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Doing Business in UkraineTM

The Essential Legal Guide 2004/2005

Scott E. Brown

**Introduction by Dr. Daniel Thorniley
Senior Vice President
Economist Corporate Network (East European Group)**

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Senior Vice President
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Diplomats, economists and lawyers are unanimous in their praise for previous editions of the Frishberg & Partners Legal Reference Guide.

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"I highly appreciate your publications which we receive from time to time. You may be aware that we are quoting your firm as a reference firm. We know you and your colleagues as highly professional legal advisors in Ukrainian law. In all cases we were working together, we have appreciated your professionalism." Thomas Heidemann, Beiten Burkhardt, Moscow & Beiten Burkhardt, St. Petersburg

"Many thanks for your book on doing business in Ukraine. This is indeed an excellent work, and we will no doubt be consulting it in relation to any Ukrainian work we do." Lovells (Moscow Office)

"This is a great work, which I will definitely keep at hand should matters involving Ukraine ever materialize." White & Case (Warsaw Office)

"Since 1992 we have the pleasure of being the client of Frishberg & Partners, and recent results just confirm that this was and still is a very right choice." Sergey Fomenko, Commercial Manager (KLM Royal Dutch Airlines for Ukraine)

In summary, anyone with a business interest in Ukraine must own a copy of this current and comprehensive book.

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Sehr geehrte Damen und Herren!

Wir möchten Ihnen heute die **"Moskauer Deutsche Zeitung" (MDZ)** vorstellen – ein traditionsreiches Blatt, das bereits 1870 in Russland gegründet wurde. Nachdem die Zeitung im Jahre 1914 geschlossen wurde, haben wir 1998 wieder an die Tradition dieses deutschsprachigen Mediums in Moskau angeknüpft.

Seit nunmehr fünf Jahren sind wir mit Qualität und Kompetenz auf den Gebieten Politik, Wirtschaft, Gesellschaft und Kultur Russlands und der GUS am Markt vertreten. Die MDZ lesen heute Unternehmer und Politiker, deutschsprachige Geschäftsleute, Diplomaten und Touristen sowie russische Bürger und russische Unternehmer, die in den deutsch-russischen Beziehungen besonders engagiert sind und mit den deutschsprachigen Ländern zu tun haben. Alle zwei Wochen bekommen Sie auf 24 Seiten Informationen über alle Schnittstellen zwischen Deutschland und Russland, Aktivitäten deutscher Unternehmen in Russland und der GUS sowie Hintergrundanalysen anerkannter Spezialisten aus Russland und anderen Ländern zu aktuellen Themen. Außerdem enthält jede Ausgabe die Sonderbeilage "Wo und was in Moskau?" über das Kulturleben in der Hauptstadt, die besten Theater, Ausstellungen und Museen Moskaus, Restaurants, Bars, Klubs, Diskotheken, Fitnesscenter, Schönheitssalons und medizinische Einrichtungen.

Die MDZ plant für das laufende Jahr neue Projekte mit thematischen mehrfarbigen Sonderausgaben auf Hochglanzpapier.

Wir würden uns freuen, Ihnen als Wegweiser durch Russland dienen zu können.

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FRISHBERG & PARTNERS
*is one of the oldest and most experienced law firms
 with foreign ownership based in Kiev, Ukraine.*

Since the declaration of Ukraine's independence in 1991, we have accumulated a significant body of experience advising clients on a wide range of Ukrainian business law, including company registrations, mergers/ acquisitions, large and small scale privatization, securities/ banking law, timber and mineral rights, telecommunications, taxation, labor law, import/ export and intellectual property. In particular, we specialize in mergers and acquisitions, securities law, and real property transactions, including transfer of apartments, land use and lease rights, and large scale privatization.

Some of our recent clients include: Baltic Beverages; Bank Austria Creditanstalt; British Energy; Bruhn Internationale Transporte GmbH; Commerzbank Aktiengesellschaft; Credit Commercial de France; Deloitte & Touche; DUROPACK; FL Smidth & Co.; Freshfields Bruckhaus Deringer; Hewlett-Packard Company; Imanto AG; The Interpublic Group of Companies; (KIS) Quality Schools International; KLM Royal Dutch Airlines; KPN Royal Dutch Telecom; Linklaters & Alliance; Notaro & Michalos; Philips Electronics; Robert Fleming & Company, Ltd.; SCL Corporate Finance SA; Sealed Air Limited; Skanska East Europe OY; Theeuwes de Jong B.V.; The Investment Fund for Central and Eastern Europe (Danish Investment Fund); Thornkild Kristensen Properties AS; the former Embassy of Denmark in Ukraine; and, the Embassies of Austria and Sweden, as well as The US Embassy in Kyiv, among others.

When necessary, we draw on quality consultants from all pertinent areas in order to best achieve our clients' objectives in a timely fashion. Our attorneys also maintain personal relations with high-level officials of the Ukrainian government who influence the trade and investment climate.

In particular, we work closely with the State Property Fund in providing our clients with advice on a wide range of real property and privatization matters. In addition to legal assistance, our experienced consultants can provide a complete range of privatization-related services (including enterprise valuation and legal due diligence).

Direct contacts are also maintained with the largest and most competitive Ukrainian factories and institutes currently undergoing conversion and/or privatization.

FRISHBERG & PARTNERS
provides the following services:

- privatization-related services (including due diligence, structuring acquisition of controlling shares of stock and negotiating strategies as well as documenting the transfer of ownership);
- legal advice on Ukrainian business laws (including acquisition of apartments and buildings, joint venture formation, currency regulations, taxation, labor practices, among others);
- selection of appropriate business forms, drafting and registration of company documents for wholly-owned foreign subsidiaries, joint ventures and stock companies;
- real property title searches, transfer and registration of real estate acquisitions by foreign individuals or legal entities;
- negotiating and drafting investment and trade agreements with various Ukrainian production enterprises;
- supervising all Ukrainian and Russian language transactions of legal and business documents presented to the Ukrainian and foreign parties.

Our permanent residence in Kiev, Ukraine, staffed with qualified professionals and consultants, greatly enhances our clients' opportunities. For your information, we provide you with brief resumes of our attorneys and of counsel.

Please feel free to contact us if you have any questions concerning Ukrainian corporate legislation, or wish to learn more about the firm's practice and experience.

ATTORNEYS

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Author: "Ukraine's New Mortgage Law": *Eastern Europe Reporter*, January 2004, vol 14, #1; "Law "On Concessions" in Ukraine": *International Business Lawyer*, December 2003; "Higher Minimum Monthly Salary Means Higher Capitalization Requirements for Resident Companies": *Russia/Central Europe Executive Guide*, Vol. 13/ #5: March 15, 2003; "Ukraine and the Repayment of Credit to Non-residents": *World Corporate Finance Review*, Vol. 3/#2: Feb. 2003/ *Russia/Central Europe Executive Guide*, Vol. 13/#4: Feb. 28, 2003; "CD Piracy Saga: US Sanctions Applied Despite Passage of Law," *International Bar Association – Eastern European Forum News*, Vol.12/#1, June, 2002, *World Market Research Center*, March 21, 2002; "A Guide to Ukrainian Antimonopoly Legislation," *World Market Research Center*, February 14, 2002; "Industrial Land Lease," *World Market Research Center*, June 11, 2002; "The New Land Code," *World Market Research Center*, June 11, 2002; "New Rules for Joint Stock Companies," *International Bar Association – Eastern European Forum News*, Vol.12/#1, June, 2002, *Tax Planning And International Review*, Vol. 2/#3, March, 2002; "Privileges Taken Away Again," *International Bar Association – Eastern European Forum News*, Vol.12/#1, June, 2002, *Russia/Central Europe Executive Guide*, Vol. 12/#9, May 15, 2002, *Tax Planning And International Review*, Vol. 29/#4, April, 2002;

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Author: "From Russia With Cash": *Eastern Economist*, July 28, 2003; "Investment Trends in Ukraine — '99": *Financial Times: Power in East Europe*, Issue 18/ *IMPACTGlobal*, January, 2000/ *Survey of East European Law*, Vol. 10/#6. August, 1999; "Investment Trends in Ukraine — '98": *Business Links*, Vol. 3/#3, June, 1998/ *Eastern Economist*, June 15 & June 22, 1998/ *East-West Executive Guide*, Vol. 8/#6, June, 1998/ *European Legal Business*, Issue 3, July/August, 1998.

Co-Author: "A Ray of Sunshine: High-Tech Acquisitions in Ukraine: *Russia/Central Europe Executive Guide*, Vol. 10/#21, Nov. 30, 2000; "Searching the Silver Lining": *Eastern Economist*, Vol. 7/#43: Nov. 20-26, 2000; "Shareholder Rights in Ukraine": *Eastern European Forum Newsletter*, Vol. 11/#1: June, 2001 / *Russia/Central Europe Executive Guide*, Vol. 11/#4: Feb. 28, 2001.

Languages: English, Russian, Spanish.

Practice Areas: Privatization, Technical Assistance Projects, Due Diligence Preparation.

Regular speaker: Economist Intelligence Unit.

Preface

Here I am once again attempting to get a grasp of the “ever-expanding universe” of Ukrainian legislation. This edition of “Doing Business in Ukraine” posed an even greater challenge than the previous editions. Ukrainian law continues to change rapidly and the Ukrainian Parliament constantly amends the legislation with the aim of bringing it into close correspondence with European Union legislation and eventually entering the World Trade Organization. From January 1, 2004, a number of legislative acts simultaneously came into force, including new Civil, Customs and Commercial Codes, a law on mortgages, new taxation rules (flat tax for personal income tax and lower corporate tax), etc. Therefore, many of the updates in this book have only recently been put to the test in practice.

Ukraine represents a unique and potentially profitable investment target due to the expansion of the European Union up to Ukrainian borders, the success of the neighboring Russian economy and Ukraine’s population of 48 million. Ukraine’s size and highly educated, yet inexpensive, workforce also make it an interesting target for consumer goods companies, high-tech companies looking for software developers and companies interested in local production of goods or the processing of raw materials. While the economy has not yet experienced the boom we’ve all been waiting for over the past 10 years, all signs indicate that this boom may be right around the corner. Therefore, this book will prove to be a useful reference guide to Ukrainian legislation in various sectors of the economy and a traveling companion while carrying out business in Ukraine.

Much like Ukrainian legislation, the list of people contributing to the text and assisting in bringing the final version to fruition has also swollen to great proportions. I sincerely hope that I will not leave anyone out, but as it is impossible to be perfect I only hope that any omitted people will give me the benefit of the doubt and accept their omission as a basic human error. This being said, I would like to thank the following people: Alex and Lena Frishberg (Alex, is this the last one?), Alex D. Schay (thanks for helping me put this whole thing together), Valeriy Semenets and Andriy Rozhnov (for their continuing efforts and valuable contributions), Sergei Ivaniuk, Vladimir Lukovich, Christian Gessl (for once again giving support and ideas when needed most), Sergei Potabenko (a lot of facets of this book couldn’t have been done without you) Alexander Shevchenko (a.k.a. “Monster” — once again formatting and editing), Tanya Dzyadok (for helping me with the Ukrainian language and taxes) and all of the staff at Frishberg & Partners (Lena Avramenko, Vladimir Ivasiuk, Andrei Panasiuk, Vladimir Panasiuk, Anatoly Panasiuk, Anya Savitskaya, Nadya Dobrova, Natasha Samoylenko, Semyon Petrovich Tartakovsky, Galya Khmarskaya) for coping with me while writing this book.

I would also like to thank my family and friends in the United States (I love you Mom and Dad) as well as my extended Ukrainian family (Alexander Shapoval, the Kalnitskiys — Sasha and Lilya; the Ivanovs — Slavik, Olya and Vova; Vladimir Vasilievich and Tatiana Evtikhievna Kolomiyets; the Panasiuks — Marina, Anatoly, Andrei, Alla, Lilya, Michelle and Nicole; Vovka Vedomenko and all other “relatives” not forgotten) for support, love, tolerance and, most of all, loads of fun in life.

As always, we would like to point out that Ukrainian law in writing and Ukrainian law in practice can greatly differ in reality. Therefore, ***no parts of this publication should not be relied upon as legal advice*** due to the frequent changes in Ukrainian legislation. We strongly recommend seeking appropriate advice from experienced local experts before entering into any business transactions in Ukraine. Of course, if any questions arise regarding specific sections of this book, we also recommend requesting updated information before relying on this information for a transaction.

We hope this latest edition of “Doing Business in Ukraine” proves both interesting and useful. Please feel free to contact us anytime you wish to learn more about the firm’s practice or need any other information about Ukrainian legislation.

Scott E. Brown, Esq.
Frishberg & Partners

UKRAINE

Business developments

Until some three years ago Ukraine was a horrible market for 95% of Western companies trading and investing in the country. Some skeptics might say it still is! But sales for Western companies have definitely improved or boomed. The operating environment is tough: tax, bureaucracy, red-tape, licenses, corruption remain a major headache and make Ukraine one of the most challenging operating environments in the whole CEE region. Most Western executives still state that the environment is tougher than in Russia for example.

Ukraine from about 2000 benefited from some of the actions taken by the Yushchenko government, from the pick-up in the Russian economy, from import substitution, from an increase in real wages and the stabilisation of the hryvnia.

The most important business trend in Ukraine in the last 12 months has been the strong rise in sales by Western FMCGs, other consumer goods and food and beverage companies in the market. Such companies are reporting annual sales growth in Russia of about 25-35%, but many such companies are reporting better percentage sales growth in Ukraine. Obviously, the absolute size of the Ukraine market is invariably smaller for most Western companies than in Russia. The pick-up in real wages has been a key factor. Business in the real estate sector is also moving rapidly, and in the related retail sector, as new stores are built and Western retail investors look for premium sites. Construction therefore is also seeing resurgence.

The most significant operational change in the last 12 months has been Western companies upgrading their presence in the country: those trading from off-shore have gone for rep offices and those with rep offices have looked to set up legal entities or to revive dormant ones which they possessed. This is a manifest sign that these sectors of the business environment are looking up.

The size of the relevant markets in the CIS is typified by what I call the “85-10-5 rule”. For most of the kinds of companies cited above, 85% of their business is in Russia, 10% in Ukraine and 5% in the rest of the CIS. This is obviously a sweeping generalisation and does not apply of course to energy-related companies who do more in Kazakhstan and Azerbaijan. But many companies agree to this rule-of-thumb measure. Western companies have also seen their consumer goods sales and pharmaceutical sales rise 40-70% in markets such as Kazakhstan, but from a smaller base than in Russia or Ukraine.

One question is at the back or front of the minds of most executives: is this positive sales trend sustainable and will it be transferred to other sec-

tors of the economy for Western companies in heavy industry, engineering, chemicals, general manufacturing?

Sustainability: there is a 50-50 chance that this turns out to be a secure business trend over the next 1-4 years. One key issue is political stability and how President Kuchma will depart office and who will replace him. The issue for Mr Kuchma is how to leave office with immunity from prosecution and this will be the most important real political question for the country affecting all others. Although the president has been accused of malpractice, at the end of the day, for reasons of social peace a deal may well be done.

If in the best-case scenario, a reformer then wins the presidential slot, and Mr Yushchenko springs to mind, then much could go well for Ukraine. The outlook in Russia remains reasonable and so the Ukrainian economy will benefit from stability there.

Whether the positive business trends in consumer goods will be seen in others sectors, the answer may be yes, but very slowly.

Ukraine – one of the next carriages on the train of business development?

The global business environment is very tough for most companies around the world; growth figures in the developed markets for sales are often around 2-3%; the outlook for Germany and Japan and most of Western Europe for the next few years is weak. So more and more companies are looking to the emerging markets and East-Central Europe is featuring most in this equation.

Central Europe is attractive as several markets join the EU on May 1st 2004 — these are the first carriages on the train for business for the next 1-3 years. But competition is getting tighter and margins are also getting squeezed. So the next carriage of this business train is Russia, which is/will provide good growth options now, but also in the next 3-6 years. But then, too, business in Russia will mature, competition get tighter, premium prices fall. Then the next carriage on the train is/will be Ukraine where companies can look for the big growth numbers in 4-8 years. This is NOT to say that companies should postpone investment and planning until 2007. No, the argument is that when other emerging markets have, well, emerged, then Ukraine will remain for sometime a high-growth market, and there will not be many of those around in 2007-09.

Dr. Daniel Thorniley



Senior Vice President
Economist Corporate Network (East European Group)

INVESTMENT TRENDS

From Russia With Cash

As one of the primary gateways through which investment flows into any country, law firms are often a revealing barometer of current business trends. Since October, 1991, the Ukrainian corporate law firm of Frishberg & Partners has advised numerous embassies and multinationals. Such tenure renders the firm an effective “weather balloon” of Ukraine’s current investment climate. The undeniable truth, according to Alex Schay, a partner with Frishberg & Partners, is, “the Russian giants are taking over Ukraine, with Westerners following a regrettably distant second.”

“Russia is like a big faucet for Ukraine”, contends Ihor Khmarsky, managing director of DIALOG KIEV, one of Ukraine’s oldest providers of market research and purveyors of translation and other business services, “and the Russians can decide when to turn the faucet ‘on’ or ‘off.’ This fact, combined with the profitable nature of the oil & gas industry, gives Russian business the opportunity to pick and choose what they want from Ukraine. That’s just a fact of life, and there’s nothing Ukraine can do to change this reality.”

Most sources agree: Ukraine is being gradually scooped up by Russian money. Furthermore, ‘Western’ investors who wait a few years to take a serious look at Ukraine won’t find themselves negotiating with Ukrainians. Instead, they’ll find themselves sitting in Moscow, negotiating with Russian business interests, and the prices they will be discussing will be many times more than they are today.

Even Business Online’s reporters, Paul Starobin and Roman Olearchuk, who are quite bearish with respect to Ukraine, write this about Russian investment into Ukraine: “Big Russian conglomerates are snapping up refineries, metals factories, telcos, and milk plants.”

Roland Spitz, a partner in the Kiev & Moscow-based investment-advisory boutique, SARS CAPITAL, notes, “Due to the active penetration of capital into Ukraine, a number of key Ukrainian industries are increasingly being taken over and controlled by Russians.” He points out the following sectors as being of particular interest: 1) oil refining (70% — 85% of Ukrainian market under Russian control); 2) Ukraine’s retail petrol market (TNK has 600 gas stations, and LUKOil owns 200 gas stations, plus approximately 500 franchising stations); 3) mobile phone communications (MTS, ALFA); 4) the tire industry; 5) the Ukrainian food industry in general and the milk industry in particular; and, 6) perfumes.

The oil is not enough

When discussing Ukraine's impending privatization plans, Nadina Yarwood, Research Executive with the Vienna-based Economist Corporate Network, also sees a trend towards strong Russian investment into Ukraine. She notes, for instance, Talneft's (Russia) aspirations to acquire a controlling stake in the Ukrainian oil-processing firm, UkrTatNafta. Ms. Yarwood writes, "Talneft's plans reflect a broader trend towards increasing economic integration with Russia, which is no longer limited to ownership and transport co-operation in the hydrocarbons sector. In November, 2002, for example, Mobile TeleSystems (Russia) paid US \$194 million for a 57.7% stake in Ukrainian Mobile Communications (UMC), buying out state operator UkrTelekom, KPN (Netherlands) and Deutsche Telekom (Germany)."

Sergey Ivaniuk, Senior Associate with Ukrainian corporate law specialists Frishberg & Partners, and primary attorney representing KPN in the above-noted UMC-MTS transaction, offers more detail as to how big Russian investors operate. Ivaniuk says, "Russian profits from gas, oil and metallurgy are used to create large holding companies whose sole objective is to capture entire sectors of the Ukrainian economy." When asked, Ivaniuk estimates the value of such holding reserves to be in the neighborhood of, "several hundred million dollars."

His colleague at Frishberg & Partners, Senior Associate Vladimir Lukovich, adds, "The idea is to purchase percentages of specific industries / sectors (e.g.: oil, gas, foodprocessing, agriculture in general, and milk, in particular). Years from now, when these assets are sold to 'Western' investors, they will be sold not for hundreds of millions, but for tens of billions." As a final thought on the subject, Lukovich adds, "It would be safe to say that one will find Russian money and management at the helm of any serious Ukrainian export-trading company."

Of course, there are dissenters to the theory that Russian money and influence are playing a dominant role in Ukrainian business. For example, a seasoned American investor notes, "Russian investors to Ukraine have not been able to completely avoid the scandals which have made Ukraine infamous. I think you can argue that this is a case of Russians trying to play by Ukrainian rules, and getting burned. Thankfully, AES has shown foreign investors a model for large-scale, direct investment in the energy sector. Compare their success with Kyiv- OblEnerho and RivneOblEnerho to the debacle with Sumy-, Poltava-, Chernihiv-, and Kirovohrad- oblenerhos (Russian investments)."

For his part, Spitz (SARS CAPITAL) points out one area where Russian investment has made no dent in the Ukrainian economy. He writes,

"There is no Russian capital in ferrous metallurgy, and this industry covers over 22% of Ukrainian GNP and accounts for more than 30% of Ukrainian exports." Spitz also notes that it seems unpromising to penetrate the Ukrainian markets for beer and vodka.

Goldfingers

Still, the majority opinion seems to be that even if Russia can't swallow Ukraine politically, it will nevertheless gobble her up economically. According to official statistics gathered by the Economist Corporate Network, for example, Russia is Ukraine's fifth largest foreign investor. This noted, however, one must also remember that Cyprus is Ukraine's second largest source of foreign investment and The British Virgin Islands ranks sixth. Of course, a great deal of this offshore money (perhaps 50%) has Russian origins. The Economist Corporate Network's Nadina Yarwood suggests, for instance, that, "over one-quarter of all joint-ventures registered in Ukraine are established using Russian and Ukrainian capital routed through offshore centers." And Frishberg & Partners' Vladimir Lukovich adds, "In the long line of offshore owners helping to effectuate foreign investment into Ukraine, one will always find the presence of Moscow ears."

Thus, while it is impossible to state unequivocally that Russian money will one day dominate foreign investment into Ukraine and that, as a result, Western investors should throw their hat into the ring at once, a strong case can be made in defense of such an outlook, which begs the question: Why?

First of all, Ukraine reports substantial economic growth. Take, for example, the very impressive increase in Ukraine's Gross Domestic Product (GDP): 6% — 7% in 2001; growth of 3.5% — 4% for 2002, and similar increases in GDP anticipated for 2003. Notwithstanding substantial augmentation in the domestic economy, however, in 2001 Ukraine's rate of inflation stood at a remarkably low 6% annual rate and actually became slight negative (-0.6%) in 2002. This phenomenon created a realistic possibility for profit generation. The above-noted absence of an inflation problem has also resulted in a stable currency, growing National Bank (NBU) reserves, and an increased interest in Ukrainian corporate bond issuances.

It seems clear that Russian business interests have noticed these trends and the associated earning potential, and they are looking to Ukraine as a solid, long-term bet — a bet upon which they intend to capitalize to the greatest extent possible.

Alex D. Schay — Frishberg & Partners

Ukrainian Economy

I. HISTORICAL OVERVIEW AND TRADITIONS

Called the breadbasket of the Soviet Union, Ukraine lived up to this name with a well-developed agricultural sector, which was dominated by collective farms. In addition, it possessed a considerable mining industry and became strongly industrialized. Most of the industrial base was built on cheap imports of energy from other Soviet republics. With the dissolution of the former Soviet Union, the production network broke down gradually, leaving Ukraine cut off from its traditional import markets but still depending heavily on energy imports for its industry. This difficult situation and the transition process is well reflected in the strong decrease of GDP during this period (-67%), the decline of industrial and agricultural production, and worsening import-export statistics. As a heritage of Soviet times, energy consumption is extremely high and energy use inefficient. Exports are still dominated by raw materials, while imports are dominated by oil and gas.

1. Resources

A. Population and Workforce

Since independence, the population of Ukraine has decreased by more than 2 million to around 49 million. Shorter life expectancy and emigration are the consequences of deteriorating economic and social conditions during a transitional period. Emigration has a highly negative impact on the Ukrainian economy since people who decide to leave the country are often highly educated and prepared to take a risk in order to become successful.

Despite the crisis in Ukraine's educational system due to under-funding and a shortage of staff, the level of general education is still very high and the workforce is well-trained and hard working. As unemployment is high, salaries are moderate, providing a good basis for labor-intensive industries.

B. Natural Resources

With a land area of 603,700 sq. km, Ukraine is the second-largest European country. Most land is arable with some of the richest soils on the planet. A considerable part of the country is covered by forest. However, forestry and the wood-processing industry are quite underdeveloped. With untouched nature in the Carpathian Moun-

tains and an attractive coastline, tourism is set to develop in the near future. On the other hand, rich oil and gas fields are waiting to be developed along with other mineral resources.

C. Transport and Communication

From Soviet times, Ukraine inherited about 23,000 km of railway track, 250,000 km of roads, 14 airports and 7 commercial ports along the coastline. The quality of the transportation infrastructure has deteriorated significantly due to lack of funds.

The telecommunications infrastructure is still highly underdeveloped. Ukrtelekom's (Ukraine's state owned telecommunications monopoly) privatization has long been delayed, with only some shares sold to employees and pensioners so far. There are only two important telecommunications providers in the country.

II. ECONOMIC PERFORMANCE

1. General Data

Years of recession have brought Ukrainian GDP from 1990 to 1999 down by two-thirds. The year 1999 proved to be a turning point. For the first time in 10 years, recession came almost to a halt and industrial production rose by 4.3%. Starting from a very low level, 2000 and 2001 brought considerable growth in GDP and industrial output, an almost stable exchange rate compared with the USD and a balanced budget. The best performing industries, excluding the fuel and gas industries, were the wood and wood processing industries (+31.8%), the machinery and equipment industry (+24.9%), agriculture and food processing (+21.8%) and the light industry (+18.9%). Agricultural production was one of the high flyers in 2001 when the grain harvest was twice as high as in 1999. In 2002, the grain harvest was a catastrophe. Results in some areas were just a fourth of the previous year. In 2003, agriculture accounted for 13.4% of GDP, industry for 30.5% and the tertiary sector for 56.1%.

The state budget heavily relies on privatization income. However, privatization targets are never met. Keeping the budget balanced means keeping tight control of all expenses and delaying investment in the infrastructure and social sector. In 2003, the earnings of privatization were more realistic than in the previous years. By October, 1.74 billion UAH had been realized of the 2.15 billion UAH planned.

Indicators	1996	1997	1998	1999	2000	2001	2002	2003 (est.)
GDP Growth, %	-10,0	-3,0	-1,9	-0,2	5,9	9,1	4,5	8,5
Inflation, %	39,7	10,1	20,0	19,2	25,8	6,1	-0,6	8,5
Change in Industrial Output, %	-5,1	-1,8	-1,0	4,3	12,5	14,2	7,0	15,5
Budget Deficit, %	-3,2	-5,6	-2,7	-2,4	-0,8	-1,5	0,7	0,2
USD/UAH	1,830	1,862	2,450	4,130	5,440	5,320	5,600	5,33

2. Inflation and Interest Rate

In 2003, prices grew more than expected, especially at the beginning of the year. This was presumably caused by demand-side factors, in particular by panic purchases of the population stimulated by the bad grain harvest. As a result, the entire year's inflation was approximately 8.2%. This trend will slow down in 2004 when consumer prices are expected to grow by 6.6%. While inflation in 2003 was basically demand-driven, in 2004 it will be both, supply- and demand-driven. Demand-side factors include the consequences of the reduction of personal income tax, the further increase of the minimum wage, pension reform and the presidential elections, which traditionally have a positive impact on demand. On the other side, supply will be influenced by the already mentioned poor grain harvest and the increase in prices of bread and farinaceous food products.

The average annual interest rate for loans was 18% in 2003 and experts expect a stable level for 2004 followed by a slight decrease to 16.5% in 2005. High interest rate levels are another means of keeping inflation low.

3. Currency

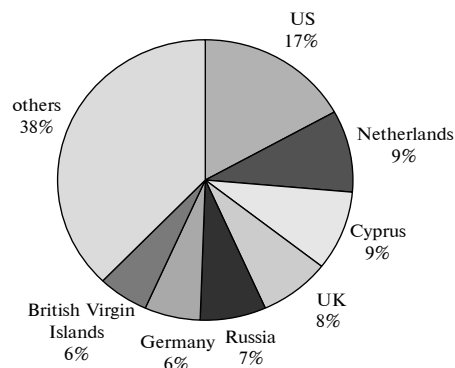
Over the last few years, the Ukrainian currency kept quite stable against the USD at an exchange rate of 5.33 UAH to 1 USD and thus devaluing against the EUR. Most probably, this policy is being pursued in order to avoid a negative influence on oil imports, which are traditionally done in USD worldwide. Furthermore, imports to the Euro-area became cheaper and grew considerably.

4. Foreign Direct Investment

Compared to other countries in the region, FDI in Ukraine is very low as a whole, as well as per capita. In 2001, around USD 650 million of FDI were registered in Ukraine, down nearly by 10 percent compared to 2000. After two years of economic growth, however,

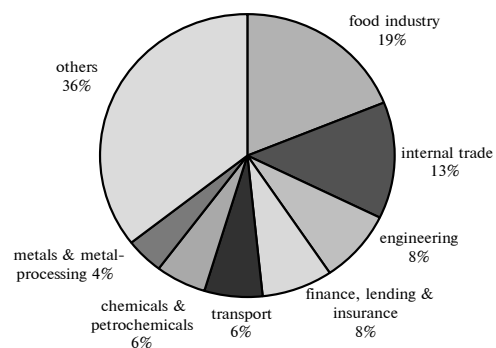
interest in investing in Ukraine is returning. In 2003, net FDI amounted to USD 1.1 billion. Lately Ukraine has been rated as one of the countries with the best ROI worldwide. Over 2004, net FDI inflow is expected to amount to USD 1 billion.

FDI by country of origin, 2003



Investment from Cyprus and the British Virgins Islands consists mainly of Russian and Ukrainian offshore capital flowing back into the economy. Lately, there has also been a significant increase in Russian capital inflow into the Ukrainian economy.

Sectors of FDI, 2003



Popular sectors for FDI are light industries, especially the profitable food industry and trade. There were also significant investments in the banking and finance sector as well as in transport and logistics. The main problems for international investors are the constant changes of taxation law and unstable legal security.

5. Foreign Trade

While GDP and production decreased, foreign trade showed dynamic growth at the beginning of the reforms. After a slight decrease during the crisis of 1998/1999, foreign trade volumes rose again, generating a small trade surplus in 2000 and 2001. In 2002, exporters faced difficulties as the value of the Hryvnia appreciated against the US dollar and the Euro, making Ukrainian exports increasingly expensive. In the following year, the National Bank of Ukraine succeeded in stabilizing the currency against the Dollar, implying a loss in value against the Euro.

The countries of the former Soviet Union, in particular Russia where energy is imported from, are Ukraine's major trading partners. The main export destination is also Russia, followed by Western European countries.

In 2003, the current account balance deteriorated but still remained fairly high due to increased service exports and increased capital transfers into the country, in particular by thousands of Ukrainians working abroad. The balance is expected to shrink from USD 3 billion in 2003 to USD 2.5 billion in 2004.

Ukrainian products have become more competitive on international markets owing to the drop in the actual effective exchange rate during 2003. The external situation proved to be very favorable, purchasing power abroad was high and Ukrainian producers would rather exports their merchandise than sell it on the domestic market. The high import growth rate of 32% in 2003 is mostly attributable to imports of agricultural and chemical products, and machinery and equipment. Investments in fixed assets rose considerably in 2003 owing to an increased cash flow coming from brisker exports. However, the import growth rate will slow down somewhat in 2004.

The completion of negotiations about accession to the WTO will have considerably positive impacts on the Ukrainian economy. Although Ukraine is also in the process of forming a minor form of economic union with Russia, Belarus and Kazakhstan (CEA), the country is expected to become a member of the WTO at the beginning of 2005.

In September 2003, Ukraine signed an agreement with Russia, Belarus and Kazakhstan with respect to a Common Economic Area, which includes a customs union, abolishment of trade barriers and, finally, the handing over of a part of state sovereignty to a central government. The agreement is stipulated so vaguely that no legal consequences can

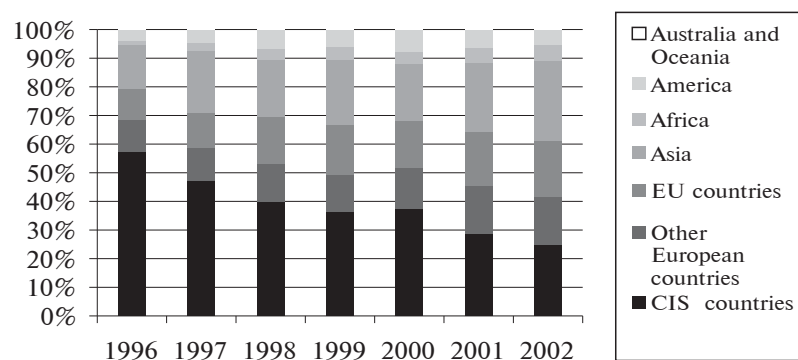
be taken in case of non-performance. Reactions of European Union officers to this step were skeptical or negative. The European Union has so far refused to grant Ukraine the status of “associate member” which the country’s government persistently requested in 2003.

The accession of ten new states to the European Union will substantially affect Ukrainian exports to these countries. There will be positive as well as negative impacts. In the short-term, Ukraine’s exports will shrink by an estimated USD 320-340 million annually due to non-tariff restrictions. Technical, sanitary and veterinary EU regulations will make exports to the new member countries more difficult, while stricter anti-dumping measures will be applied along with EU quotas on metal imports extended to the accession countries, which implies lower Ukrainian exports to these countries. On the other hand, exports could be boosted by higher purchasing power in the fast growing new EU nations and by lower future customs tariffs with Poland, Hungary, Slovakia and the Czech Republic. In the medium term, the implications of the EU enlargement will depend on the quality of Ukraine’s foreign trade policy and its accession to the WTO.

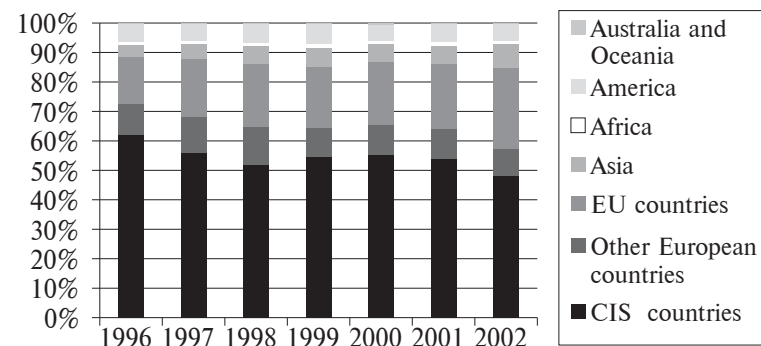
6. Structure of Foreign Trade

The number and structure of Ukraine’s trading partners have changed over the last years. As can be seen from the following graph, the countries of the former Soviet Union still dominate Ukraine’s export and import sector but are consistently losing importance.

