

A New Legal Framework

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Before describing the legal framework in Ukraine it is worth reviewing where past developments have led. Two basic conclusions can be drawn from Ukraine's experience so far.

First, despite the occasional steps backwards and the inevitable conflicts in choice of direction that result in a democracy, Ukraine has made extraordinary progress towards a democratically based Western style legal system over its initial six years of independence. The result is uniquely Ukrainian, unlike in many of the other Commonwealth of Independent States (CIS) republics that have followed the Russian model. Second, although there has been consistent progress over the past several years in resolving the outstanding problems, there are still significant difficulties and numerous legal traps in Ukraine for the unwary.

It is therefore essential for an investor in any transaction to seek advice from legal counsel and accountants 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.

Legal developments

The new Constitution

Among the most significant developments has been the adoption on 28 June 1996 of the new Constitution of Ukraine, replacing the Soviet-style Constitution of 1978. This resolved some of the tensions between those fighting to retain aspects of, or even move back to, a more Soviet style of government and those interested in creating a democracy along Western lines.

Traditionally, the dominant groups within the Ukrainian Parliament (the Verkhovna Rada) have fought to protect state enterprises by providing enormous subsidies, especially trying to maintain the status quo for mining and agricultural enterprises and to retain state ownership of land. The new Constitution has moved the debate on many of these issues

towards the implementation of reform, rather than on the question of whether reform will take place. It has allocated powers among the Parliament, the President and the Cabinet of Ministers to produce a political system that is democratic by western standards.

Not everyone in Parliament is pleased with this result, and there are groups fighting a rearguard action, in particular to diminish the powers of the President. The most recent development has been the adoption of the 22 October 1997 law 'On Elections', which replaces a system where each individual deputy was elected to represent a single Parliamentary district with a system founded on a mix of party lists based on a form of proportional representation and single seat districts.

Under the new Constitution, Ukraine is to be based on the 'rule of law' principle. The Constitution enshrines the concept of an independent judiciary and guarantees the protection of private property, including, by permitting private land ownership. In addition to providing for independent courts, the Constitution establishes a special Constitutional Court to allow for independent interpretation of how the Constitution applies. In October 1996, individuals and legal entities were given the right to petition the Constitutional Court directly to challenge legislation and other state action.

A new currency

Another important recent event was the introduction in 1996 of the hryvnia as the national Ukrainian currency, and the adoption of legislation and decrees providing the framework for the present strong monetary policy of the National Bank of Ukraine as well as the continuation of the system of exchange controls. As a consequence, inflation has decreased from the catastrophic 10,000 per cent levels of 1993 down to roughly 10 per cent in the second half of 1997.

Privatisation

The third major development is the privatisation of large sectors of the Ukrainian economy. Although privatisation has not proceeded in Ukraine as quickly or as comprehensively as in Poland or Russia, significant progress has been made, especially for small and medium-sized enterprises. Privatisation of many larger state enterprises is being scheduled to take place over the next several years. It is now possible to foresee substantial privatisation by the turn of the century, except for certain strategic enterprises in defence or energy, which are still listed by Parliament as being exempted from privatisation because of their public significance for the national economy. This list is being steadily reduced, and in 1996 and 1997, the government declared that some of these enterprises could be privatised with the approval of the Cabinet of Ministers.

Taxation reform

Another significant legal revolution has occurred in taxation. During the early years of Ukraine's independence, taxes were largely based on gross revenues as in Soviet times, rather than on net profits. Consequently, the tax system artificially favoured firms with low turnover and high margins and generally discouraged investment. Cumulative rates for all taxes on gross income could exceed 100 per cent of net profit, which encouraged false accounting and corruption. Since the adoption of the income and corporate tax laws of 1995 and subsequent tax laws and amendments, particularly those in 1997, tax rates have been substantially reduced and taxes are now based on profits after expenses. [See Chapter 32.]

