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The New Legal Framework

Bate C Toms, Vladimir Sayenko and Mykola Orlov, BC Toms & Co

Introduction

On 24 August 2001, Ukraine celebrated the tenth anniversary of its independence. Over the past decade, the country has sought to develop its legal and administrative system from its Soviet foundations towards the basic legal platform of a Western-style democracy that shares many common values with the rest of Europe, such as the rule of law, abolition of the death penalty and political pluralism. Much remains to be done, however, for the continued practical implementation of these changes in Ukrainian law.

It should be borne in mind that the Ukrainian legal system is based in part on the centuries of common tradition with the rest of Europe prior to the Soviet era. First as an independent state and later as a part of the Austro-Hungarian, Polish and Russian Empires, Ukraine developed within a European cultural, political, legal and economic context. These values continued to be reflected in many of the legal codes during Soviet times, even if their implementation in the economic and human rights spheres was quite restricted.

Since its independence, in only 10 years Ukraine has made extraordinary progress towards a democratically based Western-style legal system increasingly suitable for a market economy. The result nonetheless has a distinctly 'Ukrainian' flavour, unlike in some of the other former Soviet Union republics that have more or less followed the Russian model, or even returned to a quasi-Soviet style system. Although there has been consistent progress over the past several years in resolving outstanding problems, there are still significant difficulties and numerous legal traps in Ukraine for the unwary.

This chapter provides a general overview of legal developments since Ukraine's independence.

Economic freedoms and human rights

The legal framework of Ukraine is based on the Constitution of Ukraine, adopted by the Ukrainian parliament (commonly known by its Ukrainian name, *Verkhovna Rada*) on 28 June 1996. The Constitution laid firm groundwork for the subsequent democratic transformation of the State and overhaul of the legal system. It provides that it is the supreme law of the land, directly applicable to all legal relations governed by Ukrainian law. Its provisions are therefore directly enforceable by litigation irrespective of further implementation.

Foundation of the legal framework

The Constitution provides for the protection of human rights, which are expressly stated to include political, social and economic rights, of both the citizens of Ukraine and other individuals permanently or temporarily present in Ukraine. It guarantees that foreign nationals in Ukraine shall have the same rights as Ukrainian citizens with the sole exception of certain political rights, for example to vote and to be elected to political office or to enter the civil service. It also, for the first time in more than 70 years, acknowledges the existence of private property and guarantees its protection.

Among the economic rights that the Constitution establishes is the right of individuals and legal entities to entrepreneurial activity free from any arbitrary state interference (ie without a proper legal basis). State bodies may only act within the legal framework as established by Ukrainian legislation.

The structure and separation of powers

The Constitution provides that Ukraine is an independent, democratic state that consists of 24 regions (called *oblasts* in Ukrainian), the cities of Kyiv and Sevastopol and the Autonomous Republic of Crimea. The capital is Kyiv. The state language is Ukrainian, which is required to be used for all official documentation and public service (although in certain areas, state bodies may use the language of the dominant ethnic minority alongside Ukrainian).

State power is divided amongst three branches: legislative (Parliament), executive (the Cabinet of Ministers, with various functions also reserved for the President) and judicial (the courts of general jurisdiction, headed by the Supreme Court, and the Constitutional Court). This division is still in the process of development, in particular concerning the allocation of powers between the Cabinet of Ministers, the Parliament and the President, and the basis for their effective co-operation.

In the recent past, Ukraine experienced several lengthy legislative deadlocks due to disagreements between the legislature and the executive branch. Such problems are increasingly being resolved by the formation of governments (whose ministers must be proposed by the President and approved by the Parliament) on the basis of political parties that collectively hold the majority of the seats in the parliament (as evolved long ago in the Western parliamentary democracies).

Under the Constitution, the judicial branch is based on the 'European' model, with the Constitutional Court being separated from the rest of the judiciary. The Constitutional Court has the sole authority to render official interpretations of the Constitution and the laws of Ukraine. It is authorized to examine laws for their compliance with the Constitution.

In turn, the courts of general jurisdiction form a single system, with the Supreme Court of Ukraine being the highest judicial body for all cases other than those raising constitutional issues before the Constitutional Court. The year 2001 marked a significant transformation of the judiciary in Ukraine. Long neglected and underfinanced, it is undergoing a complete overhaul. All of the specialized courts, such as the commercial courts that are responsible for resolving disputes between companies, have now been brought within the system of the courts of general jurisdiction as its branches, with final appeals to the Supreme Court.

