

# Privatisation in Ukraine

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**Ten years have passed since, shortly after gaining independence, Ukraine began privatising its State owned property. During this period, privatisation law in Ukraine developed sporadically, improving in stages. The privatisation process has now evolved into a reasonably transparent and suitable mechanism that should be attractive for foreign investors. A significant number of large companies are presently being offered under this process each year to qualifying investors.**

The main objective of this privatisation process, as professed in the 1992 Law of Ukraine “On the Privatisation of State Property”, the framework legislation on privatisation in Ukraine, is to improve the social and economic efficiency of the use of State property and to attract funds for the reconstruction of Ukraine’s economy.

Privatisation is presently an important part of the Ukrainian government’s domestic policy as well as one of the major sources of income for the State.

## History

The process of privatisation of State property may be divided into three types, being:

- privatisation of land and assets in the agricultural industry;
- privatisation of housing; and
- privatisation of State-owned industrial and other non-agricultural property (excluding housing).

While the agricultural privatisation process has been markedly slow in its development, the other two types have gone much further and produced better results.

Since the agricultural and housing types of privatisation have been mostly reserved for Ukrainian citizens, this article will focus on the privatisation of industrial and other non-agricultural property (hereinafter “industrial privatisation”). This industrial privatisation has moved through two stages and is now well into its third stage, as follows: [Initial stage \(1992 - 1994\)](#). During this period, typically privatisation was carried out through the leasing and subsequent purchase of the property of State companies by the management and employees of these companies.

[Mass privatisation stage \(1995 - 1997\)](#). This stage began in 1995 when all Ukrainian citizens received the right to obtain privatisation certificates, a special type of security that could be exchanged for shares of State companies sold in special privatisation certificate

tenders conducted by the certificate auction centres.

Another type of security used in these privatisations was the compensatory certificate issued to cover the losses incurred by the holders of deposits in the State Savings Bank during the period of hyper-inflation from 1991 to 1995. Most of these privatisation and other certificates were used by the end of 1997, although some tenders using these certificates took place until 2000.

Parallel to these certificate privatisations, thousands of small State-owned firms and other State properties were sold through auctions for cash to private owners. Large scale cash privatisation stage (approx. 1997 - present). Unlike the two preceding stages, the main emphasis during this third stage has been to raise substantial revenue for the State. As a rule, during these larger cash privatisations, shares in medium and large companies are privatised by sale for cash in blocks at tenders or as individual shares at stock exchanges.

One of the characteristic features of the current privatisation process is the sale of shares of strategic and monopolistic companies, for example natural monopolies like the State telecommunications operator Ukrtelecom (planned for 2002-2003) and the energy distribution companies.

In the view of many economic commentators, privatisation in Ukraine has not yet achieved most of its declared goals. On the one hand, privatisation has not created a broad class of property owners, as the majority of the shares in the privatised State companies, at least the most valuable ones, were accumulated by a few powerful corporate groups or by the existing senior managers of these companies.

On the other hand, the first two stages of industrial privatisation demonstrated that privatisation by itself does not automatically guarantee any improvement in the management of the companies or the property involved or result in any genuine re-structuring of the economy beyond

the change in ownership. All too often, the controlling shares sold by the State were accumulated by a company's existing directors who continued to apply Soviet-style management techniques.

In addition, the non-cash privatisations often also failed to involve adequately financed sources for the funding needed for the modernisation of the privatised companies and their future growth.

## Privatisation process

In Ukraine, the privatisation process is mainly regulated by the laws of Ukraine and the legal acts of the State Property Fund. The basic laws governing the process are the Laws "On Privatisation of State Property" (the "Privatisation Law"), "On Privatisation Securities" and "On the Privatisation of Small-Sized State Companies (Small Privatisation)" adopted in 1992.

These laws regulate the overall legal framework governing the privatisation process in Ukraine, such as to determine what can be privatised, who can be parties to the privatisation process and privatisation procedure to be applied.

