Recent developments in Ukrainian distressed debt disposal strategies

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There has been a continued rise in the Ukrainian distressed debt market in 2011 and early 2012. The aggregate amount of overdue loans in Ukraine reached US$10.4bn (10.7% of the gross loan portfolio) by the end of 2011.

In view of relatively high costs incurred by the banks for keeping non-performing loans (NPLs) on their balance sheets, as well as the continuous pressure from the National Bank of Ukraine (NBU) to comply with the economic ratios set forth by the latter, it became hardly affordable for a number of Ukrainian banks to hold NPLs on their balance sheets, and therefore, banks continued to develop solutions for debts restructuring arrangements or workouts utilising either in-house or outsourced resources.

Distressed debt disposal methods

Depending on the priority for a distressed debt vendor, the following NPL sales methods appeared to be the most popular in Ukraine in 2011: (i) open tender, (ii) closed tender, and (iii) outright sale, each of them having its advantages and disadvantages which are considered in Figure 1.

Distressed debt disposal structures

In view of peculiarities of Ukrainian legislation, the following three basic structures are most common for the distressed debt disposal process: (i) NPLs sale to a Ukrainian factoring company; (ii) NPLs sale to a non-resident SPV; and (iii) NPLs sale to a Ukrainian venture fund.

The choice of the strategy depends on distressed debts value and the type of the investor.

Ukrainian factoring company structure

The applicable Ukrainian legislation provides for two possible options of NPLs sale – on the basis of either

Figure 1: Distressed debt disposal methods – advantages and disadvantages

Option	Advantages	Disadvantages
Open (Public) Tender	• Wide range of professional investors. • Potentially higher price for NPL portfolio (as compared to closed tender and outright sale) due to the competition among investors.	• Sensitive information disclosure due to advertised sale of NPLs portfolio among unlimited number of potential investors. • Longer process compared to outright sale. • Process requires significant management resources.
Closed Tender	• Longer process compared to outright sale, but shorter compared to open (public) tender. • Confidentiality of the process due to limited information disclosure.	• Limited investor base (a number of companies which cooperate with the vendor). • Process requires significant management resources.
Outright Sale	• Relatively fast process. • Negotiations with one counterparty only. • Confidentiality of the process due to limited information disclosure. • Customised transaction structure specifically tailored to the investor.	• One potential investor only. • NPLs purchase price is usually lower due to absence of competition. • Risk of failed negotiations.

Source: Vasil Kisil & Partners

factoring (in case of NPLs sale at a discounted value) or an assignment agreement (in case of NPLs sale at their par value). Brief characteristics of the elements of a factoring transaction are provided in Figure 2.

Until recently it has been a common practice in Ukraine to establish debt collection agencies focused on distressed debt acquisitions in the form of factoring companies, enjoying a status of financial institution governed by the Commission for Regulation of Financial Services Market (FSA).

To obtain a status of a factoring company the following requirements are to be observed:

(a) equity capital of a factoring company must constitute no less than UAH3m;
(b) established system of accounting and reporting, meeting legislative requirements, has to be in place;
(c) chief executive officer and chief accountant have to meet eligibility criteria set forth by the FSA;
(d) appropriate owned or leased premises, communication facilities, hardware and software suitable for rendering financial services must be available; and
(e) competent staff for rendering financial services must be employed by the factoring company.

In case distressed debts to be sold to the factoring company are denominated in any other currency than Ukrainian hryvnias (UAH) it would be advisable to keep the NPLs vendor as a servicer for collection of proceeds under the loan agreements, their subsequent conversion into UAH and transfer to the factoring company – to sidestep the requirement of obtaining a general NBU licence for the performance of FX transaction by the factoring company.

Functions of the vendor, as a servicer of proceeds, can be performed on the basis of the respective agency (commission) agreement entered into with a factoring company. According to the said agency (commission) agreement, the NPL vendor is entitled to act on its own behalf but in favour of the factoring company, being the NPLs acquirer, as the NBU regulations allow conversion of funds obtained from the debtors in foreign currency into UAH on the basis of the said agency (commission) agreement.