Under the old system few expenses were deductible, but since the 1997 reforms, in particular, expenses incurred in connection with a business have been made generally deductible, more like one would expect in the west. However, in some specialised sectors such as oil and gas, the special tax treatment that exists in the west, reflecting that activity's circumstances, does not yet exist in Ukraine.

Along with a fairer tax system has come much more rigorous enforcement by the state tax authorities. Audits are common and several joint ventures and subsidiaries of western firms have been subject to large fines. In most instances, these fines are being vigorously contested by Western firms that allege that foreign investments are being unfairly singled out. The government is presently dealing with these claims.

Securities legislation

Turning to securities law, the principal laws are the law 'On Securities and Stock Exchange' of 18 June 1991 as supplemented by the law 'On State Regulation of the Securities Market' of 30 October 1996. The Securities Commission has adopted numerous regulations pursuant to these laws to regulate trading activity in securities as well as depository and registrar activities. Mechanisms have been created for the acquisition of government bonds by non-residents through Ukrainian banks. A law on the creation of a national depository system and on electronic trading of securities has also recently been adopted by Parliament. The Securities Commission has also recently created a mechanism that will allow Ukrainian companies to have their securities traded, which was previously effectively prohibited except by indirect trading structures. However, much remains to be done to define securities regulation, and there are currently laws being prepared on the stock exchange and on investment funds and investment companies.

In addition to the Securities Commission and the various stock exchanges, the State Property Fund, National Bank of Ukraine and Anti-Monopoly Committee are also involved in securities regulation. It is

expected that future legislation will clarify the jurisdictional overlaps that have caused a number of conflicts, in particular concerning the ability of banks to purchase government securities.

Foreign investment

Change has also occurred concerning the regulation of foreign investment. 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 the 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 generally thought that the tax holidays contributed little to attract investment and lost needed revenues for the state. However, termination of these previously granted tax holidays, partly on the basis of which several large western investments were made, has resulted in some controversy and litigation.

In the future, there may be incentives for investments in specific economic sectors that are deemed to need special assistance, but 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 become interested in investing for reasons other than tax holidays, and, once interested, simply need to know what to expect and be reassured that their legitimate rights and expectations will be adequately protected.

In order to promote faith in the rule of law, the court system has been effectively transformed and functions increasingly well to protect legal rights. Western parties can now expect to be able to take Ukrainian individuals and entities to court where necessary and, when 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 litigation against the state, something that was unknown during the Soviet era.

Oil and gas

Turning to oil and gas regulation, on 12 September 1997 the Cabinet of Ministers defined a new rate for the tax on use of mineral rights as applied to oil and gas. The existing framework for oil and gas regulation and licensing is established by a series of resolutions of the Cabinet of Ministers, as supplemented by instructions and other regulations of the Ministry of Economy and the State Committee on Geology and the Use of Natural Resources (SCG), as well as by the State Committee on Oil and Gas. This created a system for licensing oil and gas exploration pursuant to licensing agreements with the SCG.

Ordinarily, Western investors form a joint venture company with a Ukrainian entity, and the joint venture company then seeks such a licence. However, many western companies in the oil and gas industry have been lobbying for production sharing legislation that would permit them to participate directly in production sharing agreements. The proposed production sharing law is still being revised by Parliament. There is considerable debate currently on how the regulatory power should be allocated to govern oil and gas exploration, development and production and further substantial charges, especially for gas, are possible in the near future.

Other areas of legislative reform

While it is impossible in a brief chapter to cover all areas of legal development, it is important to appreciate the enormous volume of legislation that has affected all sectors of the economy. For example, beginning with the law 'On Environmental Protection' of 25 June 1991, the system for environmental protection was supplemented with measures that could lead to rigorous regulation and significant fines. So far, the most serious environmental fines have been imposed by ports against western ships for water pollution, but the potential is there for broader enforcement. Western investors should take precautions to avoid exposure to such liabilities at the outset, beginning by conducting environmental audits of sites of factories being acquired or of 'greenfield' sites for new construction.

