

Debt restructuring in Ukraine: The impact of war

Catherine Bridge Zoller writes about the impact of the war in Ukraine on the ability of small businesses to generate profits and repay debts



CATHERINE BRIDGE ZOLLER
Senior Counsel, EBRD



OLEKSANDER PLOTNIKOV
Partner, Arzinger Law Firm, Ukraine



KYRYLO SENYSHYN
Senior Associate, Arzinger Law Firm, Ukraine



LIUBOV SKORYK
Associate Counsel, EBRD

Russia's full-scale invasion of Ukraine in February 2022 has caused irreparable damage to many Ukrainian companies, including small and medium-sized enterprises (SMEs). Assets that generated profits for Ukrainian businesses and were used to pay off debts to creditors were destroyed or damaged.

As a result, many businesses have been unable to repay bank loans. This has increased the risk of foreclosure and claims against guarantors, including business owners. It has also put the spotlight on Ukraine's insolvency and restructuring laws and whether these are sufficiently robust to support long-term restructuring.

The legal framework and NPL trends

The increase in the number of borrowers who cannot repay a loan to a bank in Ukraine is evidenced by the rising share of non-performing loans (NPLs). According to National Bank of Ukraine figures, on 1 July 2024, the volume of NPLs was equal to 34.6% of all banking-sector loans. The actual number of distressed loans is likely to be higher.

NPLs had previously been on a declining trend, falling from 55% in 2018 to 27% in 2022. This success in reducing NPL levels was partly due to efforts by Ukrainian legislators, which included the enactment of a new Code of Ukraine on Bankruptcy Proceedings No. 2597-VIII (the Insolvency Law) on 18 October 2018, which came into effect a year later. The new Insolvency

Law was complemented by a voluntary framework for financial restructuring of legal entities, the Law of Ukraine on Financial Restructuring No. 1414-VIII (the Financial Restructuring Law). Enacted on 14 June 2016 and effective from April 2017 for a limited period, the law was part of efforts by the Ukrainian authorities to tackle high NPLs, with assistance from the World Bank and the European Bank for Reconstruction and Development (EBRD).

Restructuring statistics and tools

According to statistics compiled by Secretariat, a body that administers the Financial Restructuring Law from the offices of the National Association of Ukrainian Banks, as at July 2024, 63 restructuring cases had been completed under the Financial Restructuring Law framework. In total, these restructured more than UAH 81 billion (almost US\$ 2 billion) of debt owed by Ukrainian businesses.

However, there has been a sharp decline in new cases since February 2022: only one case has been initiated in the last two years, compared with a previous average of eight new cases a year. Meanwhile, there has been an increase in the number of formal insolvencies. The Supreme Court of Ukraine confirmed that in 2023, the number of insolvency applications had increased 44.4 per cent to 14,400 applications from 9,700 in 2022.

While Ukraine has a relatively new Bankruptcy Code, it still lacks certain restructuring tools –

something that has become more widely adopted within the European Union (EU) since the EU Directive on Restructuring and Insolvency 2019 framework. In a recent assessment by the EBRD – the Business Reorganisation Assessment 2022 – Ukraine ranked 27th out of the 39 jurisdictions assessed for the effectiveness of their restructuring frameworks.

Moreover, Ukrainian insolvency legislation does not contain any express protection of new financing. While the Bankruptcy Code acknowledges that any Article 5 pre-insolvency rehabilitation plan may include “measures to obtain loans or credit”, it also gives secured creditors a veto right on any change in priority, undermining support for any new financing.

Another issue is the lack of protection of so-called “essential contracts” necessary to support the continuation of day-to-day operations. There are no meaningful limitations on ipso facto clauses to prevent the termination of contracts solely on the grounds of insolvency or the commencement of an insolvency procedure. While the Article 5 pre-insolvency rehabilitation procedure states that the approval and implementation of the rehabilitation plan will not be considered a breach of the contract between the debtor and any non-participating creditor, it falls short of an outright prohibition on ipso facto provisions and does not apply to any in-court rehabilitation proceedings.

Also, under the Insolvency Law, there is no concept of cross-

class cram-down, where the decision of a creditor majority in one or more classes can be imposed on other classes of creditor voting against the reorganisation plan. Each class of unsecured and secured creditors must approve either the pre-insolvency or in-court rehabilitation plan. Awkwardly, the majorities for secured and unsecured creditor classes differ in the legislation. An approval for a secured creditor class requires a two-thirds majority by value compared with a simple majority of more than half by value for unsecured creditors.

Functioning courts and the impact of war

Insolvency cases have continued to be heard by Ukrainian courts despite the war. In 2022, the work of courts located on or near the territory where military action was taking place was undermined. However, this issue was swiftly resolved by transferring ongoing cases to other Ukrainian courts that were able to review them.

