GAP ANALYSIS OF BANKRUPTCY CODE OF UKRAINE

KEY FINDINGS

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A. General Remarks

The EU-funded Pravo-Justice Project is currently preparing a comprehensive GAP analysis of the new Bankruptcy Code of Ukraine. This is in an advanced but not yet final status. The following considerations and proposed amendments are part of the current state of work, but do not reflect it completely. It is therefore to be expected that by the time the final version of the GAP analysis, which is expected for the quarter 2/2020, is available, there will also be changes to the present proposals and that the proposals as a whole will be extended.

Out of legal caution, the authors of this document have to point out that the examination of the proposals for general compatibility with competing or prior-ranking legislation is also still ongoing.

Nevertheless, in our opinion a discussion of the following, mostly general points is already possible and necessary in order to be able to start the amendment of the law in the most essential points in a timely manner.

B. Introduction

The new Ukrainian Bankruptcy Code (so-called BCU), which came into force on Oct. 21st, 2019, has taken a further step towards reorganising the legal system. Within the framework of this reorganisation, the issue of debt collection is of considerable importance.

As noticed previously by Pravo-Justice experts, the key directions of reform should be focused on dealing with the following remaining **uncertainties** and **gaps** in the r**egulatory framework and institutional capacities**, including notably efforts to:

- institute **personal insolvency**, which has never existed in Ukraine before, including its **impact** on the processes of **enforcement**;
- strike a balance between the interests of **business freedom and accountability to creditors** in matters of **corporate bankruptcy,** including the scope and extent of responsibility of **beneficial owners** in cases of corporate bankruptcy;
- better define **criminal liability** and role of law enforcement in cases of intentional bankruptcy;
- create conditions for **transparent** (electronic) **sales**, while safeguarding the appropriate degree of **discretion and accountability of BTs to creditors,** the latter being the **ultimate tool** to achieve the most **adequate** asset sale **price** in advanced jurisdictions;
- improve efficiency of **court procedures**;
- better regulate and oversee BTs by **MOJ,** while building **stronger** profession **and self-governance**;
- get rid of any **moratoria** on enforcement and bankruptcy for protected State entities.

The following remarks are based (unless explicitly stated otherwise) on the law as of Oct. 21st, 2019 including the amendments by laws On Stimulation of Investment Activity in Ukraine (132-IX) and On the Repeal of Law On the List of State Owned Entities That Are Not Subject To Privatisation, (145-IX).

The topic of debt collection thus includes not only the regulations on enforcement in the event of non-payment of individual claims, but also and in particular the issues of insolvency of companies,

business people and natural persons. Ukrainian law offers solutions for all these areas in the new BCU.

In summary, on the basis of investigations to date, it can be stated that a convincing solution has not been achieved completely. However, it can also be stated that a large number of ideas are new and require testing in practice.

To simplify matters, the problem areas can be divided into three large groups:

- Transitional provisions
- Absence of rules
- Arrangements to be postponed and supplemented

The last two topics in particular sound similar, but their significance is quite different: Missing regulations refers to topics that need to be completely supplemented, while the area of "regulations to be postponed and supplemented" refers to topics that are already laid down in the law, but are also important in other procedural areas and require more attention there.

In this context, reference should also be made to the previous findings from the evaluation in summer 2019. The main findings were as follows:

1. terms must be defined more clearly and unambiguously
2. deficiencies in the professional regulations
3. self-regulatory organisation requires further development
4. the regulation of international insolvency proceedings must be aligned with standards and best practices of the EU and its Member States
5. classification in the legal system could be improved
6. special areas essentially not regulated

It has already been possible to further specify some of these points, so that they now relate to the following key issues, which are considered by the experts as immediate actions. The mid-term and long-term actions to be taken by Ukrainian stakeholders are specified in the long version of Bankruptcy Gap Analysis.