The Privatisation Law identifies the following three groups of State-owned property that are subject to privatisation:

- (i) shares in the capital of business companies and other entities;
- (ii) unfinished constructions and mothballed developments; and
- (iii) certain individual items of property or "integrated property complexes" (defined as being a group of assets sufficient to conduct a separate business activity) of State-owned companies.

This Law also effectively excludes from privatisation State property that is defined as being of "national importance" (the principal examples of such property are listed in Figure 1).

Based on these criteria, a list of particular companies and property that are excluded from privatisation is adopted and, from time to time, modified by the Parliament of Ukraine (the Verhovna Rada). The current list contains over 1,200 State enterprises. This list is likely to be reduced gradually in the future, unlike the rapid reduction that occurred in 1999 when the list was cut from over 6,000 to about 1,500 State enterprises.

The Privatisation Law provides a limited number of restrictions on who can be the purchaser of State property in a privatisation. It prohibits from participation in privatisations: (i) legal entities more than 25% owned by the State; (ii) State government bodies; and (iii) employees of State privatisation bodies.

Ukrainian law does not provide for any express restrictions on the participation of foreign persons

or entities in privatisations. However, there are a number of statutory limitations on the foreign ownership of, or investment in, the capital of certain entities that may effectively limit foreign involvement in a privatisation, as described in Figure 2.

In principle, pursuant to the Partnership and Cooperation Agreement between Ukraine and the European Community, the application of many of these limitations to EU based companies is to be eliminated.

## The State Property Fund of Ukraine

The main State body responsible for the development and implementation of the State privatisation policy is the State Property Fund of Ukraine ("SPF"), established in 1992 by the Ukrainian Parliament pursuant to the Privatisation Law and the "Temporary Regulation on the State Property Fund of Ukraine" approved by the Resolution of the Ukrainian Parliament of 7 July 1992, No. 2558 (the "Temporary Regulation").

The SPF is proclaimed in Article 7 of the Privatisation Law to be an independent State body that is subordinated to, and reports to, the Parliament of Ukraine. However, the Constitutional Court of Ukraine ruled in 1998 that this provision subordinating the SPF to Parliament is unconstitutional.

The status of the SPF is supposed to be clarified in the proposed law on the SPF, the new draft of which is to be considered by the newly elected Parliament. The debate in the previous Parliamentary session focused on whether to subordinate the SPF to the Cabinet of Ministers (which is the principal State executive body).

The scope of the SPF's authority is spelled out in Article 7 of the Privatisation Law and in the Temporary Regulation. Among other powers, the SPF is given the authority to perform the following functions:

- sell State-owned property in the course of privatisation, including the property of liquidated enterprises and uncompleted construction projects;
- take actions to engage foreign investors in the privatisation process;
- develop and submit to the Cabinet of Ministers drafts of national privatisation programmes, and organise and control their implementation;
- change the organisational and legal form of State owned enterprises in the course of their privatisation by transforming them into open joint stock companies (to facilitate share sales);
- exercise the authority of the owner of the shares of State owned joint stock companies, which were not sold in the course of a privatisation, and bear the commercial risks connected with such shares;

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**Figure 1: Selected property that cannot be privatised due to its “national importance”**

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- assets of enterprises that ensure the issuance and storage of banknotes, coins and securities;
  - radio and television transmission centers;
  - state radio and television channels;
  - educational, sport and scientific establishments funded by the State;
  - assets of enterprises producing and repairing arms used by the Ukrainian army;
  - assets of aviation industry enterprises;
  - roads outside a company’s premises;
  - railroads and enterprises producing locomotives and rail cars;
  - metros and other electric transport in cities;
  - assets ensuring the operation of the united energy system and the dispatch of electricity as well as the operation of high voltage networks;
  - atomic electro-power stations, combined heat and power plants, and hydro-electropower stations using dams that ensure water supply and hydromelioration;
  - oil and gas underground storage facilities and major pipelines; and
  - assets of enterprises producing spirits, wine and hard liquor.
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- approve plans for the privatisation of State-owned property;
- conclude agreements with intermediaries regarding the organisation of the privatisation process and the sale of State property;
- act as a lessor of State-owned property;
- participate in the development and conclusion of international agreements on property and the use of State-owned property; and
- represent, in Ukraine and abroad, the State’s interests in State-owned shares, as well as the interests of State enterprises, organisations and institutions etc.