Destination of Exports



Origin of Imports

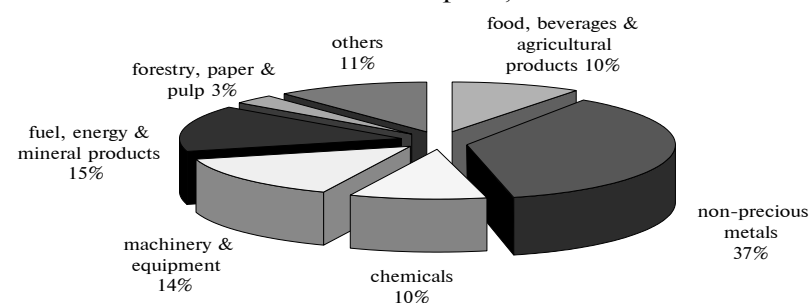


Source: Ukrainian Statistical Committee

The Ukrainian export structure has also changed considerably over the years. While exports in the early Nineties were still dominated by oil and oil-products bought at preferential rates from Russia, these exports dropped along with the price increases in Russia. Since then, the main export items are products from ferrous metallurgy, metal scrap, clothes and oil seeds.

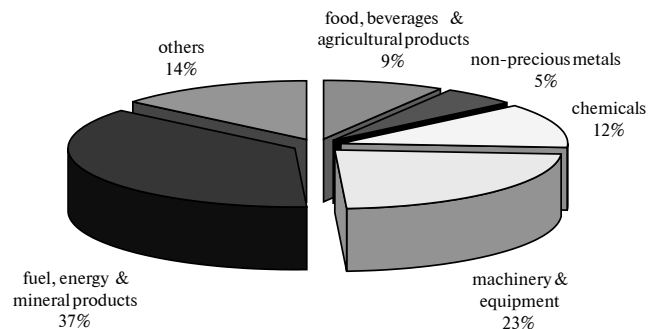
As with most developing countries, a large share of exported products is of low processing degree (agricultural commodities, mineral products, and ferrous metals). Highly elaborated Ukrainian goods are mainly consumed domestically or in former Soviet countries since they can hardly compete with Western quality. However, trade volumes with the European Union are picking up at the expense of former Soviet Countries. A tendency to export more labor-intensive products can be observed in most CEE-countries in order to make better use of their stock of well-trained and cheap human capital. The key factor for this development was the inflow of European Union capital and Western management know-how.

Ukrainian Exports, 2003



Imports to Ukraine are traditionally dominated by energy – mainly from Russia, Turkmenistan and Kazakhstan – and consumer products from EU- and MOEL-countries. Ukraine has one of the highest energy consumption rates compared with per capita GDP and there is no change of this situation in sight. A big share of machinery and equipment in imports is typical for emerging market economies.

Ukrainian Imports, 2003



This economic overview was kindly provided by Christian Gessl the Commercial Counsellor at the Austrian Embassy in Ukraine 48-A Volodymyrs'ka St., 01034 Kyiv, Ukraine.

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THE MACHINE BUILDING INDUSTRY IN UKRAINE

1. Development and Historical Background

The machine building industry in Ukraine has a long traditional history, which started in the 80's of the 19th century when in Kiev, Odessa and Kharkiv companies started to construct agricultural machines. Due to Ukraine's fertile soil, Ukraine was known as the "breadbasket" of the Tsarist Empire and the Soviet Union. In order to cultivate the soil and provide for transportation and further production in the food industry, machinery was much an absolute necessity. Later, the coal-rich Donbas region and the dense industrial area of Dnepropetrovsk developed as centers for the mining and metallurgical industries, in Mykolajiv and Kherson the ship-building industry developed, and in Odessa, Kirovograd and Kharkiv well-known machine constructors founded branches for the manufacturing of agricultural machinery. In the Soviet Union, the Ukrainian machine building industry was the technology leader in aerospace technology, airplane construction (Antonov-factory), transport ships, engines (turbines) and other fields of technology.

With the fall of the Soviet Union and the independence of Ukraine in 1991, the centrally planned economy finally broke down. Customers of Ukrainian factories found themselves unable to pay and, due to this loss of a guaranteed market and the sudden loss of demand, mass production was under the present circumstances no longer profitable. Furthermore, worldwide innovation in the high-tech sector was so quick that Ukrainian products were simply not competitive.

Production facilities were not yet modernized upon the break up of the Soviet Union, especially in automation technology, in energy production and distribution, as well as in oil production and distribution. As a result, there were no resources for replacement. During recent years, the industry has recovered and has even experienced a boom in growth. In 2000, growth was almost 17% and the following year approximately 19%, only slowing down in 2002 to 8% but regaining speed again in 2003.

Growth 2000 – 2003:

2000	2001	2002	2003
16.8%	18.8%	8%	5.8%

The main reason for the productive growth rates were, on the one hand, the positive development of the global export of Ukrainian products mainly in metallurgy and the chemical industry and, on the other hand,

the positive rate of domestic demand. Consequently, liquidity increased, while barter decreased. Net profit in the industry was two times higher in 2001 than in 2000, and interest rates for bank credits in Ukrainian Hryvnia sank from more than 40% per annum in 2000 to 18% in 2003. In comparison, interest rates for hard currency loans sank from 18% to 11% in 2003. Moreover, new legislation regarding taxation and investments facilitated development.

2. Importance of the Industry for Ukraine

From January until September of 2003, growth in the machine building industry was more than 30%. Astonishingly, the development of the vehicles sector grew almost 60%. This was due to strong demand from Russia for transportation vehicles, an extremely protectionist tariff policy and an increase of private income, which in aggregate had a very positive impact.

The machine building industry contributed during the first 10 months of 2003 to about 13% of the total industry production, and industry accounted for 30% of the total GDP. The growth rate of industry was about 15.7% for the first ten months of 2003, however it reached 33% in the machine building sector supported by related industries like petrochemicals, metallurgies and food. This development will ultimately slow down, yet it will still provide interesting growth rates over the next years.

3. The Current Situation

Expenditures for modernization of machinery grew rapidly and, in 2001, more than 13 billion UAH were invested into machine inventory, resulting in approximately 40% of the total investment in the industry. On the other hand, there are still enormous over capacities, which also must be remedied. Furthermore, from a financial point of view, many companies face economic problems resulting in a lack of money for research and development. Another major problem is the lack of marketing knowledge.

On the other side of the coin, there are various considerable advantages, for example the cheap and highly qualified workforce and the existence of vast mineral resources. The aeroplane production industry, the aerospace industry and the ship-building industry are all competitive with Western industries and, therefore, offer interesting products of surprisingly good quality.

4. Distribution

Foreign exporters should have at least a sales representative or representative office in one of the major cities, as it is better to monitor and

develop the Ukrainian market from a domestic point of view rather than as an attached market of Russia. Companies wishing to enter the spare parts market may establish a legal entity in simple form.

5. Trends and Summary

Generally, old or bankrupt facilities are bought out and modernized by potent investors or banks. This notwithstanding, demand will continue to rise and the most interesting sectors will be the rapidly growing sectors such as transportation vehicle manufacturing, the food industry, the chemical industry, construction, metallurgy and, especially, automation machinery. There is currently a rapidly growing semi-finished product sector as well, such as the frozen food and fast food industries.

Up to now, the most successful companies on the market were those that offered the best price, thus cheap but old machines were bought. Nowadays, however, there is a trend to purchase modern equipment as Ukrainian companies strive to get ahead of their competitors. Packaging and logistics are becoming more important with rapid market changes and customers now demand a package of goods and services consisting of projection, delivery, installation and after-sales-service with financing also becoming a decisive factor.

BUILDING MATERIALS

1. Historical Development

Before the fall of the Soviet Union, Ukraine already had a well-developed building materials industry and was the center of building material production because the country has prominent resources of china clay (kaolin), limestone, fire clays, granite, gypsum and glass sands.

Nowadays Ukraine still has a very strong building material sector and in all major sectors more than half of the products are produced domestically. In 2003, the Ukrainian economy grew approximately 8% and the building industry contributed to this growth with an expansion of 25%. The current share of the building industry in the total GDP is approximately 3.5%. The building material industry considerably profited by this development and also grew by 20% in 2003. Due to the plans of the government (i.e., the construction of power plants, expansion of the underground, etc.) and the strong promotion of housing, continued growth can be expected. Thus, export and domestic production of building material are quite interesting sectors of the economy. Today, there are more than 1,000 domestic producers of which more than 90% are privately owned.

2. Situation in the Industry

The industry is currently fragmented into several sectors, yet they all have one feature in common, namely there is considerable domestic production and cheap imports from the former Soviet countries and, where possible, high value imports from Western countries. However, the product range in the sectors is not as broad as in developed Western markets. Total building material production in the first 11 months of 2003 amounted to 6.1 billion UAH implying an increase of 16.9% from the previous year. The most traded goods in this sector are dry building substances such as cement and salts. In 2003, 207,017,000 USD of such products were exported while materials worth 137,518,000 USD were imported. Apart from dry building substances, ceramics products account for the biggest part of imports and glass products for exports. The prices in spring, summer and fall are typically higher than in winter due to the stoppage of construction and renovation projects as a consequence of unfavorable weather.

Some of the most important sectors of the industry described in detail below:

a) Dry Building Material

In 2001, the total market volume in this sector was approximately 350,000 tons of which 150,000 tons were imported. There are around 100

domestic companies in the market but only five of them (Pawlograd Schylstroj, Henkel-Bautechnik, Fomalgaut, Polirem, Gelios) control 70% of the domestic production. As one can see, Henkel Bautechnik is an affiliated company of the German Henkel group and already a major player on the market. Domestic products often face quality problems. As a result, most imports come from Poland and Turkey (basically gypsum products) and there are western companies as well from Italy, Germany and France, which import high quality products. In the near future, the market will grow significantly with experts estimating the market to reach 500,000 tons in 2003 and, consequently, more companies will enter the market. The product range will also broaden since in Ukraine only 20 different products are offered compared to 300 in Western Europe.

b) Ceramic Tiles

The total ceramic tile market reached approximately 130 million USD in value in 2001 and about 20 million square meters in volume. As in many other sectors, low value products are produced domestically and high value products are imported. Only about 40% of the ceramic tiles in Ukraine are of Ukrainian origin, and of all importing countries Spain accounts for the majority of all imports followed by Italy.

In Ukraine, 7 million m² of ceramic tiles is produced, which has a value of only approximately 14 million USD, meaning that Ukrainian products account for one third in quantity but only for one tenth in value of the market. Sales of domestic products to the local market have remained constant over the last three years rendering the participation of Ukrainian ceramic producing companies in the market growth almost obsolete. This is a result of outdated production facilities and a lack of quality and marketing know-how. Currently, there are 10 local producers of which the most successful are Kharkiv Ceramic Tiles Plant, Lviv Ceramic Plant and Kiev Ceramic Plant.

There are some interesting peculiarities on the market, for example major trade companies attempt to integrate backwards and establish their own ceramic tile production. Experts expect the market to grow sharply up to 40 million m² or more in the coming years. Owing to this growth there are still export possibilities. However, direct investment is becoming more lucrative since competition is tight and custom duties are on the rise.

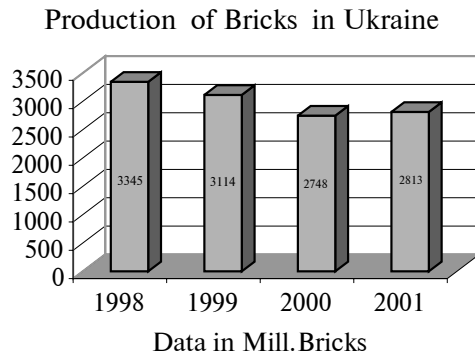
c) Paints and Varnishes

The total volume of paints and varnish sales is about 180,000 tons of which 25% are imported. The imported share, however, accounts for 60% in value. There are basically two categories of imports: (i) high-end

importers from Western countries (Scandinavia, Germany, England and Netherlands) and (ii) importers of cheap products from the former Soviet countries, especially Russia. Among the ten domestic production companies, "Dnipropetrovskiy LFZ" from Dnepopetrovsk is the largest company with a total output of 30-35 thousand tons, which is considerably greater than the 6 thousand tons from Lakma, the Kiev-based second largest company. Within the near future, domestic production will rise and companies will focus on specialization within the product range. Furthermore, the expensive and high-quality product share constantly increases and offers good export possibilities.

d) Bricks

In 2001, more than 200 companies produced approximately 2.8 billion bricks and comparable products; however, production has decreased during the past three years.



The tightest competition is in Kiev, where two out of three of the biggest production companies are located. High transportation costs make the market entry for exporters difficult and economies of scale give domestic producers an additional advantage. Since there are no mentionable imports and Ukrainian companies attempt to grow within the country, competition constantly increases.

3. Customer Structure

Over the past few years, the preferences of customers have evolved and, currently, price and quality are the decisive factors to be successful on the market. Western products have the image of high quality, making consumers willing to pay a higher price for them. Direct end-users may be sub-divided into two categories: (i) general consumers and (ii) collective consumers.

General consumers shape the market into two distinct spheres: (1) The market for the "average" Ukrainian citizen, and (2) the market for the "nouveau riche".

The general consumer in Ukraine expects construction materials of good quality but within an affordable price range. Many average consumers are renovating their apartments and "dachas" (summerhouses) at their own expense and with their own resources. The most frequently requested products include wall coverings, floorings, ceramic tiles, paints, insulation materials, and bathroom and kitchen fixtures. General consumers primarily purchase these building materials in specialized retail stores. Unfortunately, not all the products shown in catalogues or on display may be available for sale. Therefore, the consumer is often unable to find all materials necessary for complete renovation.

Due to the high prices charged at small specialty shops, bazaars or markets still dominate in the distribution of cheap building materials. In Kiev alone there are more than a dozen bazaars where building materials of local, Polish, and Turkish origin may be purchased at reasonable prices.

Ukraine's "nouveau riche" includes both Ukrainian and Western businessmen who demand Western-standard office and living space (which often goes for US \$1,000 per square meter). Typically, new residential construction uses expensive imported materials; apartments are elaborate consisting of at least 5-6 rooms. This new "elite class" is spending large amounts of money on the construction of new, single-family luxury "cottage" homes, which boast spacious rooms and gardens, swimming pools, high fences, and state-of-the-art security systems. This sub-group of general consumers prefers to renovate their residential premises with the assistance of local or foreign construction contractors.

Direct collective end-users include private local and foreign companies and Ukrainian state-owned companies, institutions, and organizations. The number of local and foreign private companies operating on the Ukrainian market is rising due to the demand for renovation and construction services. Collective customers use the services of local or foreign construction contractors. The general cost of construction services often includes the estimated cost of building materials before the contract is signed. Price, quality, and style in modern construction design, as well as the preferences of clients, play a major role in the final cost of a construction project.

Indirect end Users

Local and foreign construction contractors are the indirect end-users of building materials. These are private and state-owned local con-

tractors and foreign private contractors. Contractors are the prized category of customers for distributors of building materials since they buy in volume and on a regular basis. Foreign contractors sub-contract to small Ukrainian companies or employ local construction specialists. There are more than a dozen foreign construction contractors in Ukraine dealing with the construction and renovation of state-owned property, commercial property, single family homes, industrial premises, and warehouses. Austrian, British, German, Polish, South Korean, Turkish, and to a smaller extent French, Italian contractors have also been active on the Ukrainian construction market.

The Ukrainian supply system for building materials differs from supply systems in the West. Buyers must deal with a collection of small, poorly-organized stores, which are strapped with low inventories, poor customer service and high prices. Utilizing distributors helps in expanding foreign supply links and the assortment of products.

Building material stores also exist, which are rated highly by consumers based on stock availability, assortment, price, and customer service. Major distributors work through their own network of shops and usually conduct wholesale and retail trade directly from their own warehouses.

Distributors of windows, doors, roofing, flooring materials and drop ceilings often provide installation and other services for consumers. There are a few "elite" stores located in the center of Kiev, however their prices are nearly double the average retail prices and even their stock, choice and brand name products are not entirely satisfactory.

Presently, there are few one-stop shopping centers where consumers may find all building products and services to meet their needs at a time. Often, consumers must spend tremendous amounts of time in a multitude of stores to find specific building or even basic materials. Some contractors have direct supply contracts with foreign or local suppliers of building materials. Unfortunately, materials selected at stores may not actually be available.

Most foreign producers try to cooperate with domestic distributors, who have important insight into the markets and know the administrative processes. However, it can be quite difficult to find a reliable and competent partner.

The Building Industry

The biggest domestic construction companies are Kievmiskbud, Kievmetro-bud and Ukrrestavrazija, which are all located in Kiev, while there is an

organization of building material producers (Ukrbudmaterialy) and another organization of cement producers (Ukrtsement). According to a decision of the Ukrainian government, approximately 44 million m² of housing space must be created by 2004, a very ambitious goal to say the least. By way of comparison, in 2001, about 6 million m² of housing space was built and Kievmiskbud constructed more than 600,000 m² in Kiev alone.

The major investments in the building industry take place in the cities (Kyiv, Donez'ka obl., Dnipropetrows'ka obl., Odes'ka obl.) and, consequently, the market for building material develops in the cities at a much faster pace.

4. Market Entry of New Companies

In many sectors of the industry, more and more companies will enter into the markets. The government tries to protect the domestic industry, which makes import more difficult, however it is still a good option for entering the market. There are import duties on building material from 10-25% and, furthermore, items crossing the Ukrainian customs borders are subject to sanitary, veterinary, radiological, and ecological customs regulations. Goods can only pass the border if they meet all regulations. There are nowadays custom brokers taking care of imports whose fees can range from 200 USD to 300 USD.

5. Summary and Forecasts

The Ukrainian market for building materials offers sound opportunities to exporters. The developing Ukrainian construction industry is constantly on the look out for new supply sources and contacts. Domestic production of building materials is lagging due to increasing energy costs, obsolete technology and aging facilities. These conditions have increased prices for locally produced products, which in turn have opened up the market for Western products. Presently, the Ukrainian market for building materials is highly competitive with German, Italian, Scandinavian, French, and Spanish exporters aggressively promoting their products. Many well-known European brands are represented at construction exhibitions and shows held in Kiev. However, distribution systems are still in the process of development where even major distributors are not able to serve as one-stop shops and consumers spend entirely too much time searching for products of quality with reasonable prices. In spite of the underdeveloped economy, price and quality are the decisive factors in consumer choice. It should be highlighted, however, that not all imported products have high potential in Ukraine.

AGRICULTURE IN UKRAINE

1. Historical Development and General Information

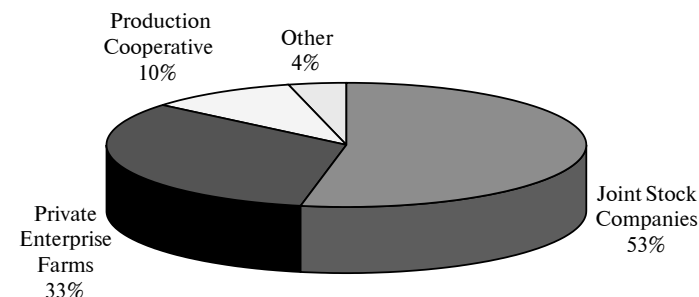
Ukraine has a total area of 603.000 km², 55% of which is composed of arable land and 12% as grassland. Among the numerous types of soil, "black earth" is the most fertile and 40% of the world's black earth is located in Ukraine. The climate is generally continental, however in Crimea the climate is subtropical and comparable with the Mediterranean climate. Therefore, the climate and soil of Ukraine are excellent for profitable agricultural production. Organizational structures are still problematic due to the Soviet past and land reforms have not been very successful up to now. Officially the agricultural sector accounts for 15% of Gross National Product and among 12% of population works in this industry. The average household income in this sector in 2002 was approximately 470 UAH per month. The remuneration for labor is provided largely in cash but also in agricultural products.

In Ukraine, a prompt change from the tsarist feudal system to the communistic centrally planned economy took place, except in the West, which was part of the Austrian-Hungarian Monarchy and only later became part of the Soviet Union. During the Soviet era all land officially belonged to the state and, in 1992, the first land reforms were introduced, which originally met with the resistance of the Communist party. This reform transferred the ownership of land from the state to collective agricultural companies. In the second stage, the shareholders of such agricultural companies received Land Certificates, which provided them with the right to buyout parts of the land. This law was not implemented and only in 1999 the land reform process was encouraged by Presidential Decree. One year later, the final enforcement took place. The third and final step of land reforms is the transfer of public documents to the owners of Land Certificates.

In 2001, a new land code was passed allowing domestic legal entities as well as domestic natural persons to purchase arable land subject to a limit of 100 hectares between 2005 and 2010.

1.1 Structure of Ownership

Nowadays there are two major forms of agricultural companies, namely private family farms, which emerged for the first time in the late 1980's and to this day are mostly small-scale production units; and large-scale agricultural enterprises, which inherited many of the assets and resources of the former collective agricultural farms and still have large-scale operations.



Despite the fact that private farms have a slightly longer tradition, large agricultural companies employ far more specialists of former collective agricultural enterprises. One consequence of the land reforms was a change in the size of agricultural companies. Specifically, in comparison to the '90s, private farms have increased their sizes, while reformed agricultural enterprises have become somewhat smaller, yet still much larger than private farms. The average size of the overall area of all private farms is 48 hectares and for agricultural companies 1513 hectares. According to previous years, these figures were 45 hectares and 1561 hectares respectively. This is an indication of the steady growth of private farms and the development of land lease legislation. Different specialization and the availability and possibility to purchase farm land may also be an explanation. A commonly known fact in Ukrainian farming operations is the high percentage of arable land in the overall area of an agricultural enterprise, which percentage rate varies in different regions but has an overall figure of 93%.

2. Current Situation in the Industry

The 15,000 Ukrainian agricultural companies do not currently possess much earning power. The major problems of the industry are the lack of financial resources, the low level of technical and economical knowledge, an undeveloped insurance market and a poor infrastructure. Further, there still exist remnants of demand-oriented production and therefore a lack in competition. Financing is a major problem as credit is extremely expensive with up to a 40% interest rate. This is due to the fact that pursuant to current legislation agricultural land cannot be sold and therefore has no value for banks.

2003 was a catastrophe for the Ukrainian agriculture sector. With grain production at just half of 2002 and wheat used for making bread, the harvest has not even reached a one-fourth of normal levels. The average harvest of wheat fell from 20 tons per hectare to 4.5 tons. However, corn and sunflowers achieved above-average results. The bad harvest had direct neg-

ative effects on milk production, which has decreased considerably, and so has general livestock with the exception of chicken. Due to low meat prices it is not profitable for farmers anymore to feed their livestock with expensive grain. This trend will continue in 2004, but in 2005 improved fodder supplies should stimulate a 3% increase in meat and dairy production.

Due to inaccurate statistical harvest data in 2002, too much grain had been exported and reserves for 2003 were too low to meet the Ukrainian demand. In 2002, the country exported more cereal than ever for a price of 81 USD per ton. The following year it was forced to purchase about 400,000 tons a month on the international market at very high prices, namely approximately 100USD. Together with transportation costs, financing costs and phyto-sanitary costs, the difference between the selling price and buying price was about 100 USD per ton, and multiplied by the quantity the total loss is about 480 Mill. USD, which is quite high compared to the GDP of 41 billion USD. In addition, bread prices, a traditionally political price, rose accordingly.

The results of last year raise the question of how successful the agricultural reforms of the government have been. However, experts believe that a basic positive development will continue and the recent deterioration was an exception due to bad weather.

Most of the agricultural businesses are specialized in growing grain and technical crops. Winter wheat, spring barley and corn for grain are the main crops harvested. As it turned out, however, winter wheat is the most frequently used crop at private family farms, but only in low volumes. This is basically because small operations cannot compete with the large-scale agricultural businesses where the wheat industry has become a highly technological and profitable business.

Technical crops in Ukraine are represented by sunflowers, sugar beets and canola. Due to the relatively high profitability of sunflowers, small farms also attempt to harvest these crops. While agricultural enterprises produce grain and technical crops, smaller family farms are responsible for vegetables and fruits. As a result, they are somewhat niche-players, allowing them to survive in the business and even expand, albeit slowly. The main reasons for the choice of special grain crops are high yield and high quality of products, ranking them second in Ukraine.

The cost of production is another important topic for the industry with the cost structure of family farms and agricultural enterprises being quite similar. The main differences are the cost of field work, which is slightly lower for agricultural enterprises, and the purchase of seeds and mineral fertilizers, which is the only factor that is lower for family farms.

The costs of field work are higher due to bad equipment and a lack of economies of scale. This also explains the higher costs for seeds. The less frequent use of mineral fertilizers in family farms is the main reasons for the lower costs in this area.

The existing machinery in the industry is old and not very cost-effective. Since the availability of domestic machinery is insufficient and of low quality there is a strong market demand for such equipment. Most agricultural companies simply cannot afford such machinery due to the overall poor financial situation in the country and especially due to the dreadful year of 2003. Therefore, the opportunities to sell machinery to Ukrainian farmers are minimal. For example, in Ukraine about 200 combine harvesters were sold in 2002 in comparison to 1,200 units in Germany.

Farming is a type of business where farmers must possess comprehensive knowledge and good skills in different areas. Many family farms had a lack of knowledge when they started their businesses, whereas the situation with agricultural enterprises was much better due to their employment of experts. Thus, the biggest concern of farmers is the introduction of new varieties of crops. Another matter of concern is the observation of crop rotation principles. A considerable number of farmers still believe that the simplest and best solution is to grow only the most profitable crops, which can lead to soil erosion.

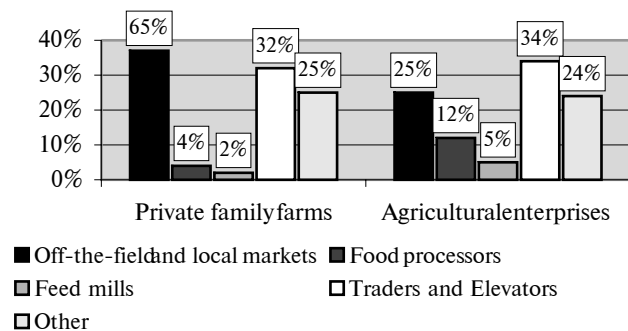
3. Customer Structure and Distribution Channels

The profitability and success of Ukrainian agricultural producers to a large extent depend on how effectively their products are marketed, but firstly Ukrainian farmers should know to whom they are selling their products and what prices they can expect on the market. This is why establishing sustainable marketing channels should be a top priority. Nowadays, most producers use only a few distribution channels with varying importance, meanwhile a clear trend is visible: private family farms use smaller distribution channels than agricultural enterprises.

Taking into consideration the distribution channel there are two groups of agricultural products: grain and oil crops, on the one hand, and vegetables on the other hand. Grain and oil crops are sold directly off the field and through local farmer markets. The main reasons for the appearance of this channel are probably the low marketing costs and the low transportation costs, while the farmers get their money in a quick fashion. As a consequence, this channel is more important to private farms. Furthermore, another important distribution channel for grain and oil crops is trading companies, but they are more relevant to agricultural enterprises. This is most likely due to the fact that private

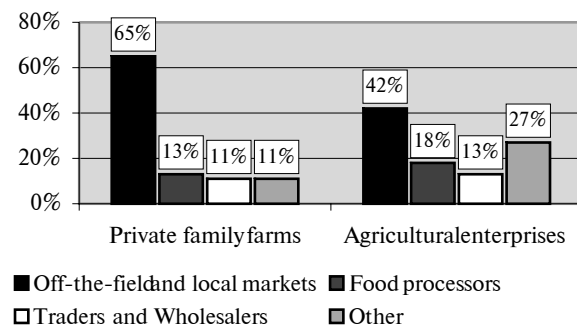
family farms cannot deliver the much-needed larger batches. Other less important distribution channels are feed mills, government institutions and food processors.

Grain and oil crops - distribution channels



With respect to the sale of vegetables, it is important to note that there are even less distribution channels than for grain and oil crops. Most of the harvested vegetables are sold off-the-field and at local farmer markets. Moreover, another important channel is food processors. Their importance varies in the different regions. For example, due to the presence of the massive food processing enterprises CHUMAK and SAN-DORA, which are located in Ivano-Frankivsk and Kherson respectively, these channels are much more important in their respective regions. Among other distribution channels, traders and wholesalers play a rather significant role. Interestingly, neither private farms nor agricultural enterprises significantly use other distribution channels such as direct sale to supermarkets, direct export or commodity exchanges.

Vegetables - distribution channels



The main reasons for the selected distribution channels are basically good prices and payment procedures and stable sales. These facts are another indicator of a poorly developed market for agricultural crediting. Other general facts about sales are that products are sold in a geographically narrow area and organic farming is not of particular interest for farmers. Notably, although consumers are interested in buying organically grown food, they are not ready to pay premium prices for such goods.

4. Summary and Trends

The agriculture industry is very important for Ukraine's economy, accounting for 15% of GDP. Furthermore, it is often the only industry creating jobs in rural areas. Ukraine is currently negotiating entry into the World Trade Organization. WTO membership would have a very positive impact on the country in general and on the agriculture industry in particular. Moreover, due to EU-enlargement the export of some of Ukraine's most important trading goods to EU accession countries will cease due to the required sanitation certification. Thus, a certification procedure in compliance with EU standards must be introduced in the nearest future.

At the moment the industry's most pressing problems are the lack of financial resources and, as a consequence, low mechanisation. Obtaining credit is particularly expensive and the almost non-existence of an insurance market only adds to the problems. In addition, for family farms, an important topic is how to gain access to more know-how.

Ukrainian agricultural businesses are currently at the beginning of a prosperous and prospective road. Due to the extraordinary quality of the soil and a considerable number of large enterprises, these businesses will be able to compete on the international market once minor sanitary standards are introduced. Smaller private family farms have also a wealth of possibilities in niches and, as development during the last years shows, they are also showing a surprising trend of being able to take advantage and use these possibilities.

THE FOOD INDUSTRY IN UKRAINE

1. Importance of the Food Industry in Ukraine

In the time of the Soviet Union, Ukraine was known as the breadbasket of the region because of its wealth of arable land and fertile soil. Nowadays, the food industry is one of the fastest growing industries in Ukraine, accounting for almost 18% of the industrial output. Experts expect a continuing positive upswing for the next few years although the present growth rate will slow down a bit. The growth rate for the last few years was constantly above 15% with the exception of 2002 due to the extremely poor grain harvest.

The table below indicates the growth rates of the industry from 2000-2003:

	2000	2001	2002	2003
Growth in %	23.0	18.2	18.0	17.5

The food industry is characterized by:

- Orientation on the domestic market;
- Access to high-quality and cheap raw material from the agricultural industry;
- Depreciation of the Ukrainian Hryvnia compared to the Euro; and
- Significant capital investment in the industry.

The food industry accounts for a large share of overall exports. In 2003, produce worth 1.4 billion USD was exported implying a 55% increase from the previous year. Popular export products are oil, margarine, sugar and condensed milk.

The following table lists the fastest growing production of agricultural products:

Product	Growth in percent from 2002 to 2003
Canned vegetables and fruit	95.2%
Lump sugar	80.7%
Crystal sugar	44.7%
Farinaceous food	40.4%
Oil	37.6%
Powdered milk	27.4%

In 2001, approximately 270 billion UAH were invested into Ukrainian industries, and 7% of this sum was directed toward the food and food-related industry, which is about 19 billion UAH. The level of Foreign Direct Investment in the industry is particularly high. By the end of 2002, the total sum of FDI was 852.3 million USD, which is 16% of the total investment in Ukrainian industries. For the first 9 months of 2003, investment in fixed capital assets grew compared to the previous year by 23%.

The Ukrainian standardization and certification system is a big concern in the food industry as only 10% of the Ukrainian standards are harmonized with those from the European Union. Furthermore, there are numerous "counterfeit" food products and food products from unregistered food producers, which are not subject to standardization in any case. In 2002, about 1,400 tons of "counterfeit" food products were seized, which represents an increase of about 25% compared to the previous year. As a consequence, export, especially to Western countries, is impossible even for high-quality goods from Ukraine.

Another problem of the Ukrainian food industry is the obsolescence of its equipment and production techniques. In particular the flour, oil, margarine, mayonnaise, sausage and pastries industries are in need of modern production plants, thus offering chances for foreign companies wishing to export machinery to Ukraine. Ukrainian machinery, available at lower cost, brings along the disadvantage of much higher energy and raw material consumption.

Another industry profiting from the above-described necessary modernization process is the chemical sector. Emulsifiers and other chemical products for the food industry face increasing demand as production techniques and the products themselves are modified and modernized.

2. Single Markets

2.1 Distillery Products

The alcohol industry was a state monopoly during Soviet times when the state controlled everything from alcohol production to final distribution. Needless to say, this monopoly was extremely profitable, for example the production cost of a bottle of vodka was approximately 50 kopecks whereas the official selling price was 10 Rubles. The difference went straight into the state budget. Moreover, the amount of illegally produced vodka was considerably low and tobacco imports rarely slipped through the iron curtain.

Since the breakdown of the Soviet Union, the situation has changed and the state has lost its control over the retail process while maintaining control over the production process. Thus, the state tried to influence distribution by taxes, licensing and other state-imposed regulations. Still, production costs have not significantly risen. According to the Ministry of Finance, there are more than 600 legal alcohol producing companies, more than 2,000 wholesalers and 70,000 traders in Ukraine.

In the meantime, the main problems for the industry are corruption and illegal production. In 1996, only 29% of the total vodka production was estimated to be illegal, but this figure increased to 45.7% in 2000 and will continue to increase over the next few years. An explanation for this development is the excise tax of 70% on the most popular vodkas. As a result, the state is losing approximately 4 billion UAH annually.

2.2 Tobacco

Similar to the alcohol industry, the tobacco industry was another state monopoly in the Soviet Union, and Ukraine was one of the major tobacco producers. Since legal actions in industrialized countries are becoming more frequent, the entrance into new emerging markets like Ukraine becomes more important than ever for tobacco companies. Another interesting factor as to why Ukraine is considered very attractive is the country's high consumption of tobacco products, which is at 75 billion cigarettes per year or 73.5 packs per person. According to experts, about 40% of the Ukrainian population smokes and anti-smoking regulations are insignificant. These facts led foreign companies to invest more than 160 million dollars into the Ukrainian tobacco industry, which is approximately 5% of the total Foreign Direct Investment in the country. Today, the tobacco industry accounts for 2.5% of total industrial output and for 17% of food industry output.

The total worldwide production of tobacco was about 7 million tons in 2000. Ukrainian production was about 3,500 tons but the Ukrainian Tobacco Association estimates a demand of 55,000 tons with the country accounting for about 2.5% of world tobacco imports. The major suppliers to Ukraine were Kazakhstan, Brazil and Turkey. The usual purchase price is 2-5 USD per kilo.

The Ukrainian cigarette market is dominated by four foreign tobacco companies, which all purchased major domestic producers. Ukrainian-owned factories account only for 6% of the market. The foreign companies on the Ukrainian market are British-American Tobacco (Priluky Tobacco Factory), Japan Tobacco International (Kremenchuk Tobacco Factory), Philip Morris (Kharkiv Tobacco Factory) and Reemtsma (Kiev and Cherkassy Tobacco Factory). Among these, Philip Morris (Kharkiv Tobacco Factory) has the biggest market share in Ukraine.

