Equitable Solutions

Year over year the Ukrainian banking sector finds itself in the flux of new changes. Mindful upgrading of the regulatory field entails a new wave of debate between various stakeholders. **Oleg Malinevskiy**, managing partner of **EQUITY law firm**, explained why the trust in the banking system has not been restored yet, diving into certain paradoxes of the current situation and the most recent court practice. It turns out that bank owners are still in search of equitable solutions. Going further, we argued about whether the non-performing loans market disposes of such lucrative opportunities, and what it could actually mean for legal professionals.

UJBL What is your assessment of the current situation in the banking sector? What are the implications of legislative changes?

Oleg Malinevskiy: The current situation in the banking sector can be assessed from several points of view. From the regulator's perspective — the National Bank of Ukraine (NBU), operations of the banking sector have certainly got better, due to the tightening of standards, which, as a result, have caused an outstanding reduction in the total number of banking institutions. 97 banking institutions were taken out of the market during the period from 2014 to 2019 on the basis of the NBU's decisions. Hopefully, in such a painful way, the state has been preparing the market for the entry of major international investors, and this will happen in the near future, which would reduce tension with cash liquidity. Indeed, the market has become even more closed to borrowers, the cost of money is overpriced (as it's significantly higher than abroad), and methods for restructuring previous loans are not provided. In this new reality, the banks find it more attractive and profitable to make money on government bonds than to lend to the real sector of the economy. Largely due to the state's one-sided policy aimed at cleaning up the market, the balance of "borrower-lender" interests was lost and the population of Ukraine, the major investor in the banking sector, has quit the game. Proof of this is the fact that the size of the deposit portfolio has reduced dramatically in recent years. Thus, while in 2013 the total volume of deposits portfolio came to about USD 85 billion, by 2019 this figure had dropped to USD 20 billion.

Talking about major legislative changes, it is definitely worth mentioning the Laws *On Financial Restructuring* of 14 June 2016 with further amendments, *On Lending Reinstatement* of 3 July 2018, the *Bankruptcy Procedure Code* of 18 October 2018, and some other legislative acts. However, as of now, they have not fundamentally affected the situation on the market and, more importantly, have not restored trust in the banking system. Therefore, the main paradox of the banking sector at present is that the sector has been influenced by changes that have not yet been adopted. This especially relates to the situation with distressed banks and debts.

However, this situation has a positive effect on the development of the legal market, providing additional reasons for evolution of such practice areas as litigation, financial restructuring, bankruptcy, and white-collar crime. Having good expertise in all these areas allows us to provide our clients with a range of the most effective ways for protection of their rights, without imposing on them any one option.

UJBL What are the latest trends in disputes with the Deposit Guarantee Fund? Are there already any precedents? If yes, comment please.

O. M.: One of the major conceptual innovations of the judicial reform of 2017 is that in the past resolutions of the Supreme Court Plenum were adopted on the basis of summarized court practice, and now we are moving towards quasi-precedents — resolutions mandatory for the courts and contained in decisions taken in specific cases by a newly-created authority called the Grand Chamber of the Supreme Court, which is composed of 21 judges. As the cases are being heard by the Grand Chamber, a picture of emerging case law is becoming more and more legibler.

Thus, with respect to the amount of debt recovery, according to the Resolution of the Grand Chamber of the Supreme Court of 31 October 2018 in case No. 202/4494/16-ц and others, the Grand Chamber prohibited charging interest on loans after the loan term expires or after acceleration of the entire obligation is claimed. Herewith, the expiry of the statutory period of limitation with respect to claims for repayment of the principal amount of the loan, is the reason for applying the statute of limitations to all additional claims (fines, penalties). The period of limitations for each installment starts running from the moment of delay in payment of the installment. As the Fund manages many lingering loan debts, such an approach improves the borrowers' fate to some extent.

With respect to jurisdiction, which is one of the most burning issues in disputes with the Fund's participation, two important rules have been formulated here at the same time, where the Fund is to be treated as an authority or as an authorized entity (by the bank's governing body). In the first case, for example, when a list of depositors entitled to State-guaranteed reimbursement of deposits at the expense of the Fund is being drawn up, and when a register of depositors for making guaranteed reimbursements is being approved, a dispute is considered to be a public law dispute and falls under the jurisdiction of administrative courts (Resolution from

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KEY FACTS

EQUITY LAW FIRM

Year of establishment: 2002

Location: Kyiv, Ukraine

Number of partners: 8

CORE PRACTICE AREAS

Banking and Finance
Bankruptcy and Insolvency
Corporate/M&A
Criminal Law/White-Collar Crime
Litigation/Arbitration
Real Estate
Tax

