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**ROUNDTABLE ON ENTERPRISE DEVELOPMENT AND INVESTMENT CLIMATE IN
UKRAINE
(Kiev, 13 June 2006)**

SESSION 1: LEGAL FRAMEWORK FOR BUSINESS OPERATIONS

Summary of recommendations and issues for discussion¹

In light of the fundamental and systematic economic reforms needed in Ukraine and the pronounced “rule of law” (“verkhovenstvo prava”) policy, as well as on-going dramatic increase in foreign and domestic investment, it is imperative to ensure that Ukraine’s legal system is prepared to serve as a modern and adequate legal basis for the economy. The current legal basis is not only inadequate, but to a large extent it sabotages the development of a market economy in Ukraine.

There has been for many years various efforts made by the Government, international institutions, business organizations to conduct an inventory and evaluation of everything that has gone wrong with the legal framework for business in Ukraine. This evaluation, to a large extent, already has been accomplished: the problems and the proposed solutions were identified in great detail in several major recent reports, including: (i) the OECD Report on Improving the Conditions for Enterprise Development and the Investment Climate for Domestic and International Investors in Ukraine: Legal Issues With Regard to Business Operations and Investment; (ii) the UNDP Blue Ribbon Commission for Ukraine's “Proposals for the President: A New Wave of Reform”; (iii) the EBA Report on Barriers to Investment in Ukraine.

¹ The paper was prepared by Dr. Irina Paliashvili, President of the Russian-Ukrainian Legal Group, who was also the moderator of Session 1 of the OECD Roundtable in Kiev on 13 June 2006.

The main priority for the Government, therefore, should be to act, and to act swiftly and decisively. Ukraine's legal system can be improved immediately and dramatically just by cancelling the most archaic and damaging legislation, using the so called "guillotine" principle, which worked successfully in other countries that undertook modernization reforms.

What is also very important for this work is that the Government stays in constant contact with the business and investment communities. To this end, a number of practical measures is suggested, which basically center on making Government available for on-going dialogue with the business and investment communities, represented by various business groups (such as the European Business Association, AmCham, reputable industrial and trade associations, associations of small and medium-sized businesses, the business press, etc.). In particular: (i) the Cabinet should designate a Vice Prime Minister and one Deputy Minister in each Ministry, and assign to them the responsibility to act as a liaison with the business and investment communities; (ii) Government officials should actively participate in business conferences in Ukraine and abroad (which very rarely happened in the past); (iii) Government officials should attend meetings of various business groups and take immediate action on their concerns; (iv) the Government should create an analytical/monitoring body (perhaps on the basis of the current Committee on Entrepreneurship and Regulatory Policy) that will research, collect and summarize the problems that businesses are facing and swiftly react to them and hold Government bodies and individual officials accountable for violations.

OECD has been working for several years in close cooperation the Ukrainian Government, international institutions, and private sector to improve Ukraine's legislative environment and make the country more attractive to domestic and foreign investors alike. Based on this work, five key substantive problems in the current legal system were identified and the solutions were developed and recommended, as described below.

I. Civil and Commercial Codes

On 1 January 2004 two separate Codes, Civil Code and Commercial Code, took effect, becoming the new legal basis for civil and business relations in Ukraine. Both Codes were developed over the course of several years by two different drafting groups with very little or no coordination between them. The Civil Code covers relations among both individuals and legal entities and generally market-oriented, but contains many conflicted rules and flaws, which act as an impediment to enterprise development and investment. The Commercial Code covers relations among legal entities, and the State, and is clearly anti-market. For example, the Commercial Code severely restricts the freedom of contract and replaces such basic types of contract as sale-purchase with the archaic "supply" contract, which was used under the Soviet system. Moreover, the Commercial Code specifies that "supply" contracts will be further regulated by decrees from the Cabinet of Ministers.

With the two opposing Codes, Ukraine ended up with two fundamental laws, regulating largely the same subject, but being conceptually opposite and containing numerous specific conflicts. Moreover, each of these two Codes has many internal conflicts, and both of them conflict with other existing laws. Today, drafting any simple contract in Ukraine is a frustrating and impossible exercise in reconciling artificially created irreconcilable differences. Numerous other unnecessary

obstacles and hidden charges (some of them are described below) were created by both Codes that make full compliance with the law virtually impossible.

The consequences of this situation include not only serious impediments to enterprise development and investment, but also overwhelming number of court disputes, and create breeding ground for corruption in the regulatory authorities and in the court system.

Based on a thorough study of both Codes and two years of practice, OECD came to a recommendation, which is similar to the one made in the UNDP Blue Ribbon Commission Report's Key Recommendation #8 (out of 12): there is an urgent need "to abolish the anachronistic Economic [Commercial] Code and improve the market-oriented Civil Code". The "guillotine" principle should be applied in this case, and should bring an immediate and unequivocal end to the long and fruitless academic debates about which Code is better and how to reconcile them.

The Civil Code should be quickly and substantively improved, based on the Dutch Civil Code, which in a slightly transformed format, has been successfully applied in Russia and Kazakhstan for the last 10 years.

II. Corporate Legislation

Corporate legislation suffers from two major gaps: Ukraine urgently needs a Law on Joint-Stock Companies and a Law on Limited Liability Companies, which are the two most often used corporate structures in Ukraine. However, the good quality corporate laws cannot be developed until the problem of the irreconcilable Civil and Commercial Codes is resolved.