In 2000, about 12% of the produced cigarettes were exported and the main export trading partner is Russia regardless of the fact that Russia cut cigarette imports by 700 million items. Further insignificant exports go to Israel, Spain and Germany, as well as Armenia and Uzbekistan. Despite the growth in domestic production, 30% of such production still accounts for contraband. In particular, contraband cigarettes from Russia gain a market share of about 30% and the turnover of these cigarettes is estimated to reach 170 million USD. However, contraband is not the only problem for cigarette companies as the government attempts to solve the problems of tobacco producers at the expense of cigarette companies. For example, the government passed a law, which forces cigarette companies to buy at least 10% of their required tobacco domestically.

2.3 Mineral Water

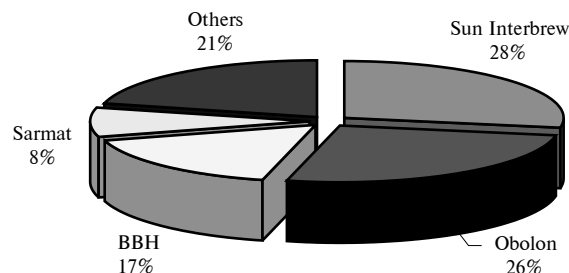
In 2002, the total mineral water production was estimated to reach about 100 million USD, or 2 USD per capita. Production increased by 30% in comparison with the previous year. This strong growth is due to the steadily growing demand for mineral water. Marketers researched that the demand for mineral water does not depend as much on the season as it does in other markets like the beer, soft drink or low-alcoholic drink markets. 70% of mineral water sales are from April through October and, furthermore, consumers pay attention to brand popularity, taste, and packaging, while price is the last decisive criteria. They also do not differentiate between curative and table sorts, but the mineral water should sparkle.

Presently, approximately 250 enterprises are bottling mineral water with more than 400 trademarks of which the majority are locally sold. The largest 15 companies control about 70% of the market. Most of the water is bottled in 0.5-1.5 liter plastic bottles. The most prominent mineral water brands are Myrhorodska, Sorochynska, Ukrainochka, Dobra Voda and BonAqua.

2.4 Beer Market

Domestic beer production fell 2.5 times from 1985 through 1997, but a complete turnaround has been reached. Nowadays, the average Ukrainian drinks 34 liters a year, which in comparison to the consumption levels in Germany or Czech Republic where the average citizen drinks 140-150 liters a year is still very low. However, a clear upward trend can be observed. There are more than 100 breweries in Ukraine but only 4 companies control about 80% of the Ukrainian beer market. These players are Sun Interbrew (Yantar brewery in Mykolaiv), Obolon, Baltic Beverages Holding (Slavutych in Zaporizhia, Kolos Brewery in Lviv) and Sarmat.

Ukrainian Beer Market, 2002



In 2002, the Sarmat brewery, backed by an investor, purchased a majority share in the Obolon brewery thereby becoming the biggest player on the market. Obolon's management was not pleased with this step but was unable to avoid it.

2.5 Chocolate and Sweets Market in Ukraine

In Soviet times, chocolate was a product for privileged people and, therefore, never was a product of mass consumption as in Western countries. Consumers had the choice between only a handful of brands. During that time in Ukraine, there were 28 factories with a total output of 600,000 tons a year and chocolate accounted for only 5%.

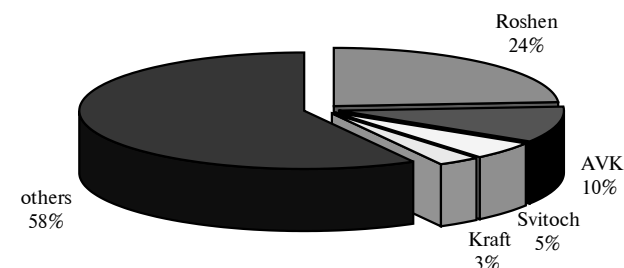
In 2002, the total chocolate and sweets market was about 800 million USD and the market grows annually by 8-10%. There are more than 600 companies producing chocolate or sweets, but most of them have only regional markets. Only 20 of them have a market share of 1% or more. There are four major players on the market: (i) Roshen, a UkrPromInvest subsidiary, (ii) AVK, (iii) Svitoch, in which Nestle holds a controlling interest, and (iv) Kraft Foods Ukraina.

UkrPromInvest, established in 1993, is the leader on the Ukrainian market with a share of 27%. This group of companies owns more than 50 factories producing chocolate, fruit juices and dry milk. In 2001, Roshen produced approximately 170,000 tons of sweets with a considerable share of their products exported to Russia. Furthermore, Roshen has announced its intention to launch a confectioneries plant in Lipetsk, Russia.

AVK is the second biggest producer in Ukraine with a share of about 14% and a production volume of 73,000 tons in 2001. Branch experts estimate its turnover at approximately 75 million USD and its net profit at 6 million USD. Their most popular trademarks are Mazhor, Mix-Mazhor and Zehle. 26% of its sales are from exports mainly to Russia.

Svitoch holds third place and, since 1999, Nestle holds a controlling interest in the enterprise.

Ukrainian Chocolate and Sweets Market, 2002



All of the larger companies have a considerable share of exports which account for 10-30%. In 2000, about 190,000 tons confectionaries were exported, the main exporting destiny being the former Soviet Countries among which Russia had a 90% share. The most important importing countries were Germany, Italy, Spain and Belgium. German chocolate is the only competition for domestic products in the high price range level. Companies from the said countries are quite content with the market development and constantly decide to introduce new products into the market.

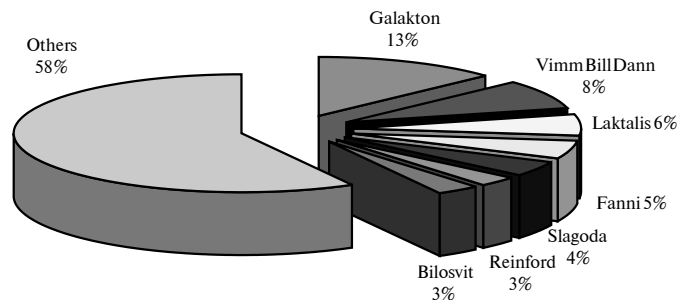
2.6 Milk and Dairy Products

Since 1998, the total sales volume for dairy products has risen at a yearly pace of 15-20%. In 2002, yearly sales amounted to USD 600 million. The traditional dairy products of milk and kefir have registered growth rates between 30 and 35% per annum and 15-30% respectively, whereas cream and cheese consumption rose by 10-15% per year.

Annual milk consumption in Ukraine amounted to 285 kg per capita in 2002 and according to experts is likely to grow up to 450 kg in the next years. Currently, there are 300 milk processing factories in Ukraine. Total production capacity amounts to 20 million tons per year, but only 25% of that capacity is being used.

40 to 50% of the market is dominated by the seven biggest dairy companies. Among them the Russian firms Vimm Bill Dann and Planjeta Management stand out. Planjeta Management took over the local company Galakton in 2002 and announced plans to buy up to 20 dairy factories in order to gain a higher market share than Vimm Bill Dann on the Russian and Ukrainian markets.

Ukrainian Dairy Market, 2003



The sector for traditional Ukrainian dairy products is quite saturated by now. Rather new products, such as yogurt, offer high growth perspectives. An almost untouched niche of that market is "wellness and health products" and target group specific produce for children, sportsmen, pregnant women, etc.

2.7 Meat Market

Meat consumption in Ukraine, with 34 kg per capita per year, is comparatively low. Due to weak purchasing power and high meat prices, the average Ukrainian consumes only one third of the European Union average. In 1990, the per capita consumption of meat was still up to 68 kg. However, the sector is expected to recover and grow hand in hand with the GDP. Sausages production was not exempted from this decline between 1990 and 2001. In 2002, this trend was reversed, however, leading to considerable growth rates of 15.6% per annum.

The Ukrainian market clearly differs from the Western European in its structure: while beef, pork and poultry account for one third each of the market in Western Europe, in Ukraine 78% beef is produced, 16% pork and only 5% poultry.

Imports basically consist of canned meats and poultry. Exports almost exclusively consisting of beef of which 99% is directed to Russia. Low sanitary standards in Ukraine make exports to Western European countries almost impossible.

Great potential for foreign investors lies in the ineffective production techniques and outdated equipment in poultry farming and sausage production. Without modernization, the future development in these sectors will be stunted.

THE TIMBER INDUSTRY IN UKRAINE

1. General Data and Introduction

Forest Area: 9,400,000 hectares

Forest Area Per Capita: 0.18 hectares

Average Annual Growth Per Hectare: 3.8 m³

Employees in the Industry: 95,000

According to this data, the total forest area in Ukraine is about 16%, which is below the central European average. The afforestation in the different regions varies heavily, from more than 50% in Zakarpattia to 3.7% in Mykolajiv. The Carpathian Mountains account for more than a third of the total timber resources of the country, which are approximately 1,750 million cubic meters.

The public forest fund is distinguished by protected forestry (56% – national parks, biological reserve forests, etc.) and profit-oriented forests (44%). Due to artificial plantation, biological diversity is not satisfactory and, therefore, the current assortment consists of only 70 breeds. The major breeds are conifer (43% with pine at 33%) and broad-leaved trees (57% with oak at 25%).

The age structure of Ukrainian forests is too young according to current statistics, although the situation has improved slightly since the last inventory. This situation is a consequence of the radical felling of timber from 1920 to 1970. Currently, there are 1,855 tree nurseries where conifer is basically bred.

After the Chernobyl disaster, a certificate of origin system was launched, which guarantees that only radiation-free timber is used in the production process. Any corporation can request such certificates, however certification costs up to 15% of the production costs and, therefore, certification is issued only for a minor portion of timber in Ukraine.

2. Ownership of Ukrainian Forests

Pursuant to the Forestry Code of Ukraine, all forests are owned by the state and included into the so-called "forest fund" as administered by the Cabinet of Ministers (the Ministry of Agriculture), which may delegate its administration functions to local Councils of People's Deputies and Derzhkomisgosp (the State Committee for Forestry). Forests are separated into areas of permanent use and temporary use. For permanent use, forests are handed over to organizations with a special forestry department. Small areas, which may not exceed 5 hectares, are leased to

private persons with a special education in forestry. Foreign legal entities, Ukrainian legal entities and natural persons can lease parts of the forest fund for a maximum term of up to 25 years for purposes of timber procurement provided that a special license is obtained for such procurement.

3. Industry Production and Investment

In the first 11 months of 2003, the production of goods in the timber and wood processing industries increased by 22.8% to 1.3 billion UAH. The pulp and paper industries registered an even higher growth rate of 25.3% to 3.9 billion UAH.

There are two forms of timber procurement. The first form is the regular felling of mature, high-quality trees and the second form is the results of forest fostering. In 2002, 12.8 million cubic meters were cut down, but only 5.8 m³ was cut down in the form of regular felling. Compared to the previous year, this represented an increase of 6.7% with only 5% hewed down by regular felling.

Only 55-60% of timber is produced by regular felling, the remaining is produced by forest fostering, which is an indication that a considerable amount of high-quality timber felled is sold under the guise of forest fostering thereby avoiding the taxation for the use of the forest. This is possibly a consequence of the lack of coherent Ukrainian legislation. As statistical information, 43.5% of the felled timber was log wood, 35.4% firewood and 18.7% timber for technological research.

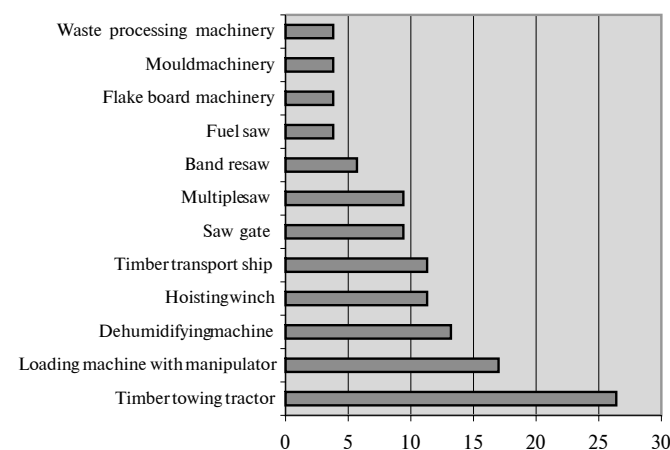
In 2003, 87.241 million UAH were invested in the timber industry by the state while 5.6 million USD were injected into the industry as Foreign Direct Investment in the first 10 months of the same year. The total investment in the branch is quite low and represents only 0.2% of the total investment in Ukraine rendering the use of old technology prevalent in the industry.

4. Machinery Used in the Timber Industry

In general, the inventory of machinery is obsolete and energy intensive and, therefore, effective operation is rarely achieved. In a market survey, 53 of the participants in the industry were asked the following questions by telephone:

1. Which machinery would be interesting for you now or in the near future?

Necessary Machinery in %



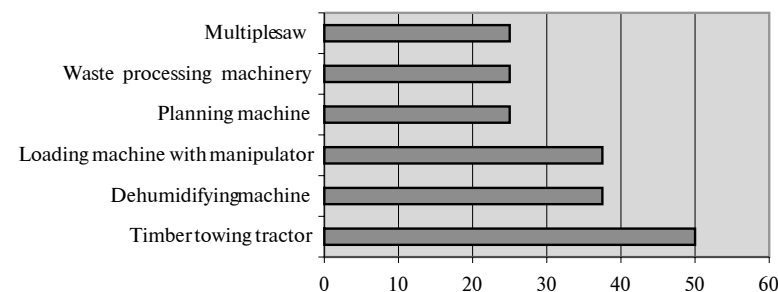
[53 companies; 1 entry represents 1.9%]

Approximately 1/3 of the questioned companies answered in the affirmative when asked if they did not have the necessary funds to buy necessary equipment and indicated an interest in attracting investors. Such companies often expect the investor either to take over some products itself or to do perform marketing. Machinery produced in Ukraine is only capable for use in initial processing and machinery for further processing must be imported.

Those companies, which currently do not need any machinery, were additionally asked the following question:

2. Which machinery does the timber industry need?

Necessary Machinery in %



[16 companies; 1 entry represents 6.25%]

Most companies believe that there is a demand for marketing knowledge and leasing possibilities.

5. Import and Export

In 2002, the timber, pulp and paper industries accounted for 12% of all exports. In 2003, its export share climbed to 22% and is forecasted to plunge again to 6% in 2004. The growth is due to an increase in the volume of low-quality products, which account for up to 85% of the total timber product exports.

The general decrease in imports is a direct result of the reduction of imports from Russia. Furthermore, imported products are often of higher quality and, thus, more expensive. In Ukraine, produced timber products are up to three times cheaper than foreign products. This low cost level is achieved due to the use of old and outdated technology.

6. Paper Industry in Ukraine

At the end of 1980s, there was a downturn in the industry and the total paper production decreased from around 1 million tons (utilization ratio 90%) to 300 thousand tons in 1998. Since the industry recovered at the end of the decade, the production in 2002 was already up to 500 thousand tons once again. The transport cardboard sector developed particularly well with the production output reaching the nineties level.

Ukraine was able to independently cover the demand (105,000 tons) of the newsprint sector at 40%. Most of the additionally needed imports come from Russia. The basic raw materials are cellulose, on the one hand, and recovered paper on the other, of which 80% is of Ukrainian origin.

The total paper and cardboard market in the country is estimated to reach 550 million USD of which 80% is covered by imports. Consumption per capita doubled during the last eight years and reached 15.4 kg in 2001, which is still low compared to the European Union with 45 kg. Experts believe that with the support of the government imports can go down to 35%. As a first step, the government raised the duty on paper products, which are also produced within the country. Although there was a 20% import duty on office paper until January 1, 2004, there are only three companies in this market and, thus, 98% of the 35,000 ton market is imported. There will be a decrease in the growth of the currently 25% per annum for the next years in the office paper market, however the rates are still higher than in the European Union (4–6%). Furthermore, the product range will broaden and large importers will supersede the smaller ones.

7. Other Timber-related Markets

The total capacity of Ukrainian cellulose production was approximately 40,000 tons, while 50,000 tons with a value of 23.7 million USD were imported mainly from Russia. Currently, an increase in prices is observable.

The furniture industry in Ukraine is highly diversified with more than 700 producers, although the larger companies are in close proximity to the major cities (i.e., Kiev, Kharkiv, Dnepropetrovsk) and to the forests (i.e., the Carpathian Mountains, Kiev, Zhytomyr). Taking into consideration that in Kiev alone there are more than 930,000 apartments, the market is enormous, yet the buying power is low. Nevertheless, the market grows around 10% per year. In the first semester of 2003, the furniture industry could even register a growth rate of 23%. Import accounts for 10% of the Ukrainian market, and these imports are mainly high-end products of Italian origin. However, it is expected that imports will decrease due to the trend toward higher domestic quality and, as a consequence, new and contemporary machinery will be brought into the country. The number of exports has grown sharply but at a low volume of orders, the main partner being Russia.

The production of flakeboards, fibreboards and plywood are the core sectors of the Ukrainian timber industry. This is due to the large volume of low-valued timber. In 2002, 12 companies produced flakeboards, 4 companies produced fibreboards and 19 companies produced plywood.

Production of flakeboards and fibreboards 1998-2002 in thsd. m ³ (estimated)					
	1998	1999	2000	2001	2002
Fibreboards	13.333,6	13.237,0	16.719,8	20.158,1	21.492,3
Flakeboards	189,4	218,2	264,4	378,9	549,9
Plywood	35,8	44,2	56,3	79,9	101,6

According to publicly available data, in 2002, 1.3 million m² of flakeboards and fibreboards were produced by more than 130 Ukrainian corporations. In 2001, 15% were exported to the European Union, USA and Canada, and exports will still grow annually up to 10%. Generally, competition in the market is very high and smaller companies are being crowded out.

8. Scientific and Technical Support for Further Development and Organisation in the Industry

There are 6 institutes in Ukraine responsible for scientific and technical support. The major organisation is the Research Institute for Mechanical Wood Machining. Furthermore, there are special organisations responsible for furniture innovations, as well as "Ukrpcktilisprom" (in the meantime a

privatised engineering and technology institute) which develops machinery. The State Committee for Forestry (Derzhavnyj Komitet Lisovogo Gospodarstva or "Derzhkomlisgosp") unifies the legislation, while controlling and administrating all Ukrainian forests. Since it runs several corporations as well, this organisation can be a matter of conflict.

9. Possibilities for Foreign Companies

The market expands rapidly and costs are quite low with raw timber produced at far cheaper prices than in Western countries. Domestic companies tend to focus on special sectors of the market. A particularly interesting market will be furniture export which will call for new and contemporary production machinery. Experts estimate that the furniture industry will become one of the most important sectors in the timber industry. The felling machinery sector is also promising as companies mentioned in the telephone survey with the demand for wheeled tractors expected to sharply rise upon the passing of a law to be introduced on January 1, 2005 forbidding the use of certain types of tractors in the felling industry in the Carpathian Mountains. As a result, machinery for the creation of track ways will be in demand. Also, due to the weak financial situation, companies need leasing possibilities or other innovative financing methods. In all areas of the timber industry, quality and energy consumption is an increasingly strong issue.

Another interesting area will be the outsourcing of furniture production into Ukraine. After the European Union enlargement, Ukraine will be a bordering country of the EU and production and labor costs are relatively low in comparison with the EU. Due to the significant demand for cellulose, investments in this industry will become attractive although one can expect the competition to be stiff.

10. Recent Trends and Problems

Due to pollution and poor ecological planning, for example the drying up of swamps, there is a tendency for mature timber to deteriorate. The infrastructure in the forests is poor, evidenced by the fact that in every 1,000 hectares there are only 2-3 km cast tracks. By way of comparison, Austria has 26 km cast tracks per 1,000 hectares. As a consequence, often heavy machinery is used in Ukraine, such as tanks, which has of course bad effects on the environment.

Three years ago an international certificate was introduced facilitating competition on the timber world market. The output of the timber industry is constantly on the rise. However, due to the lack of adequate machinery, low value timber (i.e., with more trunk wood) cannot be processed.

TOURISM IN UKRAINE – AN UP AND COMING, BOOMING INDUSTRY

1. Tourism in Ukraine - General Facts

Situated in the southeastern part of Europe, Ukraine possesses vast tourism-recreational potential: favorable climate conditions, flatland and mountainous landscapes, flora and fauna richness, a gradually developing transportation structure, and vast historical-architectural monuments. Easy to reach by airplane in roughly two to three hours from the major European airports, Ukraine still is a tourist destination to be discovered. Within Ukraine, the transport system is quite well-developed with the railway system playing a considerable role. All major cities and also the main tourist attractions can be reached by train, bus or airplane from Kiev.

But Ukraine does not only mean natural beauty. A few historical monuments have been included into the *UNESCO World's Heritage List*, such as the Kyiv-Pechersk Lavra (Monastery of the Caves), St. Sophiya Cathedral in Kyiv, and the historical downtown of Lviv City. There are over 150 castles and more than 300 museums to be visited. During Soviet times, health resorts played an important role in Ukraine, and more the 100 of the "sanatoriums" are left mainly in the Carpathian Mountains and in Crimea.

Today, tourism contributes approximately 1.3% to the country's GDP. However, in the long run, the government set a goal to increase this share to 10%, which is quite unrealistic as none of the big tourism players worldwide reach more than 6% and the increase in tourism revenues is not considerably higher than the GDP increase.

Tab. 1.1.

SPECIFIC VALUES OF DEVELOPMENT OF TOURISM IN UKRAINE: 1995-2002								
[Figures shown in millions]	1995	1996	1997	1998	1999	2000	2001	2002
Number of incoming tourists	3.7	3.9	7.6	6.2	4.2	4.4	5.8	6.3
Number of outgoing tourists (leaving Ukraine)	6.9	11.5	10.5	8.6	7.4	8.7	9.4	
Number of domestic tourists	8.6	6.2	5.7	5.7	6.4	6.6	6.9	7.2

Source: State Administration of Tourism of Ukraine/ Statistic Bulletin, 2002

Since 1997, an evaluation of the tourism flow has been implemented according to the standards of the World Tourism Organization (WTO). Evaluations given in this report are based on data ascertained by the State Committee of Border Protection of Ukraine (Derzhkomkordon Ukrainy).

While data on incoming and outgoing tourists is quite reliable, information on domestic tourism is difficult to trust. Many hotels and almost all private accommodations do not record all guests. As the shadow economy in Ukraine is considered to be the size of the official economy, official data is not always reliable. In any case, a positive trend for both the quantity of tourists and tourist-spending can be seen. Among tourism destinations, Ukraine ranks around 22nd within the international WTO-listing.

1.1 Domestic Tourism

Most Ukrainians spend their holidays within Ukraine. This fact is due to comparatively low prices in the lowest segments of tourism and an increasingly difficult visa regime with the EU, but also with increasingly improved infrastructure at the top-level segment.

Tab. 1.2.

ACCOMMODATION FACILITIES IN UKRAINE structured by type - WTO-method: 2002		
	Absolute number	%
TOTAL number of domestic tourists	7,178,959	100
Private accommodation (through travel agents)	62,333	0.9
Hotels	3,102,366	43.2
Health resorts	2,778,955	38.7
Summer/youth camps	1,235,305	17.2

Source: State Administration of Tourism of Ukraine/ Statistic Bulletin, 2002

1.2 Incoming Tourism

Incoming tourism has shown a steady growth. Almost 6.3 million foreign tourists visited Ukraine in 2002, up by 10% compared to 2001. In 2002, most tourists came from the Russian Federation (2,850,524), Moldavia (1,217,138), Hungary (619,679), Belarus (579,529) and Poland (377,633). Only very few tourists from the EU, the US and Asia visit Ukraine entered the country.

One third of all tourists visited Crimea, followed by Kyiv and Odessa (both approximately 25%). Recently, city tourism to Western Ukraine (espe-

cially Lviv) and skiing and mountaineering tourism to the Carpathians has picked up. Health tourism and religious tourism is growing fast as well as.

Tab.1.3.

NUMBER of TOURISTS structured by PURPOSE OF TRAVELING to the UKRAINE: 1998-2001 (in %)				
[in %]	1998	1999	2000	2001
Recreation	60.7	49.8	51.3	51.2
Business trip	31.3	40.2	31.9	27.5
Sport and health tourism	3.1	1.1	3.4	5.1
Treatment at health resorts	1.6	1.5	5.9	7.4
Extraordinary tourism (e.g. religious tourism)	1.5	1.4	1.2	2.4
Other purposes	1.8	6.0	6.3	6.4

Source: State Administration of Tourism of Ukraine/ Statistic Bulletin, 2001

Organized trips are not very popular with Ukrainians and Russians. The majority of domestic travelers prefer to plan their trips individually and stay in private accommodations. Thus, the official statistics are likely not to include a considerable share of domestic tourists. Organized trips are more popular among tourists from Western European countries and, therefore, play only a secondary role.

1.3 Outgoing Tourism

In 2002, a total of 15.6 million Ukrainian citizens traveled abroad, 2.5 million purely for tourism, 270,000 of whom were provided with services by travel companies marking an increase of 35% in relation to the prior year. In 2003, the number of people visiting foreign countries increased by 2.5%.

The purposes for Ukrainians' visits to foreign destinations in 2002 are determined as follows:

- Business trips: 17%
- Organized trips (by agencies): 22%
- Private trips: 61%

The main destinations were

- Russian Federation: 38%
- Poland: 27%
- Hungary: 11%
- Moldavia: 7%
- Belarus: 6%

1.4. Travel Companies and Agents

A special license is required in order to be active in the tourism business. Approximately 2,500 companies are active in the country, employing 38,000 people. Recently introduced legislation divides these businesses into tour operators and travel agents. In order to obtain a license as a tour operator, a considerable deposit must be made with the tourism administration of Ukraine. The major enterprises are located in Kyiv (25%), Crimea and Odessa.

2. Sanatoria: The Ukrainian Answer to Western Spas

A total of 3,300 sanatoria/health resorts offer 494,000 guest beds in the main season and 146,000 in the off-season. Ukrainian Sanatoria have become more popular among Western tourists over the last years due to low-cost medical treatment.

Most health resorts are located on the Crimean peninsula (17%), in the Donetsk Region (15%), and in Odessa (11%). The majority of these facilities is owned by communities. The largest owner of health resorts is the joint stock company for therapeutic health-promoting facilities "Ukrprofsdorovnytsya". This corporation possesses over 100 health resorts, which annually welcome more than 0.5 million people. However, 31% of tourists rest in state-owned facilities.

Tab.1.4.

STRUCTURE OF PROPERTY: 2001		
	Number of facilities	Share in %
State property	848	26
Communal property	1,970	60
Private property	94	3
Property of other countries	112	3

Health tourism has a considerable potential for growth since health and beauty services can be provided at a much lower cost in Ukraine than in Western European countries due to lower wage levels.

3. Exemplary Region: The Crimean Peninsula

The further development of health resorts on the Crimean peninsula boasts quite promising prospects as the peninsula holds numerous resources in store.

A. Health Treatment

The Crimean peninsula is rich in therapeutic mud and mineral resources. 26 sites of curative mud and more than 100 mineral sources may be found. 15 curative mud pits and 13 sources of mineral water have been declared to have curative properties.

B. Cultural and Nature Tourism

- Cultural and historic resources:

On the territory of the Crimean peninsula, more than 11,500 historical, cultural and architectural sites exist, originating from various epochs (i.e., cave towns and monasteries, fortresses, and holy sites of various religions).

- Natural resources:

There are 5 State Nature Reserves, 33 sanctuaries and 87 natural monuments attracting tourists looking for natural beauty and recreation.

More than 90% of all these tourism and recreational places are concentrated on a 3 kilometer-wide coastal line. 500 km of beaches, of which 100 km were artificially created, are at the disposal of tourists.

During Soviet times, 8 million tourists annually spent their vacation on the coasts of the Black and Azov Seas. At that time, the Crimean peninsula was the largest and most important tourism center of the Soviet Union. In comparison, only 4 million tourists visited Baltic Sea resorts and 1 million visited the Caspian Sea side. 77% of all Soviet tourists spent their vacation time on a non-organized basis (i.e. camping, etc.) as the capacity within the diverse types of accommodations was meant to provide for only 29% of the tourists.

In 2003, 5.2 million tourists paid a visit to the Crimean peninsula. Approximately half of the visitors are Ukrainians with the remaining share represented by Russians for the most part. Tourism services in Crimea are being offered by 700 enterprises, which employ approximately 10,000 people.

3.1 Investment opportunities

The Tourism Industry accounts for almost 90% of all investments to Crimea. From the roughly 40 million USD in investment, most is invested in greater Yalta, Alushta and Sudak.

The biggest projects on the peninsula included investments in the reconstruction of hotel "Oreanda" (USD 18.75 million), the vacation home "Terlezkiy" (USD 2.4 million), the vacation facility "Morye" – (USD 7.48 million) and the recreation facility "Marianida" (USD 6 million). However,

overall foreign direct investment is still very low compared to international levels. Financing would be needed for extended development plans and infrastructure projects.

4. Tourism Development in the Carpathians

Approximately 500,000 tourists come to visit this region every year, 50,000 of which were foreigners in 2002. Lviv (former Lemberg), with 33.3% of the total number of tourists, is ranked as the most visited area of the region (previous year: 35.1%), followed by the Ivano-Frankivsk region (28.2% of the total number of tourists in the Carpathians), the Zakarpattia region (26.5%) and the Chernivtsi region (11.9%).

4.1 Development of Tourism in the Zakarpattia Region

In this region, 80% of the total territory is covered by mountains and 50% by forests. Thus, health resorts and the sports industry, especially hiking and skiing, are the most important branches in Zakarpattia. In 2001, visitors mostly from Poland, USA, Germany and Russia traveled to the Carpathian region.

A. Health Treatment

The Zakarpattia region was formerly the traditional health resort region for the Soviet elite. Presently, there are 170 tourism-related businesses, institutions and health resorts, of which 36 are sanatoria and 87 hostels and recreation points.

B. Winter Sports Industry

High hopes were pinned on the development of winter sports in the Zakarpattia region. In the 1980s, the Council of Ministers of the Socialist Republic of Ukraine took the decision to construct the Olympic winter sports complex in Borschivski Polonyny. The planning was finished only 7 years ago. However, the complex was not built. Many other investment projects share the same destiny. The Cabinet of Ministers planned to approve an 85 million UAH investment into the region of Borschivski Polonyny in order to push development forward, but not much of this project has been realized.

Over the past few years, modern tourist mountain area complexes have begun to operate where one may indulge in winter sport activities, including the following zones:

- Sports and tourism complex "Synjak", Mukachevo county - built in 2000. It has reserved the rights to organize 35 International Olympic students' games to be held in 2005;

- "Podobovez - 2000";
- "Dragobrat" (Rachiv county);
- "Forel" (village Shdeniyev, Volovetchyna);
- "Piku";
- "Dubovyj gaj";
- "Edelveys" (village Verkhniy Studenyj, Mishgirshyna);
- "Tysa";
- "Trembita";
- "Krasya" (Velykoberesnjanshyna).

In 2002, 51 ski lifts were available, of which only 40 were ready for operation. In the counties of Svalyava and Mukatchevo, 3 new ski lifts were put into operation in 2001, and in Irshava and Tyakshiv, 2 new ski lifts opened. In the region, up to 30 T-bar lifts exist, which to a great extent were installed some 25 years ago.

Tourism in the Zakarpattia region shows only slow-moving development. In 2001, new winter sport institutions were built, including 2 new motels in Dragobrat. Apart from the village of Pylypez, which holds a new and modern cable railway (700m), the only other cable car of such kind in this county is available at the mountain Krasya.

Unfortunately, there are only a few slopes corresponding to European standards and there is only one chair lift in the region. Despite their unsatisfying conditions, the ski lifts remain the main tourist attraction in the area.

One big advantage of the Carpathian Mountains is their favorable snow condition – in most skiing resorts there is snow until early May. This fact might become quite defining in times when many Western European skiing areas are struggling with dwindling amounts of snow each year. Summer tourism is underdeveloped in the region and calls for consulting, the drafting of long-term development plans, financing and the actual construction of an infrastructure.

The author of these specific sectors of the economy, Mrs. Viktoria Verchoglad, is a consultant at System Consult Ltd., doing market research in various fields. System Consult Ltd is a consulting and services company providing market research and assistance to companies with a desire to enter the Ukrainian market. The company also organizes visits by delegations of businessmen to Ukraine with the aim of finding business partners. Mrs. Verchoglad can be reached at:

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I Introduction

A HISTORICAL PERSPECTIVE OF UKRAINIAN BUSINESS ENVIRONMENT

On July 16, 1990, the Ukrainian Parliament passed the Declaration of State Sovereignty, formally announcing the country's intention to control its own affairs. Adopted in the Soviet climate with President Gorbachev's blessing, however, this declaration was largely a theoretical step towards Ukraine's political and economic independence.

The real break with Moscow came rather unexpectedly more than a year later, on August 24, 1991, and was primarily due to failure of the hard-liners' coup in Moscow in the immediately preceding days. Thereafter, in December of 1991, Ukraine's independence was confirmed by a nationwide referendum.

Foreign investors started to arrive to Ukraine, a country the size of France with more than 48 million people, in early 1992. At that time, the Western business world viewed Ukraine as an enormous, yet "open" territory, full of business opportunities. Fueled by optimism, numerous foreign companies, large and small, rushed into what they perceived as the opening of a uniquely large market, void of competition.

The abnormally high attrition rate in the following decade sadly confirmed that comparatively few of those brave souls have survived. As a general observation, the foreign entities still doing business in Ukraine more than a decade later can be categorized as either (a) large multinational corporations with substantial capital and a long-term strategy for market penetration, or (b) a one-man shows with a few thousand dollars in their pockets, who came to Ukraine hoping to strike a gold mine.

Notably absent are the mid-sized companies, and for a good reason. In the former case, large investors never relied upon (and did not require) profits from their Ukrainian investment for at least the first several years, while the members of the latter category have enjoyed a varying degree of success. In sharp contrast to these two groups, mid-size companies required regular turnover and profit for their day-to-day operations. As a result, this category of investors found it especially difficult to survive the notoriously harsh Ukrainian business climate.

In the early, dark ages (1992-1994), mid-size foreign investors' repulsion at undertaking projects in Ukraine was understandable: in most cases, strict compliance with Ukrainian legislation, known for such unpleasant economic mechanisms as dual exchange rates, limitations on profit mark-ups and punitive taxation, rendered otherwise viable transactions

unprofitable. The lack of real property for industrial (production) purposes killed many large investment deals at the inception. Sudden, and often retroactive, changes in foreign investment legislation did not help the country's reputation either.

Fortunately, most of these drawbacks are history since the arrival of the Kuchma government, which reversed many of the previous government's near-idiotic legislation. As a historical curiosity, few people in Ukraine expected Leonid Kuchma to win the 1994 Presidential election. Nevertheless, following his accidental emergence onto the world stage, President Kuchma brought economic and political stability to a large yet undeveloped nation in the middle of economic revolution.