The SPF also prepares the triennial privatisation programmes that are to set out the main objectives and terms of privatisation for successive three-year periods. The privatisation programme is supposed to be reviewed and approved by the Parliament of Ukraine in coordination with the annual State budgets for the relevant period and then remain effective until a new programme is approved.

### Privatisation methods and procedure

Privatisation methods and procedures differ depending on the entities or other property to be privatised as listed in a privatisation programme. In the present privatisation programme for the Years 2000 to 2002 (the “2000-2002 Programme”), the entities or property to be privatised are grouped by type (e.g. strategic and monopolistic companies, unfinished construction, etc.)

and the number of persons employed at these State companies.

The privatisation programme is implemented by the Cabinet of Ministers and the SPF. They typically begin by creating a privatisation commission for each company being privatised, which commission prepares the actual privatisation plan covering all aspects of the privatisation process to be applied.

Under the Privatisation Law, the impetus for a privatisation may come from the SPF, or it may be in response to an application from any foreign or domestic prospective buyer (which may include employees of the company to be privatised).

In the past, many privatisations took place through the so-called “non-commercial” tenders, when the winner was the person that, for the fixed price stated for each such tender, proposed the best investment and operational terms. Presently, the bidders in such tenders also propose the price that they will pay. At these tenders, the winner not only pays for the acquired shares, but also undertakes certain investment and other obligations.

Currently, a priority is generally being given to “commercial” tenders for the larger privatisations, where the winner is determined solely on the basis of written sealed submissions by the potential purchasers quoting a price, with the best price winning. In addition to non-commercial and commercial tenders, which are the two principal methods of privatisation, the Privatisation Law also

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**Figure 2: Foreign investment in Ukrainian companies**

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Foreign investment in Ukrainian companies is limited to 30% for the following types of Ukrainian companies:

- publishing houses;
  - organisations distributing publications;
  - information agencies; and
  - broadcasting companies and television and radio organisations.
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permits auctions, buy-outs and sales through stock exchanges and OTCs (over-the-counter markets) to take place.

The sale of State property in a privatisation is documented by a purchase and sale agreement with the SPF, which must be notarised. The agreement ordinarily provides for additional obligations to be imposed on the buyer, usually for defined periods of time, which may include:

- criteria for the reconstruction of the facilities;
- an obligation not to decrease the number of work places;
- preservation of the production of certain products;
- preservation of certain social infrastructure;
- subsequently making investments in certain amounts and
- performance of “mobilisation tasks” (measures designed quickly to restructure the company in case of a threat of war, etc.).

Restrictions may exist on any subsequent sale of property acquired in a privatisation, if such sale occurs before any such privatisation obligations are performed or expire.

According to Article 27 of the Privatisation Law, the purchase and sale agreement may be terminated (including by rescission) or declared invalid by a court decision in case one of the parties fails to timely perform its privatisation obligations. Although, as a matter of legal theory, arguments can be made against the use this provision on termination, it is in practice used to reverse privatisations even where the obligation stated in the purchase and sale agreement can only be performed by the company and not directly by the one or more shareholders which bought their shares in the company’s privatisation. In such cases, it is essential for the acquiring shareholders to have effective control over the management from the outset.