The President of Ukraine has an executive role apart from this structure. He is to be the guarantor of the Constitution and an intermediary between the other branches of government. He is the commander-in-chief of the armed forces of Ukraine and has the right to submit bills to Parliament. Since the adoption of the Constitution, the Presidency has, as a matter of practice, developed into a powerful institution that shapes many of the internal and external policies of the State. In particular, the President wields power, in addition to nominating the Prime Minister (subject to parliamentary approval) and appointing all ministers on the Prime Minister's nomination, by having the right to veto legislation (a two-thirds vote is required for Parliament to override a veto) and the right to dismiss the Prime Minister and the rest of the government.

Sources of law

Ukraine is a civil law country and, as such, recognizes statutory law as its main source of law. Secondary sources, such as decrees and resolutions of the President of Ukraine, resolutions and regulations of the Cabinet of Ministers of Ukraine and legal acts of State and local bodies, may be issued only within the framework created by the Constitution and statutory laws, including on the competence of state bodies. International agreements of Ukraine duly ratified by Parliament become part of the national legislation with priority over all other laws except the Constitution.

Although judicial decisions were traditionally considered not to be a source of law, they play an increasingly important role in the effective interpretation of statutes. Furthermore, guidance resolutions of the Supreme Court of Ukraine are now obligatory for the lower courts, and the rulings of the Constitutional Court serve as official interpretation of the Constitution and Ukrainian law. Increasingly, as Ukrainian law is still in a process of development, the courts are actively filling in gaps in legislation and regulations to meet the requirements of a market economy.

An interesting development within the recent legal reforms is the introduction of business practices as a source of law (provided for in the proposed new Civil Code of Ukraine, final adoption of which is expected shortly). Certain forms of such 'soft law' are already in effect. For example, the use of the International Chamber of Commerce's Incoterms in foreign economic contracts was made mandatory by a decree of the President of Ukraine in 1994.

Legal reform

General

The transformation of Ukrainian law, and in particular the regulatory environment for business, began soon after the proclamation of Ukraine's independence in 1991 and has continued to develop sporadically since. A major milestone was the adoption of the Constitution of Ukraine in 1996, followed soon after by an overhaul of the taxation system. Presently, Ukraine is completing a period known as the 'code revolution' with the adoption of four new codes in 2001, the Criminal, Budgetary, Family and Land Codes, and the preparation of new Civil and Criminal Court Procedures, Tax and Civil Codes, which are currently under consideration.

Many of the recent developments of Ukrainian law can be attributed to the efforts of the Ukrainian government to make Ukraine eligible for membership of the European Union (EU). This intention was initially declared in the resolution of the Ukrainian Parliament of 2 July 1993, 'On the Main Principles of Ukrainian Foreign Policy', and has been repeated on many occasions.

Pursuant to Article 51 of the Treaty on Partnership and Co-operation between Ukraine and the European Communities and their Member States of 14 June 1994, Ukraine undertook an obligation gradually to harmonize its legislation with the laws of the EU, one of the prerequisites for future integration of Ukraine into the EU. Particular attention in this respect has been given to the following areas: customs regulations, company law, securities regulation, banking, tax and

accountancy, intellectual property, financial services, technical rules and standards, competition law and consumer protection.

As discussed below, significant progress has been made in many of these areas in recent years. In the next several years, substantial progress can be expected on corporate governance issues, the regulation of insider dealing and the activities of intermediaries in the securities markets, as well as for intellectual property protection and the prevention of money laundering.

The following discussion reviews in greater detail some of the more significant developments in legal regulation that are of particular importance for business activity generally in Ukraine, and foreign investment in particular. (Some of these are dealt with further in the other chapters on specific topics.)

Civil law and commercial transactions

Presently, commercial transactions are regulated by the old 1963 Civil Code that was originally designed to govern transactions for a centralized economy based on state ownership of property. It is not surprising that, over the past 10 years, a considerable part of this Civil Code has effectively become inoperative. Instead, transactions in the emerging Ukrainian market economy have been increasingly regulated by separate statutes, for example the Law 'On Pledge' or the Law 'On Enterprises in Ukraine'. However, this patchwork regulation as it interrelates with the Civil Code has often resulted in conflicts of legal rules and confusion as to the applicable law.