After coming to power in the summer of 1994, President Kuchma's team correctly assessed the root of the problem and immediately began to "clean the Kravchuk house" in a remarkably well-coordinated fashion. By November, Kuchma succeeded in quietly removing most political opposition, with the exception of the Parliament, which he increasingly ignored. Since then, much of the former legislation has been revised and implemented (with varying degrees of success) in an ongoing effort to transform Ukraine into a market-driven economy.

President Kuchma's final assault on the Ukrainian government establishment became known as "administrative reforms," beginning immediately after his re-election to a second, and final, term in November of 1999. Many ministries were ordered to cut their staff, and several were actually reorganized (e.g., Ministry of Foreign Economic Relations was dissolved and its functions were delegated to the Ministry of Economy and Issues of European Integration). In the end, however, the grandiose plans for comprehensive administrative reforms folded, evidencing that even the President can do little with the massive government apparatus.

Thankfully, the Cabinet of Minister's aggressive privatization campaign, aimed at selling off the very last of the state-owned enterprises, kept up the reform momentum. With most small and mid-sized Ukrainian enterprises already in the private sector, the Cabinet of Ministers specifically slated for privatization large-scale enterprises in a variety of lucrative sectors, such as energy and telecommunications. Other state-owned enterprises were sold with the assistance of foreign consultants. Up until 2004, privatization has moved quite slowly with only a few success stories. It remains to be seen whether privatization will eventually latch on or fall to the background.

True: the Great Economic Cataclysm of August 1998 brought about a near-collapse in Russia and, consequently, in Ukraine, underscoring

Ukraine's dependence on its "Big Brother." For several months after the crisis, the already minimal in-flow of foreign investment into Ukraine stopped altogether. Less than a year later, Ukraine's economic situation stabilized.

By 2001, foreign investment picked up significantly. This time, however, the foreign investors were Russian multinationals, not their West European or American competitors. Still weary of doing business in Ukraine, many foreign investors adhere to the traditional "wait-and-see" approach, cautiously evaluating their strategies for Ukraine while bemoaning its difficult business climate. This is still true in 2004 due to Ukraine's poor image in Western markets. It seems that Ukraine's political scandals are what remain in the forefront of the minds of Western investors.

The business climate, in the meantime, is changing rapidly. To negate the public opinion about difficulties of working in Ukraine, major changes in legislation have recently taken place. For example, the Parliament worked out a law on joint investment institutions under which investment funds may work with the cash or assets of legal entities and individuals with the aim of making a profit for its investors. This method of joining investment resources gives interested foreign investors the ability to join a strong group of investors striving for profits without taking on the risks of the Ukrainian market alone.

With the aim of eventually integrating Ukraine into the European Union, President Kuchma signed the Law "On Discharging Taxpayers' Obligations Before the State Budget and State Target Funds." This vital law gives Ukrainian residents and resident companies (including companies with foreign participation) a new methodology by which they may dispute their tax liability, and avoid the unsightly consequences of the past when the tax administration could simply debit an account on a whim.

Ukraine has also begun to shore up its customs legislation with the aim of simplifying import-export transactions. Ukraine already has a product classification nomenclature, which corresponds to the product classification nomenclature of the European Community. In addition, a new Customs Code has been passed, including a unified customs tariff and simplified customs procedures by eliminating discrepancies between the customs legislation and the independent actions of customs officials. The new Customs Code makes it possible to clear goods on a continuous customs declaration rather than declaring goods upon each entry into Ukraine.

In 2001, foreign investors were finally permitted to purchase goods or services from Ukrainians by writing out checks. The year 2002 saw a new Land Code put into effect, whereby foreign investors can finally purchase

non-agricultural land in Ukraine with certain restrictions of course. The Ukrainian insurance market has become quite attractive to foreign insurance companies with the removal of foreign ownership limitations in Ukrainian insurance companies in November of 2001.

Ukraine has passed new Civil and Commercial Codes, which presently contain various contradictions. However, this represents Ukraine's attempts to bring its legislation up to date with the demands of a market economy. Theoretically, one foreign founder may open a limited liability company with certain limitations as opposed to the past requirement of at least two founders. In addition, a new mortgage law has come into force from January 1, 2004 marking the beginning of a mortgage market for banks and Ukrainian physical and legal entities looking for credit to bolster their businesses.

Finally, since the last months of 2001 until the present, the Ukrainian government has been working diligently to strengthen its copyright laws and anti-piracy measures. This was exemplified by a complete re-writing of the Law "On Copyrights and Related Rights," the passage of the Law "On the Peculiarities of State Regulation of the Activity of Business Entities in Connection with the Production, Export and Import of Discs for Laser Reading Systems" (January 17, 2002) and the President's Decree No. 85/2002 "On Urgent Measures for Strengthening the Protection of Intellectual Property in the Process of Production, Export, Import and Distribution of Discs for Laser Reading Systems (January 30, 2002). The new Customs, Civil and Commercial Codes also contain significant provisions on the protection of intellectual property.

Conclusion

One reason why Ukraine's business climate remained stagnant since 1991 is that the same people have occupied different government positions for over a decade, and they cannot be dismissed since there is no one who can replace them. At the same time, nobody has really tried to radically reshape the Ukrainian economy which, at a minimum, involves providing foreign investors with adequate legal and business infrastructure.

The Ukrainian government's attitude toward foreign investors has generally been indifferent, to say the least. Instead of actively promoting investment opportunities, which necessitates adopting transparent rules, the Ukrainian government deferred to Boris Yelstin's example, reluctantly adjusting Ukraine's system to fit in with the new market economy.

Fortunately, Yelstin has been replaced with Putin, who is efficiently wrestling Russia away from its oligarchs and a well-developed Sicilian-style

economy. Moreover, time in this part of the world can run at a condensed pace, as evidenced by Poland and Hungary, and significant progress can be made within one or two years of sustained reforms.

The next Presidential elections, scheduled to take place in November, 2004, will most likely bring about significant changes in 2005. At the time of this publication, it was not entirely clear whether President Kuchma would return for another term or whether a new investment-oriented President would take Kuchma's seat. As always with publications on Ukrainian legislation, much of the text contained in this book will remain valid for quite some time, although some changes will certainly render other portions completely useless or outdated.

In conclusion, therefore, we urge all readers not to rely on this book for any definitive legal advice. In fact, we strongly urge anyone interested in doing business in Ukraine to consult with professionals who can verify that the information contained herein has not changed significantly.

B PRACTICAL GUIDELINES TO DOING BUSINESS IN UKRAINE

I. Introduction

As a general rule, all foreign companies doing business in Ukraine must interface with government officials at one point or another. In fact, each step of doing business requires some interaction with the state authorities that can negatively influence a given transaction.

In the case of privatization, the SPF is the key agency responsible for continually failing to implement large and mid-scale privatization with strategic (foreign) investors. In import-export operations, the state customs authorities play the lead role in expediting (or delaying) the customs clearance process. In all cases, each rayon administration requires a company registration certificate and a valid lease agreement for a company to engage in business activities.

Thus, prior to entering the Ukrainian market, foreign investors must decide whether they will approach the relevant state officials directly or, alternatively, send someone else to represent their interests. This initial choice is important because depending on the degree of preparation, the first official visit can either produce insurmountable future barriers or provide immediate positive results.

In one case, an initial misunderstanding quickly escalated into a personality conflict when a state official, reportedly not familiar with the multinational foreign company, scribbled an overly inflated amount of a requested bribe on a piece of paper. The shocked representative refused to pay, and the company lost the tender for the reconstruction of a building. There was little anyone could do in this situation after the conflict of personalities had already developed. Many of these situations, however, can be avoided with minor preparation.

II. Diplomacy or Bribery: That Is The Question

Multinational companies with large investment projects frequently attempt to "arrange" the success of their transactions through diplomatic connections (ambassadors, commercial officers, congressmen, senators, etc.). Unfortunately, direct lobbying through diplomatic channels, however dignified, provides no guarantees that such projects will materialize, as exemplified by Procter and Gamble's protests with the U.S. government that their certification had been unreasonably withheld by the Ukrainian authorities.

Other foreign companies, often registered in exotic off-shore zones, rely on a more direct approach, including, but not limited to, making cash gifts or other presents of appropriate material value in exchange for various favors. In such situations, the projects often receive the green light with greater degree of expediency than through diplomatic connections. This alternative, however, carries significant risks for the reputation of the company and the welfare of the official employees (several officials from the Ministry of Foreign Economic Relations were imprisoned in 1992 for accepting bribes in exchange for export licenses).

Many mid-size organizations cannot engage the attention of their ambassadors to represent their agenda, and refuse to "reward" a Ukrainian state employee in his or her individual capacity at all costs. Other companies, such as small businesses and non-profit organizations, simply cannot afford the amount of the requested payment. Still others, including many U.S. companies, are legally handicapped by the notorious Foreign Corrupt Practices Act, whose provisions they dare not violate. Inability to wield influence through either diplomatic or financial channels provides these companies with the only, and arguably the most efficient (and legal), alternative: using the infrastructure available only to local consultants.

III. Use of Local Consultants as Intermediaries

Unlike foreign representatives, local consultants are uniquely equipped to operate within the existing system. The Soviet Union blessed local consultants with bitter cynicism, enabling them to anticipate and avoid the numerous pitfalls in the system that frequently entrap and frustrate wealthy (foreign) entrepreneurs.

Dealing with local consultants is not for everyone: through trial and error, foreign companies have learned that such dealings can become a cruel and unusual experience. During the Kravchuk administration, it was not uncommon for members of various racket groups to sign up as representatives of foreign companies, only to appropriate the goods stored in the warehouse for re-sale on the black market. Today, the Ukrainian government punishes anyone caught in the more obvious scams with greater regularity, but we continue to recommend that one select local consultants based on their reputation in the field and references.

Unlike foreigners, local consultants have a variety of tools at their disposal, allowing them to "lobby" individual projects with greater efficiency. Typically, the consultant will begin by gathering information about the parties involved in the transaction. Analysis of this preliminary information often provides clear guidelines in doing the follow-up work to achieve the ultimate results. The actual follow-up can consist of several

steps (or events) aimed at building a general consensus of support for the given project.

Depending on the nature of the project, a number of tools can be used to accomplish difficult projects. Sometimes, as in the case of British Know-How Fund's privatization of 5 vegetable bases and 40 stores, much of the success depends on influencing the public opinion through the press (newspapers, radio and television). Other times, successful transactions depend on organizing a small, quiet, yet influential, base of support for a given project within a specific government ministry or its branch.

In this regard, it is far easier to mobilize support within one ministry, where all the "players" know (and usually respect) each other. The situation becomes more difficult when consent-building must be coordinated with two or more government agencies (e.g., in case of privatization, the Cabinet of Ministers and the SPF). Because each situation is different, a case-specific approach increases the chances of a successful transaction.

Sometimes a local consultant will need to retain the services of a specialist with a unique expertise in a certain area (e.g., securities regulations, banking, intellectual property, etc.) If so, such arrangements are reached on a case-by-case basis, either at an hourly rate or reasonable flat fee basis (much like engaging a lobbying group in Washington, D.C.). A sum viewed as "unreasonable" could, of course, amount to indirect bribery and would be counter-productive to the goal of transacting business without violating the Foreign Corrupt Practices Act.

IV. Conclusion

The first barrier preventing foreign investors from working in Ukraine, is a "Catch-22" situation: as in any developing market, investment demands that careful due diligence is performed. At the same time, foreign companies rightfully complain that no useful information is available through official means.

Frequently, companies try to enter the Ukrainian market based on promises made by senior government officials, only to be rebuffed at the local government level. Others try to arrange transactions themselves. As could be expected, their high attrition rate since 1991 has only enhanced Ukraine's notoriety for its difficult working environment.

Undoubtedly, the key to success lies in the procurement of reliable information in a timely fashion. Local consultants are the best resource in procuring the necessary information and implementing the investor's assignment. Conveniently, they can be a worthy alternative to corruption.

II. Foreign Economic Activity

A IMPORT-EXPORT LEGISLATION

I. Introduction

Since declaring its independence in August of 1991, the Ukrainian government has struggled to establish a legal system to accommodate its entrance into the global commercial economy. For instance, commercial structures are addressed in such legislative acts as the Civil and Economic Codes and the Law "On Economic Associations." In the case of joint stock companies, the Law "On Securities and the Stock Exchange" and relevant Ministry of Finance instructions will also apply.

Foreign investment is governed by the Laws "On the Protection of Foreign Investments in Ukraine," "On the Foreign Investment Regime," "On Foreign Economic Activities," "On Privatization of State-Owned Property," "On Privatization of Small State Enterprises (Small-scale Privatization)," "On Restoration of the Solvency of a Debtor or Recognition of a Debtor as Bankrupt," and "On Secured Transactions," as well as the Ukrainian Customs and Land Codes. In the case of privatization, additional SPF instructions must be analyzed. Other laws also impact foreign investment, such as taxation, currency and import-export regulations, and intellectual property laws.

Therefore, it is incorrect to say that Ukraine's legislation is not functional. Admittedly, some provisions in Ukrainian legislation are ambiguous, and sometimes contradictory, while others are plainly unenforceable. Nevertheless, a jigsaw puzzle-like legislative system exists and, as dysfunctional as it may be, deserves the analysis contained herein. By way of introduction to the peculiarities of Ukrainian commercial law, we begin with an overview of the foreign economic activities and, specifically, import-export aspects of Ukrainian legislation.

II. Foreign Economic Activity and Import-Export Contracts

A. The Law "On Foreign Economic Activities"

All foreign entities (legal and physical) can engage in different forms of economic activity in Ukraine and effectuate various types of investment. As a rule, any activity contemplating foreign participation is designated as "foreign economic activity," and is therefore subject to a specific legislative regime.

The 1991 Law "On Foreign Economic Activities," No. 0959, is clearly outdated. Nevertheless, it is still technically effective, and therefore deserves

at least a superficial review. Drafted and enacted in the nostalgic pre-hyper-inflationary Soviet economic era, when the ruble zone provided Ukraine with necessary economic support, much of this antique law has been supplemented or amended, either legislatively or in practice. The unaffected remainder does not reflect the substantial changes in commercial legislation that have occurred since Ukraine's independence.

In its heyday, this law encompassed all types of "foreign economic activities," including export and import of goods, services and capital; servicing of foreign businesses; scientific activity and training of personnel; international financial operations and securities trading; credit and financial operations and the creation of corresponding institutions; joint entrepreneurial activity; entrepreneurial activity through the granting of licenses, patents, know-how, trademarks; conducting of shows, auctions, trade fairs, conferences, symposiums, seminars, etc.; wholesale, retail and consignment trading for foreign currency; leasing operations; currency trade and sale through currency auctions, currency exchanges and inter-bank currency markets; contracts between Ukrainian citizens and foreign legal entities; employment of foreigners in Ukraine, among others.

Regardless of the self-proclaimed breadth of its jurisdiction over all transactions involving foreign entities, in reality the law "On Foreign Economic Activities" primarily serves as a basis for effectuating import-export operations. Immediately below, we summarize the various facets of Ukrainian import-export legislation, as reflected by the supporting laws which accomplish what the law "On Foreign Economic Activities" never could: namely, provide a functional structure for standard import-export transactions.

With this brief overview, we can begin our analysis of the relationships and rights between these Ukrainian entities and foreign importers.

B. Import-Export Contracts

According to the Law "On Foreign Economic Activities," the single most important rule is that a foreign economic (or "international") contract must be in written form. Later, the Regulations "On the Form of Foreign Economic Agreements (Contracts)," approved by Order No. 75 of the Ministry of Foreign Economic Relations and Trade of Ukraine on October 5, 1995, provided a variety of standard clauses to be incorporated into foreign economic agreements executed in Ukraine. Order No. 75 was rendered ineffective by Order No. 201 "On Approval of the Regulation on the Form of Foreign Economic Agreements (Contracts)" issued by the Ministry of Economy and European Integration on September 6, 2001, which provides the guidelines regarding the material terms and conditions of for-

eign economic contracts, taking into consideration the relevant provisions of international agreements to which Ukraine is a party. Also, under the Ukrainian Civil Code, there must also be an agreement between the parties as to the material terms in a contract, such as quantity, price, etc.

Until the end of October 1999, it was relatively well-settled that one of the key requirements for the execution of agreements with Ukrainian companies was the appearance of two signatures on the behalf of the Ukrainian party to such agreements. This requirement was repeatedly stated in the Law of Ukraine "On Foreign Economic Activities," as well as the above-mentioned Regulations. However, on October 21, 1999, the Parliament adopted the Law "On Amendments to Article 6 of the Law of Ukraine 'On Foreign Economic Activities,'" No. 1182-XIV, which excluded the dual signature requirement for foreign economic agreements.

No additional permissions or registrations of such foreign contracts are usually required by the state administrative authorities, unless specifically provided otherwise by Ukrainian legislation or unless licensing is required in the specific import-export transaction. Several exceptions exist, however, including barter and counter-trade contracts with foreign parties, almost all contractual arrangements with Ukrainian state-owned enterprises (which are subject to review and approval by such enterprises' higher-standing organization, such as its Ministry), certain transactions in foreign currency (which sometimes require special permission from the National Bank or registration of the Ukrainian party as a subject of entrepreneurial activity) and, recently, joint investment agreements with foreign entities.

Previously, Ukrainian citizens were required to register their "foreign entrepreneurial activities" with government officials; however, in the last several years, Ukrainian law has abolished this requirement. Today, any Ukrainian physical or legal entity may enter into foreign trade contracts without obtaining any special state permissions. That said, however, Ukrainian individuals engaging in any commercial activities (local or foreign) must now register as "subjects of entrepreneurial activity" with the local state authorities and pay the much-dreaded income tax. The introduction of a simplified taxation procedure and a flat tax rate in 2004 (13% until January 1, 2007, and 15% thereafter), however, have made the payment of income taxation less burdensome.

The parties to a foreign economic contract have the right to choose foreign arbitration for settlement of disputes. Alternatively, such issues can be resolved in Ukraine under foreign law by agreement of the parties. If the parties failed to agree as to choice of law under a contract, Ukrainian law will dictate the law to be applied to the contract. However, there are

notable exceptions. For example, contracts for the construction or acquisition of immovable property on the territory of Ukraine are governed exclusively by Ukrainian laws.

The form of foreign economic contracts is determined by the place of execution thereof, unless the parties provide otherwise. Accordingly, a contract entered into in a foreign country cannot be invalidated by Ukrainian laws for reasons of non-compliance with Ukrainian standard forms. However, such foreign economic contract must adhere to substantive Ukrainian laws.

On the other hand, a foreign economic contract must be complete in form as well as substance if such contract is executed in Ukraine. Under Ukrainian law, either a foreign agreement or some of its provisions may be declared invalid or void by a court if it does not comply with the requirements of Ukrainian law or international agreements of Ukraine. An agreement is void under Ukrainian law from the moment of its execution.

1. New Licensing Requirements

Most recently, the Law of Ukraine No. 1315-IV, dated November 20, 2003, introduced amendments to Article 16 of the Law "On Foreign Economic Activity" regarding the licensing of certain foreign economic operations. Such amendments deal with the licensing of the export/import of goods into Ukraine under either an "automatic" licensing procedure or a "non-automatic" licensing procedure in some cases for purposes of maintaining the balance of certain goods in Ukraine. Automatic licensing grants permission to subjects of foreign economic activity for the export or import of goods within a specified period provided that such goods are not subject to a quota. Conversely, non-automatic licensing grants permission to subjects of foreign economic activity within a specified period for the export or import of goods, which are subject to quotas (quantitative or otherwise limited).

The exportation of goods will be subject to licensing in Ukraine if there is a violation of the balance of certain vitally important goods on the internal market or if protection of the population, animals, plants, the environment, public morale, national wealth, intellectual property or state security is necessary. The exportation of goods is also subject to licensing in case of the export of precious metals (except bank metals), the necessity to protect national production, the necessity to protect patents, trademarks and copyrights, and the necessity to fulfill international agreements.

Likewise, the importation of goods will be subject to licensing in case of (i) certain fiscal problems; (ii) a decrease in gold-currency reserves; (iii) the

necessity to protect the population, animals, plants, the environment, public morale, national wealth, intellectual property or state security; (iv) the import of precious metals (except bank metals); (v) the necessity to protect the national production of goods and patents, trademarks and copyrights; and (vi) the necessity to ensure the fulfillment of international agreements of Ukraine.

The Cabinet of Ministers is empowered to apply quotas and establish a licensing regime on certain goods at the request of the central body of the executive branch responsible for issues of economic policy or other authorized body. According to the amendments to Article 16, only one type of license may be established for each type of good. The licenses themselves are issued by the central body of the executive branch responsible for issues of economic policy or other authorized body on the basis of applications. In some cases, the granting authority may also request to review any documents and information necessary to confirm the data in an application, as well as the foreign economic agreement itself.

In the case of automatic licensing, the application for a license and the other necessary documents may be submitted on any working day before the customs clearance of goods. The term for the issuance of a license should not exceed ten (10) working days from the date of receipt of the application packet. However, in the case of non-automatic licensing, the following will apply:

- 1) the term for consideration of applications should not exceed 30 days from the date of receipt of applications if they are considered in the order of their receipt, but not more than 60 days commencing from the date of the expiration of the announced term for acceptance of applications if they are considered simultaneously;
- 2) a license shall be issued on the basis of an application within the limits of a quota with an indication of the validity term of the license;
- 3) if established quotas are exhausted at the moment of submission of an application (in case of the application of procedures of consideration pursuant to the order of receipt), such application shall not be considered. A subject of foreign economic activity, which submitted a corresponding application, shall be informed in writing of the fact of the exhaustion of quotas within seven (7) working days from the date of its receipt;
- 4) a decision on the issuance of a license shall be taken, taking into account information on earlier received licenses provided that the applicant observes the requirements of the legislation on the protection of economic competition.

Upon payment of the issuance fee and a positive consideration of an application, a license will be issued to the subject of foreign economic activity. The customs clearance of goods will only take place upon the presentation of an original license. A copy of the license will be attached to the cargo customs declaration and will serve as one of the grounds for the admission of the goods across the customs border of Ukraine.

Each month, the regional customs authorities will receive information on the issuance of licenses for the export or import of goods falling under a licensing regime. For its part, the regional customs authorities will inform the central body responsible for issues of economic policy on the volume of the export or import of goods.

The licensing requirements will also apply to barter operations with goods falling under a licensing regime and to the export or import of disks for laser reading systems, matrixes, equipment and raw materials for their production. However, the licensing requirements do not apply to the export and realization of compensation and profit goods received by an investor into ownership on the basis of production sharing agreements, unless otherwise provided by the production sharing agreement itself. They also do not apply to certain goods related to military production, atomic energy and state secrets of Ukraine on the basis of Article 20 of the Law "On Foreign Economic Activity."

Finally, the list of goods, the export or import of which fall under a regime of licensing, the validity term of licenses and any amendments to such information, as well as the procedure of the submission and consideration of applications for licenses is published in the official publications of Ukraine with a notice to the corresponding committee of the World Trade Organization (WTO) within 60 days from the day of the publication and the presentation of copies of such publications.

If a quota is allocated amongst countries-suppliers, information on such allocation is subject to publication with a notice about the allocation to other countries interested in the supply of certain goods in Ukraine. The official publication must take place within a term of no later than the date of the introduction of a licensing regime. At the request of an interested member of the WTO, the corresponding information must be provided regarding the following:

- 1) the procedure for the application of limitations;
- 2) the quantity of issued licenses for a specific period with an indication, if necessary, of the volume and/or value of goods;
- 3) the allocation of licenses amongst countries-suppliers;
- 4) the statistical information regarding the volume and/or value of goods.

II. Miscellaneous Supporting Legislation

The simplicity of the Law "On Foreign Economic Activity" ultimately necessitated additional legislation to provide a common payment mechanism for effectuating various import-export transactions. A separate set of supporting instructions governs case-specific transactions, such as barter or consignment agreements. As should be expected, therefore, numerous supporting legislative acts govern import-export transactions, including:

- Resolution No. 1996 of the Cabinet of Ministers "On Lists of Products, the Exportation and Importation of Which are Subject to Licensing and Upon Which are Established Quotas in 2004," dated December 24, 2003;
- Resolution No. 136 of the National Bank of Ukraine "On Approval of the Instruction on the Procedure for Executing Control Over and Obtaining Licenses for Export-Import and Leasing Operations," dated March 24, 1999 (as lastly amended on February 12, 2003);
- Resolution No. 1104 of the Cabinet of Ministers "On Approval of the Procedure for the Issuance, Circulation and Repayment of Promissory Notes Which Are Drawn In The Amount of VAT When Importing (Carrying) Products Onto the Customs Territory of Ukraine," dated October 1, 1997 (as lastly amended on May 12, 2003); and
- Order No. 201 of the Ministry of Economy and European Integration "On Approval of the Regulation on the Form of Foreign Economic Agreements (Contracts)," dated September 6, 2001 and registered with the Ministry of Justice on September 21, 2001 under No. 833/6024.

In combination, these directives create a system whereby a Ukrainian resident can execute a contract to sell or purchase any desired goods or services. In a typical import transaction, for instance, a Ukrainian resident can convert Hryvnia, the Ukrainian national currency, into virtually any foreign convertible currency. The contractually agreed-upon amount will then be wired to the seller as payment under a foreign economic agreement (e.g., sale-purchase of goods or services).

Note that Ukrainian legislation requires that the purchased goods must enter the Ukrainian territory within 90 days of the payment date. Otherwise, the Ukrainian importer will be subject to a penalty in the amount of 0.3% of the customs value of the undelivered products. However, in certain cases, the above 90-day term may be extended if the Ukrainian importer receives an individual license from the National Bank of Ukraine.

The supporting legislation wisely protects against the more obvious abuses, such as inflating the contract price (for receiving kickbacks) or deflating them (for dumping on foreign markets). For instance, the "Regulations on the Method of Forming and Using Indicative Prices," approved by the Ministry of Foreign Economic Trade in its Order No. 506 of August 8, 1996, impose indicative prices on all subjects involved in foreign economic activity (entering and effectuating any foreign economic agreements) for comparison purposes. Such indicative prices are set on the basis of current international market prices for the relevant goods.

On October 2, 1996, the National Bank of Ukraine's Directive No. 254 imposed a system calling for the "registration of foreign contracts" whereby all licensed banks were required to provide guarantees for their clients' performance of contractual obligations if such a foreign contract contained a pre-payment provision. Ukrainian banks suddenly found themselves liable for 100% of the contract amount if the goods were not delivered in a timely fashion and, as a result, no contracts were signed with "pre-payment" clauses. Fortunately, this Directive was canceled on January 10, 1997, by Directive No. 2, and pre-payment clauses are once again permissible without limitations on Ukrainian banks. Nevertheless, such theatrics should serve as a reminder of the necessity to seek advice immediately prior to undertaking any transaction in Ukraine.

The last significant step in completing the cycle of an import transaction under the Law "On Foreign Economic Activities" involves clearing Ukrainian customs taking into account the Cabinet of Minister's Resolution No. 390 "On the Importation onto the Territory of Ukraine of Certain Types of Goods," dated March 29, 2002, which takes effect from January 1, 2004. Generally, the Ukrainian customs officials allow products to cross the Ukrainian border only upon presentation of a customs declaration and proof of payment of customs duties and value added tax (and, where applicable, excise tax). We discuss these issues in more detail below.

In reviewing the following section, however, it is important to remember that placing the imported products in a licensed customs-bonded warehouse postpones the necessity of presenting the customs clearance documents (and payment of the various duties and taxes) until the Ukrainian purchaser accepts the goods under the sale-purchase contract.

B

IMPORT TAXES: VALUE ADDED TAX, EXCISE TAX, CUSTOMS DUTIES, LABELS AND CERTIFICATION

I. Introduction

As in other European countries, Ukrainian import-export operations are subject to various taxes, including, but not limited to, customs duties and value added tax. Further, depending on the specific product, excise tax and other miscellaneous payments (including both "facilitation fees" and the official costs associated with obtaining licenses or necessary product labels) may be applicable. The Cabinet of Ministers has also implemented a licensing system for the import of certain goods, such as chemical substances, fertilizers, pharmaceuticals, cosmetics and veterinary items, among others.

The various taxes associated with standard import operations are summarized below.

II. Value-Added Tax

Ever since December 26, 1992, when the Cabinet of Ministers executed its Decree No. 14-92, "On Value Added Tax," the legislation governing value added tax ("VAT") has changed frequently, arousing the ire of many companies, foreign and local, large and small.

Staying true to its reputation for constantly amending key legislation, on April 3, 1997, the Parliament approved a new and improved VAT law, which became effective on October 1, 1997 (as lastly amended on November 28, 2003). Subsequently, the Cabinet of Ministers passed Resolution No. 540, dated June 9, 1997, implementing a new VAT payment procedure.

Generally, the law continues to apply a 20% tax for all businesses and other legal entities (such as funds) providing goods and services on the territory of Ukraine, but the calculation mechanism has been liberalized somewhat. The new law finally closed one of the last loopholes by canceling tax holidays for non-profit "Chernobyl-type" organizations, but wisely kept the exemptions for products used by underprivileged children and the disabled, (e.g., children's food products, magazines and newspapers, etc.). The law also implemented a new mechanism for effectuating the payment of value added tax: the importer simply posted a promissory note instead of effectuating a cash payment. The ability to post promissory notes was taken away (most notably from enterprises

with foreign investment) by virtue of the Law of Ukraine No. 2899-III "On Introduction of Amendments to Certain Laws of Ukraine for Purposes of Eliminating Cases of Evasion of Taxes and Duties (Mandatory Payments) by Certain Enterprises Created with the Participation of Foreign Investors," dated December 20, 2001, effective as of January 9, 2002. However, the Law of Ukraine No. 1218-IV "On Introduction of Amendments to Article 11 of the Law of Ukraine "On Value Added Tax," dated October 2, 2003 and which took effect on January 1, 2004, temporarily, at least until July 1, 2004, removed the restriction on the issuance of import VAT promissory notes by Ukrainian companies with foreign investment.

Ukrainian VAT legislation sets up a two-tier structure that effectively protects its domestic market from foreign imports. For that reason, below we describe each of the two VAT structures separately.

A. Import VAT

The VAT rate under Ukrainian law is 20%, as levied against taxable turnover, which does not include VAT. Taxable turnover for import VAT is calculated as the customs value of the goods, including customs duties and any applicable excise taxes. This import VAT is due and payable at the same time customs duties are being assessed (with a potential thirty-day extension made at the discretion of the customs office).

B. VAT on Retail Sale in Ukraine

Of course, VAT is levied on all products and services manufactured and sold in Ukraine. Costs associated with obtaining/maintaining equipment that are reflected in the final price of the goods also are subject to VAT.

Any goods or services sold in Ukraine are subject to a 20% VAT, which is levied against the costs of the materials and is included in the sale/purchase price (i.e., sales turnover). Upon resale, sales VAT is levied on the total difference between customer-paid VAT and the VAT paid by the seller for all component materials.

In the event that an imported product is re-sold in Ukraine, VAT is paid on the difference between the sale price and the customs value (including customs duties and any excise taxes) plus import VAT.

III. Excise Tax

The Ukrainian government has always levied excise tax on luxury items imported into Ukraine, such as alcoholic beverages and tobacco prod-

ucts, and the letter from the State Tax Inspection "On Excise Tax," No. 16-1221/10-7232, dated September 9, 1997, merely reaffirms this fact. Other legislation governing excise tax includes Decree No. 18-92 of the Cabinet of Ministers "On Excise Tax," dated December 26, 1992 and the Law of Ukraine No. 329/95-VR "On Excise Tax on Alcoholic Beverages and Tobacco Products," dated September 15, 1995.

In the past, there was no clear system of tracking the importation and distribution of cigarettes and liquor products. Naturally, the sale of unchecked contraband products resulted in a gold mine of tax-free opportunities for all types of traders, who supplied Ukraine with well-recognized vices with virtually no payment of taxes.

In an attempt to control the illegal importation and distribution of cigarettes and liquor, on July 12, 1995, the President executed Order No. 609/95, "On Excise Stamps on Alcoholic Beverages and Tobacco Products." Unlike the excise tax law, this order provides a new approach for collection of excise tax by requiring importers to purchase special customs stamps and place them on each bottle of alcohol and every individual cigarette pack. Without such stamps, no alcohol or tobacco products can enter or be sold in Ukraine and, if found in Ukraine, they are subject to confiscation.

Entirely too much legislative attention has been devoted to alcohol and tobacco, as evidenced by the Parliament's Resolution, dated September 15, 1995, "On the Procedure for Implementing the Law of Ukraine 'On Excise Tax on Alcohol Drinks and Tobacco Products,'" as amended on July 11, 1996 (No. 305/96-VR); the Cabinet of Ministers' Resolution No. 1755 "On the Term of Validity of Licenses for Carrying Out Certain Types of Economic Activity and the Procedure for Calculating the Payment Amount for the Issuance Thereof," dated Nov. 29, 2000; Decree No. 666 "On Measures for Implementing Excise Stamps on Domestic Alcohol Drinks," dated June 20, 1996, as amended on July 30, 1996; Decree No. 493 "On the Temporary Procedure for Issuing Licenses for Import, Export and the Wholesale Trade of Ethyl Alcohol, Cognac Alcohol Drinks and Tobacco Products," dated May 13, 1996, as lastly amended on March 28, 2001; among others.

Other luxury items, also subject to the excise tax, are identified in the Cabinet of Ministers' Resolution No. 1078, dated September 29, 1997, and include caviar, crab, shrimp, chocolate, automobile tires, audio and video cassettes, televisions, among others. Interestingly, the new minimum rates for television and video equipment imported by Sony and Panasonic are higher than for Daewoo and LG Electronics.

The excise tax rates and the listed products tend to change constantly, which keeps the importers on their toes (and the notorious customs machine well-greased). On June 2, 1997, for instance, the Cabinet of Ministers imposed minimum customs values for certain foodstuffs (e.g., coffee, black caviar, frozen chicken and turkey legs, among others.) and clothing (fur coats and leather jackets).

IV. Customs Duties

As a rule, all imports are subject to payment of customs duty (and, of course, value added tax). The only exception applies to foreign investors who contribute qualified foreign investment into a Ukrainian resident company's authorized capital in exchange for the ownership rights in such company.

The Foreign Investment Law expressly provides that in-kind investment imported into Ukraine as a foreign partner's contribution to the authorized capital of any Ukrainian company, such as a joint venture or a 100% foreign-owned subsidiary, is exempt from customs duty and value added tax. If, however, the above foreign investor's property is alienated within three (3) years from the date it is credited to the Ukrainian company's balance, the Ukrainian company will need to pay customs duty and value added tax thereon.

The specific rates for various products may be found in various laws starting with the Customs Code of Ukraine, which took effect on January 1, 2004 and the Cabinet of Ministers' Decree No. 4-93, "On Unified Customs Tariff," dated January 11, 1993, as lastly amended on November 27, 2003. Other legislation evidencing that import duty rates are subject to constant changes include: the Cabinet's Resolution No. 1648 "On Introduction of Amendments to and Recognition of Certain Resolutions of the Cabinet of Ministers of Ukraine Which Were Rendered Ineffective," dated December 13, 2001 (as lastly amended on June 2, 2003); Law No. 313/96-VR, "On Rates of Excise Tax and Import Duties on Certain Products," dated July 11, 1996, as amended on May 22, 2003; the Law of Ukraine No. 2097-XII "On Uniform Customs Tariff," dated February 5, 1992 (as lastly amended on November 27, 2003), among others.