1. Obligation to maintain an account
2. Definition of Ranking Classes
3. Adaptation of the provision on contestation
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C. Summary of identified gaps

1. Obligation to maintain an account

The obligation to keep accounts plays an important role in insolvency proceedings. The bankruptcy trustee never manages his own money, but always third-party funds. These third parties may include ordinary creditors as well as secured creditors and those who benefit from the costs of the proceedings. In particular, the bankruptcy trustee has no right to withdraw own funds without a corresponding basis. The resulting **duty of care** is an essential part of insolvency administration; this is also reflected in the fact that violations of this duty of care are punishable by law.

Without this component, neither trustworthy administration of third party funds nor proper reporting on the funds received and administered is possible. However, this reporting, which can be objectively supplemented by the inclusion of external fiduciary sources (regularly these are account statements from the account-holding banks), necessarily requires a **separation of equity and third-party funds**. In addition, external funds must be managed separately for each case to be administered, so that even if a bankruptcy trustee is appointed several times, the allocation of funds to the respective insolvency proceedings is always obvious.

It remains the secret of the legislator why this separation was prescribed in the area of liquidation but not in the other areas. The provision of Art. 61 No. 3 (1), (2) BCU would therefore have to be moved to the area of the tasks of the bankruptcy trustee (the new numbering follows further additions to Art. 12 No. 2 BCU and is therefore neither in itself nor from this summary alone understandable).

This point becomes even more incomprehensible when the legislator has even specifically ordered in Art. 114 No. 2 BCU the obligation to open separate bank accounts in the area of private insolvency and demands that this be passed on when the responsible bankruptcy trustee changes.

In our opinion, the duty to keep separate bank accounts must therefore be regulated uniformly for each procedure and at each stage of the insolvency proceedings. However, since the legislator is also planning (Draft Law on Improving the Regulation of Banking Activities 2571-д) to reorganize the rights of intervention in bank accounts in the event of a bank becoming insolvent, it must be ensured that the bankruptcy trustee is also protected against recourse by creditors.

2. Definitions of ranking classes

In some places in the law there is information on the ranking classes of creditors. These ranking classes are always structured differently, so that a uniform handling of the proceedings is difficult. This also applies to the software still to be developed. In our view, it would therefore be very advisable if the ranking classes were formulated in the law in a uniform manner and at a very early stage.

In this way, every creditor would also be able to understand very quickly whether and, if so, at what point his own claim is classified. In this way, effects on the quota can be determined even before the insolvency proceedings are initiated. This would enable the creditor to check for himself whether or not it is economically advantageous for him personally to initiate insolvency proceedings

against the debtor's assets. If the latter were the case, the creditor could be inclined to write off his own claim and not to spend further financial resources by paying advances on procedural costs.

3. Adaptation of the provision on contestation

Contestation (Art. 42 BCU) plays a clearly subordinate role in the existing body of standards, and unfortunately its content is not conclusively regulated. For example, it does not regulate what happens to transfers based on an act of state sovereignty (e.g. through compulsory execution). It is also not regulated what happens to the contested claim of the counterparty after repayment of the funds received - does it become existent again? to what extent? at what time? is the claim eligible for participation in insolvency proceedings? what happens to released securities for the claim?

In addition, consideration should be given to adapting the deadlines to the possibilities of a renewed application for insolvency in order to avoid abuses.

All in all, it is advisable to note how little the law deals with the very frequent relocation of assets prior to insolvency proceedings.

If the debtor is obliged in private insolvency proceedings to provide information on his current assets and the development of his assets over the past three years, this is not convincing. On the one hand, this means that a large number of personal data is brought before the court, most of which is not relevant (and therefore may not be collected according to European standards). On the other hand, it makes it considerably more difficult to apply for private insolvency. Furthermore, the information provided by relatives is not relevant under starter or procedural law: Incorrect information has no consequences. The relatives are not involved in the insolvency proceedings and are obliged to tell the truth. However, the debtor cannot be put at a disadvantage due to a lack of love of truthfulness, as he can (regularly) only point out the relatives' obligation to tell the truth, but cannot fulfil this obligation himself.

However, this means that the norm no longer helps in the area of rescission either: the information on the transfers of assets would have become apparent from these documents. Thus, the bankruptcy trustee must carry out his own investigations and in particular intensively observe the claims to information from the registers. This already applies to legal entities anyway.