In accordance with the FSA regulations, financial institutions are obliged to create provisions under the NPLs acquired considering the price paid by the factoring company for the NPLs acquisition, interest and other payments due accrued from the date of the NPLs acquisition

The main guidelines for creation of provisions by factoring companies, prescribed by the FSA are the following:

(a) provisions are to be created in UAH only, hence, under foreign currency denominated NPLs the calculation is to be made on the basis of the available NBU exchange rate; and
(b) provisions are to be created on a monthly basis regardless of the factoring company's financial results.

Since factoring companies are obliged to create provisions regardless of their financial results,

Figure 2: Elements of a factoring transaction

1.	Loan Claims value	Discounted value of the loan to be paid by the assignee (the factor). Alternatively a commission for the services rendered by the assignee (the factor) to be paid by the assignor (i.e. so-called 'hidden discount').
2.	Acquirer of loan claims	The assignee (the factor) has to be established as a bank, or a non-banking financial institution, registered by the FSA.
3.	Consent of the debtor/ restrictions envisaged by the loan agreement	No consent of the debtor is required. Restrictions for an assignment stipulated by loan agreements (if any) are not applicable to the given case, therefore, factoring could be made even in case of the said contractual restrictions.
4.	Further (secondary) assignment	Can be performed through further factoring agreement only.

Source: Vasil Kisil & Partners

additional equity financing may be required for this purpose at some point of their activity.

According to the FSA regulations, factoring companies are obliged to keep non loss-making activity, as well as to keep equity capital in an amount of no less than UAH3m in the course of their activity. Hence, as a result of NPL acquisition and creation of provisions, factoring companies may incur losses during the first and next years of their activity, potentially resulting in their negative equity. To deal with potential issues that may be raised by the FSA in this respect it would be advisable to prepare a profitable long-term financial plan for the factoring company prior to registration of the factoring company as a financial institution by the FSA.

It should also be noted that according to the Civil Code of Ukraine, in case net asset value of the factoring company (if established in the form of an LLC) at the end of the second or third financial year is lower than the amount of its registered capital, such factoring company would be obliged to reduce its registered capital. In case the factoring company's net asset value at the end of the second or third financial year is lower than the minimum amount of the registered capital provided for by the law, such company will be subject to liquidation.

Though the recent amendments to the Civil Code of Ukraine cancelled the minimum amount of the registered capital for LLCs, there is still a risk of filing a claim by tax authorities aimed at the company's liquidation in case of its negative net worth. As a matter of practice, Ukrainian tax authorities have not been active in filing such claims so far, and, therefore, the risk of liquidation of the factoring company under a court decision could be treated as rather remote. In the worst case scenario (i.e. in case court proceedings aimed at liquidation of the factoring company, having negative net worth, are commenced by the Ukrainian tax authorities), such company would be entitled to make further sale of NPLs and the underlying security to another legal entity prior to its liquidation.

In addition, it should be noted that the FSA has recently issued a regulation prohibiting factoring companies to acquire loans borrowed by private individuals, limiting distressed debt portfolios to be sold to factoring companies to corporate and private entrepreneur loans only. Further to the said regulations, several factoring companies have been already instructed by the FSA to stop acquiring private person loans.

From the Ukrainian tax perspective, the Ukrainian factoring company structure has some disadvantages the following reasons:

(a) the Ukrainian factoring company is subject to all applicable taxes, including corporate profit tax;

(b) the difference between the purchase price paid by the factoring company for acquiring each separate distressed debt and the proceeds collected under such debt is subject to taxation. Unfortunately, tax legislation provides for restrictions on netting losses and gains under different loans. Consequently, if factoring companies incur losses under certain loans, it is impossible by law to deduct such losses against gains obtained under other loans or against taxable profit under other transactions carried out by the factoring company.