Most recently, on December 21, 2000, the Parliament adopted amendments to the Law "On the Unified Customs Tariff," according to which the Cabinet of Ministers no longer has the authority to establish rates of customs duties. Reacting swiftly, on January 12, 2001, the Cabinet of Ministers decided to exercise its right (before the Parliament actually takes it away) to adopt Resolution No. 16 "On Amending the Rates of Import Duties for Certain Types of Products and Certain Resolutions of

the Cabinet of Ministers of Ukraine." Resolution No. 16 was thereafter rendered ineffective by the Cabinet of Minister's Resolution No. 1648 of December 13, 2001. Currently, according to the most recent text of the Law "On the Unified Customs Tariff" (as lastly amended on November 27, 2003), the Parliament has the authority to make the final approval of the Cabinet of Ministers' proposals regarding the unified customs tariff. Additionally, the Law of Ukraine No. 2371-III "On Customs Tariff" was passed on April 5, 2001, which replaced the old Commodity Nomenclature for Foreign Economic Activity with the Ukrainian Classification of Goods of Foreign Economic Activity.

V. Miscellaneous Costs: Labels and Certification

Several categories of import products are subject to special licenses or "certifications" such as pharmaceutical, agro-chemical and food products (e.g., the Cabinet of Ministers' Resolution No. 1996 "On the List of Goods, the Importation and Exportation of Which is Subject to Licensing and On Which Quotas are Established in 2004).

Naturally, cigarettes and alcohol are subject to a mandatory "certification" process under Orders Nos. 378 and 379 of the State Committee on Standards, Metrology and Certification, entitled "The Rules of Obligatory Certification of Tobacco Products" and "The Rules of Obligatory Certification of Alcohol Products," both dated September 13, 1996. The last amendments to the rules for tobacco were made on August 31, 2000, while the last amendments to the rules for alcohol products were made on December 10, 1998.

Food products were the next in line for certification. As of January 1, 1997, all imported food products undergo a "certification" process, during which the required labels containing various information (in the Ukrainian language) must be affixed onto the product. The required information includes the product's name, volume, chemicals and additives, expiration date, and calorie content, among others.

On November 4, 1997, the Cabinet of Ministers, by its Resolution No. 1211 "On Approval of the Procedure of the Customs Clearance of Imported Goods (Products) Which Are Subject to Mandatory Certification in Ukraine" (as lastly amended on August 27, 2003), approved the procedure for the customs clearance of imported products subject to obligatory certification in Ukraine. Four years later, on December 13, 2001, the above procedure was slightly amended by Resolution No. 1671 of the Cabinet of Ministers.

The practical implementation of the otherwise reasonable certification requirements continues to cause great anxiety amongst importers. Many

foreign companies complain, and rightfully so, that clear and transparent compliance with this particular piece of legislation is often possible only after financially (in cash or in-kind) "rewarding" the state official(s) responsible for granting the necessary permissions.

This viewpoint has merit. On the one hand, product certification is designed to ensure consumer safety and quality standards. On the other hand, certification can also become a good tool to protect domestic producers from importers. A good example of this dichotomy is provided by Procter & Gamble's struggles with the Ukrainian authorities.

On March 3, 1998, the State Committee for Standardization, Certification and Metrology ("DerzhStandart") revoked Procter & Gamble's laundry detergent certificates, which reportedly cost the company \$135,000 to acquire. The DerzhStandart asserted that the formula used to produce Procter & Gamble's soap powder was of inferior quality and was aimed at the poor Ukrainian public.

Procter & Gamble disagreed wholeheartedly, and launched a counter-attack on March 20, 1998, by requesting that the Presidential Independent Chamber on Foreign Investments form an expert panel to resolve this conflict, and initiating a criminal investigation to trace its payment of \$135,000 for the certificates. In the meantime, the dispute had a negative side-effect on Procter & Gamble's advertising activities, subjecting the multi-national company to severe fines because Ukrainian legislation prohibits advertisement of uncertified products.

VI. Conclusion

As a rule in any import-export transaction, something always goes wrong at the last possible moment. Even a miniscule degree of non-compliance with Ukrainian import rules may lead to significant delays, increased costs, additional efforts, and even lost profits (especially in case of perishable goods). As legislation in this area changes all too frequently, foreign business entities wishing to sell their products in Ukraine are advised to exercise diligence in informing themselves about the latest applicable import taxes and duties, certificates and licenses, contract formalities, and other related matters.

C CUSTOMS LICENSED WAREHOUSES

I. Introduction

All countries do their best to monitor and control import-export flows that pass through their borders. While some European countries have significant experience in these activities, contemporary Ukraine is continually developing its customs control systems (and supporting legislation) due to its rather short history of independence.

As elsewhere, the Customs Service of Ukraine ("Customs Service") plays the most important function in monitoring goods during their passage through the Ukrainian borders. Due to the importance of controlling the flow of goods into and out of the country, Ukrainian legislators drafted provisions governing Customs Warehouses, and included these provisions in the Customs Code of Ukraine (hereinafter the "Customs Code"), which is dated July 11, 2002 and came into force on January 1, 2004. This new Customs Code was widely anticipated but the practical application of its provisions is not fully clear. Originally, the new Customs Code was supposed to come into force on January 1, 2003. However, due to the fact that most customs authorities were not prepared for its novelties, the Code was postponed until January 1, 2004. This notwithstanding, the Ukrainian customs authorities are still not yet completely prepared for the provisions of the new Customs Code, thus it is extremely important to seek expert advice when dealing with Ukrainian customs authorities.

Importantly, the Customs Code distinguishes between ordinary customs warehouses and so-called "*Customs Licensed Warehouses*." Ordinary customs warehouses are defined as specially-equipped buildings for the storage of goods and other items, which are owned and used by the Ukrainian customs authorities.

The following goods are subject to mandatory transfer for storage in ordinary customs warehouses:

1. Goods which are prohibited from passage into Ukraine due to established bans or restrictions on their importation into Ukraine or transit through Ukrainian territory, provided that such goods will not be exported from Ukraine on the same day of import;
2. Goods which are subject to duties and customs fees during importation into Ukraine, provided that the said duties and customs fees have not been paid and the importer has no documents evidencing deferred or installment payments thereof;

3. Goods which before the expiration their term of temporary storage by an enterprise were not declared by the owner or its authorized person/body in accordance with a customs regime;
4. Goods which were declared in a regime of abandonment in favor of the state.

The Customs Code also allows any subject of entrepreneurial activity to own a so-called "customs licensed warehouse," provided such entity complies with the requirements of Ukrainian legislation, receives the proper license for the right to open and operate a customs licensed warehouse and complies with the Regulations on Opening and Operating Customs Licensed Warehouses.

Below, we focus on the peculiarities of Customs Licensed Warehouses in Ukraine.

II. Discussion

As an observation, the Ukrainian government, including the Customs Service, took its sweet time in drafting and approving instructions that were urgently required for the day-to-day operations of import-export businesses. For instance, the Customs Service approved the Regulations on Opening and Operating Customs Licensed Warehouses in Ukraine, dated September 3, 1992, almost nine (9) months after the approval of the Customs Code itself. These regulations were subsequently amended several times because the Customs Service of Ukraine was stepping into previously uncharted territory when it drafted the Regulations

On December 2, 1996, as a New Year's present to the Ukrainian business community, the Cabinet of Ministers ordered the Customs Service to draft and approve a new text for the above Regulations. On December 31, 1996, the Customs Service amended the Regulations once again via Regulation No. 592, aptly entitled "On Approval of the Regulation for Opening and Operating Customs Licensed Warehouses" (as lastly amended on December 24, 2003). Such actions only served to confirm the popular belief that Ukraine's legislation is rather fickle.

The said Regulations subject a customs licensed warehouse to a special customs regime pursuant to which goods imported into Ukraine are kept under customs control without imposing any duties and other taxes thereon. Further, non-tariff regulations and other restrictions are not imposed during the storage of such goods. If the goods are to be exported from Ukraine, such goods are kept under customs control from the beginning of their customs clearance until their actual exportation from the territory of Ukraine.

Ukrainian legislation provides for the following two (2) types of customs licensed warehouses:

1. open customs licensed warehouses, which are used for the storage of goods by any person, and
2. closed customs licensed warehouses, which are used for the storage of goods that belong strictly to the owner of such warehouse.

The Cabinet of Ministers of Ukraine establishes the state fee for receiving a license to open and operate a customs licensed warehouse. Currently, those entities who wish to receive such a license must pay a fee equal to two thousand five hundred US Dollars (\$2,500.00), which must be paid in Ukrainian Hryvnias at the exchange rate of the National Bank of Ukraine as of the date of filing the relevant documents with the Customs Service of Ukraine.

III. Technical Requirements of a Customs Licensed Warehouse

Any duly equipped buildings or other premises designated for storage of goods within the customs warehouse regime can serve as a customs licensed warehouse. Notably, the territory of a customs licensed warehouse must be fenced in, and the following facilities must be available:

- (a) security and fire-safety alarm devices, which must be connected to the guard post of the organization hired as security for the customs licensed warehouse;
- (b) communication means in the places designated for the customs officials to exercise customs control in such warehouse; and
- (c) metal grating on the internal side of the warehouse's windows, if applicable.

Additionally, the owner of a warehouse must provide the relevant logistical equipment sufficient for the warehouse's operation. At the same time, the Ukrainian customs authorities have the right to establish additional requirements for outfitting customs licensed warehouse facilities in order to ensure the safe storage of goods.

IV. The Procedure for Opening a Customs Licensed Warehouse

An entity, which intends to open and operate a customs licensed warehouse, must first file an application for the applicable license to open and operate such a warehouse. This application must be filed with the relevant customs office in the customs zone at the location of the warehouse.

The following documents must be attached to the application form:

- (a) copies of the foundation and registration documents (i.e., the charter, founding agreement, registration certificate, etc.) of the entity seeking to receive a license;
- (b) documents confirming the right to own and use the building(s) designated as the warehouse;
- (c) the economic grounds for the necessity to open a customs licensed warehouse;
- (d) the blueprints of the building designated as a customs licensed warehouse specifically marking the areas designated for use by customs employees;
- (e) the security and fire-safety alarm plans approved by the relevant authorities;
- (f) an agreement on the provision of security services for the premises with the authorities of the Ministry of Internal Affairs or with an entity possessing a license for providing security services issued by the Ministry of Internal Affairs;
- (g) any relevant permits issued by the authorities for sanitary and ecological control (for warehouses which are designated for the storage of goods subject to control by such authorities);
- (h) a technological scheme, including the means of control and inventorying (this pertains only to warehouses designated for the storage of liquid and granular (loose or poured) goods); and
- (i) a list of goods to be stored in the warehouse (this is related only to closed customs licensed warehouses).

The local customs office at the location of the customs licensed warehouse reviews the application form within thirty (30) days from the date of its receipt. If the local customs office grants preliminary permission to open a customs licensed warehouse, it will establish a so-called "Procedure of Organization of a Customs Regime – Customs Warehouse" (hereinafter the "Procedure").

Significantly, while each Procedure is established on a case-by-case basis, the mandatory contents include a list of employees who will have access to the customs licensed warehouse, the head of the customs licensed ware-

house, the number of customs officials who will participate in the clearance of goods, the working hours, etc. Additionally, the customs office may establish a simplified methodology for the customs clearance of goods for closed customs licensed warehouses.

Once the Procedure has been finalized, the local customs office delivers the package of documents to the main office of the Customs Service of Ukraine. The Customs Service then makes a final decision on issuing a license within thirty (30) days. If necessary, the management of the Customs Service may extend the term for consideration of the above matter for an additional thirty (30) days.

In the final stage, the Customs Service will issue a license signed by the Chairman or Deputy Chairman of the Customs Service. Licenses can remain in force for an indefinite period of time, provided that the customs licensed warehouse is re-registered annually. The state fee for such annual re-registration is equivalent to one thousand five hundred US Dollars (\$1,500.00), which must be paid in Ukrainian Hryvnias as of the date of filing the relevant documents with the Customs Service. Significantly, the license to open and operate a customs licensed warehouse is not transferable to third persons.

The Customs Service may refuse to issue a license if: (i) the facilities/equipment of the building(s) designated for the customs licensed warehouse do not comply with the Regulations; (ii) not all required documents were submitted for consideration, or (iii) the information contained in the filed documents contradicts applicable legislation. In case of refusal, the Customs Service will inform the applicant in writing, specifying its reason for such a refusal. Fortunately, the decision of the Customs Service is not final, and the applicant may appeal the refusal.

V. Storage of Goods in Customs Licensed Warehouse

All goods, regardless of their origin (Ukrainian or foreign), may be stored in a customs licensed warehouse, except goods associated with humanitarian assistance, the storage of which the Customs Code specifically forbids in customs licensed warehouses.

Various goods in transit through Ukrainian territory may be placed in customs licensed warehouses if they are to be reloaded from one type of transport onto another. It is worth noting, however, that certain goods, which are not permitted to be imported into or exported from Ukraine, as well as goods which are specifically prohibited from being contained in customs licensed warehouses pursuant to the laws of Ukraine, will be denied storage in such warehouses.

Certain goods require the prior consent of the Customs Service if their storage requires specific conditions due to toxicity, inflammability, etc. Such goods may be stored only in specially equipped areas of a customs licensed warehouse. Naturally, all goods and any other items are stored in a customs licensed warehouse under customs control and strict watch by the customs authorities. Along with the said security measures, the seal of the owner of the customs licensed warehouse must be available at all times. Goods placed in a customs licensed warehouse may be released only in the presence of authorized customs officials. All operations in a customs licensed warehouse are carried out with the permission of the customs authorities and at the expense of the warehouse owner.

As a general rule, goods imported into Ukraine can be stored in a customs licensed warehouse for a maximum of three (3) years. However, the customs authorities can shorten this period for certain goods. In contrast, goods to be exported from Ukraine can be stored in a customs warehouse for a maximum of three (3) months before actual export. In all cases, however, the specific term for storage of goods within the above periods is determined jointly by the owner of the warehouse and the person placing the goods for storage.

During the transportation of imported goods from one customs warehouse to another, the term for storage of these goods is determined from the date of their initial placement into the customs warehouse regime. After expiration of the storage term, such goods must be transferred for storage to a customs office, or a new customs-warehousing period must be declared and approved. In the latter case, the customs clearance of goods will be effected pursuant to the terms of the newly-declared regime.

VI. Functions of a Customs Licensed Warehouse

A customs licensed warehouse may only be used for the storage of goods specifically declared for storage in certain customs warehouse. For the storage of goods in a customs licensed warehouse, the owner or holder of the goods must submit a well-grounded application to the relevant customs authority stating the purpose of the storage of such goods.

If the goods will be stored pursuant to a long-term agreement, the application must be submitted upon the storage of the first consignment of goods. In this case, the goods may be stored in the warehouse for the term of validity of the agreement or one calendar year. In all cases, goods stored in a customs warehouse are subject to declaration, regardless of their value, by filling out a cargo customs declaration and submitting the following documents:

1. the agreement on the storage of goods in the customs licensed warehouse between the owner of the customs licensed warehouse and the entity, which stores such goods in the warehouse, and the foreign economic agreement (contract) pursuant to which the goods are imported or exported into/from Ukraine;
2. the transportation and other accompanying documents (way-bills, bills of lading, certifications, invoices, etc.);
3. permission of state bodies, which carry out control during the crossing of goods via the customs border of Ukraine.

If the goods are subject to certification after import into Ukraine, then the certificate of conformity does not have to be submitted with the above documents. In all cases, the storage of goods in a customs licensed warehouse must be carried out in the presence of a customs official.

A customs licensed warehouse may perform certain operations with goods stored therein in order to ensure storage, including the movement of goods within the warehouse for purposes of rational storage, cleaning, ventilation, creation of optimal temperature, painting, protection from corrosion, inventorying, etc. Additionally, in order to prepare for sale and transportation, a customs licensed warehouse may split up consignments of goods, prepare shipments, and sort, pack, re-pack, mark, load, unload, reload and test goods. Operations involving the equipping and repair of warehouse premises may also be conducted by a customs licensed warehouse. Regardless of the operation conducted, the description and nature of goods may not change in relation to their classification under the Ukrainian Classification of Goods of Foreign Economic Activity.

Goods stored in the customs regime of a customs warehouse may be released from a customs licensed warehouse:

1. into free circulation on the customs territory of Ukraine;
2. outside of the customs territory of Ukraine;
3. for temporary use on the customs territory of Ukraine under a regime of temporary import;
4. for processing on the customs territory of Ukraine;
5. for transfer to a warehouse of a customs body for storage or upon their abandonment in favor of the state;

6. for destruction under the control of a customs body;
7. for transfer to another customs licensed warehouse in the zone of activity of the same customs body;
8. for transfer to another customs body for the purpose of customs clearance under the selected customs regime;
9. temporarily with the subsequent return for:
 - (a) demonstration at an international exhibition held in Ukraine;
or
 - (b) certification by the state standards authorities of Ukraine or examination by other state bodies (i.e., sanitary-epidemic, veterinary-sanitary, phyto-sanitary and ecological authorities). If, upon the carrying out of certification or examination, samples of goods are completely used up or destroyed and are not returned to the customs licensed warehouse, then they are taken into account in the consignment of goods during the customs clearance into free circulation on the customs territory of Ukraine. The quantity of samples, which are released from a customs licensed warehouse, may not exceed the norms established by the authorized state body for certain types of goods.

In order to release goods from a customs licensed warehouse, the declaring party must submit to the relevant customs body a duly executed cargo customs declaration and all documents required for carrying out customs clearance of the goods and paying all taxes and duties (mandatory payments) established by law.

The customs value of goods is determined during the release of goods from a customs licensed warehouse. However, if goods are released for demonstration at an international exhibition or for certification or examination, the owner of the warehouse must submit to the relevant customs authority an application for permission to release the goods. The application must contain the following:

1. information on the good(s) (name, quantity, weight, value) with a mandatory indication of its code under the Ukrainian Classification of Goods of Foreign Economic Activity;
2. information on the purpose of the release of the good(s) temporarily with its (their) subsequent return;

3. information on the documents pursuant to which the goods were stored in the customs licensed warehouse;
4. the obligation to return the good(s) to the customs licensed warehouse with an indication of the term for return;
5. the obligation to pay the taxes and duties (mandatory payments) due in case of the failure to return the good(s) to the customs licensed warehouse within the established term;
6. information on the director of the customs licensed warehouse (surname, name and patronymic).

In addition to the above-described application, the following must be submitted along with the application:

1. the agreement between the owner (or holder) of the goods and the corresponding controlling body on the carrying out of an examination with an indication of the quantity of samples of the good and the term for performing the work; or
2. the certificate of the corresponding controlling body on the conclusion of such agreement with an indication of the number of the agreement, the date of its signing, the quantity of samples of the good and the term for performing the work.

The term of the release of goods from a customs licensed warehouse temporarily with subsequent return for demonstration at an international exhibition held in Ukraine may not exceed the term for holding such exhibition, taking into consideration the time necessary for the transportation of the exhibits and the construction and deconstruction of the exhibition. In contrast, the term of the release of goods from a customs licensed warehouse temporarily with subsequent return for carrying out certification or examination may not exceed 45 calendar days. In case of the impossibility to carry out an examination within 45 calendar days, such term may be extended on the condition of the submission to the relevant customs body of a document confirming such impossibility issued by the corresponding controlling body.

Upon the transfer of goods from one customs licensed warehouse to another in the zone of activity of one customs body, the goods may only be transferred within the term of their storage. However, the procedure of customs control over the transfer of such goods must be approved by an order of the customs body. Transfer is permitted in case of the following:

1. the liquidation of the customs licensed warehouse in which the goods are stored;
2. force majeure circumstances, which may cause the loss or damage of the goods stored at the customs licensed warehouse;
3. the termination of the storage agreement concluded between the owner of the customs licensed warehouse and the entity, which stored the goods in the warehouse, and the conclusion of a new storage agreement with an owner of another customs licensed warehouse.

The transportation of goods to another customs body for carrying out customs clearance pursuant to the selected customs regime may be carried out on the condition of the submission by the declaring party to the customs body of an internal transit document pursuant to the procedure established by the State Customs Service of Ukraine.

If a customs licensed warehouse released goods without the permission of a customs body or goods are lost (except in cases of force majeure or a defect of goods as a result of natural deterioration (wear and tear) or a decrease due to normal conditions of storage), the owner of the customs licensed warehouse bears liability pursuant to the Customs Code of Ukraine and must pay cash in the amount of import (export) taxes and fees, which should have been paid had the goods been cleared pursuant to the customs regime of import (export).

VII. Cancellation and Suspension of a License and Liquidation

A license to operate a customs licensed warehouse can be suspended for a period of up to three (3) months, or even cancelled altogether, by the Customs Service. Specifically, the head of the local customs office has the right to suspend the validity of a license in the following cases:

- (a) if the operations of a customs licensed warehouse are halted for over four (4) months;
- (b) if the owner of the warehouse or persons with access to the warehouse repeatedly violate the Regulations and applicable customs legislation;
- (c) if the owner of the customs licensed warehouse violates foreign economic legislation after receiving notice to cease and desist certain activities;
- (d) non-fulfillment of the requirements set forth in the head of the local customs office's decision to suspend the validity of a license;

- (e) if a customs licensed warehouse continues the violations mentioned in paragraphs (a), (b) and (c) in this list of suspension cases, provided that temporary suspension of the validity of a license has been earlier applied;
- (f) if a criminal case is initiated against the customs licensed warehouse with respect to its foreign economic activity; and
- (g) if the Customs Service uncovers violations of applicable legislation during an inspection of the customs licensed warehouse.

The head of the Customs Service will cancel a license upon petition of a local customs office. Upon cancellation of a license, the owner of the warehouse must return the license to the local customs office no later than seven (7) days from the date of such cancellation.

VIII. Conclusion

The provisions of the Customs Code concerning customs licensed warehouses are rather straightforward, although proponents of economic reforms constantly propose amendments to the legislation governing this topic (taking into account the provisions of the new Customs Code). Instead, what is sorely needed is a concentrated effort to implement in a transparent manner this otherwise well-developed and comprehensive legislation.

D LICENSING

I. Introduction

Weapons, narcotics, explosives, precious metals and shiny stones... Nobody, in their right mind, would admit to producing or possessing these items in their declaration form. Still, Law No. 1775-III "On Licensing Certain Types of Economic Activity" (the "Law"), dated June 1, 2000 (as lastly amended on December 11, 2003), lists up to 60 types of activities subject to licensing.

In the early days of independence, licensing of only the so-called "forbidden goods" (i.e., weapons, narcotics, etc.) or life's necessities (i.e., water supply, medical services) was mandatory in Ukraine. As the bureaucracy grew, so did the number of activities requiring a license. Accordingly, the number of Ministries and administrations that issued licenses grew, as did the number of licensing procedures and documentation requirements.

Under pressure from various international organizations demanding order in the licensing system, the Ukrainian Parliament passed the Law with the aim of establishing a unified licensing procedure, a unified list of activities subject to licensing and one authorized licensing body. The unified list includes the following activities in which foreign investors might be interested: the exploration and prospecting of minerals, the production and sale of medicines, activities in the spheres of telecommunications and television, precious metals and stones, oil and gas transport, construction, passenger transportation, education, insurance and securities market activities, just to mention a few. Of course, any individual or business engaged in the activities set forth in the Law without a license is subject to hefty penalties and even criminal sanctions.

With this background in mind, the discussion below describes the new unified licensing procedure.

II. Discussion

A. Licensing Bodies

Pursuant to the Law, a specially authorized body was established, responsible for issues of licensing (the "Licensing Authority"). Among its many functions, the Licensing Authority is responsible for developing and consenting to any normative acts in the sphere of licensing, creating licensing terms and conditions, supervising licensing bodies and licensees, publishing explanations about the application of licensing leg-

isolation, determining the form of licenses and the documents required for receiving a license, maintaining the unified licensing register, training qualified specialists and carrying out control over the presence of proper licenses in licensed activities. Interestingly, with respect to the last aforementioned function, the Licensing Authority and other authorized executive bodies may carry out control over the presence of licenses via so-called "planned and unplanned" inspections. Presumably, the introduction of this amendment to the Law on January 17, 2002 was in direct connection to the recent crackdown efforts on CD piracy and other violations of intellectual property rights.

In order to effectively carry out the above functions, the Law permits the Licensing Authority to establish territorial bodies, which are bodies of the executive branch of government and which must function according to so-called "Regulations" approved by the Licensing Authority. In turn, these territorial bodies may delegate their authorities to their territorial subdivisions. Generally, the territorial bodies serve the same purpose as the Licensing Authority on their own territories. That is, they exercise control over licensed activities, set the terms and conditions for working under such licenses, issue licenses and duplicate licenses, annul licenses, minimize violations, etc.

All licensing issues are reviewed internally by the so-called "Expert and Appeal Board" (the "Board") of the Licensing Authority. Decisions of the Board are effectively expert conclusions, and are obligatory for the Licensing Authority's review. The Board is responsible for rendering expert opinions on the draft legislation and the Licensing Authority's supportive acts, submitting recommendations to resolve existing problems in the licensing sphere, providing preliminary conclusions on the expediency of licensing certain economic activities and reviewing applications, claims and complaints towards the decisions of the Licensing Authority in regard to violations of licensing conditions.

The Board also acts on the basis of "Regulations" approved by the Cabinet of Ministers, and consists of state employees, members of scientific bodies, other specialists and representatives of public organizations. However, only 20% of the Board's members may consist of independent experts and representatives of public organizations. This way, the State retains a firm grip on the decisions of the Board.

Once registered with the Licensing Authority, draft normative acts, propositions and appeals must be reviewed by the Board within 20 working days. All decisions of the Board are passed by a simple majority of votes, which are put into a protocol and form the basis for issuing orders to combat violations of licensing legislation by licensing bodies.

B. Licensing Terms and Conditions

All licensing terms and conditions are described in normative acts and regulations, which establish the qualification, organizational, technological and other requirements for carrying out certain types of economic activity. Further, all subjects of economic activity must comply with the effective licensing terms and conditions.

If a licensed activity requires special knowledge (i.e., qualification requirements) or special premises, equipment or other technical means, then such specific requirements must be included in the licensing conditions. Importantly, if a business activity is subject to licensing in part or in separate transactions or services, then the licensing terms and conditions apply only to the relevant parts of such activity as set forth in the license.

The licensing terms and conditions for certain activities are approved in joint decrees of the Licensing Authority and the territorial licensing bodies. Licensing terms, and any changes thereto, are subject to publication in accordance with a well-established procedure and come into force 10 days from the date of their state registration, unless otherwise provided in the published normative act.

C. Documentation Requirements

All businesses, including individuals and companies, interested in receiving a license for a certain activity must submit an application (in the established form) along with the required documents. The application may be submitted personally or by a representative with a power of attorney, and must contain the following:

- (a) information about the applicant;
 - (i) for legal entities: its full name, location, bank requisites, identification code;
 - (ii) for individuals: surname, first name, patronymic (if applicable), passport information (series, number, issuer, date of issuance, residence) and identification number as a taxpayer; and
- (b) the type of licensed activity (to be performed in full or in part) for which the applicant wishes to receive a license.

In addition, Resolution No. 756 of the Cabinet of Ministers of Ukraine "On Approval of the List of Documents Which Shall Be Attached to an

Application on the Issuance of a License for Certain Types of Economic Activity," dated July 4, 2001, lists the documents, certificates, permissions and other information, which must be submitted along with the above-mentioned application for certain types of licenses. Resolution No. 756 is subject to somewhat frequent amendment and was lastly amended on October 2, 2003.

If the applicant has affiliates or other subdivisions, which will carry out the licensed activity, the application must indicate their place of location. The applicant must also attach to the application a copy of its certificate of registration as a so-called "subject of entrepreneurial activity" (for individuals) or a copy of its certificate, evidencing that the applicant was introduced into the Unified Register of Enterprises and Organizations of Ukraine (for legal entities). Importantly, the above certificates must either be notarized or certified by the issuing authority.

To the delight of those foreign investors accustomed to dealing with Ukrainian authorities, the Law strictly stipulates that the licensing bodies are prohibited from demanding any other documents not listed in the Law and Resolution No. 756. The application and attached documents are accepted according to a checklist, a copy of which is issued to the applicant, signed by the authorized officer and marked with the date of receipt by the relevant licensing body.

A licensing body may refuse to review an application in one of two cases: (i) the application was submitted (signed) by an unauthorized individual or (ii) the documents do not comply with the requirements of the Law. In either case, the applicant will be informed in writing about the refusal, including the reason for such refusal. After remedying any faults, the applicant may submit an application once more, which will be treated as if it were submitted for the first time. Therefore, if the receipt of a license is time sensitive, the applicant must carefully follow the application rules.

The relevant licensing body will issue its decision on whether or not to issue a license no later than 10 working days from the date of submission of an application, unless another term for issuing licenses in special spheres is provided by specific laws. Notice about the decision will be sent to the applicant in written form within 3 working days from the date the decision was adopted.

There are two reasons for the refusal to issue a license:

- (i) if the applicant includes false information in the application or the documents attached thereto; and

- (ii) if the applicant does not meet the licensing terms and conditions for the specific activity, as evidenced by the documents submitted with the application.

In the first case, the applicant may re-apply for a license no earlier than 3 months from the date of refusal. In the second case, the applicant may re-apply for a license after remedying any faults in the application. In both cases, the decision on the refusal to issue a license may be appealed in a court of law.

D. License Tenders

If two or more applications are submitted for a license to carry out activities related to limited resources or the application of new technology/equipment for exploiting limited resources, then the issuance of such a license must be decided on the basis of an open tender between the applicants. Although the Law does not list all of the activities related to "limited resources," it specifically singles out the mining of uranium ore, the mining of precious metals and stones, the transportation of natural gas according to regulated and non-regulated tariffs, the storage of natural gas in volumes exceeding the licensing threshold and the provision of radio communication services (via radio frequency bands).

These license tenders are held according to the general procedure established by the Cabinet of Ministers, unless another procedure exists under specific Ukrainian laws. Firstly, an announcement about the tender must be published in the official government publications no later than 60 calendar days before the day of the tender. Anyone interested in participating in the tender must send a notice to the licensing body as well as the required documents.

The results of the tender are documented in a protocol and confirmed by the relevant licensing body within 5 working days from the date of the tender. In accordance with the tender results, a notice on the issuance of a license or refusal to issue a license is sent to each applicant in written form within 3 days from the date of confirmation of the tender results. The results of the tender may be appealed in a court of law.

If a license, which was granted pursuant to a tender, is annulled, the licensing body must announce a new tender for such license within 10 working days from the date of the prior license's annulment. Further, if a licensee, which received its license as a result of an open tender, does not carry out the activities for which the license was issued for a

period of six months, then the relevant licensing body has the right to annul such license.

E. The License

For the first time in its history, Ukraine has a unified form for licenses. Licenses contain a series and a number and must indicate the following: the name of the issuing body, the type of licensed activity, the full name of the legal entity or individual licensee, the identification code or number of the licensee, the location or residence of the licensee, the license's term of validity, the date of issuance, the presence and number of annexes to the license, etc. A license must be signed by the head of the relevant licensing body or its authorized replacement, with such licensing body's official seal affixed thereto.

After rendering a positive decision to issue a license and upon receipt of the document evidencing payment of the license fee, the issuing licensing body must issue the license within 3 working days. If the applicant does not present the documents evidencing payment of the official fee or fails to request the executed license within 30 calendar days from notification on the issuance of a license, then the issuing licensing body has the right to cancel its decision or deem such license invalid.

The validity term of a license is established by the Cabinet of Ministers, but in all cases it may be no less than 3 years. If a license is issued by a central body of the executive power, then the licensed activity may be performed anywhere in Ukraine. However, if a local licensing body or specially authorized executive body issues a license, then the licensed activity may only be performed on the territory of the corresponding issuing authority.

If a licensee has affiliates or other subdivisions that will carry out the licensed activity, then the licensing body will issue a certified copy of the license, which will be registered in the registry of applications and issued licenses. A certified copy of a license confirms the right of an affiliate or other subdivision to carry out a licensed activity. The petty fee for such copies is one non-taxable minimum income (currently 17 Hryvnia) and must be sent to the state budget.

In case a licensee creates a new affiliate or other subdivision, which will carry out a licensed activity, the licensee must submit an application to the licensing body for a certified copy of the original license and all of the documents, which were submitted along with the original application. Conversely, if a licensee liquidates an affiliate or subdivision or if such affiliate or subdivision simply terminates its licensed

activity, then the licensee must inform the relevant licensing body about such liquidation or termination of activities in writing within seven working days.

If a licensee intends to carry out its licensed activity beyond the expiration date of its license, such licensee must re-apply for a new license according to the same procedure whereby it received the original license. In other words, the prior receipt of a license does not make it any easier to receive a subsequent license, even for the same activity. Accordingly, a new license will be issued no earlier than the last working day of the previous license. In all cases, a licensee may not transfer its license or the notarized copies thereof to a third party.

The official fee for a license is established by the Cabinet of Ministers and is transferred to the state budget upon receipt. The most recent schedule of official fees can be found in Resolution No. 1755 of the Cabinet of Ministers, entitled "On the Term of Validity of Licenses for Carrying Out Certain Types of Economic Activity and the Procedure for Calculating the Payment Amount for the Issuance Thereof," dated November 29, 2000, as lastly amended on August 17, 2002. Procedurally, the official fee may be paid only after the decision to issue a license is deemed final.

In most cases, the official fee is calculated on the basis of 20 non-taxable minimum incomes for a 3 year license issued by a central body of the executive power. As one non-taxable minimum income is currently equivalent to 17 Hryvnia, the official fee for most licenses for activities, which may be carried out anywhere in Ukraine, is 340 Ukrainian Hryvnia (or approximately 64 US Dollars at the time of this publication). If the license is issued by a local body of the executive power (i.e., the licensed activity may only be performed on the territory of the issuing body), then the official fee for most license activities is 15 non-taxable minimum incomes. Thus, such fee will be 255 Ukrainian Hryvnia (or approximately 48 US Dollars at the time of this publication).

According to Article 15 of the Law, ten (10%) percent of the official fee to the state budget for a license is transferred to an earmarked fund and used for compensating expenses connected with maintenance of the unified license register and the preparation of blank license forms. However, according to the most recent changes to the Law, which were introduced on November 27, 2003, this provision of Article 15 has been suspended for 2004. In fact, ever since the Law's passing in 2000, this provision of Article 15 has been suspended at each year's end.

If any of the information regarding the licensee changes, including changes of names, location or licensed activity, then the licensee must submit

an application to introduce the appropriate amendments to the licensee's information within 10 working days. The license itself must also be submitted along with the meager official fee and the documents confirming the grounds for the relevant changes (or notarized copies thereof). Thereafter, the licensing body must issue a new license, indicating the relevant changes, within 3 working days. However, if the changes are related to the licensee's intent to expand its licensed activity, then the licensee must go through the entire licensing procedure once more.