Finally, in our understanding, this standard lacks a regulation on what happens to ongoing court proceedings with regard to a challenge when the insolvency proceedings themselves enter the next phase: even in Ukraine, the conclusion of civil court proceedings within the time allowed by law for the settlement of the individual phases of insolvency proceedings is rare. However, if the rules are not adapted, the previous bankruptcy trustee loses its active legitimacy and the new bankruptcy trustee must (if this is still possible) enter the process in accordance with the legal regulations. This, however, entails a loss of knowledge and time. It is even possible that the previous process will become ineffective because one bankruptcy trustee is not the legal successor of the other.

4. Insurance of the Bankruptcy Trustees

The insurance of the bankruptcy trustee is a particular difficulty. This is caused by several points:

- For example, the amount of the insurance remains a matter of controversy and separate consideration. These considerations must later also take into account which specific actions of the bankruptcy trustee should be insurable and which should not.
- How such an insurance should be granted technically and in what relation it should be to the licensing of the bankruptcy trustee.

According to the current regulation, the applicant who wishes to become a bankruptcy trustee must submit an insurance policy and will then be entered in the register, provided that he fulfils the further requirements.

This regulation is extremely disadvantageous for the applicant. The applicant already has insurance, but is not yet allowed to carry on the insured activity without the licence. However, issuing the licence may take some time. During this time, however, the applicant is obliged in this construct to pay for insurance that he does not need.

This risk can be solved by the insurer granting a so-called provisional insurance cover and issuing a certificate for this. This certificate should serve to prove in the application that insurance will be available once the license has been granted. If the license is granted, the licensee must send the license to the insurer and the insurer in return (after payment of the insurance premium) sends the licensee (and the licensor) final proof of the existence of insurance. This ensures documentation and eliminates the risk of time delays in the application process away from the applicant. For the insurer, this will result in a disadvantage due to the lower premiums, but not in a higher risk, since the possibility of a claim without a license does not exist. Art. 24 BCU had to be amended additionally in order to keep the law consistent.

5. Re-election of members to the various commissions of the self-governance organisation

The current law does not provide rules on the re-election of members to the governing bodies of the SROs. At the same time, the term of office is limited to 2 years. Such a short term of office is detrimental to the continuity of the work in the self-governance organisation (SGO), as the first half year of the term of office regularly passes with familiarisation and the last half year the body is still in office as a so-called "lame duck". To put it pointedly, this would mean that the effective term of office would only be one year, followed by one year of inactivity. The possibility of re-election reduces this risk of inactivity and extended induction period and allows for continuous execution with consistent quality. In addition, a continuous transition to successors can be achieved in this way. By replacing only part of the board, knowledge and experience remain on the board, which shortens the induction period for new members considerably. Furthermore, there is continuity in the decisions to be made, as these must be represented by both the new and the re-elected members. Thus the conditions for re-election had to be created within the law.

However, in addition to re-election, there must also be a limit on the maximum term of office. The team initially discussed how long the maximum term of office should last. The international experts had initially assumed a maximum term of eight years, which would have corresponded to three re-elections. After consultation with local colleagues, however, this was reduced to six years or two re-elections. The decisive point for this reduction was the speed of changes in the Ukrainian legal system over the last 30 years. These have been much faster and more profound than elsewhere. By shortening the maximum term of office, this factor is also to be taken into account in such way that

new ideas and considerations can be implemented more quickly and fully, also with regard to the various bodies of the SROs. This is based on the assumption that representatives of outdated ideas will not be (re-)elected.

6. Commitment to further training of the Assistant bankruptcy trustees

The training of bankruptcy trustees is governed by the SGO regulations. The SGO will determine - if necessary in consultation with the Ministry - which training courses the bankruptcy trustee must attend and in what number and within what time frame.

However, no such regulation exists for the Assistant Bankruptcy Trustees. Nor is it apparent that the SGO is responsible for their training. Consequently, special guidelines for further training had to be drawn up and laid down.