20 November 2019 in Case No.761/46959/17). If, however, a claimant challenges actions of the Guarantee Fund not as an authority, but as a governing body of a bank, which takes measures to secure the assets, to prevent the loss of the bank's property and funds, then such a dispute is not a public law one, and a relevant bank represented by the Fund's authorized person, but not the Fund itself, shall be a defendant in such a case (the Resolution of 19 June 2019 in Case No. 752/17889/17-ц). In the second scenario, when the Fund or its representative performs a function of the bank's owner or its official, and the dispute is not subject to the administrative judicial procedure, it is necessary to classify disputes between the Fund and the bank's officials on reimbursement of damages to a third party (the Resolution of 11 September 2019 in Case No. 757/75153/17-ц), disputes on challenging the Fund's decisions to sell the assets of troubled assets through public tenders (the Resolution of 4 December 2019 in Case No. 826/18877/16).

At the end of 2018, the Grand Chamber formulated a position, which significantly affected the NPL market. It made it impossible to assign lenders' rights of claim against loans to individuals, since they are not authorized to provide financial services (the Resolution of 31 October 2018 in Case No. 465/646/11). Also, in its Resolution of 11 September 2018 in Case No. 909/968/16, the Grand Chamber established a clear distinction between agreements on assignment of rights (cession) and factoring agreements, and defined the explicit features of factoring, the absence of any of which enables the conclusion to be drawn that the case relates not to a factoring agreement but to assignment of a lender's rights.

Yet, the Grand Chamber's practice is not always consistent with the generally accepted notion of justice. As an example, it is worth mentioning that the Grand Chamber of the Supreme Court considers it impossible to claim invalidity of null and void contracts, which is expressed in the Resolution of 4 June 2019 in Case No. 916/3156/17, by which the previous practice of the Supreme Court consistent with the civil law doctrine and existing legal realities was changed completely. Also, Resolutions of the Grand Chamber of the Supreme Court of 30 October 2018 in Case No. 914/3217/16 and 6 March 2019 in Case No. 914/260/18 contain a not entirely fair conclusion on the impossibility to set-off receivables denominated in different currencies (regardless of the possibility of their mutual conversion).

UJBL Indeed, after sizeable mass insolvencies of banks in Ukraine, cases of banks returning to the market through a court decision have become more frequent. To what extent is this justifiable? What legal tools are available in such cases?

O. M.: In general, such disputes are a classic example of the fight by investors to restore their rights, rule of law and justice. Please note that up until 20-s cases on the insolvency of banks in Ukraine used to be initiated only on the basis of court decisions. This approach is correct, since it did not allow a bank's insolvency procedure to be initiated by mistake, without sufficient grounds, and prevented possible lasting disputes.

Such decisions are an external trigger of irreversible negative consequences for a bank's depositors and beneficiaries — anything starting from the loss of control and up to the subsequent withdrawal of a license, that moment when a bank by definition ceases to be a bank. While cancellation of the NBU's decision allows the legal restoration of control over an institution, the license, reputation and normal banking activity cannot be brought back. That is why such regulator's decisions must be highly balanced, as well as legally and economically justified.

In this regard, the apocalyptic predictions of the NBU and the State Guarantee Fund regarding the detrimental effects of court decisions on the unlawfulness of liquidation of a number of banks are, in my opinion, an overstatement. On the contrary, such decisions have certain benefit to the sector, because they: firstly, demonstrate the gaps in the law, thereby pushing legislators to further mindful upgrade of the sector; secondly, restore justice and the balance of interests of all market players, ensuring judicial protection and property rights for private bankers, including protection against arbitrary abuse by the NBU; thirdly, removes the burden from the State Guarantee Fund's budget, which is known to have a substantial deficit and, finally, paradoxically, they give the chance to return deposits to thousands of depositors, especially those whose deposit exceeded the minimum guaranteed amount (the efficiency of debt collection in the private sector is significantly higher). It is worth considering the case of UkrInCom (formerly, UkrInbank), which was proactively supported by its depositors in court cases on debt collection. Unscrupulous debtors sided with the NBU and the State Guarantee Fund. The conclusions are obvious.

Speaking about mechanisms of the return of banks to the market, in the situation where special legislation is silent and the legislator does not pay attention to this issue, it is the owners of institutions restored by the courts who are forced to take control of the situation. The main option — if possible, to get back the license, and in case of the regulator's failure to act, I believe it would be fair to continue business activity within the framework of a limited legal capacity. It should not be forgotten that, along with the return of the asset and control over it, the founders get the burden of liabilities that makes the "former" bank focus primarily on recovery of loans and repayment of deposits at that expense. It is also important not to forget about the measures towards the recovery of damages caused by the actions of the NBU.

UJBL Can we say that practice on these issues has already been established?