Another legislative example is in the telecommunications market, which is being reorganised to allow Ukrainian television to be privatised and permit significant foreign investment. On a practical note, it remains important to deal regularly with the ministries and administrative agencies involved. Recent experience has shown, for instance, that even after obtaining a radio licence, continued attention is necessary to ensure that the licence is maintained.

Curiously, the recent law regulating media coverage restricts state-owned media coverage of the President, the Parliament and other state bodies to 3 per cent of air time, and prohibits any such coverage by non-state owned entities except by agreement. These restrictions might be tested by the Constitutional Court.

Other areas of extensive reform include laws on leasing, rental of agricultural land and labour. Regarding commercial transactions, the new law adopted on 21 October 1997 on pledges of moveable property provides for the creation of a national register along the lines of that used under the US Uniform Commercial Code. It should soon be approved by the President and become effective. It should allow, once the register is created, financings using personal property as security, marking a significant step in legal reform.

Some remaining problems

There are, however, a number of serious problems that need to be borne in mind when planning an investment or operating a business. For example, the general director of a Ukrainian company has broad powers to execute contracts binding the company, even if his actions exceed or violate restrictions in the company's charter or board resolutions. A number of Western companies have experienced problems with local general directors, installed at the request of their Ukrainian joint venture partners, who then acted with little regard for the limitations on their position. This is a potential problem that should be considered when agreeing an investment structure.

Likewise, many Western investors are surprised that there is no central registry of real property mortgages, making verification of prior charges extremely difficult. Another example of a problem experienced by western companies is discovering that there is a three-day deadline for responsive briefs in many court proceedings, thus giving little time for a company to react to new claims. There is little doubt that a central register of mortgages and a reasonable litigation timetable will be adopted in the future, but for now they remain examples of unexpected problems.

Finally, one interesting trend is the use of ECUs instead of US dollars as a hard currency reference point in Ukrainian legislation and regulation. Increasingly, Ukraine is looking to the European Union as a model to guide legal development.

The legal framework

Turning to an overview of the legal framework resulting from the developments described above, the Constitution has created a democracy based on separation of powers. Under the Constitution Parliament is the principal source of law, within the limits created by the Constitution. On many matters, however, law (meaning legally effective rules in the broad sense) can be created by decrees and other acts of the Cabinet of Ministers, to the extent that these are not in conflict with Parliamentary statutes and with the Constitution. The President also has broad Constitutional powers, including the ability to legislate by decree in a number of areas, to the extent that this is not in conflict with the Constitution or overriding Parliamentary statutes and Cabinet of Ministers' decrees.

These statutes, decrees and other regulations and acts create and define the powers of the numerous ministries, government departments, state committees and other government agencies and entities, many of which have received delegated authority to adopt their own regulations and interpretations that create effective law. For example, the National Bank of Ukraine applies an exchange control regime largely based on its decrees and interpretations. In the oil and gas sector, the SCG, the State

Committee on Oil and Gas and the Ministry of Economy adopt regulations that govern licensing and exploration, development and production operations as well as many of the applicable fees and taxes.

The President and the various ministries, departments and other government entities also act as the executive branch of government to implement these laws and decrees. The third branch, the judiciary, is composed principally of ordinary state courts that hear disputes involving individuals, arbitrage courts (these are not arbitration tribunals as that term is understood in the West, but instead a type of state court) that hear cases among companies, other legal entities and entrepreneurs (sole traders) and the Constitutional Court, described already, that independently interprets the Constitution.

Finally, it should be observed that the position of some government bodies and their interrelationships are still being defined. For example, the militia is supposed to enforce judgments of the state courts and arbitrage courts, but these courts have no direct power over the militia, which is subject to effective supervision only by the President. That said, there are fewer and fewer cases where the militia refuses to carry out a court order. However, instead of automatic enforcement, the prevailing party often has to deal directly with the militia rather than rely upon the court to enforce its judgment.

For those who have been in Ukraine since independence, the progress is impressive. Much remains to be done, especially in terms of implementation, to make the legal framework always function with the certainty of expectations that is essential as a basis for both foreign and domestic investment. However, the direction is positive and the future appears promising.