Work on the new Civil Code started in the mid-1990s, with the first draft being presented to Parliament in 1996. Today the process for adoption of the Code is nearing completion. The new Civil Code, in its current draft, is largely based on Dutch and German civil law traditions. Among other novelties, this Code provides for the unlimited legal capacity of legal entities, so individual powers to undertake particular actions will no longer need to be separately provided for in corporate charters. In general, it will liberalize the legal regulation of commercial transactions.

Regulation of cross-border transactions

The Law of Ukraine 'On Foreign Economic Activity', passed in 1991, paved the way for a free market to replace the exclusive state control over cross-border trade that was a characteristic of the Soviet system. Since then, state control and regulation has been steadily reduced. Today only a few official limitations remain on the free flow of international trade with Ukraine, including in particular the following:

- requirements for state registration of certain types of foreign contracts, mainly those for barter arrangements or transactions involving the importation of goods that are subject to licensing, quotas or anti-dumping proceedings;
- currency exchange controls, including to require: (1) that Ukrainian sellers be paid for exports of goods within 90 days of their export; and similarly: (2) in import transactions, that goods be imported by Ukrainian buyers within 90 days from the date of any pre-payment, except in either case if an extension to the time limit is granted by the National Bank of Ukraine (NBU) in an individual licence (which must be specially applied for); and
- licensing and other requirements for the importation of certain goods into Ukraine.

It should be noted that transfers of hard currency from Ukraine are still closely monitored by the state authorities and are limited in general authorizations to certain specified types of transactions. Banks are required to apply these restrictions and allow non-qualifying transfers to be made only pursuant to an individual licence. Care must therefore be taken for a particular transaction to verify that any necessary cross-border transfer of the funds will be allowed.

As a practical matter, complex procedural rules, applied by Ukrainian customs and the requirements of various other state authorities, including for product certification and sanitation control, may make certain cross-border import transactions excessively burdensome compared with what is typical in the West. The expected admission of Ukraine to the World Trade Organization should promote reform of this state regulation of the importation process and further develop foreign trade.

Foreign investment regime

Soon after independence, the Ukrainian Parliament decided that the best way to attract foreign investment would be to grant special tax privileges to foreign investors. The 1992 Law 'On Foreign Investment' and a 1993 decree of the Cabinet of Ministers created a special regime of tax holidays for significant investments. These tax holidays were abolished in 1997, and there is little prospect of their being brought back.

It is thought that the tax holidays contributed little to attract investment, but lost needed revenues for the State and unfairly favoured foreign over local businesses. However, termination of these previously granted tax holidays, in reliance on which several large Western investments were made, resulted in some controversy and litigation. Instead, in the future, there may be incentives for investments in specific economic sectors and particular locations that are deemed to need

special assistance. Thus a number of special economic zones have been created in which significant tax privileges exist for all investors, domestic and foreign.

The government's announced intention is to attract foreign investors by developing a legal framework that meets international standards. It is thought that most investors into developing economies principally seek a stable legal regime, in which their legitimate rights and expectations will be adequately protected, rather than focus on tax privileges.

Judicial reform

The court system has been transformed, as indicated above. The previously separate commercial and general jurisdiction courts are now consolidated into a unified, coherent system that, as a practical matter, functions increasingly well to protect legal rights. Reasonably tight deadlines have been imposed to oblige courts to decide cases promptly, usually within 60 days.

Western parties can now expect to be able to take Ukrainian individuals and entities to court where necessary and, where justified, to win and have their judgments readily enforced against the defendant's Ukrainian bank accounts and other assets. A number of Western investors have had success in such litigation against private Ukrainian entities as well as against the State.

Land law

Traditionally, issues over land ownership and the legal regulation of transactions with land have been controversial. Ukraine is claimed to have over 30 per cent of the world's black soil resources, and there are those who have argued that this asset should remain in state ownership. Thus, until recently, despite the constitutional provision expressly permitting private ownership of land, arable land was mainly reserved for the so-called 'collective ownership' of collective farms or state agricultural enterprises.

This situation is changing. The new Land Code, adopted by Parliament on 27 October 2001, provides for private, instead of collective, ownership of land, including arable land, and liberalizes the opportunities to purchase and sell land, subject to certain restrictions. Foreign legal entities and individuals now have the right to own land under buildings which belong to them. However, before the new Land Code can be implemented, a number of supplemental laws and procedural regulations will need to be adopted, which is likely take another 6 to 12 months.