O. M.: If we consider "pro-bank" practice of the Supreme Court, in particular the disputes with the regulator concerning such banks as ZlataBank, Capital, UkrInbank (the last two cases were handled by our team), I would highlight several important legal positions of the courts:

— the discretion of the regulator is not absolute and is subject to judicial review;

— a 180-day period from the date of recognition of the bank as troubled, during which it must bring its indicators in line with the applicable law, may be prematurely interrupted by the NBU by introducing an interim administration only in exceptional cases;

— the bank's financial recovery plan is not a normative document, and its breach does not serve as direct evidence of the bank's failure to fulfill obligations stipulated by paragraph 5 of Article 76 of the Law of Ukraine *On the System of Guaranteeing Deposits of Individuals*, but this fact can be taken into account as a part of the aggregate evidence when evaluating actions the bank and the justification of the regulator's decision;

— the shareholder (shareholders), whose share in the authorized capital exceeds 10% and/or the bank itself, including the liquidated one, have the right to challenge the decisions of the NBU on the introduction of an interim administration and/or on liquidation of the bank;

— the decision of the NBU on the introduction of an interim administration and/or liquidation of the bank must be made in compliance with the internal procedures of the NBU;

— recognition as unlawful and cancellation of a decision of the NBU is an appropriate and sufficient way to protect the rights of the plaintiff (the bank, its shareholder and others);

— the cancellation of the decision of the NBU by a court excludes the possibility of their continuing the procedures for the introduction of an interim administration and/or liquidation of the bank, depriving them of any legal grounds.

The core problem in disputes between bank owners and state authorities is the absence of special legislation governing the status of a legal entity, which in the past was a bank, managed to defend justice in the courts, by setting aside the illegal decisions of the regulator on its insolvency and liquidation, as well as the absence of the legally established way to return the banking license to such entity. This is exactly the situation that happened to one of our clients — the financial company PJSC UkrInCom, which in the past had a license and the name PJSC UkrInbank. After the setting aside of illegal decisions made by the regulator regarding the institution of a temporary administration and liquidation and due to failure to get back the license, PJSC UkrInCom was forced to change the name by excluding the word "bank" from it and to obtain a license as a financial company. This was necessary, *inter alia*, for continuing business activities and servicing obligations to depositors. Thus, there are two opposing approaches in court practice to address this issue.

The first approach suggests that UkrInCom is, by "general legal capacity", the same entity as UkrInBank. That is, the absence of a special legal capacity cannot exclude the capacity of the entity in other legal relationships, and, therefore, UkrInCom must perform obligations to depositors under deposit agreements and, accordingly, has the right to repayment of previously extended loans. The above approach has remained dominant and fully supported by the civilian doctrine and practice of civil courts.

The second approach is that UkrInCom, is not entitled to its own assets acquired at the time when it had the status of a banking institution, and, therefore, it can not collect loans extended by UkrInBank or perform any obligations to depositors. Such an approach was initiated in the aforementioned Resolution of the Joint Chamber of the Cassation Commercial Court of the SC of Ukraine of 3 August 2018, in case No. 910/8117/17. Certain commercial courts started to mistakenly follow the approach, thereby not only violating the rights of a legal entity, the former bank, and its shareholders (who attained the setting aside of illegal decisions made by the NBU), but also ignoring the rights of depositors (creditors) of the institution, depriving them of hope to recover their own savings in full.

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Unfortunately, the Grand Chamber of the Supreme Court failed to give a clear solution of this problem, having adopted a Resolution on 10 December 2019 in a case which, without a unanimous opinion of the judges, guided the case on this issue (the right to recover one of the loans granted by PJSC UkrInBank) to the court of first instance for reconsideration.

UJBL Are investors in the banking sector really protected? Is the legislation being amended accordingly?

O. M.: Let's face the truth. Is it possible to talk of protection of investors when almost 100 banks were forced to be dissolved and not more than five owners managed to assert their rights at risk of losing property due to gaps in legislation, or even worse — its further changes in favor of the regulator? At the same time, during the most difficult times for the industry because of the annexation of Crimea, the war in Donbas, and, as a consequence, a threefold jump in the exchange rate and massive loss of collateral assets, the regulator not only did not lend a helping hand to domestic banks, acting as the master lender, but also raised the requirement criteria and even prevented implementation of the financial recovery later, refusing to register owner-led investors (the real situation which happened with UkrInbank). Of course, the situation needs to be fundamentally changed, finding fair solutions that restore the balance between bank owners and the regulator, lenders and borrowers, depositors and the Deposit Guarantee Fund.

