman, disagreed. He claimed that the bankruptcy was artificial or custom-made. He did not name who carried out the order to initiate the bankruptcy.

The Rivjensky administration said that Vladimir Petrov was suggested by Oaieiaano, a company of one of the shareholders, and that the same nominee had been suggested by a direction from the Ministry of the Industrial Policy.

In this particular case, the question of who is right and who is wrong or guilty might never be answered as the case is extremely complicated. The most important question is how connected the change in management was to the bankruptcy, and how lawful the transfer of the company's shares was to the local administration. Why did the transfer happen when there was a bankruptcy proceeding under way at the company? If it is true that the company needed new management, why was it necessary to initiate such a change though power reinforcement? Why could this change not be done in a more civilized way: as a result of a completed procedure of bankruptcy or by means of asset sale at an open privatization auction? Also, why did the Rivnensky administration sympathize with Cheminvest Aktiengesellschaft, since the production of

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<sup>49</sup>RivneAzot' is a nitrogen-producing company. Its name is a combination of two Russian words - part of the word Rivnensky (the name of a Ukrainian region with a local government administration) and Azot, which is a Russian word for nitrogen.

nitrogen is not its specialty? What if tomorrow the central authority were to take a block of shares from the Rivnensky administration and transfer it to someone else? What would happen if that someone were to decide to sympathize with some other company? How should the investors proceed in such circumstances?

The case with RivneAzot once again proved that as long as the legislation is in its current state, the investors' rights are not protected. Similar conflicts have been happening in many regions of Ukraine, and the regional authorities got involved to solve them without any transparency.

### Conclusion

The bankruptcy laws of the Ukraine are not being used the way the same laws are commonly used in more economically experienced countries. This reality manifests itself in a number of ways. Bankruptcy has become an instrument of (or back door to) shadow privatization. This is especially the case because the Ukrainian laws, and the courts responsible for implementing them, are working under a set of specifications whose goals are only marginally acting to protect the creditors and to resolve the debtors' situation.

Bankruptcy law has triggered an increase in bankruptcies of state enterprise, often artificial or specially constructed by the company's management. The unstable political system, weak judicial system, and underdeveloped capital markets have resulted in a lack of transparency of bankruptcy processes.

Since the introduction of the first Bankruptcy Law in 1992, bankruptcy has continued to be used in Ukraine as a tool to change ownership of state enterprises. The practices of application of 1999 indicated its weak points, and businessmen quickly learned how to get around them.

Not to undermine the importance of the process, the bankruptcy system in Ukraine has become a mechanism for quicker reallocation of productive resources and retaining potentially viable enterprises hurt by the transition process.

The following reasons help explain the capturing of state-owned enterprises by the means of bankruptcy as opposed to the official privatization methods:

- slow down of official privatization
- current political sustainability of large financial industrial groups
- need to capture complementarities in production
- desire to capture higher market share of a particular market

The structure of the laws and the relative inexperience of the courts in implementing them have resulted in a system that benefits neither the debtor nor the creditor. One of the key potential beneficiaries of bankruptcy are commercial banks holding past due debt, yet two out of

three seriously past due borrowers are not being forced into bankruptcy. This behavior represents a failure to use the bankruptcy system wisely. The system is not operating such that creditors are willing to negotiate a practical distribution of available assets. The system is not transparent in a way that permits creditors to see getting a proper return if they accept a negotiated settlement. This failure to use the bankruptcy system effectively occurs in spite of the fact that banks should have first priority due to the pledges that they hold.

Part of the problems with current Ukrainian bankruptcy laws are that they are an attempt to mix a solution to a variety of goals, instead of being focused on resolving the economic problem that bankruptcy is intended to address. In addition, the relative newness of the whole Ukrainian legal code in the post-Soviet era has left significant inconsistencies between the related economic laws and other laws covering criminal, tax, insurance, and labor issues.

This set of problems is extenuated by the lack of experience that all parts of the process have with financial and business matters, especially the judges responsible for making the rulings based on the recommendations of the arbiters.

Another troublesome issue is that many bankruptcy cases include significant fraudulent actions on the part of management designed to force a company into bankruptcy in order to make it into takeover target. This is especially the case with state enterprises. It shows up vividly in the state of the large number of Ukrainian mining companies, many of whom are, for all practical purposes, bankrupt. Special laws were recently passed to prevent using bankruptcy against such companies, even though the proper use of such process is exactly what these companies need if they are to become viable. Some of these rules give local authorities the ability to step into the bankruptcy process, again putting excessive influence in exactly the wrong hands.

A final gap in the process involves how well the final resolutions are actually enforced, especially when foreign investors are present. A number of recent cases involved U.S businesses who were unable to get court decisions enforced, both in private disputes and in those involving the Ukrainian government. The real measure of both the bankruptcy system and the overall drive to become part of the international economic system will be whether an investor has the comfort to make investments knowing both the rules and that those rules will be applied evenly and fairly. Without that comfort, foreign investment in the Ukrainian economy will be quite limited. [See Norton Bankr. L. & Prac. 2d §§ 152:1 to 152:64.]