Once the decision is made to re-issue a license due to informational changes, the licensing body will annul the original license and introduce the corresponding entry into the unified license register by the next workday. The expiration date of the re-issued license will remain the same as the original license. In the interim between re-applying for a license and the issuance thereof, the licensing body gives the licensee a temporary certificate so that it may continue with its licensed activity. The licensing body will issue a similar temporary certificate in case a license is lost or damaged, and an application has been submitted for a duplicate license.

If there are any changes to the documents submitted with the application to receive a license, the licensee must inform the appropriate licensing body by sending a written notice and the documents, or notarized copies thereof, confirming the changes to the supporting documents. The licensing body, on the basis of the submitted documents, may annul the license if the licensee will no longer be able to meet the licensing terms and conditions due to the said changes.

F. License Annulment

There are several bases for annulling a license, including:

1. voluntary annulment by the licensee;
2. repeat violations of licensing terms and conditions;
3. cancellation of the state registration of a licensee;
4. the death of an individual licensee;
5. submission of false information with the license application;
6. the transfer of a license to a third party;

7. untimely notice to the relevant licensing body regarding changes in the licensee's documentation;
8. the failure to fulfill official orders to cure violations of licensing terms and conditions;
9. the inability of the licensee to continue fulfilling the licensing terms and conditions; and
10. the licensee's refusal to permit an inspection for the presence of a license by the relevant licensing body or the Licensing Authority.

In all cases, the official documents evidencing the grounds for annulment must be presented to the licensing body. The licensing body is obliged to invite the licensee or its representative to participate in the review of the supporting documents in cases 5-8 above. Once the licensing body reviews the supporting documents, it must hand down its decision to annul the license within 10 working days, which is relayed to the licensee with an indication of the annulment grounds within 3 working days from the decision.

If the licensee submits an appeal to the Board, the validity of the licensing body's decision will be suspended until the Licensing Authority makes its final decision on the matter. If the final decision favors annulment, then the date and number of the corresponding decision is written into the unified license register by the following day.

In cases 2, 5, 6, 7 and 8, the licensee may only receive a new license for its particular type of licensed activity no earlier than 3 years from the date of annulment of the original license. Of course, the licensee has the right to appeal the final decision of the Licensing Authority in a court of law.

III. Conclusion

Whether the Law was written as a result of international pressure or the local lawmakers' genuine desire to make things easier for Ukrainian businessmen and foreign investors alike, the result brings optimism. The Law and its implementation are quite simple and straightforward, to the point where at last licensing activities appears to be somewhat more tolerable and surprisingly comprehensible.

E CERTIFICATION OF GOODS AND SERVICES

For years, horror stories circulated about the intricacies of setting up shop in Ukraine. Legitimate grievances continue to exist, perhaps best exemplified by the notorious certification system.

In the West, most producers of goods and services voluntarily certify the quality and safety of their products through independent, non-governmental organizations. The concept is simple: most Western companies want their customers to have faith in their product, and therefore they guarantee the quality and safety of their products themselves because the sale of poor quality and unsafe products can lead to a loss of goodwill and extensive legal expenses.

In Ukraine, however, all goods and services must go through a mandatory certification process that involves two state entities: the Ministry of Health and the DerzhStandart (the State Committee for Standardization, Certification and Metrology). This certification process is expensive and lengthy, which adds to the price of the goods and services offered by the producers. For instance, a company must receive a so-called "hygienic conclusion" from the Ministry of Health with the corresponding certification of the goods and services from Derzhstandart.

Likewise, any Ukrainian company that wishes to utilize European technology in Ukraine must present the equipment/machinery to the laboratory of DerzhStandart in order to receive a certificate for its use. Although this certification means absolutely nothing in Europe, it raises the price of the goods to be produced because literally every nook and cranny must be checked and certified. Not surprisingly, this cumbersome barrier to entry does not sit favorably with foreign companies.

Furthermore, DerzhStandart establishes the size of packages and the storage term for products. Therefore, if a company wishes to produce, for example, three and a half liter bottles of a soft drink and such bottle sizes are not provided for by DerzhStandart, then the company does not have the right to produce such bottles. Additionally, DerzhStandart can establish a storage term for the soft drink at 15-20 months while the corresponding certificate will be valid for only 6 months.

If taken literally, this means that every six months the company must re-certify the soft drink, which will be done at the same cost as the first certification. Officially, the cost for certification can run between 1,000

and 1,500 Ukrainian Hryvnia each time certification becomes necessary. Taking all of these costs into consideration, the price of goods and services can increase by as much as 10-15% of the actual cost. Ultimately, this cost increase negatively affects the buying power of the customer.

Importantly, the Presidential Decree No. 817/98 "On Certain Measures for the De-regulation of Entrepreneurial Activity," dated July 23, 1998 (as lastly amended on August 22, 2000), exempts products (except food products) whose quality is confirmed by certificate issued outside of Ukraine in accordance with the international standard ISO or other international standards, from having to repeat the certification for such goods in Ukraine. This being said, however, Ukraine is still not a member of the European Co-operation for Accreditation ("EA"), therefore the accreditation of goods in a Ukrainian laboratory for their subsequent export is not accepted by most member states of the EA (i.e., the goods must be examined in a European laboratory). Likewise, goods imported into Ukraine must go through the accreditation process in a Ukrainian laboratory if Ukrainian accreditation is not accepted in the country of origin. Again, this affects the price for which goods will be sold on the market.

In a related matter, on December 1, 1999, the Parliament issued Resolution No. 1258-XIV "On the Draft Law 'On Liability of Suppliers for the Manufacture and Sale of Poor Quality and Dangerous Products.'" The draft law was prepared by the Derzhstandart (the State standardization authority), and finally resulted in the Law of Ukraine No. 1393 "On Extraction From Circulation, Processing, Utilization, Destruction or Further Use of Poor Quality and Dangerous Products," dated January 14, 2000 (as lastly amended May 15, 2003), which covers one of the requirements for joining the European Union, namely the quality maintenance of sanitary and ecological norms in accordance with international standards. Among other clauses, it levies disciplinary, administrative, civil and/or criminal liability for supplying poor quality or dangerous products and failing to comply with the provisions of the law.

For years, certification has been a thorn in the side for foreign investors. However, a light at the end of the tunnel has recently appeared. Through the efforts of such organizations as the European Business Association, the American Chamber of Commerce and various delegations from the European Union, the Ukrainian government is attempting to bring its certification requirements up to European standards with the aim of someday joining the EA, the World Trade Organization and, perhaps eventually, the European Union. Although many of the old practices remain in custom, the Ukrainian government has taken significant steps

in implementing more transparent certification procedures. This is most recently evidenced by the recent passing of Order No. 9 of the Ministry of Health Protection "On Approval of the Procedure for Carrying Out Certification of Pharmaceuticals for International Trade," dated January 14, 2004 and registered with the Ministry of Justice on January 30, 2004 under No. 129/8728. In the near future, hopefully, Ukraine will permit the construction of Western and/or European accreditation laboratories on the territory of Ukraine thereby making the accreditation procedure cheaper and decreasing the price of goods which still require both Western and Ukrainian accreditation.

F FREE ECONOMIC ZONES

With the cancellation of the formerly granted 5-year tax holidays, the Law "On Foreign Investment Regime" ceased to be a useful (or reliable) vehicle for effectuating investing in Ukraine. As a result, the ever-resourceful Ukrainian legislative minds came up with a new and improved plan for attracting elusive foreign capital. While passing restrictive legislation on the one hand, the Ukrainian Parliament passed several laws designed to inject foreign capital into Ukraine's so-called "special regions."

This is not a new idea. The first attempt to create free economic zones was made on October 13, 1992, when the Ukrainian Parliament passed Law No. 2673-XII "On General Principles on the Creation and Functioning of Special (Free Economic) Zones," as lastly amended on May 15, 2003 (the "FEZ Law"), which established a general framework for the creation of free economic zones ("FEZ"), and that was about it. This experiment had lasted less than one year and was eventually forgotten. Perhaps for that reason the Parliament, together with the President, once again attempted to return to the policy of the free economic zones.

This time around the Parliament started to pass such case-specific gems as the Law of Ukraine No. 65/96-VR "On Certain Questions Related to Currency Regulation and Taxation of Subjects of the Experimental Economic Zone Syvash," dated February 23, 1996; the Law "On Special Regime of Investment Activity in the Zakarpatskaya Region," dated December 24, 1998; Law No. 356-XIV "On Special Economic Zones and the Special Regime of Investment Activity in Donetskaya Region," dated December 18, 1998 (as lastly amended on February 7, 2002); Law No. 970-XIV "On the Special Regime of Investment Activity on the Priority Development Territories in Luganskaya Region," dated July 15, 1999 (as lastly amended on January 16, 2003); Law No. 402-XIV "On the Special Economic Zone 'Yavoriv,'" dated January 15, 1999 (as lastly amended on January 1, 2003); the Law of Ukraine No. 514-14 "On Special Economic Zone of Tourist-Recreational Type 'Kurortopolis Truskavets,'" dated March 18, 1999 (as lastly amended February 7, 2002); the Law of Ukraine No. 721-XIV "On the Special Economic Zone 'Slavutych,'" dated June 3, 1999 (as lastly amended on January 16, 2003); and the Law of Ukraine No. 1276-XIV "On the Special Regime of Investment Activity on Priority Development Territories in the Zhytomirskiy Region," dated December 3, 1999 (as lastly amended on February 7, 2002).

Still more free economic zones were established under the following laws: the Law of Ukraine No. 1605-14 "On the Special Economic Zone 'Reni,'" dated March 23, 2000; the Law of Ukraine No. 1607-14 "On the Special (Free) Economic Zone 'Porto-Franko' Within the Territory of the Odessa Cargo Port," dated March 23, 2000; the Law of Ukraine No. 1714-III "On the Special Regime of Investment Activity on the Territory of the City of Kharkov," dated May 11, 2000 (as lastly amended on February 7, 2002); the Law of Ukraine No. 1909-14 "On the Special Economic Zone 'Mykolayiv,'" dated July 13, 2000 (as lastly amended on February 7, 2002); the Law of Ukraine No. 2189-III "On the Special Economic Zone 'Port Krym' and the Special Regime of Investment Activity on the Priority Development Territories in the Autonomous Republic of Crimea," dated December 21, 2000 (as lastly amended on February 7, 2002); the Law of Ukraine No. 2322-III "On the Special Economic Zone 'Zakarpattya,'" dated March 22, 2001; and the Law of Ukraine No. 2354-III "On the Special Regime of Investment Activity on the Priority Development Territories in the Volyn Oblast," dated April 5, 2001 (as lastly amended on February 7, 2002).

The broad purpose of the original FEZ Law was to attract and retain foreign investment, develop export-oriented entrepreneurial activity with foreign investors, develop high quality market conditions and attract new technologies and agricultural market methods. To effectuate this general purpose, the FEZ Law established a "special legal regime of economic activity" for Ukrainian and foreign legal entities and natural persons.

The forms, terms and boundaries of FEZs, according to Law No. 2673-XII, are established through special legislation. These zones can take the following forms, or combinations thereof: free trade zones and ports, export zones, transit zones, customs collection zones, technological parks, manufacturing complex zones, tourism-recreation zones, insurance and banking zones, among others.

FEZs are created by parliamentary legislation on the initiative of the President, the Cabinet of Ministers, municipal councils or municipal state administrations. If the initiatives come from the state (national) level, then no final decision on creating a FEZ can be made without the written consent from the appropriate municipal bodies. If the initiatives arise on the municipal level, they must be in the form of proposals and submitted to the Cabinet of Ministers. The Cabinet of Ministers reviews such proposals and submits its conclusions to the Parliament.

For example, the head of the Ivano-Frankovsk Region Administration announced on March 15, 1999 that the Cabinet submitted for consider-

ation documents concerning the creation of a Free Economic Zone in the city of Yaremcha. The proposed FEZ in Yaremcha would target promotion of travel agencies, health clubs and resorts. A special tax regime will be implemented in the FEZ, which should theoretically be sufficiently advantageous to attract national as well as foreign investors, and create jobs for residents of the unemployment-hit resort region. To this date, however, a FEZ has not be set up in Yaremcha.

The Creation of a FEZ is not a simple task, as exemplified by the adoption of the Truskavets Free Economic Zone. On February 4, 1999, the draft of the Law "On Truskavets Free Economic Zone" was submitted to President Kuchma, but he vetoed it. Among other objections, the President was against introducing the law as of the date of its publication, arguing that since the law was enacted subsequent to the law on the state budget for 1999, the budget will have no funds to offset the losses resulting from the law on the Truskavets FEZ. The President, therefore, wanted to introduce the law as of January 1, 2000, but on March 18, 1999, the Parliament approved the law on the free economic zone "Kurortopolis Truskavets" in the Lviv Region, incorporating the changes Kuchma suggested. The Law went into effect on January 1, 2000, and notably did not exempt sales of medical services from VAT.

Within the city of Truskavets area, the Kurortopolis FEZ was created for a period of 20 years. According to the law, profits generated by investment projects worth over US \$500,000 are exempt from taxation for 3 years; after 3 years, the rate of corporate income tax will be 50% of the base rate. Equipment, software and pharmaceuticals (except excise goods), which are imported for FEZ companies' production needs, are exempt from VAT and any import duties.

Under the Kurortopolis law, the taxable gross income of FEZ companies will not include investments made in the form of cash or tangible and intangible assets, the hard currency value of which has been confirmed in compliance with the legislation of the country of the foreign investor or international trade regulations, as well as by expert assessment in Ukraine. The above law also imposes a spa tax on all persons coming for medical treatment to Truskavets. All hard currency revenues from the sale of goods, works and services by FEZ companies are not subject to the mandatory sale of foreign currency to the National Bank.

Another example of a "special legal regime" is the free economic zone in the Zakarpatskaya region. According to the Presidential Edict No. 1338/98 "On the Special Regime of Investment Activity in Zakarpatskaya Region," dated December 9, 1998, and the Law of Ukraine No.

357-XIV by the same name, a "special regime" is established for 15 years in the Zakarpatskaya region for investment projects that are given so-called "priority" economic activity status. The special regime provides tax and customs privileges for companies that enter into agreements with the city state administrations regarding investment projects. Of course, all such agreements must be approved by the Cabinet of Ministers.

The special regime in the Zakarpatskaya region grants to its participants the following privileges:

1. no more than 5-years VAT and customs exemptions on imported equipment used for the effectuation of investment projects (excluding excise duty). Note, however, that customs duties and VAT will become due if the imported equipment is alienated before the expiration of the term of the investment project;
2. A 2-year tax holiday for new production, including the restructuring of enterprises with investments of no less than 250,000 US Dollars (or the equivalent in Hryvnia) and income of enterprises from reconstruction or modernization investments, if such investments are equal to or greater than 250,000 US Dollars.

The aforementioned income is taxed at a rate of 50 percent of the present tax rate, for the third through fifth year of investment. This 2-year tax holiday begins from the date of the company's first profit. The procedure of profit calculation for companies with tax-holidays is determined by the State Tax Administration.

A word of caution: this approach is disturbingly similar to the "qualified foreign investments" of more than 50,000 with a 5-year tax holiday, once granted by Decree No. 55 "On the Foreign Investment Regime." Based on bitter past experience, it is difficult to determine how long the present tax holidays will remain valid;

3. A 2-year exemption for newly established enterprises from payments to the State Innovation Fund; and
4. For purpose of taxation, the following in-kind investments, according to the specific investment project, are not included in the profit of enterprises: (a) monetary funds; (b) material valuables; and (c) non-material assets, the value in convertible currency of which are documented according to the laws of the investor's country or international trade customs, as well as by expert valuation in Ukraine, including copyrights, trademarks for goods and services and know-how registered on the territory of Ukraine.

According to the Law "On the Special Regime of Investment Activity in the Zakarpatskaya Region," all investments projects which are connected with so-called "priority spheres" of business activity have first-priority right to obtain credits, backed by state guarantees, international financial organizations and international banks. Income received by the FEZ companies from tourism services in the Zakarpatskaya region will not be taxed until the year 2004.

In comparison, Law No. 970-XIV "On the Special Regime of Investment Activity on the Priority Development Territories in Luganskaya Region" establishes a special regime for a term of 30 years in the Luganskaya region. In comparison, the same 5-year tax holiday for imported equipment in the Zakarpatskaya FEZ law is prescribed, but a 3-year tax holiday on income of newly-established or reorganized enterprises with investments of no less than 1,000,000 US Dollars in the Ukrainian Hryvnia equivalent is also available.

Another Law "On Special Economic Zones and Special Regime of Investment Activity in Donetskaya Region" (No. 356-XIV) introduces a special regime for investment activity on the "priority territories" in the Donetskaya region. According to this law, a "priority territory" is defined as a territory within the limits of a city, district or region, where unfavorable social-economic conditions exist which require investment. The special economic zone "Donetsk" has already been created and will continue for a period of 60 years.

Finally, as briefly mentioned, all foreign currency earned on the territory of special zones is free from obligatory sale by Ukrainian banks. Further, special customs and tax regimes are introduced on the territory of such special zones. For example, the system of taxation in the Donetsk FEZ is as follows:

1. profits of taxpayers are taxed at the rate of 20% of the object of taxation; and
2. profits of non-residents, which result from investment activity on the territory of special zones, are taxed at a rate of 2/3 of the normal tax rates, as defined by Article 13 of the Law of Ukraine "On Profit Taxation of Enterprises."

In conclusion, special investment legislation (i.e., FEZ laws) offers another alternative to foreign investors looking for tax breaks in exchange for taking the risk of investing in Ukraine. While the general investment legislation (i.e., the Laws "On the Foreign Investment Regime," "On Investment Activity" and other laws) has been subject to debate with

respect to the current or past existence of promised tax holidays and exemptions for foreign investment, the special investment legislation is quite clear. If an investment project in a particular zone meets the criteria of the applicable FEZ law, the investor can count on receiving the investment and taxation benefits established thereby, provided the investment project stays within the requirements set forth in such FEZ law. While each law is specifically tailored to the various regions due to the diversity of their natural advantages, one thing remains constant: it is imperative to contact the local administrations when attempting to enter a FEZ because each administration can offer various methods in facilitating an investor's entrance into the FEZ.

G THE BASICS OF UKRAINIAN IMPORT-EXPORT CONTRACTS

I. Introduction

Eastern European countries are known for their strict rules governing cross-border contracts. Ukraine is no exception. A closer analysis, however, reveals that the "strict" Ukrainian legislation is not that different from the demands of comparable European and American laws.

Generally, what is otherwise known in the world as an import-export contract is known in Ukrainian legalese as a "foreign economic sale-purchase agreement (contract)," which must correspond in form and substance with the Law of Ukraine No. 959-12 "On Foreign Economic Activities" (hereinafter the "Law No. 959-12") and Order No. 201 of the Ministry of Economy and European Integration Issues "On Approving the Regulations on the Form of Foreign Economic Agreements (Contracts)," dated September 6, 2001 and registered with the Ministry of Justice on September 21, 2001 (registration No. 833/6024) (hereinafter the "Regulations").

The Regulations define a foreign economic agreement as a transaction executed by two (2) or more business entities and their foreign counterparts, which transaction is directed at the establishment, alteration or termination of mutual rights and duties in foreign economic activity. The agreement (contract) must be executed according to the requirements of Law No. 959-12 and other Laws of Ukraine, especially taking into account the provisions of existing international treaties to which Ukraine is a party.

When drafting the text of a foreign economic agreement, the parties thereto may use recognized international customs and recommendations of international bodies and organizations, unless such use is directly and expressly prohibited by the provisions of Law No. 959-12 and other Laws of Ukraine. Notably, if Ukraine is a party to an international treaty, which provides different terms and conditions than contained in Law No. 959-12, then the provisions of such international treaty will prevail.

A business entity on an authorized representative thereof must execute a foreign economic agreement in a written form, unless otherwise provided by Ukrainian legislation or international treaties to which Ukraine is a party. A representative's authority may arise out of a power of attorney, the business entity's constituent documents, specific agreements or other grounds, which do not contradict Law No. 959-12. Importantly, actions taken on behalf of a foreign business entity by a properly authorized Ukrainian business entity are deemed to be actions taken by such foreign business entity itself.

Finally, if the parties to an agreement (contract) fail to draft such agreement in accordance with the requirements of the relevant Ukrainian laws or international treaties to which Ukraine is a party, then a court of law may recognize such agreement as invalid.

II. Form and Substance: Keeping Within The Guidelines

The rights and duties of the parties to a foreign economic agreement must be in compliance with the substantive and procedural law of its place of conclusion, unless the parties to such agreement specifically agree otherwise and set such out in writing in the terms and conditions of the agreement.

Unless the parties to the agreement in question have agreed otherwise with respect to setting out the terms and conditions, and such agreement does not deprive the agreement of its subject matter, object, purpose and other material terms and conditions without the approval of the parties, the agreement may be deemed as not concluded or it may be recognized as invalid as a result of failure to comply with the effective requirements of Ukrainian legislation regarding the form of foreign economic agreements. The mandatory terms and conditions of a foreign economic agreement (including sale-purchase agreements for goods, services and works and barter agreements) are the following:

1. The agreement's title, number, date and place of conclusion.
2. A properly drafted preamble. The preamble must include (i) the full names of the parties to the foreign economic transaction (as duly registered in their countries of origin); (ii) the names of countries; (iii) an abbreviated identification of the counterparts (e.g., "Seller," "Buyer," etc.); (iv) the name of the person on behalf of which the foreign economic agreement is being concluded; and (v) titles of the documents governing the counterparts during the conclusion of the agreement (e.g., constituent documents, etc.).
3. The subject matter of the agreement. This section must determine the goods (services or works) that one counterpart undertakes to provide to the other, including accurate titles, brands, grades, sorts or the final result of any services provided.

In case of barter agreements or a contract for processing a customer's goods, the parties must also state the accurate name (brand, sort) of mutual deliveries (or the name of the product, which is the final objective of the processing of the customer's goods).

If the goods or services require description in greater detail or the nomenclature of the goods or services appears to be rather extensive, then such items must be described in an annex, which will become an integral part of the agreement. Importantly, an appropriate provision to this effect must be set out in the text of the agreement as well.

In case of a barter agreement, it must be balanced according to the total value of the exported and imported goods or services.

An annex to an agreement for the processing of a customer's goods must state the corresponding technological scheme of such processing. Significantly, this technological scheme must reflect the following:

- i) all of the principal processing stages for the materials and the process of transforming the materials into a finished product;
 - ii) quantitative indicators of the materials at each stage of processing, which must include substantiated technological losses of materials; and
 - iii) the losses of the processing performer at each stage of processing.
4. Quantity and quality of goods or scope of provided services. In this section the parties must state, depending on the nomenclature, the measurement unit of the goods, which is accepted for the type of goods in question (e.g., ton, kilogram, units, etc.), its total quantity and the qualitative characteristics. In case of an agreement for the provision of services, the parties must state in the text the specific scope of the services and the deadline for their performance.
 5. Basic delivery terms of goods or acceptance of provided services. In this section, the parties must state the type of transportation and the basic terms of delivery (according to the INCOTERMS effective at the time), which determine the counterparts' duties regarding delivery of the goods and which establish the moment when the relevant risks transfer from one party to the other. Of course, the agreement should clearly set forth the specific term of delivery of the goods (specific shipments thereof).

In case of an agreement for the provision of services, the parties must state in the text the specific terms and conditions, as well as the deadlines, for the provision of the appropriate services.

6. Price and total value of the agreement. In this section, the parties must determine the price for the measurement units of the goods and the total value of the goods or provided services delivered (performed) under the agreement (except when the price of the goods is calculated according to a specific formula), as well as the monetary currency of the contract. If the parties deliver goods of various quality and assortment under an agreement, the price must be determined separately for the unit of goods of each sort. The total value of such agreement must be separately set out in a separate provision. If this is the case, the pricing indicators may be set out in annexes with the relevant references thereto in the agreement.

If the price of the agreement is determined according to a formula, then the parties must state the estimated value of the agreement as of the date of its conclusion.

In case of an agreement (contract) for the processing of a customer's materials, the parties must state the collateral value of the materials, the price and total value of the finished products and the total cost of processing.

In case of a barter agreement, the parties must state the total value of the exported goods or services and the total value of the imported goods or services under the contract. The total value must be expressed in a foreign currency, which is placed by the National Bank of Ukraine into the first group of its Classification of Foreign Currencies (so-called "hard currencies").

7. Terms of payments. In this section, the parties must state the currency of payment, method of payment, order (procedure) and deadlines for financial settlements, as well as the parties' security for the performance of their mutual payment obligations. Depending on the selected terms of payment, the parties must include the following into the agreement:
 - i) the terms of the bank transfer prior to (advance payment) and/or following the dispatch (shipment) of goods or the terms and conditions of the documentary letter of credit or cash collection (with a guarantee) as determined according to Resolution No. 444 of the Cabinet of Ministers of Ukraine and the National Bank of Ukraine, dated June 21, 1995; and,
 - ii) the terms and conditions of the guarantee, if any, and if necessary the type of guarantee (demand guarantee, conditional guarantee, etc.), the effective term of the guarantee and the possibil-

ity to change the terms and conditions of the agreement without changing the provisions of the guarantee.

8. Terms of accepting and turning over goods or services. In this section, the parties must state the dates and place for the actual turning over of the goods (or final performance of services) and the list of title documents to such goods. Goods are accepted according to the title documents as far as the quantity is concerned. As far as quality is concerned, goods or services are accepted according to the documents that certify their quality.
9. Packing and marking. In this section, the parties must include the information regarding the packing of the goods (boxes, sacks, containers, etc.), proper marking placed thereon (name of both the seller and the buyer, number of the agreement, place of destination, dimensions, specific storage and transportation conditions, etc.) and, if necessary, the terms for returning the goods.
10. Force Majeure. As in most cross-border agreements, the parties must include information regarding the circumstances that allow the parties to refrain from complying with the terms and conditions of their agreement (e.g., acts of God, hostilities, embargo, intrusion by governmental authorities, etc.). Under such circumstances, the parties are typically relieved of their duty to comply with the terms and conditions of the agreement for the specific duration of the circumstances, or they may decline to perform the agreement in part or in full without additional financial responsibility. In most agreements, the parties must receive confirmation of the existence and duration of Force Majeure circumstances from the chamber of commerce and industry of the country where such circumstances occur.
11. Sanctions and complaints. In this section, the parties must set out the procedure for applying penalties, recovering damages and lodging claims in connection with the failure to perform or the improper performance of their respective obligations.

Please note that the parties must expressly set out the size of the penalties (in percentage of the value of non-delivered goods or services or non-paid amounts), the terms of penalty payments (i.e., when the penalty starts to apply and how long it remains applicable), or any limitations on penalty amounts. The parties must also set forth the terms during which claims may be lodged, the parties' rights and duties in such cases and the methods of settling claims.

12. Dispute resolution. This is a standard for all types of agreements in the modern age. Quite simply, the parties must set out the procedure for

dispute resolution in courts, which disputes may arise out of the interpretation, failure to perform or improper performance of the agreement. This section must also expressly state the forum and/or the express criteria for determining the forum by any of the parties depending on the subject matter and nature of the dispute, as well as the parties' selection of the substantive and procedural law that will be applied by the forum and the rules of procedure.

13. Finally, any cross-border agreement must reflect the place of the parties' location (residence), mailing and their banking requisites (account number, name and location of the bank, etc.). This information is important for any notices that must be sent under the terms and conditions of the agreement and for other obvious reasons.

The above list of material terms and conditions for cross-border agreements in Ukraine is by no means exhaustive. The parties may agree to set out additional requirements regarding insurance, quality guarantees, agents, freight forwarders, etc., as the parties may see fit.

III. Conclusion

Many foreign companies attempt to apply their typical worldwide agreements to Ukrainian transactions without foreseeing any risks involved. This lack of foresight more often than not leads to problems in the intended transaction because Ukrainian legislation does not recognize many provisions included in standard company agreements. Once a Ukrainian court recognizes a contract as null and void, the process of collecting debt becomes quite difficult. Therefore, companies without experience in Ukraine should seek professional advice before attempting to apply their standard agreements to the typically non-standard Ukrainian market.

H PRODUCTION-OUTSOURCING (TOLLING) TRANSACTIONS IN UKRAINE

I. Introduction

Although production outsourcing in Ukraine is in its nascent stages, when properly implemented, toll-manufacturing schemes enable foreign manufacturers to avoid Ukrainian import taxes, circumvent Ukrainian VAT, reduce their cost of production, and realize greater profit margins in the West.

Presently, the concept of outsourcing is, quite predictably, absent from Ukrainian legislation. Instead, Ukrainian law provides for a so-called "tolling transaction," which is actually a specific type of outsourcing known traditionally as production outsourcing. Tolling transactions involving the manufacture of products by Ukrainian producers by using raw materials imported by foreign customers are surprisingly widespread in Ukraine. Many foreign companies currently apply a tolling strategy, which enables them to minimize expenses for the production of the intended finished products and to avoid the necessity to upgrade their own production facilities and hire additional workforce in the home country.

Such toll manufacturing transactions, which involve the use of imported raw materials, constitute a specific type of import-export transaction. Issues associated with this type of transaction are primarily governed by the Civil Code of Ukraine, the Law of Ukraine No. 327/95-VR "On Transactions with Tolling Raw Materials in Foreign Economic Relations," dated September 15, 1995, and the Law of Ukraine No. 959-XII "On Foreign Economic Activity," dated April 16, 1991. In addition, the terms and conditions of an agreement (contract) for processing tolling raw materials must comply with the requirements of the Law of Ukraine "On the Procedure for Effectuating Payments in Foreign Currency," the Decree of the Cabinet of Ministers "On the System of Currency Control and Currency Regulation," the Presidential Edicts "On Indicative Prices for Import and Export Transactions Carried Out by Subjects of Foreign Economic Activity," "On the Application of International Rules for Interpreting Commercial Terms," and "On Measures for Improving Settlements under Agreements Concluded by Subjects of Entrepreneurial Activity of Ukraine," as well as the Joint Resolution of the Cabinet of Ministers of Ukraine and the National Bank of Ukraine "On Model Payment Terms for Foreign Economic Agreements (Contracts) and Model Forms of Clauses for Foreign Economic Agreements (Contracts)

Which Provide For Payments in Foreign Currency." Below we provide you with a brief analysis of tolling transactions in Ukraine.

II. Discussion

According to the general principles of a tolling transaction, a customer supplies a producer with raw materials for further processing and/or manufacturing of finished products. The relationship between customer and producer is based upon a remuneration basis (either in cash or by a portion of finished products and/or raw materials) for payment by the customer to the producer. Practically, a foreign customer may either import the raw materials into Ukraine or purchase them on the territory of Ukraine. After production, the finished products are exported (re-exported) to the customer according to the terms and conditions of the specific agreement between the customer and producer. The imported raw materials and the finished products made therefrom are actually exempt from import taxes (with the exception of customs fees) and VAT under a tolling transaction provided that such transaction meets the requirements of the applicable Ukrainian laws.

Pursuant to Ukrainian legislation, an international tolling transaction is a transaction connected with the processing (enrichment or use) of raw materials as a result of a technological process aimed at producing finished products for the relevant remuneration. Each foreign business entity, which intends to carry out a tolling transaction in Ukraine, should keep in mind the peculiarities of Ukrainian law described below regarding transactions involving tolling raw materials.

A. Minimal Value of Tolling Raw Materials – The 20% Rule

Ukrainian law prescribes that raw materials used in tolling transactions must have a value of no less than 20% of the value of the finished products made therefrom and must be supplied to the producer before commencing the manufacture of the finished products. If the value of the raw materials is less than 20% of the value of the finished products, then the transaction will not be considered by law as a tolling transaction. When calculating the value of the raw materials into the value of the finished products, the value of all raw materials and the expenses incurred in connection with the transportation of the raw materials to the producer must both be taken into consideration.

As an example, if the value of the finished products is 1,000 EUR, then all imported raw materials, as well as their transportation to the producer, must have a value of at least 200 EUR. If this test is not met, the

customer will be required to pay the relevant import tax (customs duty) and VAT, which are imposed on the products imported on a common importation basis.

B. Title to the Tolling Raw Materials

According to Ukrainian law, the ownership rights to tolling raw materials at each stage of their processing and the ownership rights to the finished products manufactured from such raw materials belong to the customer throughout the entire transaction.

C. The 90-Day Rule

Tolling raw materials, which are imported onto Ukrainian territory by a foreign customer, are subject to import duties according to the rates as set forth in the Unified Customs Tariff of Ukraine, whereas taxes and fees associated with import of raw materials are governed by general Ukrainian legislation. The payment of import duties, taxes and fees (with the exception of customs fees) is effectuated by the Ukrainian producer by way of a promissory note to the tax body at the producer's location with a repayment term equal to the period of time required for completion of the tolling transaction. Importantly, however, this repayment term may not exceed ninety (90) calendar days from the date of execution of the import customs declaration. The sum of the promissory note must be defined in the currency reflected in the contract for carrying out the tolling transactions. If finished products manufactured from tolling raw materials are exported from Ukrainian territory within the above 90-day term, the promissory note will be deemed as repaid and the import duties, taxes and fees (with the exception of customs fees) will not be collected. If, however, the finished products are not exported from Ukraine within 90 days, then, in addition to taxes owed, the Ukrainian producer will be subject to a fine in the amount of 0.3% of the total value of the undelivered finished products for each day of delay.

D. Technological Scheme

As an important rule, the implementation of a tolling transaction requires preparation of a so-called "technological scheme" for processing raw materials. Such scheme must be given to the Ukrainian customs authorities in order to determine the indices of the specific proportion of raw materials as a percentage the value of the finished products. Notably, technological schemes usually include:

- (i) all of the major stages of processing the raw materials and the transformation process of raw materials into the finished products;

- (ii) the quantitative indicators of raw materials at each stage of processing with an indication of grounds for the technological costs of the raw materials;
- (iii) the producer's expenses at each stage of processing; and
- (iv) a calculation of the output of finished products.

E. Form of an Agreement (Contract) for Processing Raw Materials on a Toll Manufacturing Basis

As one of the parties to an agreement (contract) for processing tolling raw materials must be a Ukrainian non-resident (a foreign business entity), such agreement (contract) will be deemed a foreign economic agreement (contract) under Ukrainian law. In accordance with Order No. 201 of the Ministry of Economy and Issues of European Integration "On Approval of the Regulations on the Form of Foreign Economic Agreements (Contracts)," dated September 6, 2001 and registered with the Ministry of Justice of Ukraine on September 21, 2001 under registration number 833/6024, all mandatory terms and conditions must be incorporated into a foreign economic agreement (contract). Specifically, each foreign economic agreement (contract) for processing (using) tolling raw materials must contain the following terms and conditions:

- (i) name of the agreement (contract), reference number of the agreement (contract), and its date and place of execution;
- (ii) a preamble, which must include the full name of the parties under which they are officially registered with an indication of the relevant country of registration, and the name of the persons who sign on behalf of the parties with an indication of the document based upon which the representatives of the parties derive their authorities;
- (iii) the subject matter of the agreement (contract);
- (iv) the quantity and quality of goods (volume of work to be performed);
- (v) the basic delivery terms for the supply of goods (acceptance/transfer of performed works);
- (vi) the price and total value of the agreement (contract);
- (vii) the payment terms;

- (x) the terms for the transfer (acceptance) of goods (works);
- (x) packaging and marking requirements; force-majeure;
- (xi) sanctions and reclamation;
- (xii) arbitration; and finally,
- (xiii) the full legal addresses, postal addresses and bank account information of the parties.