Non-resident SPV structure

The structure of NPLs sale to a non-resident SPV would be less complicated from a regulatory perspective compared to Ukrainian factoring company structure, as the requirements with regard to non-loss making activity or positive net worth do not apply to a non-resident SPV.

Another obvious advantage of this structure is that a non-resident SPV can be established in tax favourable jurisdictions much faster and cheaper than a factoring company in Ukraine.

However, according to the NBU regulations in force, NPLs may be sold to a non-resident provided that the change of the creditor under each separate loan agreement (i.e. substitution of NPLs vendor by the non-resident SPV as the NPL acquirer) is duly registered with the NBU prior to effectuating the NPLs sale transaction. Such registration may be done solely based on the debtor's application and therefore entails direct involvement of the borrowers into the NPLs sale process, which might be a potential deal-breaker if the borrowers are not cooperative with the vendor. Moreover, non-resident investors may face serious difficulties within the course of distressed debts enforcement due to complicated provisions of Ukrainian legislation governing legal succession, as well as peculiarities of the Ukrainian court process.

Therefore, in practical terms, non-resident SPV structure is workable in a very limited number of cases.

Ukrainian venture investment fund structure

For tax purposes it might be advisable to sell a distressed debt portfolio to a Ukrainian venture investment fund, managed by an asset management company (the 'AMCo'), as the Ukrainian tax regime provides for certain tax exemptions for such funds - namely, capital gains of a unit venture investment fund are subject to taxation in the following cases only:

(a) in case of selling investment certificates (i.e.

securities evidencing an investor's right to a share stake in the fund) by an investor to third parties;

(b) in case of selling investment certificates of the venture fund to the said fund itself (e.g. in the event of repurchase of investment certificates by the venture fund in view of closing of the latter); or

(c) in case of profit distribution between investors of the fund.

Considering the above, capital gains of venture funds are not subject to corporate profit taxation, in case they are not received by investors in the process of profit distribution (as dividends), but are reinvested by the said funds.

Such unit venture funds structure, commonly utilised for efficient tax planning, allows making further sales of assets without taxation of capital gains till closing of the fund, or distribution of profit (if any) between its investors.

In the structure discussed, a venture investment fund does not enjoy the status of a legal entity and represents a contractual mutual investment vehicle (a set of assets) jointly owned by the fund's investors and managed by the AMCo.

All transactions with the venture fund's assets are carried out by the AMCo on its own behalf rather than on behalf of the fund. According to the laws of Ukraine, asset management activity, including managing venture investment fund, requires a licence from the National Securities Commission (the 'Commission'). Therefore, the AMCo is entitled to establish a venture investment fund upon obtaining such a licence from the Commission.

Although the applicable Ukrainian laws allow distressed debt acquisition by a venture fund, the Commission regulations governing such activity are very underdeveloped. As a result, there might be some issues with proper calculation of the venture fund's assets and compliance with the reporting requirements set forth by the Commission.

Moreover, the Commission is reluctant to openly endorse NPLs acquisitions by venture funds due to vague and underdeveloped regulations governing such activity, which have been utilised by professional collection agencies focused on distressed debt acquisitions in a public outcry against NPLs acquisitions by any other institutions.

At present, the Commission is in the process of developing the respective regulation to fully govern all legal aspects of distressed debt sales to joint investment institutions, including venture investment funds. The first stage of this process, which is almost finalised by the Commission, is carrying out a pilot project involving several selected venture funds, which have been allowed to invest a limited amount in distressed debt acquisition under the Commission supervision, for the purpose of testing appropriate regulatory tools and elaboration of a methodological base required for NPL purchases by joint investment institutions.

Structural considerations

As a matter of practice a much wider range of legal issues has to be taken into account for the purposes of proper planning and structuring NPLs sale/acquisition transactions, including but not limited to banking secrecy and personal data disclosure within the course of distressed debt disposal, legal due diligence of assets and limitations of vendor's liability, transfer of the underlying security to the NPLs acquirer, as well as legal succession of the investor and further NPLs enforcement proceedings.

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