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14. *Unconstrained Bankruptcy*, Rustam Kolesnik, Monday, #37, 10/27/2003, in Russian.
15. *Unpunished Bankruptcy*, Ukrainian Net of Business Information, <http://www.liga.net>, in Russian.
16. The Economist; <http://www.economist.com/countries/Ukraine/>.
17. The World Fact Book; <http://www.cia.gov/cia/publications/factbook/geos/up.html>.
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## Laws

1. Law of Ukraine on Bankruptcy
 

“On Recovery of Debtor’s Solvency or Declaration of Its Bankruptcy,” Dated May 14, 1992, Vidomosti of the Supreme Rada, No. 31, item 440, with Amendments and Additions Introduced by the Following Laws of Ukraine:

  - Dated June 17, 1993, No. 3292, VVR No. 29 1993, p. 308;
  - Dated February 25, 1994, No. 4036, VVR No. 27 1994, p. 224;
  - Dated March 14, 1995, No. 90/95-VR, VVR No. 14 1995, p. 93.
2. Law of Ukraine on Bankruptcy
 

“On Recovery of Debtor’s Solvency or Declaration of Its Bankruptcy,” Enacted August 31, 1992, Vidomosti of the Supreme Rada, No. 31, item 440.
3. Commercial Code of Practice of Ukraine. Adopted on November 6, 1991 #1798-XII.
4. Land Code of Ukraine. Adopted on October 25, 2001 #2768-????.
5. On proceeding rule of taxpayers liabilities disbursement to budget and state target funds. Law of Ukraine as of December 2000 #2181-III.
6. On property. Law of Ukraine as of February 7, 1991 #697-XII.
7. On enterprises of Ukraine. Law of Ukraine as of March 27 #887-????.
8. On farming economy. Law of Ukraine as of December 20, 1991 #1009-????.
9. On collective agricultural enterprise. Law of Ukraine as of February 14, 1992 #2114-XII.
10. On commercial courts. Law of Ukraine as of June 4, 1991 #1142-????.
11. On creation in arbitrary courts of Ukraine special commissions on regarding bankruptcy cases. Decree of President of Ukraine as of March 21, 1998 #333/98.
12. On proceeding rule of entrepreneurs state registration. Decree of Cabinet of Ministers as of May 25, 1998 #740. Approved by Cabinet of Ministers decree as of August 25, 1998 #1340.
13. The procedure of payment capitalization in order to perform

obligations of bankrupt-enterprise to the citizens caused by damages made to their life and health. Approved by Cabinet of Ministers decree as of May 6, 2000 #765.

14. On organizing work concerning arbitrary managers operation licensing by Ministry of economy of Ukraine. Ministry of economy of Ukraine decree as of June 1, 2000 #106.

15. Provisions as for training and advanced training of arbitrary managers (property administrators, sanation managers, liquidators). Approved by Ministry of economy of Ukraine decree as of March 17, 2001 #57.

16. Determination the fact of bankruptcy and debtor's sanation. Method guide on revealing insolvency signs of enterprise and signs of hiding the fact of bankruptcy, fake bankruptcy or bringing to bankruptcy. Approved by Ministry of economy of Ukraine order as of January 17, 2001 #10.

17. Proceeding rule for assets sale in order to disburse tax debt of a debtor undergoing bankruptcy procedure. Approved by Ministry of economy of Ukraine as of June 7, 2001 #123.

18. Preceding rule for carrying out pre-court sanation of partnerships whose statutory fund state share exceeds 25% and of state enterprises determined to be privatized. Approved by State property fund of Ukraine order as of October 12, 2001 #1865.

19. Provisions regarding sanation plan co-ordination of business partnerships and state enterprises, which are determined to be privatized. Approved by State property fund of Ukraine order as of October 5, 2000 #1809.

20. On decisions adopted by arbitrary expertise council. The Supreme arbitrary court of Ukraine order as of March 14, 1997 #01-8/132.

21. On liquidation commissions operating for commercial banks bankruptcy proceedings. The Supreme arbitrary court of Ukraine information letter as of November 10, 2000 # 01-8/651.

22. On enterprise liquidation procedure. The Supreme arbitrary court of Ukraine information letter as of December 10, 2001 #01-2.1/374.

23. On initiation bankruptcy case proceeding pursuant to applications of state tax service bodies. Explanatory note of the Supreme commercial court of Ukraine as of August 21, 2001 #02-5/926.

24. On co-operation of registrar and issuer, who is acknowledged bankrupt. Professional registrars and depositaries Association letter as of April 9, 2001 # 01-03/132.

25. On bills payable. State tax administration of Ukraine letter as of February 1, 2000 #491/6/15-1116.

26. Method guide regarding employment by commercial banks the Law of Ukraine "On bankruptcy". National bank of Ukraine recommendation notes as of July 21, 1994 #23012/105.

27. On specification of VAT taxation base for transactions concerning sales of property of enterprises, which undergo liquidation procedure. State tax administration of Ukraine letter as of October 17, 2000 # 416/4/16-1210.

28. On proceeding rule of sales of shares of joint stock public company undergoing bankruptcy procedure though enjoying no court decision regarding stoppage its privatization procedure. State property fund letter as of April 11, 2003 #10-19-4578.

29. On approving plan of measures on improving state policy on bankruptcy prevention, ensuring solvency recovery for debtor or declaring it bankrupt. Ministry of economy order as of May 15, 2003 #118