III. Conclusion

Taking into consideration the low cost of skilled Ukrainian labor, one may conclude that Ukrainian production outsourcing has vast potential, and foreign business entities should take the opportunity to tap into this market while production costs are still relatively inexpensive. As added incentive, potential Ukrainian producers are highly interested in attracting foreign business entities to Ukraine not only for outsourcing, but also for establishing links to international markets. These producers are on the look-out for foreign business entities, which will offer new and continuous production orders and more attractive remuneration for their work than will local customers. In turn, the cost savings achieved by foreign customers may enable them to realize greater profit margins abroad.

III. Corporate Law

A

GENERAL OVERVIEW

1. FOREIGN INVESTMENT LEGISLATION

I. Introduction – The History of Tax Privileges

Once upon a time, in the heady days of 1992, Decree No. 55 “On the Foreign Investment Regime” generously granted to any company willing to contribute “qualified foreign investment” of 50,000 US Dollars an automatic 5-year tax holiday. Moreover, Decree No. 55 guaranteed that such tax holidays would not be changed for a period of 10 years.

Soon after, however, the Law “On Profit Taxation of Enterprises” cancelled the automatic 5-year tax holidays for all companies registered after January 1, 1995, emasculating one of the key benefits granted by Decree No. 55. Out of fairness, the Law “On Profit Taxation of Enterprises” specifically preserved the tax holidays for companies, which registered their qualified investment under Decree No. 55 prior to January 1, 1995.

A year later, on March 19, 1996, the Parliament adopted a new and improved Law “On the Foreign Investment Regime,” which was conspicuously silent on the issue of tax holidays and granted no new privileges to investors. The new law merely reaffirmed many provisions contained in Decree No. 55. On October 23, 1997, the Parliament once again amended the law “On Profit Taxation of Enterprises,” finally and irreversibly canceling all tax holidays for foreign investors, once and for all.

Naturally, foreign investors with unexpired tax holidays felt cheated, and they fearlessly filed several law suits before the Ukrainian Constitutional Court, complaining that Parliament’s actions were unconstitutional. This embarrassing conflict was addressed by President Kuchma’s Edict No. 42/99 “On Certain Issues of Foreign Economic Activity,” dated February 26, 1999. This retaliatory Edict required the complaining thirty seven companies (some with foreign investments) to terminate their foreign economic activities until the Constitutional Court provides its official interpretation of the law on foreign investments.

The unfortunate thirty seven companies included such well-known enterprises as “Grand-Hotel” and “UMC.” To assure that the President’s intended goals were met, the banks, where the penalized companies kept their foreign currency accounts, suspended all foreign currency operations of these companies, as well as all LORO account operations used for transferring funds for foreign economic contracts.

In due course, having considered the legal issues concerning the reinstatement of tax holidays, the Supreme Court of Ukraine affirmed that foreign investors could not lose their rights and privileges after the Law “On the Foreign Investment Regime” was passed in 1996. In total, seven companies won their court case. This precedent alarmed the government sufficiently to pass the notorious Edict No. 42/99, which punished the fearless 37 companies.

The issue of reinstatement of tax holidays soon became over-shadowed by the quiet debate concerning the constitutionality of the President’s actions in punishing thirty-seven unlucky companies. According to the Law “On Foreign Economic Activity,” temporary termination of foreign economic activity can be effectuated only by special sanctions in case of violation of the law or any actions, which may damage the national interests of economic security of Ukraine. Such sanctions must be accompanied by appropriate resolutions of judicial and/or arbitration bodies of Ukraine, or by petition of the tax administration to courts, but certainly not by arbitrary and capricious Presidential Edicts.

Soon enough each of the dissident companies resolved its problems with the Ukrainian government, and continued to function without insisting on further tax benefits. In the meantime, foreign investments continue to be governed by the relatively useless Law “On the Foreign Investment Regime,” which was adopted on March 19, 1996, and subsequently amended on July 16, 1999, June 8, 2000 and May 15, 2003. For your convenience, below we provide an analysis of the current Law.

II. The Law “On the Foreign Investment Regime”

The Law “On the Foreign Investment Regime” (the “Law”) extends no favorable treatment and rather minimal guarantees to foreign investors, which includes physical persons and legal entities. The Law defines “enterprises with foreign investments” as having at least 10% foreign ownership in their authorized capital; no minimum foreign capitalization requirements are stated (instead, they are prescribed by other legislative acts).

The Law wisely recognizes that foreign investment takes place in the following forms: (1) the formation of joint ventures; (2) the acquisition of stock in existing enterprises; (3) the creation of wholly-owned foreign subsidiaries (enterprise with 100% foreign investment); (4) the acquisition of real estate (including apartments, houses, land use rights, etc.); and (5) acquisitions of property rights by purchasing securities (stock, etc.) of enterprises with such property rights.

Foreign investment, including any contributions to the authorized capital of an enterprise, is valued in both foreign convertible and Ukrainian currencies by agreement of the parties based on international or Ukrainian market prices (in the past, only international market prices were used for valuation criteria, a requirement often used to increase the value of Ukrainian contributions). Further, foreign investors may value contributions to the authorized capital of an enterprise in a convertible foreign currency, but it will be recalculated in Ukrainian Hryvnias at the official exchange rate of such currency of the National Bank of Ukraine.

Theoretically, at least up until 2002, foreign investors occupied a privileged position in the Ukrainian market, and the Law provided certain guarantees to such qualified investors. Some of the guarantees included the following:

- a 10-year grandfather clause which permits any qualified investor to enjoy the favorable treatment and guarantees contained in the Law for a period of 10 years, regardless of subsequent changes in legislation (similar to the grandfather clause in the original Decree);
- foreign investment is exempt from nationalization (state taking of property), except in case of natural disasters. Interestingly, taking possession by eminent domain may still take place via instructions by the Cabinet of Ministers;
- foreign investors may seek damages (losses of profit and moral injury) resulting from negligent acts or omissions to act on the part of state bodies. Such damages must be based on a valuation, confirmed by an auditing firm;
- in case of terminating its activities, the investor has 6 months to remove its investment, in-kind or in cash, without payment of customs duties, as well as any profits earned in-kind or in cash forms, at their real market value on the date of termination of the investment activity; and
- foreign investors are once again guaranteed the immediate right to repatriate their profits abroad, but only after the investor pays a 15% repatriation tax (unless over-riding tax treaties exist) and other mandatory payments and/or obligations. As usual, the actual procedure for transferring profits abroad is governed by a separate instruction of the National Bank of Ukraine.

Originally, imports designated for a resident company’s “own use” or as “contributions to its authorized capital” enjoyed customs duties and value added tax exemptions. As mentioned above, the regulation passed

by the Cabinet of Ministers on March 23, 1999, temporarily suspended such preferential treatment, subjecting all imports to customs duties and VAT. However, the VAT law and the Law still contain provisions granting exemption from customs duties and VAT for contributions to a legal entity's authorized capital.

The Law also granted foreign investors the general protections provided by Ukrainian intellectual property rights, as well as the right to decide whether to seek patent registration in Ukraine or abroad. The Law also provided foreign investors with the right to enter into concession agreements, which cannot exceed a 99-year period. The right to enter into concession agreements was further bolstered upon the passing of the Law "On Concessions" on July 16, 1999.

Foreign investors may also enter into agreements on joint production and cooperation agreements. The Law provides specific guidelines for maintaining financial accountability under such agreements (i.e., separate bank accounts or so-called "investment accounts").

As before, any disputes between foreign investors and the Government of Ukraine concerning the regulation of foreign investments are subject to dispute in Ukrainian courts in accordance with Ukrainian legislation. All other choices for settlement of disputes are agreed upon by the contracting parties, and can certainly take place abroad.

III. Conclusion

Once upon a time, Ukrainian foreign investment legislation offered something valuable: tax holidays for companies with "qualified foreign investment." After the cancellation of this provision, however, the only remaining justification for the Law "On Foreign Investment Regime" was that it generously exempts foreign in-kind investment from usual customs duties and import VAT.

Most recently, many enterprises with foreign investment have been attempting to restore the tax privileges previously afforded to them upon their registration, but taken away by virtue of the Law of Ukraine No. 2899-III of December 20, 2001, via lobbying efforts. However, on January 29, 2002, the Constitutional Court of Ukraine rendered Judgment No. 1-RP/2002, which held that the effective laws of Ukraine set the grounds for the denial of the right to apply for and receive tax privileges by enterprises with foreign investment, regardless of the time when such investments were introduced and registered. The Constitutional Court confirmed that enterprises with foreign investment may no longer enjoy the tax privileges, which were previously afforded to them, and

that they should be treated as equal to any domestic company set up with the participation of local capital.

While it may be difficult to argue with the noble purpose of the law, i.e., to level the playing field for all companies on the Ukrainian market, it is equally difficult to conceive that Ukraine would not provide incentives for a much-needed injection of foreign investment capital. Therefore, we believe that this issue has not yet been put to rest. Perhaps, after the Presidential elections in 2004, the Ukrainian Parliament will once again look to stimulate foreign investment in Ukraine by providing specific privileges to foreign companies looking to invest in Ukraine in addition to those provided in special (free) economic zones. In this regard, one thing for the Ukrainian Parliament to consider will be the increased attractiveness of Ukraine upon the integration of the new European states into the European Union. As the economic levels of these countries come into line with the economies of the original members of the European Union, Ukraine will be particularly attractive for its cheaper production and labor costs and its proximity to the new European states.

2. UKRAINIAN COMPANY LAW & BUSINESS STRUCTURES

The Ukrainian Civil Code (No. 435-IV, dated January 16, 2003, effective January 1, 2004) and Economic Code (No. 436-IV, dated January 16, 2003, effective January 1, 2004) in combination provide for various types of companies (also known in general as legal entities — organizations, which are established and registered pursuant to the procedure established by law), including the following principal types:

- A) Private enterprises;
- B) Collective enterprises;
- C) Communal enterprises;
- D) State enterprises;
- E) Enterprises established in a mixed form of ownership (on the basis of the unification of property of various ownership forms);
- F) Other enterprises, which are provided by law (this catch-all type of enterprises leaves enough leeway in the law to add various types of enterprises in the future);

As a rule, the Economic Code of Ukraine divides enterprises into two categories: unitary and corporate enterprises. *Unitary enterprises* are defined as enterprises created by one founder, which apportions the property necessary for such creation, forms the authorized capital pursuant to legislation, approves a charter not separated into shares, distributes incomes, administers the enterprise and forms its labor collective on the basis of hired labor directly or via an appointed chief executive and decides issues regarding reorganization and liquidation. Notably, state and communal enterprises and enterprises established on the property of a union of citizens, religious organizations or private property are also considered unitary enterprises.

Conversely, *corporate enterprises* are defined as enterprises created, as a rule, by two or more founders pursuant to their mutual agreement, acting on the basis of the union of property and/or entrepreneurial or labor activity of the founders (participants), and their mutual administration of affairs on the basis of corporate rights, including via the organs, which are created thereby, and the participation of the founders (participants) in the division of profits and risks of the enterprise. Corporate enterprises include enterprises created in the form of a business company and other enterprises, including those founded on the private property of two or more entities.

- G) Stock companies;
- H) Companies with limited liability;
- I) Companies with additional liability;
- J) General partnerships; and
- K) Limited partnerships.

The companies listed in points G-K above are known as economic associations and are governed by the Civil and Economic Codes of Ukraine, as well as specifically by the Law of Ukraine No. 1576-XII “On Economic Associations,” dated September 19, 1991. The companies listed in points A-F were once governed by the Law of Ukraine No. 887-XII “On Enterprises in Ukraine,” dated March 27, 1991, which was lost its legal force on January 1, 2004 when the new Economic Code of Ukraine came into force. However, the Economic Code of Ukraine covers many of the basic enterprise forms which were formerly included in the Law “On Enterprises in Ukraine.”

The general characteristics of the above main types of company structures are discussed in more detail below.

1) Private Enterprise

A private enterprise is defined by the Economic Code of Ukraine as an enterprise, which acts on the basis of the private ownership of a citizen (citizens) or a subject of business activity (legal entity). Whereas a private enterprise may be created by one or more citizens, as natural persons, a private company may not be created by more than one legal entity.

2) Collective Enterprise

Under the Economic Code of Ukraine this refers to an enterprise which acts on the basis of collective ownership of the founder (founders). This category includes production cooperatives, enterprises of consumer cooperatives, enterprises of public and religious organizations, etc.

3) Communal enterprise

The Economic Code defines this type of enterprise as an enterprise, which acts on the basis of communal ownership of a territorial community (local city councils, districts, etc.).

4) State enterprise

Simply put, an enterprise which acts on the basis of state ownership. State enterprises are created by a competent state body pursuant to an administrative procedure on the basis of an isolated part of state property, as a rule, without division of the property into shares. The creating competent body usually administers the corresponding state enterprise.

Because of the state-owned nature of these enterprises, and the current legal framework governing the disposition of state-owned property, such enterprises may only be sold by competitive means (tenders or auctions) according to the procedure established by the State Property Fund of Ukraine. For more information, see our discussion regarding privatization.

All of the above types of enterprises are generally described in the Economic Code of Ukraine and may encompass numerous types of company forms, including those governed by the Law “On Economic Associations.” Therefore, while the legislation is still quite underdeveloped in this sphere, we will provide a brief overview of the definition of an “enterprise”.

Generally, an enterprise is defined as an independent subject of business activity created by a state or local power or other business subjects for the satisfaction of public and personal needs by way of production, research, trade or other commercial activity. Enterprises may be created for carrying out entrepreneurial activity or non-commercial activity (in contrast, economic associations are created solely for the purpose of profit-generating activity). Enterprises act on the basis of a charter (by-laws, articles of association), unless otherwise established by law, and are separate legal entities with separate property, an independent balance, a bank account and an official seal with its name and registration identification code. Importantly, enterprises may not have additional legal entities in their compositions.

The Economic Code is silent as to the minimum amount of authorized capital for enterprises, therefore we recommend an amount of authorized capital sufficient for supporting the operations of an enterprise. However, if the authorized capital of an enterprise is composed of more than ten (10) percent foreign investment, then such enterprise will be deemed an “enterprise with foreign investment.” Moreover, if the authorized capital of an enterprise is composed of one hundred (100) percent foreign investment, such enterprise will be deemed a “foreign enterprise.” This brings us to a sub-set of enterprises, which we describe briefly below.

a. Enterprise with foreign investment

This type of enterprise acquires the status of an enterprise with foreign investment from the day of the transfer of foreign investment to its balance. Foreign investment may be transferred to the balance of an enterprise after its registration pursuant to the established procedure. The Economic Code vaguely describes “foreign investment” as valuables, which are contributed by foreign investors into investment objects for purposes of receiving a profit or social effect. Enterprises with foreign investment have the right to create subsidiaries, branches and representative offices on the territory of Ukraine and abroad provided they abide by the laws of Ukraine and the corresponding foreign state. The legal status of this type of enterprises is governed directly by the Economic Code of Ukraine, the Law “On the Regime of Foreign Investment” and other laws. Further development of the laws governing enterprises with foreign investment is necessary and expected in the near future.

b. Foreign enterprise

A foreign enterprise is a unitary (see definition above) or corporate enterprise created pursuant to Ukrainian legislation, which acts exclusively on the basis of the property of foreigners or foreign legal entities. An enterprise will also be deemed a foreign enterprise if a foreigner (foreigners) or a foreign legal entity (entities) acquire such enterprise into full ownership. Notably, foreign enterprises may be restricted in some branches of the economy with strategic significance for the security of the state. Although the Economic Code states that the conditions, the creation procedure, the organizational requirements and the requirements for the activity of foreign enterprises is determined by the Code, the Law “On the Regime of Foreign Investment” and other laws, no separate laws or regulations to date have been passed governing foreign enterprises, therefore they continue to be created and registered as with other types of enterprises and economic associations. This new sub-set of enterprises leaves foreign investors wondering whether this new distinguishing of enterprises will be used as a vehicle for discrimination against foreign investors in the future.

Finally, enterprises are further divided into small-scale, mid-size or large-scale enterprises depending on the quantity of their employees and the volume of annual gross revenue from the realization of products, works and/or services. In a nutshell, enterprises with an average workforce of less than fifty (50) persons in a financial year and with a volume of gross revenue in such period of less than five hundred thousand (500,000) Euros at the average annual exchange rate of the National Bank of Ukraine in relation to the Ukrainian Hryvnia are considered

small-scale. In contrast, if the average workforce on the payroll for a financial year exceeds one thousand (1,000) persons and the volume of gross revenue for such period exceeds five million (5,000,000) Euros at the average annual exchange rate of the National Bank of Ukraine in relation to the Ukrainian Hryvnia, then such enterprise will be considered a large-scale enterprise. All other enterprises, obviously, will be deemed mid-size enterprises.

5) Stock Companies

The Law No. 1576-XII “On Economic Associations,” dated September 19, 1991, defines a stock company as a company where the authorized capital is divided into a specific number of shares of equal nominal value, the liability of which is limited to the assets of the company. The shareholders of a stock company are responsible for the obligations of the company only to the extent of the stock held by them. The total authorized capital of a stock company may not be less than 1,250 minimum monthly salaries.

The following two types of stock companies are currently permitted under the Law “On Economic Associations”:

1. open joint stock companies, the shares of which may be distributed pursuant to an open subscription and purchased and sold on a stock exchange; and
2. closed joint stock companies, the shares of which are divided among the founders of the company and may not be distributed by means of subscription, nor purchased and sold on an exchange. Of course, a closed stock company may be reorganized at anytime into an open stock company by registering its shares according to Ukrainian securities laws and amending its charter.

Up until this point, the Civil Code of Ukraine, the Economic Code of Ukraine and the Law “On Economic Association” are in basic harmony with respect to the definition of a joint stock company. After January 1, 2004, however, confusion sets in due to the conflicts present between the Civil Code and the Commercial Code. Therefore, the discussion below will highlight the contradicting provisions of the Civil and Commercial Codes, taking into account the still effective Law “On Economic Associations.”

According to the Economic Code and the Law “On Economic Associations,” a stock company requires at least two founders, which may be either legal entities or individuals, Ukrainian or foreign (at least a logical reading of the Law “On Economic Associations” leads to this conclusion). However,

Article 154 of the new Civil Code of Ukraine states that “a joint stock company may be created by one entity or may consist of one entity in case of the acquisition by a shareholder of all shares of the company.” The Civil Code continues that a joint stock company *may not have as its sole shareholder another business company which has only one participant (founder)*. Therefore, it is still not clear how the registration authorities will react to such blatant contradictions and whether they will be able to register joint stock companies at all until such discrepancies in the legislation are removed.

In addition to approving a charter (by-laws) of the company, the founders are required to enter into an agreement (the “Founders’ Agreement”). The Founders’ Agreement usually sets forth the procedures for carrying out joint activities, the parties’ responsibilities to each other, to the company and to any third parties, among other issues. Again, we run into conflicting rules. Article 153 of the Civil Code states that a Founders’ Agreement is not necessary if there is only one founder, but it is required when a joint stock company is created by more than one entity. In contrast, Article 82 of the Economic Code simply states that the founding document of a joint stock company is its charter (by-laws). There is no mention of the requirement to conclude a Founders’ Agreement either in Article 82 or in the provisions on registration of companies. Therefore, one would assume that the founders are free to choose whether to conclude a Founders’ Agreement. But, Article 4 of the Law “On Economic Associations” still states that a joint stock company acts on the basis of its *Founder’s Agreement* and charter. In the hierarchy of Ukrainian law, codes govern laws, but in this case, which code governs which? To compound things further, the instructions of the National Bank of Ukraine for opening bank accounts still require companies to provide a copy of their Founders’ Agreements. Which begs the question, what if one person decides to establish a joint stock company as a sole shareholder under the Civil Code? Or, what if two partners choose not to conclude a Founders’ Agreement relying on the Economic Code? How can bank accounts be opened in this situation? We presume that the National Bank of Ukraine will amend its instructions by requiring the charter of the company to be presented upon opening a bank account.

As discussed above, stock companies can issue shares of stock up to the full amount of their authorized capital. In addition to issuing these securities, stock companies are permitted to issue bonds and bills of exchange. Bonds issued by a stock company may not exceed twenty five percent (25%) of the authorized capital of the company, and may only be issued after full payment has been received by the company for all issued shares of stock. However, stock companies may issue bills of exchange in any amount. Upon liquidation of a stock company, holders of bonds and bills of exchange are entitled to satisfaction of their claims against the company with priority over shareholders.

6) Companies with Limited Liability

Companies with limited liability (limited liability companies or LLCs) are defined by the Law “On Economic Associations” as a company with an authorized capital divided into equity portions, the size of which are set forth in the founding documents of the company. As in a stock company, participants in a limited liability company are liable for the company’s obligations only to the extent of their contributions to the authorized capital.

The minimum authorized capital of a limited liability company must be at least 100 minimum monthly salaries. Once again, we must make reference to the discrepancies in the Civil and Economic Codes and the Law “On Economic Associations.” As with stock companies, the Codes and the Law agree that the founders of limited liability companies must adopt a charter. As with joint stock companies, the same situation currently applies regarding the requirement of a Founders’ Agreement (see discussion above). According to the Law “On Economic Associations” at least two founders are required for the formation of a limited liability company, however, the Civil Code explicitly states that a limited liability company may be established by one or more entities, while the Economic Code remains silent regarding this issue but leans toward the definition under the Law “On Economic Associations.” Importantly, according to the Civil Code of Ukraine, a limited liability company may not have another business company as its sole participant if such company has only one participant/shareholder in its shareholding.

Unlike stock companies, however, limited liability companies do not issue shares of stock, instead membership in these companies is based upon each founder’s contribution to the authorized capital. Members receive profit distributions in proportion to their contribution to the authorized capital of the company.

While companies limited are not permitted to issue stock, these companies are not limited in the volume of bonds and bills of exchange that they may issue. As with stock companies, however, holders of bonds and bills of exchange of a limited liability company are entitled to receive payment from any proceeds in a liquidation proceeding of the company prior to payments to the individual members.

7) Companies with Additional Liability

Companies with additional liability are defined as companies whose authorized capital is divided into portions in accordance with the founding documents of the company. As with limited liability companies, the

founders answer for the obligations of the company only in an amount equal to their contributions to the authorized capital. Unlike limited liability companies, however, in the event that the founders’ contributions are insufficient to satisfy the obligations of the company, each founder is additionally liable with its own personal property in an amount proportionate to its contribution to the company’s authorized capital as provided by the founding documents of the company. The founding documents of a company with additional liability must provide a maximum amount of liability for each participant.

Aside from the additional liability placed on the founders in a company with additional liability, in all other respects these companies are governed by the same rules as limited liability companies and are currently subject to the same contradictions inherent in the Civil and Economic Codes and the Law “On Economic Associations.” Thus, for example, the minimal authorized capital for a company with additional liability is set at 100 minimum monthly salaries.

Although companies with additional liability do not issue stock, these companies are permitted to issue bonds and bills of exchange in unlimited volume. In a liquidation proceeding, holders of bonds and bills of exchange issued by a company with additional liability not only receive payment from any liquidation proceeds with priority over the individual members, but are also entitled to seek recourse against the individual members for any amounts not covered by these proceeds in an amount proportionate to those members’ percentage contributions to the authorized capital of the company.

8) General Partnerships

A general partnership is defined by the Law “On Economic Associations” as a company, in which all of the participants engage in commercial (entrepreneurial) activity. Unlike the other entities regulated by the Civil and Economic Codes and the Law “On Economic Associations,” the partners in a general partnership are jointly liable for the obligations of the general partnership with all of their property. General partnerships may be created on the basis of a Founders’ Agreement only. Moreover, there are no minimum requirements for the authorized capital of these partnerships.

General partnerships are not limited in the amounts of bonds and bills of exchange that they may issue. Unlike a partnership, during the liquidation of a general partnership, bond and note holders may seek recourse against the property of any or all of the individual partners for the full amount of their unsatisfied claims.

9) Limited Partnerships

Finally, limited partnerships are companies consisting of one or more partners, whose responsibility for the obligations of the company is limited to their contributions to the authorized capital of the company (limited partners), as well as one or more participants, who are responsible for the obligations of the company with all of their property (general partners). If a limited partnership has more than one general partner, the liability of those partners for the obligations of the limited partnership is joint. The total amount of the contributions of limited partners to the authorized capital of the partnership may not exceed fifty percent (50%) of the total authorized capital.

As one may conclude in reviewing this section, since January 1, 2004, Ukrainian corporate legislation has taken a small step backwards. This being said, an entire year passed between the passing of the Economic and Civil Codes, while the necessary supporting legislation was not passed and the contradictions between the Codes were never resolved. In practice, the Ukrainian legislation authorities, which are not known for their knowledge of the laws, have not been consistent in applying one code or the other. They would rather await explicit instructions from above, while the higher authorities have been moving quite slowly in bringing the legislation into a coherent order. Therefore, each company to be registered must be done on a case-by-case basis taking into account the demands of notary publics and the various district administrations responsible for registration. We strongly advise seeking professional assistance in setting up companies in Ukraine until the smoke clears from the bomb that was set off on January 1, 2004.

As a final note, the new Civil and Economic Codes contain some new definitions with respect to affiliated entities and controlling provisions as of January 1, 2004. Article 118 of the Civil Code of Ukraine defines an economic association (limited liability company, additional liability company or joint stock company) as “dependent” if 20 or more percent of the authorized capital or shares of stock of the company belongs to another (principal) company. At the same time, the Economic Code of Ukraine defines “associated enterprises” as a group of legal entities connected to each other by economic and/or organizational dependency in the form of participation in authorized capital and/or management.

Dependency between associated enterprises may be either simple or deciding. “Simple dependency” arises if one of the associated enterprises has the possibility to block the decisions of another enterprise, which must be taken in accordance with the law or the founding documents of such enterprise by a qualified majority of votes. Conversely, “deciding depend-

ency” arises if “control-subordination” relations are established between enterprises at the account of the dominating participation of a controlling enterprise in the authorized capital and/or in the general assembly or other management body of another enterprise (i.e., daughter company), in particular the possession of a controlling packet of shares. Relations involving “deciding dependency” require consent from the Antimonopoly Committee of Ukraine.

Further, the Economic Code of Ukraine adds that a company, which possesses a controlling packet of shares of stock of a daughter company or enterprise, will be deemed a “holding company”. Interestingly, if a daughter company concludes disadvantageous transactions or operations at the fault of its controlling enterprise, then the controlling enterprise must compensate the losses caused to the daughter company. Moreover, if a daughter company becomes insolvent and will be recognized as bankrupt at the fault of its controlling enterprise, then the controlling enterprise will bear secondary (vicarious) liability before the daughter company’s creditors. This is a far cry from the pre-January 1, 2004 days when a controlling enterprise would simply be liable to the extent of its contributions into the authorized capital of a daughter company.

3. MOST COMMONLY USED BUSINESS STRUCTURES

I. Introduction

January 1, 2004 will always be remembered well by legal experts in Ukraine. This was the date when all legal logic was swept under the rug by the simultaneous coming into force of the Civil Code of Ukraine (No. 435-IV, dated January 16, 2003) and the Economic Code of Ukraine (No. 436-IV, dated January 16, 2003). While experts have counted as many as 55(!) conflicts between these two documents, the fact remains that corporate life in Ukraine must move on. In spite of the contradictions, difficulties and controversies, the Law of Ukraine "On Economic Associations" and other regulations related to the registration of legal entities and representative offices still remain in effect, at least until July 1, 2004. Therefore, we describe below the still most commonly used business structures by foreign investors in Ukraine, making note of the fact that immense changes are expected for the future in the Law "On Economic Associations" and the registration procedures will change for all forms of business structures on July 1, 2004.

Notwithstanding the dazzling range of business structures offered under Ukrainian law, foreign companies' options in Ukraine are typically limited to one of the following four alternative business structures:

1. representative office (which is not a legal entity, and can be either commercial or non-commercial);
2. wholly-owned foreign subsidiary or enterprise (usually with limited liability provided in their founding documents);
3. "joint ventures" — companies with foreign participation (either in the form of a closed stock company or a limited liability company); or
4. agreements on joint cooperation and production, which do not require registration of a separate legal entity.

One significant consideration in selecting the appropriate business structure involves Ukrainian foreign currency legislation, which categorizes the above structures as either non-residents or residents, depending on the type of activities carried out by the structure. Non-commercial representative offices are usually considered "non-residents" under currency regulations and tax legislation, while subsidiaries and joint ventures are classified as "residents" because they are legal entities, registered and residing in Ukraine for more than 183 days per year. While the distinction is not clearly expressed in other laws, it is significant in terms of tax

consequences and the ability of foreign businessmen to effectuate transactions in foreign or local Ukrainian currency.

Both subsidiaries and joint ventures have the status of separate corporate entities, and thus, both limit an investor's liability to its initial investment. As Ukrainian corporate entities, joint ventures and subsidiaries are considered to be "residents" under Ukrainian currency regulations, they are subject to a different financial regime than "non-residents" (such as representative offices). For instance, resident companies must transact business in Ukrainian currency only, which has historically shown a disturbing tendency to rapidly devalue, eating away any profits.

Sometimes, for reasons of corporate strategy, foreign investors register both structures (i.e., a non-resident representative office and a wholly-owned resident company) to give them greater flexibility in performing various transactions in Ukrainian and foreign currencies. For example, a foreign company may conclude contracts directly with Ukrainian companies via a representative office and service and receive payment under such contracts in foreign currency abroad. At the same time, such foreign company's Ukrainian legal entity may conclude local contracts with Ukrainian entities or citizens and generate revenue on the territory of Ukraine for maintaining their strictly Ukrainian operations.

Immediately below we review each of the above alternatives in greater detail.

II. Non-Resident Representative Offices

By definition, a representative office of a foreign company is not a separate legal entity, but is viewed as an "arm" of a non-resident company. As such, a representative office is not incorporated under Ukrainian law. A representative office simply represents the interests of a foreign legal entity on Ukrainian territory and, consequently, there is a flow-through liability for the parent company.

Another consequence: representative offices that are accorded a "non-resident" status under the Ukrainian taxation system are subject to a special financial regime under tax laws and currency regulations. In the past, Ukrainian foreign currency regulations permitted representative offices to pay their Ukrainian employees' salaries in foreign currency (and additional instructions further reduced taxes by 50% for all foreign currency salaries). This legislation has since been rescinded, but the established practice has to this day proved hard to eradicate.

Foreign companies initially prefer to register their presence as non-resident representative offices, particularly in case of import-export activities or sim-

ple research of the market opportunities and conditions. The key function of such non-resident representative offices is to service existing contracts between the non-resident company and a local (Ukrainian) customer, but not to engage in commercial activities on its own behalf. This arrangement legally allows the non-resident company to earn foreign currency abroad while expanding its market base in Ukraine.

In the early years (1991-1994), foreign exporters earned substantial profits through their Ukrainian representative offices. Such profits frequently were not taxed in Ukraine because representative offices, by legal definition, cannot engage in "commercial transactions" and, therefore, had no income to tax. The parent company was required to pay taxes in Ukraine on its worldwide income, subject to any treaties (double taxation, profit repatriation), but most did not.

Theoretically, engaging in the so-called "commercial activities" (executing contracts in its own name, accepting payment for goods, etc.) could have resulted in a representative office's re-classification as a "resident," thereby being taxed based on local revenues derived from its activity in Ukraine. Fortunately, in the early years, problems with re-classification and tax payments were extraordinarily rare even though most representative offices routinely failed to declare their true income to the Ukrainian tax inspection and escaped paying taxes on any income earned from their activities on the territory of Ukraine.

In response to the widespread abuse, subsequent amendments to the currency regulations and company tax law paid particular attention to the legal status and obligations of this ambiguous group of entrepreneurs, generally classified as "Ukrainian non-residents," who earned income from transacting business on the territory of Ukraine. The more significant changes impacting the representative office's tax status are contained in the Law No. 334-94 "On Profit Taxation of Enterprises," dated December 28, 1994, as restated by Law No. 283/97 of May 22, 1997, and lastly amended on November 27, 2003 (the "Company Tax Law").

Overall, the Company Tax Law places Ukrainian non-residents into two categories: those which effectuate profit-generating activities in Ukraine (a) through a permanent representative office (active), or (b) without a permanent office (passive). Different tax rates and payment procedures attach to each category. This significant distinction is aimed at closing the loophole by which non-resident representative offices circumvented currency regulations and paid lower (if any) taxes in Ukraine on activities typically performed by resident companies.

Another peculiarity applicable to all non-resident representative offices concerns the procurement of permission from an authorized bank to open a bank account type "N" in order to effectuate payment in Ukrainian currency. Thus, to legally pay its Ukrainian employees and to pay for rent of premises, necessary equipment, transportation and repairs to leased premises, obligations under contracts with Ukrainian residents, insurance of property, etc., non-resident representative offices must comply with the National Bank of Ukraine's Resolution No. 492 "On Approval of the Instruction on Opening, Using and Closing Accounts in National and Foreign Currencies," dated November 12, 2003 and registered with the Ministry of Justice on December 17, 2003. This Instruction came into force on January 1, 2004 as a direct result of the coming into force of the new Civil and Economic Codes of Ukraine.

In a nutshell, to open a bank account type "N" in Ukrainian Hryvnia, a non-resident representative office must simply apply to an authorized bank of its choice to open a bank account type "N". In order to open such an account, the head of the representative office (chief representative) should write a letter in free form to the bank asking permission to open a bank account type "N". In addition, the following documents must be submitted to the bank:

- 1) an application to open a bank account in the form established by the National Bank of Ukraine;
- 2) a copy of a legalized or apostillized extract from the commercial, bank or court register or a notarized certificate of registration issued by the authorized body of the applicant's country evidencing registration of the legal entity-non-resident;
- 3) a copy of the certificate of registration of the applicant, which must be notarized or certified by the issuing body of the applicant's country;
- 4) a copy of a notarized and legalized or apostillized power of attorney for the performance of representative functions on behalf of the applicant in Ukraine;
- 5) a notarized signature card with samples of the signatures of the relevant authorized signatories and affixed with the applicant's official seal.

If the representative office does not employ hired labor and does not pay contributions to the social insurance funds, then the applicant must indicate so in the application for opening the bank account. However, if the representative office employs hired labor and is a payer of social insurance contributions, then the representative office must submit to the bank the following documents:

- 1) a copy of the document, which confirms the registration of the representative office in the corresponding bodies of the Pension Fund of Ukraine, certified by the issuing body, a notary signature or the signature of an authorized employee of the bank;
- 2) a copy of the document, which confirms the registration of the representative office in the Social Insurance Fund for Accidents at the Workplace and Occupational Diseases of Ukraine, certified by the issuing body, a notary signature or the signature of an authorized employee of the bank.

Having opened a Hryvnia account type “N,” the representative office may transfer Hryvnia from its “N” account to satisfy its obligations. Notably, certain restrictions are placed on “N” accounts, such as transferring money abroad and, in all but limited cases, purchasing foreign currency at the Ukrainian Currency Auction.