It seems that in the main our banking sphere mostly protects not the investor but the regulator, whose legislative initiatives are aimed at further enhancement of its independence and security. If we look at Draft Law No. 2571, introduced by the Government of Ukraine on 11 December 2019 *On Amendments to Certain Laws of Ukraine regarding Particular Issues of the Functioning of the Banking System*, which, according to the opinion of the majority of critics is not related to the regulator, fundamentally contradicts the provisions of the *European Convention on the Protection of Rights and Fundamental Freedoms*, ECtHR practices, the *Constitution of Ukraine* and basic principles of private law, not to mention that it implies completely new rules without any transitional or compensative mechanisms. Just look at the provisions on continuation of the illegally initiated procedure of a bank's liquidation, having retroactive effect on the top of that. The provisions limiting the scope of the regulator's liability for illegal cutting of a bank from the market are very interesting from the point of

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view of fair balance. In fact, such liability is limited by the balance difference between the assets and liabilities of the bank, while the market value, lost profit and other losses of the bank's owner as an investor are not taken into account. In addition, for recovery of such amounts a specific procedure should be followed (the Supreme Court should be the first instance court in these cases). The duty of the regulator to protect its officials even after their dismissal, including ensuring bail for them in criminal proceedings at the expense of State Budget funds, seems to be totally illogical. With such an approach by the regulator, protection of the bank's investor will definitely depend largely on that investor and the skills of his lawyers.

If we talk about the protection of investments against unscrupulous debtors, the situation has certainly improved here via laws on relaunching lending as well as by the adopted *Bankruptcy Procedure Code*, which has a clear pro-creditor bias, as well as by incorporation of special bodies, such as the Anti-Raiding Commission of Ukraine and AIAM (Agency for Investigation and Asset Management). The significant powers and subject matter of activity of the latter are an additional argument for the development of practice as an effective tool for protecting the rights of investors in the banking sector.

UJBL How attractive are non-performing loans (NPL) for investors? Can we talk about the evolution of the NPL market as a fully-fledged one? What are the risks most often faced by investors in NPL in Ukraine?

O. M.: Of course, the NPL is one of the most attractive investments in the banking market. There are several reasons for this: the sale of the assets of distressed banks on the ProZorro electronic auction system, which generally provides a sufficient level of access to tenders and transparency of tender process (except for some techniques with an affected overpricing in favor of the second participant); bidding on the principle of a Dutch auction, which enables the purchase of a debt for a small fraction of the face value; sale of debts on both domestic and foreign sites; the option to buy with subsequent collection of debts.

The main risk is related to the state of the collateral security and the status of the debtor itself. The debtor is quite often in bankruptcy proceedings, in some cases it is closed down; the property is transferred to another entity. Therefore, an investor should enjoy the most fascinating legal work on "debris removal" and untangling of everything that was done by the debtor during the times of insufficiently effective debt management by the State Guarantee Fund. On the other hand, the game is worth a candle, since the average sale value of assets does not exceed 6% of the face value of a loan, and in record cases, assets worth billions were sold below 1% of their value.

UJBL How do banks take part in bankruptcy proceedings currently, under the new Code? What is practice at this stage? Can we say that the practice also confirms the pro-creditor bias of the Code?

O. M.: Indeed, last year the country, and especially creditors, were presented with the *Bankruptcy Procedure Code*, which came into effect on 22 October. If we're talking about corporate bankruptcy, I would single out 5 novelties most expected by the market: lifting of the minimum threshold for the initiation of proceedings; the possibility for a creditor committee to revoke the insolvency officer of the case at any time, thus gaining full control over the case; limitation of the moratorium on creditors' claims to 170 days; unification of the procedure for selling the debtor's property in electronic auctions; new mechanisms of liability of the management of the debtor.

Practice on these novelties is still emerging. However, it may already be concluded that a huge influx of bankruptcy cases has not yet occurred. Perhaps not all managers of distressed debtors understand the nature of joint and several liability for late filing of a bankruptcy petition. Similarly, there is no hullabaloo about the bankruptcy cases of individuals. Although it is necessary to wait for the moratorium on collecting foreign currency loans to expire.

UJBL Please give your forecast for the development of litigation in the banking sector. What will demand be like in 2020?

O. M.: The trends seen last year on the banking market will largely continue. NPL, as a locomotive of legal work, government bonds as a profit generator. I would be interested in taking part in the development of legal practice in accordance with the new *Bankruptcy Procedure Code*, as well as waiting for changes in banking legislation regarding the fate of insolvent banks and the consequences of their illegal withdrawal from the market. Many things can change if big financial players join the market through, for example, the announced privatization of state banks.

If the government pays attention to debts owed by state enterprises and finds a way to restructure or securitize them by providing a new financial instrument for bankers, this would be a promising area as well. The planned launch of the agricultural land market, possible inflow of financial investments and setting up of new financial mechanisms may also provide the market with a possible boost.

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