7. Voting also in absentia

The regulation of Art. 123 No. 6 BCU offers great opportunities also for the other insolvency proceedings of the Act. In particular, sentence 2 of the provision still offers the possibility of agreeing on other forms within the creditorship. Especially in the current situation, where personal meetings had to be minimized as far as possible because of COVID-19, this can be a considerable building block for future regulations.

8. Participation of external financiers in creditors' meetings

The possibility for the external financier to participate in the votes on the insolvency plan is an essential part of the chances of success of an amicable settlement. An amicable settlement usually provides the creditors with a better economic solution. However, since personal emotions often cloud the strict rationality of the economic results in the course of insolvency proceedings, the presence and participation of the third party financing the reorganisation plan can help to secure the results. However, the court must establish that no abuse is taking place. For this purpose, the court could also request proof of the financial means required to fulfil the reorganization plan.

9. Integration into the legal system and coordination with other laws

As is well known, insolvency law is not a simple law. It has too many points of contact with other provisions of the entire legal system. Rather, like a constitution, it stands above all other laws and must combine them and make them operable. All this must be done in an exceptional economic situation. For this reason, the comments made continue to apply. At the same time, the integration must be examined in concrete terms in each case and it must be ensured that the "right" law is given priority for application. The effects of the considerations on non-insolvent companies must also always be taken into account. For example, tax relief for insolvent companies can quickly also mean

an economic advantage for these companies on a more favourable terms than for non-insolvent companies - the same applies to relief in the event of termination of contracts of any kind. Here it is always necessary to find a balance that is acceptable to all parties involved in the insolvency proceedings and to the economy as a whole.

In this context, the provision of Art. 26 No. 1 para 3 BCU must be mentioned as an example: According to this provision, a bankruptcy trustee may be considered unfit to exercise his office because of any conviction. This understanding cannot be correct, since there may be distributions that are not connected with his personal and economic suitability for handling insolvency proceedings. An example is an accident with personal injury caused by negligence on the way between two insolvent companies.

10. Right to work of bankruptcy trustees

The new Code works in the interests of creditors and therefore, the latter have the right to dismiss the bankruptcy trustee at any time. This is the opinion of the vast majority of arbitrators. Does such a statement meet the provisions of the Code?

Article 28 of the Code gives creditors the right to apply to the court for the removal of the bankruptcy trustee, regardless of the grounds and at any time. If there are grounds for the removal of the bankruptcy trustee, the court shall issue a decision.

Thus, in each case, when considering the issue of the removal of the bankruptcy trustee, the court must analyse the grounds for such removal. There can be no unjustified dismissal of an bankruptcy trustee who does his job in good faith. Therefore, this issue must be resolved through the formation of **a single case law**.

From the point of view of best practice, the legislation should fully guarantee the independence of the bankruptcy trustee and the court as an independent body should evaluate in each case whether the parties act in good faith or not.

11. Disciplinary procedures

An important element of independence is the existence of an effective mechanism for bringing to account the bankruptcy trustee. Although disciplinary procedures are still under the control of the Ministry of Justice, most experts recognize that this is now justified. Over time, control functions should be fully transferred from the Ministry of Justice to the self-regulatory organization.

The transparency of disciplinary procedures will ensure that the rights of bankruptcy trustees and other participants in the process are respected. Disciplinary proceedings should be conducted in public, possibly with video fixation and commission decisions made available to the public for general discussion and study.

Much work needs to be done to summarize disciplinary practice, develop new approaches to the text of decision. The aforementioned generalisation will ensure the predictability of disciplinary complaints.

12. Remuneration of the bankruptcy trustee

The Code stipulates the obligation to advance the award to the bankruptcy trustee of three minimum wage rates for three months of exercise of authority. This amount of advance does not take into account the complexity of the case, the length of the proceedings and other factors.

Bankruptcy trustees constantly speak of violation of their right to receive compensation. In each case, the issue of remuneration is decided separately. The lack of a single, effective approach demonstrates the ineffectiveness of the system of cost reimbursement to the bankruptcy trustee.