An additional basis for termination of the purchase and sale agreement can be found in Article 29 of the Privatisation Law, which states that “a violation of the privatisation procedure established by law” or of a bidder’s rights shall be a basis for declaring a purchase and sale agreement by which state property was sold to be invalid. This provision may apply, for example, where one of the applicants for shares was denied the right to participate in a tender in violation of the privatisation procedure. Article 29 also provides for a variety of penalties that apply in the event of contractual non-performance in a privatisation.

Ordinarily, purchase and sale agreements concluded in the privatisation process provide for payment by the purchaser shortly after the agreement is executed. Article 29 of the Privatisation Law contains an important limitation that prevents

any extensions of the time for payment and inhibits conditional sales as well. It provides that failure to pay for any privatised property within 60 days from the moment when the purchase and sale agreement was concluded or registered results in annulment of the sale and in fines on the purchaser.

This means that bidders can not make payments into an escrow account and make their bids subject to certain conditions (for example, on due diligence problems being resolved) before payment would be definitely released to the SPF, as this would likely take over 60 days (an issue that arose last year for the privatisation of six electricity distribution companies).

As a practical matter, currently State owned companies that are presented for privatisation often have problems, such as concerning perfection of title to land and buildings, and documentation of changes of organisational form and control, which need to be addressed by potential bidders early in the privatisation process. It is therefore often essential to involve lawyers and accountants from the outset, not just to prepare legal and accounting due diligence audit and reports, but also to resolve all legal issues that are identified.

## Privatisation in 2002 and beyond The 2000-2002 Programme

The plan for the present privatisation process in Ukraine is outlined in the 2000-2002 Programme (referred to above) adopted by the Law of Ukraine of May 18, 2000. In many respects this Programme has marked the advent of a new era in the State’s privatisation policies compared with the previous privatisation programmes.

The 2000-2002 Programme introduced such measures as privatisation being conducted exclusively by cash sales, individualised approaches for each of the companies subject to privatisation and greatly increased information transparency of the privatisation process. The implementation of these measures is to be facilitated by the involvement of professional advisors to restructure companies before they are offered for sale, and by the employment of competitive mechanism for sales.

The main emphasis of the 2000-2002 Programme is the privatisation of a number of significant strategic and monopolistic companies, including certain “natural” monopolies like the electricity distribution and telecommunication companies (the so-called “Group G” State property), thought to be the most attractive property to sell in order to raise substantial revenue for the State.

The programme introduced a number of special provisions aimed at increasing the efficiency of such

sales. A key notion for such procedure is to provide that the so-called "industrial investors" (companies meeting certain qualifying criteria, including with respect to production and management experience) shall be the sole bidders allowed to participate in privatisations in certain areas considered attractive to foreign investors, such as the fuel and energy sector, metallurgy, the petrochemical industry, radio electronics, airlines and machine building.

This approach is designed not only to maximise the income from these privatisations, but more importantly, to ensure the long-term stability of these companies that have a key role in the national economy. While there has been some criticism of the very restrictive criteria for qualifying industrial investors to bid, it appears highly likely that the same principles will be readopted in the next privatisation program that will apply starting from 2003.

These measures by Ukraine can be reviewed as favouring multinational companies which are currently viewed as being the most desirable industrial investor for many Ukrainian industries.

The privatisation of the Group G companies is required to be conducted by means of sales of

blocks of shares of these open joint stock companies at commercial tenders. The usual condition for such privatisations is that the sale of the controlling block of shares (being at least 50% plus 1) must be to a single buyer. If the controlling block of shares is instead retained by the State, the investor may still be granted the right, at its request, to manage all or part of the State-owned block of shares, depending on the tender's terms.

One of the important preconditions for the sale of shares in monopolistic companies as well as many of the larger State companies is for the bidder to obtain the prior approval for its bid from the Antimonopoly Committee of Ukraine. Even if this is not a pre-condition, obtaining such approval is highly advisable, because the SPF may not be willing (as has happened in the past) to permit an amendment to a sale agreement subsequently so that the sale is made conditional upon the Antimonopoly Committee of Ukraine providing its approval.