III. Antimonopoly Legislation

The unnecessarily broad and ambiguous antimonopoly legislation of Ukraine, which regulates coordinated actions and economic concentrations, and the formalistic and extremely low monetary thresholds for transactions requiring prior approval from the Antimonopoly Committee of Ukraine ("AMC"), force companies to seek AMC *prior approval* of actions that really have no bearing on competition in the Ukrainian market at all. In practice the AMC's prior approval requirement is frequently ignored, knowingly or unknowingly. The AMC, however, has extensive instruments for applying large and often unjustified sanctions for even minor violations. The solution would be: (i) to remove the prior approval requirement in many cases altogether, or to replace it in some cases with *notification* requirement; and (ii) to considerably increase the monetary thresholds for transactions requiring the AMC prior approval.

IV. Unnecessary Obstacles and Hidden Charges

Under the previous political regime, Ukraine was notorious for its bureaucratic red tape, its unnecessary barriers and serious charges that were disguised as various fees, fines, mandatory intermediary and commission payments, etc. Immediate and drastic measures are required to eliminate such unnecessary obstacles and hidden charges. Just a few examples:

- *The artificial, unnecessary, overly expensive and steadily increasing involvement of notaries in many aspects of business relations.* For example, a mandatory notarisation requirement was imposed on many routine transactions between legal entities for a notary fee of a hefty 1% of the value of the transaction. Thus, the new Civil Code introduced an unnecessary rule that all lease agreements, including between companies, whose term is one year or longer, are subject to notarisation, forcing all such lease agreements to carry a burden of an extra 1% for no added value. Another problem, partially created by the new Civil Code and partially by subsequent regulations, is complications with issuing powers of attorney, which businesses use in their operations all the time. First, an underlying contract is now required for a power of attorney to be issued (a requirement that does not exist in most legal systems of the world) and second, a power of attorney no longer can be broad, but must be very specific. Considering that the cost of notarising each power of attorney is around UAH 50 (\$10), this adds unnecessary complications and costs to doing business. The following measures are recommended for putting notarisation under control: (i) immediate cancellation of all unnecessary notarisation requirements; (ii) reducing notary fees for all remaining notarisations; (iii) returning to a simple power of attorney system with no underlying contract requirement and reintroducing a possibility for giving broad authorizations.
- *90-days rule.* This is a rule that was designed some time ago, allegedly to prevent capital flight, and which while failing this task, put a tremendous financial burden on legitimate business operations. Specifically, the tax authorities impose severe fines and sanctions when a Ukrainian business fails to receive hard currency proceeds from sales (in case of export contracts), or goods (in case of import contracts), under its international contracts within 90 days of the due date. Moreover, the fines are not limited to the amounts that the Ukrainian company in question failed to receive within 90 days, meaning that the imposition of fines continues indefinitely and can exceed the original unreceived amount by many times, and could theoretically bankrupt a company. The best recommendation here would be to remove this outdated 90-days rule altogether, because it has proved incapable of preventing capital flight, and only serves as an absurdly heavy burden on doing legitimate business.
- *Outdated requirements as to the form of contracts.* Modern business operations are often conducted electronically; the contracts are signed via fax or electronic mail and corporate seals are not used in most developed countries. It is interesting to note that in Ukraine, until the new Civil Code came into effect in 2004, the law only required that parties to a contract agree, in appropriate form, on certain essential terms and conditions. The lack of an imprint of a corporate seal on a signed agreement in most cases did not constitute a violation of the form of the agreement. The new Civil Code, however, demands that all contracts, domestic and international (including addenda, amendments, and other contractual documents) be signed with an original corporate seal affixed. Lack of a corporate seal can make the contract invalid. This is a big step backwards and a major inconvenience, so businesses continue making contracts ignoring the corporate seal requirements, which obviously puts the validity of numerous contracts in doubt and provokes unnecessary disputes. The recommendation with regard to this problem is to modernize the requirements as to the form of contracts, including accepting contracts

made by fax and other electronic means of communication and removing the corporate seal requirement altogether.

- *Unnecessary obstacles and hidden charges in the areas of the currency regime and the financial sector*, including: (i) overregulation of ordinary financial activities (for example, in order to issue a simple parent guarantee, a company needs to be registered with the State Commission of Ukraine for Regulation of Financial Services Markets of Ukraine); (ii) the requirement that any sale-purchase of Ukrainian securities (even outside of Ukraine between non-residents) must be carried out only with the participation of a Ukrainian securities trader; (iii) restrictions on inter-company loans; (iv) excessive licensing requirements by the NBU with regard to foreign currency transactions and payments outside Ukraine; and many others.
- *Ongoing restrictions on land ownership for foreign investors*, whereby Ukrainian subsidiaries of foreign companies still cannot acquire ownership of land plots in Ukraine.

V. Regulatory Governance and the Permits System

Another tremendous problem, which affects all businesses operating in Ukraine at all times, is the chaotic, arbitrary, excessive and incredibly costly overregulation and interference by the authorities in all spheres of business. It is loosely referred to as the “permits system”, or by the broader, internationally known term “regulatory governance”. Several half-hearted attempts to “deregulate” were made by various Ukrainian Governments, but in the absence of true political will, they generally resulted in more overregulation and more chaos. The latest effort to eliminate several thousands regulatory acts in 2005 did not achieve considerable results because the cancelled acts turned out to be archaic documents, which had little to do with business regulation and were not applied in practice in any case.

The solution to the above problem has been proposed by the OECD which, as a first step, suggested adopting a framework Law on Fundamentals of the Permits System as soon as possible, which shall achieve two major goals: (i) stop the abuse of entrepreneurs; and (ii) give a head start to establishing a modern, transparent and liberalized permits system, setting up its principles and its framework, including for enforcement, monitoring, appeals procedure and liability (for the abuse of the system by Government officials) mechanisms.