In practice, a wide range of debt restructuring mechanisms have been used since 2022 in wartime Ukraine outside of the formal insolvency framework. Following Russia's full-scale incursion, the National Bank of Ukraine recommended that banks and other financial institutions assist borrowers in restructuring. It also eased the requirements for banks to record loans so that they were not automatically recognised as non-performing, provided that the borrower's ability to repay was affected by the war.

In general, banks agreed to restructure the debt of their borrowers if the war had significantly affected the customer's business in such a way that its loan repayments were at risk of default. Many banks also introduced their own initiatives to support corporate or retail clients. These included measures such as the waiver of mandatory fees, loan repayment holidays and a freeze on penalty interest. However, banks required appropriate supporting

documents from borrowers evidencing the deterioration of their financial situation.

The Ukrainian parliament also made temporary emergency amendments to the Civil Code of Ukraine to protect borrowers following the introduction of martial law after the Russian invasion on 24 February 2022. These amendments will expire 30 days after the end of martial law. Among the temporary measures introduced were the application of penalty amounts under credit agreements, including inflation-related payments, and the suspension of the statutory default interest rate of 3% per annum. Creditors thus wrote off any contractual penalties and other payments for borrower delays in meeting their obligations.

Currency and loan issues

In 2022, the National Bank of Ukraine prohibited any restructuring involving a change in loan currency from foreign currency to Ukrainian hryvnia (UAH). As a result, borrowers with exposure in foreign currency must deal with heightened exchange-rate risks and hedging requirements for businesses caused by the war. However, this situation is mitigated to a certain extent by much lower interest rates for loans in foreign currency than in the Ukrainian national currency.

Despite a decrease in the key interest rate from 25% at the beginning of 2023 to 13% in June 2024, loans in UAH remain expensive for borrowers. Many companies can only obtain UAH-denominated loans from banks under state support programmes such as the "5-7-9%", through which local companies can borrow up to UAH 150 million (around EUR 3.3 million) for refinancing or investment purposes or up to UAH 5 million (around EUR 109,000) for working capital financing, at preferential interest rates of 9% per annum, adjustable to 7% or 5% per annum, subject to meeting certain conditions. The

difference between the market interest rate and the preferential interest rate is funded by the Ukrainian government.

Typical restructuring measures used in the market since February 2022 have included reductions in interest rates and the extension of debt repayment terms. Most banks have agreed to provide refinancing and loan repayment holidays, usually for a period of up to six months. However, debt reductions or cancellations remain rare.

Restructuring challenges and assistance

A significant challenge for Ukrainian restructuring has been the damage, destruction and uncertainty caused by the war. Businesses have needed to document any damage and destruction to their main assets, while estimating future cash flows in highly unstable market conditions. In some cases, businesses have lost all their assets in territories in eastern Ukraine occupied by the Russian army. Consequently, many businesses have arranged a cash sweep with their lenders, whereby they turn over all or a certain percentage of their income to service their debt, after the deduction of any operating costs.

Since 2020, the EBRD, with the support of Arzinger Law Firm, has been providing information to Ukrainian SMEs on legal and regulatory changes affecting their businesses: the Ukraine SME Business Guide.¹ This website has sought to complement the existing services offered by e-governance app Diia Business with general legal guidance, including useful information on restructuring and insolvency. From 2022, it has offered Ukrainian businesses regular newsletters on emergency measures introduced by the government in response to Russia's invasion.

Future reforms

In future, Ukraine's insolvency

framework is expected to benefit from further reforms that strengthen restructuring as the country aligns with EU legislation, including the 2019 EU Directive. However, in the short term, a more radical solution may be needed to address the volume of restructuring required for Ukrainian businesses.

The Financial Restructuring Law offers a useful framework for voluntary restructuring. However, its appeal has been primarily for state-owned banks and officials previously concerned with incurring potential liability for restructuring based on contract. Changes would be needed to ensure that it could have more mainstream appeal and possibly some stewardship by the National Bank of Ukraine. The Law on Financial Restructuring is also temporary. Introduced in 2016, it has been extended several times, including most recently in August 2022, and is currently scheduled to expire on 1 January 2028.

Further consideration needs to be given to Ukraine's insolvency and restructuring framework in preparation for peace. The EBRD and other international partners stand ready to help Ukraine with reconstruction efforts, including financing and technical assistance, when the time comes. ■

NB: An overview of Ukrainian insolvency legislation can be found on the EBRD's website: EBRD Assessment (ebrd-restructuring.com).²

Footnotes:

¹ See: <https://businessguide.ebrd.com.ua/>

² See: <https://ebrd-restructuring.com/economy-profile/ukraine>