As a consequence, an illegal transfer of ownership without SPF consent can occur. In certain regulated sectors, like electricity, bidders must also be approved in advance by the relevant State

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regulator for their industry.

### **Privatisation in the energy sector**

Privatisation tenders for the sale of six electricity distribution companies were successfully held in April 2001. Despite the uncertainty over the future of the government of Ukrainian Prime Minister Victor Yushchenko at that time and the insufficient preparation of the companies for privatisation (e.g. lack of clear title to certain key assets, land use rights, required operational approvals and other appropriate documentation), the shares of all six companies were sold to strategic investors, and the prices for two of these companies were significantly higher than predicted.

Two companies were purchased by the American company "AES Washington Holdings B.V." and four by the Slovakian enterprise "Vychodoslovenske Energeticke Zavody". Ukraine received approximately US\$160m from these sales. This privatisation was also the first occasion when the SPF involved a sophisticated western bank, Credit Suisse First Boston ("CSFB") as its principal advisor.

CSFB effectively lobbied for the regulatory framework for the operation of electricity distribution companies to be made acceptable for potential bidders, for example on matters such as the setting of electricity prices. Based on this experience, the SPF plans to sell the remaining 12 State owned electricity distribution companies at the end of 2002.

The success of future privatisations in the energy sector may depend, in part, on how the Ukrainian government resolves the problem of the huge debts of the State companies being privatised.

For the first six electricity distribution companies privatised in 2001, these debts were restructured over five years with no payments within the first two years and no interest or penalties on the delayed payments. This approach might not work for some of the 12 companies to be privatised in 2002, which have accumulated substantially larger debts.

According to preliminary information in the press, the total debt of nine of these 12 companies exceeds US\$1bn. This debt significantly exceeds the minimum price that is expected to be required for bids for these 12 companies, which should be approximately US\$375m.

While the SPF and CSFB, as the SPF's advisor for the energy privatisations, are optimistic about the tenders being held by the end of 2002, certain inconsistent statements of other officials in the Ukrainian government show a lack of consensus that might result in the tenders delay. Hopefully, any delays will be used to prepare the companies better for privatisation, including to resolve land ownership and use rights, operational approvals and other

problems that often come up in the due diligence of State companies. Documenting land ownership rights to replace land use rights based on the new Land Code (that entered into force on January 1, 2002) effectively can provide an additional guarantee of value for purchasers.

After all of the electricity distribution companies are privatised, it is anticipated that privatisation of the State electricity generation companies will follow. In 2001, there were several attempts by powerful Ukrainian corporate groups to take control of these electricity generators by acquiring and enforcing their large debts. This process is commonly known as "hidden privatisation".

Several debts were enforced on this basis and recoveries were made against the assets of these companies, effectively allowing the assets to be acquired to satisfy debts at a small fraction of their true market value. This potentially dangerous trend was halted by the Ukrainian Parliament imposing a moratorium on such recoveries, including through bankruptcy proceedings, against the assets of companies that are 25% or more State owned.

### **Telecommunications - the privatisation of Ukrtelecom and UMC**

One of the next major privatisations in Ukraine should be of Ukrtelecom, the national telecommunications operator of Ukraine. The adoption of the special Law "On the Peculiarities for the Privatisation of the Open JSC Ukrtelecom" of July 13, 2000 (the "Ukrtelecom Law") establishes the basis for this sale.

The Ukrtelecom Law provides that 50% plus one share of Ukrtelecom shall be retained by the State, while at least 25% plus one share must be sold off to a single qualifying industrial investor in an open tender. Currently it is anticipated that a 37% block of shares will be offered at the tender (this assumes that it is not increased by the 6.9% block of shares remaining unsold after 13% of Ukrtelecom shares were offered to its employees).