Criminal law reform

The old Soviet Criminal Code, adopted in 1961, fell far short of respecting the human rights recognized by modern Western societies. For example, it differentiated between crimes against the State and communal property, which received harsher punishment than many types of homicide, and crimes against the 'individual' property of citizens, which received much more lenient treatment. The old Criminal Code was harsh and repressive, as manifested in the widespread use of imprisonment even for relatively insignificant crimes, such as petty theft.

The new Criminal Code, adopted on 5 April 2001 and which entered into force on 1 September 2001, has already proved to be a considerable improvement. The new Code has increased the protection of individual and private property. On the other hand, punishment for some economic crimes has become more lenient. For example, the threshold for a case of tax evasion to be considered criminal has increased 100 times to UAH17,000 (about US\$3,200). Some of the typical Soviet-era crimes have simply ceased to exist, such as speculation (defined as the reselling of goods at higher prices, which was often used to prosecute any kind of entrepreneurial activity) and transactions in hard currency.

The new Code has also taken account of new technological and political developments. Such crimes as terrorism, trafficking in people and forgery of bank cards are specifically addressed. By contrast, the number of 'crimes against the State', in particular economic crimes, has decreased.

Banking regulation

One of the real successes of the legal and regulatory reform process has been the new laws governing the banking sector. The importance of banks for the economic and social stability of the country has been generally understood after the hyperinflation and the bad loan crises of the early 1990s. In the ensuing years, the NBU has taken an increasingly rigorous stand in its banking supervision, effectively adhering to the guidelines set by the Basle Committee.

Presently, Ukrainian banking law embraces the European practice of 'universal' banks. At the same time, banks are set aside from other financial institutions as being the only bodies authorized to accept deposits and extend interest-bearing loans. In 2001 the Law 'On Payment Systems and Electronic Funds Transfer' officially introduced the use of electronic documents and electronic (digital) signatures on banking documents. Work is also under way to develop a feasible mechanism for guaranteeing the bank deposits of individuals as a means of encouraging private savings and boosting the banking sector.

Some remaining problems

Despite the apparent successes in a number of key areas of legal regulation, there remain some unresolved problems. To begin with, the Civil Code as well as the new Codes of Civil and Criminal Procedure need to be adopted and become effective. These Codes will mark the effective end of the Soviet legacy in Ukrainian law, except for a few statutes in specialized areas (such as project approvals for new construction).

The proposed radical overhaul of fiscal regulation also needs to be completed. It is widely perceived that a more economically justified and equitable system of taxation, with lower rates and more consistent application, should contribute to the continuation of the economic growth that began in 1999. A draft Tax Code has passed the first reading in the Ukrainian Parliament, and the Customs Code has already passed two readings and is expected to be adopted soon following a third reading.

Aside from such general reform, a number of other specific problems need to be addressed to permit the legal system to function better. For example, the general director of a Ukrainian company has broad powers to execute contracts binding his or her company, even if these actions exceed or violate restrictions in the company's charter or board resolutions. As charters of companies cannot be publicly inspected, it is difficult to know of any limitations on corporate power. It can also be difficult (and expensive) for the shareholders of a company to dismiss its general director for inadequate performance. There are, however, a number of practical measures that can be used under current law to mitigate such problems.

Similarly, many Western investors are surprised that there is no requirement for the registration of real property mortgages, making verification of prior charges extremely difficult. Equally surprising, promissory notes and bills of exchange can only be issued as payment for goods received or services provided and not to evidence obligations under a loan agreement. There is little doubt that these issues will be addressed in the future, but in the short term practical solutions must be relied upon.

In view of these sorts of issues, it is essential for an investor in any transaction to seek advice from legal counsel with in-depth Ukrainian experience and expertise. There are numerous examples of companies trying to operate on the basis of expectations and experience developed elsewhere, in particular in Russia, running into serious difficulties in Ukraine because, despite some similarities, the Ukrainian legal system has become relatively unique.

Conclusion

It is difficult to overemphasize the enormity of the task that faced Ukraine in 1991 when it had to develop a new legal system, both to respond to its move to independence and to the needs of a market economy. While problems remain in the details, substantial progress has been made, and the Ukrainian legal system is now functioning much as do those in the West.

As Ukraine strives to move towards greater European and international integration, beginning with membership of the World Trade Organization, it appears that in the medium term the laws of Ukraine will be even further integrated into the European Union model. This, in turn, should give foreign investors greater comfort, and they should be able to expect reasonable legal protection for their Ukrainian investments, provided that they are properly structured and implemented.

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