It is advisable to introduce a new system of remuneration of the bankruptcy trustee, where on one side the bankruptcy trustee will be interested in obtaining the result, and on the other hand, he is guaranteed to be paid for the work performed, as already in place in other countries.

13. Old vs. new law

No. 2 and para. 1-3 are of major significance in terms of legal reality in the area of transitional provisions, as they stipulate that other laws will be ceased on/before the current BCU comes into force. This concerned in particular the previous laws on insolvency law. With these laws, the requirements for the previous licensing of insolvency administrators have also been abolished. Without these requirements, however, the existing licenses are not based on a valid legal act and are therefore inherently invalid. The new licensing was only possible according to the regulations of the new BCU.

The same applies to insolvency proceedings. In the absence of an applicable transitional legal provision, their continued existence is also problematic. The old regulations have been expressly repealed.

This creates a legally unsustainable situation in several respects. It must therefore be ensured that a proper transition of licenses and procedures into the new law is possible. The proposed solution corresponds in principle to actual, but not legally justified, action: The previous procedures and licenses will be recognized on the basis of the old law, which will thus continue to apply (previously through actual action by the judiciary/ministries) and will then be converted to licenses under the new law within a transitional period. A similar procedure can currently be observed in court proceedings, where a mixture of regulations is used which is not uniform. Consequently, the legislator must also set clear guidelines here.

14. No regulations for non-controlled areas

An absolute peculiarity in Ukraine is the territorial condition. The new law will, of course, have an effect throughout Ukraine. However, some parts of it would be difficult to enforce. Nevertheless, there are still ongoing insolvency proceedings linked to these regions, which now have to be handled according to the new law. The new deadlines also apply. It is already obvious that the bankruptcy trustees are not able to comply with the requirements for handling proceedings in these regions.

Nevertheless, the law does not provide for any simplifications, thus there are many risks for the bankruptcy trustees.

Insolvency proceedings opened in other regions are also affected: there are no regulations on how to deal with assets in these regions - a sale within the statutory period is difficult, as is a transfer of ownership.

No international law will help in these cases - at least for the time to come. It will therefore be imperative to find special regulations for insolvency proceedings relating to this region. One possibility would be the purchase of these assets at fair value by the authorities to enable the insolvency proceedings to be carried out, another option is the establishment of a holding company owned by a given region. Finding these creative regulations is in any case an essential building block and best practices in this regard can be borrowed from EU countries.

15. COVID-19

The worldwide COVID-19 proliferation pandemic and the quarantine measures taken by all countries of the world will have irreparable consequences for the global economy. Of course, the Ukrainian economy is also projected to suffer. It will inevitably lead to an increase in the number of businesses that will need bankruptcy procedures and an increase in the number of citizens who will be forced to seek a way out of the debt boom.

An important function of the state is to assist such businesses and citizens in this matter. The essence of such assistance may be different from providing financial support to tax benefits. But considering the Ukrainian legal traditions, deputies today propose to introduce a partial or full moratorium on the beginning of bankruptcy proceedings. Such measures do not require additional financing from the state budget of Ukraine and at first glance appear to be quite significant. But from the point of view of the best European practices, any moratorium does not solve the problem and should be introduced in exceptional cases. Bankruptcy is a procedure about money that the debtor owes to the creditors. Such a moratorium without other measures would mean that it is the creditors who will not receive their money and the debtor will receive the time. The moratorium may be used by the debtor or other interested parties not for the purposes set out in the Code, but to obtain a moratorium and protect against creditors. In its recommendations, the World Bank has repeatedly pointed out that every business is entitled to bankruptcy.

The proposal to postpone other actions in the bankruptcy procedure, such as the sale of property, is of concern, but at the same time the extension of the procedural time limits in connection with the introduction of quarantine is justified.

Ideal ideas for using the digital capabilities of our time and taking action in video conferencing are quite reasonable. These proposed changes generally meet the objectives of the bankruptcy procedure.

In general, it should be said that even a temporary moratorium should be considered carefully, as this is not always justified and appropriate.

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