According to Article 17 of the Ukrtelecom Law, 30% of the proceeds received from the privatisation must be transferred by the SPF to Ukrtelecom after it is privatised as a subsidy for development of its telecommunications network and for the purchase of modern equipment. The capital fund of the privatised company should accordingly be increased by the issuance of additional shares, which will be added to the remaining State-owned shares and thereby reduce the investor's percentage shareholding. The net effect of these transactions on the percentage shareholdings in Ukrtelecom is as yet unclear, and it is likely that the law on this reinvestment will be amended.

However, the investor should in any case also

have the right effectively to acquire contractually the right to manage up to half of the shares that are expected to be retained by the State, which should allow the investor to exercise effective control over the company for the term of this share management contract.

To qualify as a bidder, the investor must be a telecommunications operator (or a consortium including a telecommunications operator) having at least five years of operational experience and must satisfy certain documentation requirements. Normally bidders are also required to make a cash deposit of, or to provide a bank guarantee for, about 10 % of the minimum required bid amount. Bidders may not be registered in "offshore" jurisdictions. We understand that, as for the privatisation of the electricity generators, bids will be placed in a glass box by the bidders at the tender, with the bids then being immediately opened to reveal the winner - a literally transparent procedure.

The winning bidder will then have to enter into a formal purchase and sale agreement for the purchase of the shares, and pay for them in cash within 30 days after the execution of the purchase and sale agreement.

The Ukrtelecom Law also expressly requires that the company continues rendering telecommunication services to those persons who are presently benefiting from certain tariff privileges, irrespective of when the State actually pays the planned compensation to the company to make up for the subsidy in these artificially low tariffs. In addition, the conditions of the tender and the qualification requirements for the investors must be determined by the Privatisation Commission and approved by the Cabinet of Ministers. An audit by an international accounting firm of Ukrtelecom's accounts for the year preceding the tender will also need to be completed.

It is currently estimated that the minimum price for bids for the 37% block of Ukrtelecom shares to be offered will be over UAH1.7bn (approximately US\$320m). Although the SPF claims that Ukrtelecom is ready for privatisation and the tender can be announced in the autumn of 2002, it is not yet clear whether this will actually happen. If the Ukrtelecom privatisation is postponed again, the SPF will likely try to replace it with a number of privatisations of smaller companies expected to raise at least UAH5.8bn (about US\$1bn).

While the prospects for Ukrtelecom's privatisation this year remain uncertain, the SPF is expected to be more inclined to offer a 25% block in the Closed Joint Stock Company "Ukrainian Mobile Communications" ("UMC"). Previously it was expected that Deutsche Telecom, one of the existing

UMC shareholders, would want to increase its shareholding. However, recent statements by Deutsche Telecom on the reduction of its investment plans abroad make the prospects for its participation in the tender doubtful. Success of privatisation of UMC's 25% block of shares will therefore largely depend on market conditions at the time of the tender. The minimum bid for this block is expected to be at least UAH266m (slightly below US\$50m). However, the SPF has expressed an expectation that about UAH1bn (about US\$185m) may be received from the sale of these UMC shares.

## Conclusion

The experience of recent privatisations in Ukraine shows that the Ukrainian authorities are prepared to offer a transparent privatisation process for the privatisation of companies that occupy leading positions in the Ukrainian economy. It also appears that many of these assets will be sold at a substantial discount to prices that would be paid for similar assets in western, or even central, Europe.

This is resulting in many unique business opportunities in Ukraine, such as existed 10 years ago in central Europe when countries like Czechoslovakia and Poland privatised their State assets. While the proposed privatisation of Ukrtelecom and the remaining electricity distributors and generators have attracted the most attention, in fact a wide variety of businesses are to be privatised in the near future, including in the metallurgy, machine building and chemical industries.

Initial information on the companies offered for privatisation can be obtained from the SPF's website at [www.spfu.gov.ua](http://www.spfu.gov.ua).

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