One final comment with reference to special labor relations regulations is applicable to representative offices. A bureaucratically unpleasant instruction, entitled Order No. 58 “On Approval of the Instructions on the Procedure of the Maintenance of Labor Books of Employees” and issued on July 29, 1993, jointly by the Ministries of Labor, Justice and Social Protection of the Population (registered with the Ministry of Justice on August 17, 1993), served to complicate the relatively simple hiring process by requiring that representative offices register their local employees with the local authorities if they wish for their employees to have a recorded length of service.

This instruction specifically prohibits representative offices of foreign legal entities from making labor-related entries in the labor books of their employees. Instead, representative offices found in Kiev should maintain their employees’ Labor Books through the General Directorate for Servicing of Foreign Representations of the Kiev State Administration (a.k.a. “GDIP”), while representative offices in other areas should turn to the foreign relations departments of their respective oblast state administrations. Without an entry from GDIP in their labor books, the Ukrainian employees of a foreign representative office will not be entitled to the social protection as a result of social contributions to the Pension Fund, the social security funds, the unemployment fund, etc.

On the one hand, a representative office has one significant advantage over a Ukrainian legal entity: the ability to legally earn foreign currency and to keep it abroad. On the other hand, it has some minor drawbacks: a representative office theoretically cannot enter into contracts in its own name (only in the name of its parent company), cannot conduct sale in

local currency and cannot hire full-time employees without registration with the relevant government agency, among other minor limitations.

III. Residents: Joint Stock and Limited Liability Companies

Wholly-owned foreign subsidiaries and joint ventures are usually organized in the form of either closed joint stock companies or limited liability companies, depending on the particular requirements of the project. Both structures are considered to be “residents” under the Ukrainian currency regulations and tax laws, and both have the “corporate” shield whereby the liability of founders and shareholders is limited only to the value of their contributions to the company.

Several differences exist between these two types of companies. For example, in a limited liability company, the founders own equity in the company, expressed by a percentage of ownership (i.e., such a company does not issue shares of stock). The main difference between a limited liability company and a joint stock company, however, lies in the degree of structural complexity. Limited liability companies are relatively simplistic and accommodate the interests of minority owners. In sharp contrast, joint stock companies can be extraordinarily complex, particularly in cases of highly negotiated joint ventures with state-owned enterprises, and do not give minority shareholders the same degree of protection.

The management structure of a stock company and that of a limited liability company is very similar with a few minor variations. The three-part structure is headed by the “general assembly of shareholders” (or in case of a limited liability company, “general assembly of participants”) which represents the interests of the company owners. The next level, the “supervisory council” (a.k.a. the “board of directors”) is optional in both structures; it is commonly employed in the stock company structure, but smaller companies tend to disregard it. The final level, the management board, performs the company’s day-to-day functions.

In practice, simple joint ventures or 100% foreign-owned companies usually register in the form of a limited liability company. This company structure allows a relatively small number of people to avoid a complex multi-layered management structure composed of a general assembly, supervisory council and management organs and to avoid the registration of shares of stock. It is particularly attractive in cases of 100% foreign-owned companies because the charter (by-laws) can provide for one executive organ where the founder has complete and unequivocal control.

Immediately below, we describe the general management structure applicable to both types of companies, distinguishing between them where appropriate.

A. Company Management Structure

1. The General Assembly

The General Assembly is the highest body of a company and exists in both limited liability and joint stock company structures, although minor differences exist. The following discussion will focus on the more complex joint stock company structure.

The general assembly of shareholders (the "General Assembly") must be called once per year in joint stock companies and at least twice per year in limited liability companies, unless otherwise specified in the company charter. All shareholders can participate in the General Assembly regardless of the amount of shares (equity) they hold; a quorum is satisfied when shareholders having more than sixty percent (60%) of the total combined voting power of the company are present. Voting at a general assembly is carried out according to the principle of "one share, one vote" in joint stock companies and in limited liability companies the number of votes of a participant is proportionate to his share in the authorized capital of the company.

Formerly, the General Assembly could be held at any place agreed upon by the shareholders. This was especially advantageous for shareholders living outside of Ukraine and companies with a majority of foreign shareholders. On January 10, 2002, however, the President signed an amendment to the law governing joint stock companies, which amendment makes the rules for foreign shareholders in joint stock companies a bit more difficult. According to this recent amendment, the General Assembly of a joint stock company must be held on the territory of Ukraine, as a rule, at the company's factual location. This new rule, however, does not apply to joint stock companies in which 100 percent of the shares are owned by foreign citizens, foreign legal entities and/or international organizations on the day of holding the General Assembly.

The noble purpose of the above amendment is to ensure the rights of minority shareholders to participate in the General Assembly, which can prove to be difficult for some Ukrainian citizens if the General Assembly is held outside of Ukraine. In the past, majority shareholders could avoid minority shareholders' presence by convening the General Assembly outside the territory of Ukraine. From a foreign investor's point of view, on the other hand, this amendment takes away the shareholders' right to choose to hold a General Assembly outside of Ukraine even if the consent of all shareholders is obtained prior thereto (unless, of course, all shareholders are foreign citizens, foreign legal entities and/or international organizations). Moreover, non-resident foreign investors with a

majority shareholding in a joint stock company will be forced to come to Ukraine at least once per year. The number of trips may be even more if the company's charter calls for the convocation of the General Assembly more than once per year or if shareholders with an aggregate of 10 percent or more of the voting power call extraordinary General Assemblies.

The General Assembly has the power to decide all issues connected with the company, including the appointment and the dismissal of persons on the Board of Directors and the management board, distribution of profits, and liquidation and the appointment of the liquidation commission. The General Assembly also has the right to delegate all of its powers to the Board of Directors, except certain fundamental decisions, which are within the General Assembly's exclusive jurisdiction.

In the case of a joint stock company, 75% of the quorum at a General Assembly (i.e., a qualified majority) must vote to implement the following decisions:

1. to amend the company charter;
2. to terminate the company's activities; and
3. to create and terminate the activities of subsidiaries, affiliates and representative offices (the Civil Code of Ukraine does not contain this type of decision).

In the case of limited liability companies, all issues are decided by a simple majority of votes held at a valid meeting, except for the following issues, which require 50% of the total number of votes of participants of the company:

1. to determine the fundamental directions of the company and to approve the plans and reports on their implementation;
2. to amend the company's charter; and
3. to expel a participant from the company. In such cases, the participant in question (or its authorized representative) does not participate in the voting regarding its exclusion.

These automatic provisions of the law are aimed at the protection of minority shareholders rights. A double-edged sword to foreign investors, they could lead to a burdensome relationship with an uncompromising Ukrainian partner. Thus, to have absolute control in a stock company, an investor must own more than 75% of voting stock.

All other issues on the agenda of the General Assembly are resolved by a simple majority vote of all participating shareholders or founders. In both joint stock and limited liability structures, the General Assembly may, but need not, elect a Board of Directors (literally translated as “supervisory council”), which represents the shareholders’ interests between General Assemblies, implements the General Assembly’s resolutions and controls the activities of the company’s executive body. In joint stock companies with more than 50 shareholders, however, the creation of a Board of Directors is mandatory. In accordance with the company’s charter, or as provided in the General Assembly’s initial resolution, the Board of Directors can decide matters that are usually within the General Assembly’s control (except those specifically designated as within the exclusive competence of the General Assembly by legislation or in the company’s charter).

Please note that in the stock company structure only, members of the Board of Directors *cannot* simultaneously serve as members of the executive body in joint stock companies. The limited liability structure, however, permits the same person to occupy both positions simultaneously.

The procedure for calling a General Assembly in a joint stock company requires making an announcement (as described in the company charter) regarding the upcoming assembly (its time, place and agenda) at least 45 days before such assembly. In limited liability companies, participants must be notified of a General Assembly 30 days prior to its convocation pursuant to the method provided in the charter of the company with an indication of the time and place of the meeting and its agenda. In case of stock companies, bearers of registered (or “named”) shares require personal notification. Any shareholder has the right to propose agenda items up to 30 days before the assembly in joint stock companies and 25 days before the assembly in limited liability companies.

Shareholders, who individually or aggregately own at least 10% of all outstanding shares of stock in joint stock companies, may demand that their proposals be included in the agenda if they submit said proposals at least 10 days before the Assembly. Shareholders must be given the opportunity to familiarize themselves with any necessary documents before the Assembly, therefore items not included in the agenda may not be considered at the said assembly.

In limited liability companies, the participants must be given the opportunity to familiarize themselves with any documents related to the agenda of a General Assembly 7 days prior to the meeting. Resolutions on issues, which were not included in the agenda, may be adopted only with the consent of all participants present at the meeting.

Extraordinary shareholder assemblies may be called in cases of a company’s inability to make payments, upon circumstances foreseen by the company charter or upon other instances if in the company’s best interests (in limited liability companies this also applies if there is a significant threat of a decrease of the authorized capital). The management board also has the authority to call an emergency assembly in both limited liability and joint stock companies, but the written request of the company’s Board of Directors is required in joint stock companies. Any shareholders, who individually or aggregately own at least 10% of outstanding shares in a joint stock company, however, may call an emergency assembly at any time for any reason; if this is not done within 20 days of their demand, then they may call the meeting themselves. Likewise, in limited liability company, participants, who individually or aggregately own 20% of the votes in the company, may call an extraordinary assembly at any time for any reason related to the activity of the company. In this case, if the meeting is not held within 25 days of their demand, then they may call the meeting themselves.

2. The Board of Directors, the Management Board and Other Governing Bodies

As mentioned above, the General Assembly may establish, at its discretion, a supervisory council much like a Board of Directors. This “Board of Directors” supervises the activity of the executive body (the “Management Board”). The formation and particular competency of the Board of Directors can be memorialized in the company’s charter or may be resolved by the General Assembly and documented in an internal resolution. As previously mentioned, members of the Board of Directors in a stock company structure are prohibited from holding a concurrent Management Board position.

The executive body of any stock or limited liability company is its Management Board or other body as determined by the company charter. In limited liability companies, the management body may be an individual (general manager, general director, etc.) or a board of more than one individual. The Management Board acts on behalf of, and is accountable to, the company in accordance with Ukrainian law and the company charter. Procedurally, the Management Board is accountable to the General Assembly (and Board of Directors in joint stock companies), and resolves all issues except those reserved by these said bodies. At the General Assembly, shareholders may vote to delegate some of their authority to the Management Board directly.

The Director (i.e. Chief Executive Officer) of the Management Board handles the company’s day-to-day activities. The Director and the other

members of the Management Board are hired as employees of the company. The Director does not need an official power of attorney to act in the name of the company, nor do other members of the Management Board if the company charter so states. The Director collects the minutes of the Management Board's meetings into book form and makes these available to shareholders at their request. In joint stock companies, upon demand by the Board of Directors, extracts of ratified Management Board minutes may even be published.

B. Capitalization Requirements

The Law "On Economic Associations" governs the formation of joint stock companies and limited liability companies, and contains no limitations on the size of share capital for joint stock companies, provided however that the company's authorized capital is divided into shares of stock of equal nominal value. The Law "On the Foreign Investment Regime" only encourages large amounts of foreign investment in all shapes and sizes. Accordingly, a joint stock company may have as large a share capital as it wishes.

The minimum capitalization for registration of joint stock companies is 1,250 minimum monthly salaries, while for limited liability companies it is 100 minimum monthly salaries. Currently, one minimum monthly salary is equal to 205 Ukrainian Hryvnia. The Ukrainian Parliament plans to increase the minimum monthly salary to 237 Hryvnia from November 1, 2004 and to 262 Hryvnia from January 1, 2005 (such increases are frequently subject to change, therefore please verify this information before calculating authorized capital, fines, fees, etc.). Any Ukrainian and/or foreign investor is permitted to register a company subject to these absolute minimums.

Shareholders of stock companies and founders in limited liability companies must make initial pre-registration deposits towards their contributions prior to registration. According to the Law "On Economic Associations," 50% of a shareholder's contribution must be paid prior to registration if the shares are originally distributed amongst the founders of a joint stock company (30% if the shares are distributed via an open subscription). In limited liability companies, however, the legislation is still unsettled as the Law "On Economic Associations" calls for a 30% of a participant's contribution to be paid by the moment of state registration of a company, while the new Civil Code requires a 50% of participant's contribution to be paid prior to registration. In practice, since the Civil Code is higher up than laws in the hierarchy of Ukrainian legislation, we believe that the 50% rule governs. However, changes to the Law "On Economic Association" are widely expected in the near future. The remaining sum must be paid, in its entirety, no later than one year after registration of both

types of companies. In joint stock companies, shares of stock may be given to the shareholders only after they have fully paid for such shares. Note that the founders may not circumvent these rules in the charter by providing, for instance, that the joint stock company may hold authorized but unissued stock for more than one year.

In the event a shareholder in a joint stock company fails to pay for its shares within the one-year period, the law imposes an automatic annual fine of 10% on non-paid sums, unless the charter specifically provides otherwise. Accordingly, company founders may insert a provision into the company charter providing for no fines, thereby giving the shareholders sufficient time to effectuate their respective contributions to the authorized capital. For limited liability companies, the Civil Code adds that in case the participants fail to pay their contributions in full within one year, the company must either decrease its authorized capital accordingly and register the corresponding amendments to the charter or adopt a decision to liquidate the company in case the authorized capital is under the minimum requirement.

According to the somewhat outdated capitalization provisions in the Law "On Economic Associations," the General Assembly of a stock company may increase the company's capitalization in the future by issuing additional shares of stock, provided that all previously authorized shares have been paid at no less than nominal value. A joint stock company may increase the size of its authorized capital in at least three ways: (1) issuing new shares; (2) exchanging bonds for shares; and/or (3) increasing the nominal value of existing shares.

Issuance of new shares follows the same procedure as the issuance of shares at an initial offering. Existing shareholders have rights of first refusal to purchase any newly-issued shares. The Management Board also may increase the authorized capital by up to 1/3 in accordance with procedures established in the company charter.

A stock company may reduce its authorized capital only after receiving consent of its creditors, if any. A stock company may reduce its authorized capital by either (1) reducing the nominal value of existing shares; or (2) reducing the number of shares by buying out and voiding a certain number of shares. A resolution to decrease the authorized capital of a limited liability company will not take effect until 3 months after its state registration, notice to all of its creditors and publication of the corresponding information pursuant to law. In such case, according to the Civil Code, the creditors will have the right to demand the premature termination or fulfillment of the obligations of the company and the compensation of damages.

The above discussion describes the procedure for increasing or decreasing the authorized capital of a joint stock company as it is contained in the Law “On Economic Associations.” While this simple procedure is still technically valid, it has been used and abused due to its vagueness and lack of detail, and supplanted by more comprehensive legislation. Finally, on October 16, 2000, the State Commission for Securities and the Stock Market issued Decision No. 158, entitled “Regulations on the Procedure for Increasing (Decreasing) the Size of the Authorized Capital of a Joint Stock Company,” which provides a much clearer picture of how to practically implement changes to a company’s authorized capital. This new procedure, however, is beyond the scope of this discussion on the Law “On Economic Associations.”

C. Reorganization and Liquidation

As a general matter, a company’s activity may be terminated voluntarily by the founders or shareholders/participants, or such termination may become mandatory by a court’s decision. Also, a company’s activities are considered to be terminated upon either (1) liquidation or (2) reorganization into a new commercial structure (by merger, acquisition, separation, etc.).

Although reorganization has always been a rather dormant practice in Ukraine, the separation of sub-units from the main enterprise and their subsequent re-registration as separate entities is becoming more common as part of the privatization of larger state enterprises. In such cases, all former rights and obligations of the company automatically are assigned to its successor upon official termination. A company’s activity officially terminates when such termination is officially noted in the Unified Register of Enterprises and Organizations of Ukraine.

According to the Law “On Economic Associations,” liquidation of a company’s activities occurs in the following circumstances:

1. upon expiration of the company’s term of existence;
2. by decision of the highest body of the company;
3. by decision of a court of law due to the company’s inability to pay debts (bankruptcy) or systematic violations of the law;
4. any other reasons stated in the company’s foundation documents; or
5. pursuant to the Economic Code, which adds the following: (i) in case of the expiration of the term for which the company was created or the achievement of the purpose for which it was created; (ii) upon the cancellation of its state registration in cases provided by law.

Voluntary liquidation usually takes place for the following reasons:

1. the company’s term of existence expired;
2. the company’s goals have been achieved;
3. bankruptcy; or
4. resolution by the general assembly due to an irreconcilable conflict among the founders.

Again, the Law “On Economic Associations” only provides a general, and quite vague, procedure for liquidation of business entities governed by the said Law. The specific procedures for liquidation and bankruptcy are quite detailed and, thus, beyond the scope of this brief overview.

IV. Joint Activity and Partnership Agreements

According to Article 1130 of the Civil Code of Ukraine, “joint activity agreements” are defined as agreements under which the parties undertake to act jointly without the creation of a legal entity in order to achieve a certain goal not prohibited by law. Joint Activity Agreements are also generally regulated by the provisions of the Law of Ukraine No. 93/96-VR “On the Foreign Investment Regime,” dated March 19, 1996 (as lastly amended on May 15, 2003), the Law of Ukraine No. 1560-XII “On Investment Activity,” dated September 18, 1991 (as lastly amended on November 27, 2003), and Resolution No. 112 of the Cabinet of Ministers “On Approval of the Regulations on the Procedure of State Registration of Agreements (Contracts) on Joint Investment Activity with the Participation of a Foreign Investor,” dated January 30, 1997 (as lastly amended on October 18, 1999).

On the one hand, joint activity agreements provide certain advantages to foreign investors who do not wish to go through the procedure of establishing and running a Ukrainian legal entity. Interestingly, the new Civil Code does not specify the requirement that the goal of the joint investment must be for commercial purposes and via the unification of property. Therefore, the participants in joint activity are not required to unify their investments and may provide for the contribution of various types of cooperation. However, this provision is in currently direct conflict with the definition of “joint investment agreements” under the Law “On the Taxation of Profits of Enterprises,” which calls for the unification of property and a commercial purpose to joint activity agreements.

The new Civil Code is quite liberal as to the form of a joint investment agreement, i.e., they must simply be in written form. The parties are free

to agree upon the terms and conditions of the agreement with respect to the coordination of joint activity or the carrying out of general affairs, the legal status of property designated for joint activity, the coverage of expenses and losses of the participants, the participants' participation in the results of the joint activity, etc.

Not surprisingly, the new Civil Code goes into much more detail about joint activity agreements pursuant to which the parties take upon themselves the obligation to unify their investments and jointly act for the purpose of obtaining profit or the achievement of another goal. Although similar to a simple partnership arrangement, such arrangements are confusingly defined as "simple associations" and are immortalized in so-called "simple association agreements." These types of arrangements are the focus of the discussion below, however, for simplicity's sake we will refer to them as "partnership agreements."

The contributions (investments) of a participant may be anything they contribute into the joint activity ("general property"), including cash funds, property, professional and other knowledge, skills and know-how and business reputations and connections. Importantly, the investments of the parties will be deemed of equal value if the parties fail to state so in the joint activity agreement or the circumstances are so obvious as to eliminate the possibility of equal value. As with the old Civil Code, the new Civil Code allows the parties to agree upon the appraisal value of their contributions.

The commonly shared property of the participants is the property contributed by the participants, to which they possessed the ownership rights, as well as products of their joint activity and the fruits of their labor and incomes received from their joint activity, unless the law or the partnership agreement provides otherwise. However, any contributed property, which the participants did not possess under ownership rights, must be used in the interests of all participants and will become their common property.

The participants may entrust one of the participants to carry out the accounting of their common property. The use of common property may be carried out only upon the consent of the participants or, if such consent cannot be reached, a court of law may intervene and establish the procedure for the use of the common property. In this vein, the partnership agreement must provide for the obligations of the participants with respect to the maintenance of the common property and the procedure for compensating expenses connected with the performance of such obligations.

While carrying out common affairs, each participant has the right to act on behalf of all participants, unless the partnership agreement specifically provides that such affairs are to be carried out by only certain par-

ticipants or jointly by all participants. Of course, if all affairs are to be carried out jointly, the consent of all participants must be obtained in order to execute each transaction.

In relations with third parties, the authority of a participant to conclude a transaction on behalf of all participants must be certified by a power of attorney issued to such participant by the other participants or specifically set forth in the partnership agreement. Further, in such relations, the participants cannot refer to the limitations on the rights of the participant concluding a transaction in carrying out the common affairs of the participants with the exception of cases when they can prove that at the moment of concluding the transaction the third party knew or could have known about the presence of such limitations.

A participant, which is concluding a transaction on behalf of all participants pursuant to which such participant's right to handle the common affairs of the participants are limited or which is concluding a transaction in the interests of all participants in its own name, may demand the compensation of expenses incurred thereby at its own expense if the conclusion of such transaction was necessary to the interests of all participants. In this case, however, if damage is caused to the participants as a result of such transaction, the participants have the right to demand the compensation of damages.

Each participant of a partnership agreement has the right to get familiarized with all documents related to the common affairs of the participants. The Civil Code specifically prohibits the participants from refusing such right or limiting such right even if all of the participants consent to such right to refusal or limitation.

The participants of a partnership agreement must agree upon the procedure for the compensation of expenses and losses connected with the joint activity of the participants. If the parties fail to agree upon such procedure, each participant will bear the expenses and losses proportionate to the value of its contribution to the common property. Significantly, any terms and conditions pursuant to which a participant is completely released from participation in the compensation of the common expenses and losses will be deemed null and void.

The liability of the participants of a partnership agreement hinges upon the purpose of the agreement itself. Hence, if a partnership agreement is not connected with the participants' business activities, the participants will be responsible for the common obligations with all of their property proportionate to the value of their contributions to the common property. For any obligations, which do not arise directly from the agreement, the partici-

pants will bear joint liability. Conversely, if the agreement is connected with the participants' business activities, the participants are jointly liable for all common obligations regardless of the grounds of their origin.

The profit received by the participants of a partnership agreement as a result of their joint activity must be distributed proportionally to the value of the contributions of the participants to the common property, unless otherwise established by the agreement or another covenant of the participants. Again, any terms and conditions set forth in an agreement pursuant to which a participant is deprived of or refuses the right to a part of the profit will be deemed null and void. Notably, a creditor of a participant has the right to bring forth a claim on the separation of such participant's share in the common property in accordance with the Civil Code of Ukraine and other legislation.

A partnership agreement will terminate in the following cases:

1. The recognition of a participant as legally incapable or missing or a limitation of such participants civil capability if the participants did not agree upon the maintaining the validity of the agreement in relation to the other participants;
2. The recognition of a participant as bankrupt if the participants did not agree upon the maintaining the validity of the agreement in relation to the other participants;
3. The death of a natural person-participant or the liquidation of a legal entity-participant if the participants did not agree upon the maintaining the validity of the agreement in relation to the other participants or did not agree upon the replacement of a deceased participant (liquidated participant) with legal successors;
4. The refusal of a participant to further participate in the agreement or the termination of the agreement upon the demand of a participant if the participants did not agree upon the maintaining the validity of the agreement in relation to the other participants;
5. The expiration of the validity term of the agreement;
6. The separation of a share of a participant upon the demand of a creditor if the participants did not agree upon the maintaining the validity of the agreement in relation to the other participants;
7. The achievement of the goal of the partnership or the appearance of circumstances rendering the achievement of such goal impossible.

Thus, if the participants wish to maintain the validity of a partnership agreement, they should provide for such maintenance directly in the agreement with respect to the above-mentioned termination cases (except for point 7).

Upon the termination of a partnership agreement, the objects transferred into possession and/or use of the participants will return to the respective participants, which transferred such objects, without any remuneration, unless otherwise agreed upon by the participants. The division of the property under the common ownership of the participants and the general rights to claims are carried out pursuant to the procedure provided by the Civil Code and Ukrainian legislation. Also upon termination, a participant, which contributed into common ownership an object defined by individual characteristics, will have the right to submit a claim to a court of law for the return of such object provided, however, that such participant observes the interests of the other participants and creditors. The participants bear joint liability from the moment of termination of an agreement for the non-performance of the joint obligations in relation to third parties.

Finally, a participant may petition to refuse further participation in a partnership agreement for an indefinite term no later than 3 months before the withdrawal from the agreement. If a partnership agreement was concluded for a definite term or for the achievement of a certain goal, a participant has the right to demand the termination of the agreement in relation to the other participants for well-grounded reasons with the compensation of actual losses caused by the termination of such agreement.

The above described provisions of the Civil Code are the general provisions in relation to joint activity under Ukrainian law. Please note, however, that specific laws exist with respect to certain types of joint activity, including production sharing agreements, concessions, etc. For example, the Law "On the Foreign Investment Regime" provides that foreign investors have the right to conclude joint investment activity agreements (production cooperation, joint production, etc.) without the creation of a legal entity pursuant to Ukrainian legislation (i.e., the Civil Code and other specialized laws). Such agreements are regulated by Ukrainian legislation.

According to the Law "On the Foreign Investment Regime," the parties to joint activity agreements must maintain separate accounting and file reports on the operations related to the fulfillment of the terms and conditions of such agreements. The parties must also open separate bank accounts with Ukrainian banking institutions to process payments under the said agreements. Finally, such agreements must be registered within the deadlines and pursuant to the procedure established by the Cabinet of Ministers.

As required by Article 24 of the Law of Ukraine “On the Foreign Investment Regime,” the Cabinet of Ministers issued Resolution No. 112, dated January 30, 1997, which approved the Regulations on the Procedure for the State Registration of Agreements (Contracts) for Joint Investment Activity with the Participation of a Foreign Investor (the “Regulations”). The Regulations set forth the procedure for filing the documents, their review and procedure for state registration of joint activity agreements. According to the Regulations, state registration of such agreements is absolutely mandatory.

Upon state registration, an authorized party receives three copies of a special card, evidencing state registration of the joint activity agreement. One copy is filed with the customs authorities for purposes of clearing the corresponding property through customs; another copy is filed with the state taxation bureau at the place where the joint operations are managed under the agreement. The third copy remains with the party, which is authorized to manage the joint activities. Thus, if the parties fail to register their joint activity agreement, they will face the immediate problem of not being able to clear the necessary property through Ukrainian customs.

From a legal viewpoint, agreements for joint investment activity with the participation of a foreign investor are binding even before state registration. In fact, such agreements are deemed concluded as of the moment when the parties have reached written consent regarding all essential terms and conditions necessary for the fulfillment of the agreement. Thus, mandatory state registration is designed to force the parties to comply with the customs clearance procedure and taxation requirements, without impacting on the validity of the agreement itself. Additionally, the foreign participants are encouraged to register their contributions to the joint investment activity as “foreign investment” in Ukraine. This registration will entitle them to any tax and customs privileges available for “foreign investments.”

Under the Law “On the Foreign Investment Regime,” property (except goods for sale and for personal consumption), which is imported into Ukraine by foreign investors for a term of no less than 3 years on the basis of a registered joint activity agreement, is exempt from customs duties. The customs authorities will permit such property onto the territory of Ukraine on the basis of a promissory note issued by an investor for the amount of customs duties. The promissory note will have a payment term of no more than 30 days from the day of the execution of the import cargo customs declaration. The promissory note will be considered repaid and import duties will not be collected if the property is credited to the balance of the joint activity within 30 days and the tax inspection at the location of the joint activity places a remark regarding such crediting on a copy of the

promissory note. If the property contributed to the joint activity is alienated earlier than 3 years from the day of the crediting of the property to the balance of the joint activity, then import duties will be collected for the importation of such property at the regular rates.

Although the property is subject to certain protection as foreign investment, the profit from joint activity is taxed at the same rate as any profit gained in Ukraine. Therefore, foreign investors are encouraged to inquire about the existence of any international treaties for the avoidance of double taxation and the repatriation of profit.

In conclusion, while the Civil Code of Ukraine does not expressly restrict the participation of foreign legal and physical entities in general joint activity, foreign investors should inquire as to the most optimal form of joint activity taking into account their specific demands and specialized laws before concluding a joint activity agreement. In addition, the above-described joint activity arrangements do not provide for a special tax regime for foreign participation in joint activity, therefore the receipt of tax advice as to the optimal form of foreign participation in other types of joint activity is recommended.

4. SHAREHOLDER RIGHTS

I. Introduction

An important issue for most foreign investors interested in purchasing shares in Ukrainian open joint stock companies is the extent of rights one acquires along with the purchase of shares. Although minority shareholder rights are still quite underdeveloped in Ukraine, the Law of Ukraine “On Economic Associations” provides certain minimum protection for shareholders depending on the size of the share interest which they hold.

An analysis of shareholders’ rights in a specific Ukrainian publicly-traded company requires a dissection of the Law “On Economic Associations” and the company’s charter. These vital documents set forth the general rights of the company’s shareholders (who own at least one share) and the additional specific rights provided for shareholders who are owners of blocks of shares of certain sizes (i.e., more than 10% of the company’s shares, more than 25%, etc.). Below we describe the rights tied to the acquisition of shares in a Ukrainian company.

A. General Rights of a Company’s Shareholders

Generally, the rights of all shareholders in a Ukrainian company may be realized from the moment changes to the register of owners of registered securities are officially introduced. In accordance with the Law “On Economic Associations” and the relevant company charter, which must set forth certain legal provisions etched in stone, a company’s shareholders have the following general rights:

1. to participate in the management of the company’s affairs in the manner set forth in the company charter;
2. to participate in the distribution of the company’s profits and receive a share thereof (dividends) proportionate to the amount of shares belonging to each shareholder;
3. to receive information on the activities of the company. Upon the demand of a shareholder, the company must present such shareholder with the annual balance sheets, the reports of the company concerning its activities, the minutes of any meetings and other information for purposes of familiarization with the contents thereof;
4. to receive a portion of the property of the company in proportion to the amount of shares held by each shareholder in case of the company’s liquidation;

5. to withdraw from the company as a shareholder by way of willful alienation of shares;
6. to exercise the right of first refusal for the acquisition of additionally issued shares of the company;
7. to submit proposals concerning the agenda of the general assembly of shareholders no later than 30 days before its convening. The management of the company is responsible for the decision to include such proposals into the agenda. Proposals of shareholders, which own more than 10% of the votes at the general assembly, are mandatory for inclusion into the agenda of the general assembly of the company. All shareholders must be notified regarding decisions on changes to the agenda no later than 10 days before convening the general assembly pursuant to the procedure contained in the company charter; and
8. to familiarize themselves with the documents concerning the agenda of the general assembly before convocation of the general assembly of the company.

Importantly, the general assembly of shareholders does not have the right to render decisions on issues that are not included into the agenda of the general assembly. Therefore, shareholders are protected from having to spontaneously decide issues without having the possibility to familiarize themselves with such issues thereby avoiding any misinformed decisions.

B. General Obligations of a Company’s Shareholders

Notably, along with the general rights of shareholders according to Ukrainian legislation, the following general obligations arise as shareholders of a company:

- 1) to observe the company charter and fulfill all decisions of the general assembly of shareholders and other authorized bodies of the company;
- 2) to fulfill all obligations as a shareholder before the company, including those obligations connected with shareholder contributions, as well as to make contributions (pay for shares) in the amount, procedure and according to the method provided by the foundation documents (in cases when a shareholder acquires additionally issued shares of a company);
- 3) to refrain from disclosing commercial secrets and confidential information on the company’s activities; and

- 4) to bear other obligations, if such obligations are prescribed by the Law “On Economic Associations,” other Ukrainian laws and regulations and the company charter.

C. Specific Rights of Shareholders Owning More Than 10% of a Company's Shares

In addition to the general rights described in Section A above, shareholders, who own blocks of shares consisting of more than 10% of the shares of a company, have the following additional rights:

- 1) the right to demand convocation of an extraordinary session of the general assembly of shareholders of the company at any time and for any reason;
- 2) the right to submit proposals for the agenda of an impending general assembly of shareholders. However, such proposals must be submitted at least 30 days before the date that the general or extraordinary assembly of the company's shareholders is to be held (as announced by the company's management);
- 3) to appoint a representative (proxy) to monitor the registration of shareholders participating in the general assembly of the company. Please note that shareholders must inform the executive body of the company in writing on the appointment of representatives for the above purpose; and
- 4) to demand that the Audit Commission of the company carry out an audit of the financial-economic activities of the company's management body. Importantly for shareholders questioning the activities of the management, the Audit Commission is obliged to fulfill such demands.

D. Specific Rights of Shareholders Owning More Than 25% of a Company's Shares

In addition to the general rights of shareholders described in Section A, shareholders, who own more than 25% of a company's shares, have the following additional rights:

- 1) to block decisions by the company's general assembly of shareholders regarding the following issues:
 - a) any amendment to the company charter. In this case, a shareholder owning more than 25% of the issuer's shares will be able to block decisions on the increase or decrease of the company's authorized

capital, which requires the relevant amendments to the company's charter. This gives the 25% + 1 shareholder the ability to prevent dilution of its shares. In contrast, a shareholder owning less than 25% of a company's shares does not have the ability to block a decision on the increase/decrease of the issuer's capital.

Therefore, such shareholder may face repeated attempts by the remaining shareholders to increase the company's capital. As a result, if a shareholder owning less than 25% of the company's shares does not exercise its right of first refusal to buy additional shares in proportion to its shareholding interest, then such shareholder's vote will be accordingly diluted.

- b) adoption of a resolution on the termination of the activity of the company; and
- c) establishment and termination of the activity of subsidiary enterprises, branches and representative offices of the company.

E. Specific Rights of Shareholders Owning More Than 50% of a Company's Shares (50% + 1 and 75% + 1 Shareholding)

A 50% + 1 shareholding in a Ukrainian joint stock company grants such shareholder the possibility to accept and influence all issues set forth by law and in the company charter which can be decided by a simple majority. These issues include determining the principal objectives of the company, electing and recalling members of the management and audit commission, approving the annual results of the company's activities, approving the company's rules, procedures and organizational structure, approving material contracts entered into by the company, among others.

Perhaps the greatest advantage for 50% + 1 shareholders is the possibility to appoint the General Director or management board of the company, which handles the day-to-day operations of the company. This advantage provides such shareholders with the ability to tactically control the financial activities of the company. However, the general assembly of shareholders retains the ability to strategically control the financial activities of the company.

A 75% + 1 or higher shareholding in a Ukrainian open joint stock company gives a shareholder the widest range of control over such company. Specifically, such a shareholder is armed with all of the above-discussed rights plus the absolute power to block or accept all decisions of the company, including those decisions which require a qualified majority of votes

(i.e., a majority of votes in the general assembly of shareholders). These “qualified majority” issues include approving amendments to the company charter, adopting resolutions on the termination of the company’s activity and the establishment and termination of subsidiaries, branches and representative offices of the company.

Moreover, a 75% + 1 shareholder alone can reach or defeat the 60% quorum requirement for convening the general assembly of shareholders. Thus, by not showing up at a general shareholder meeting of the company, the qualified majority shareholder can invalidate such meeting. Even in the event that shareholders holding more than 10% of the votes convene an extraordinary general assembly via the management, the 75% + 1 shareholder can defeat any issues raised by simply casting his/her vote against such issues.

The ability to block virtually all decisions can be particularly advantageous at various stages for issues which require a qualified majority. In particular, the qualified majority shareholder can use his/her power as leverage against all other shareholders with respect to the additional issuance of shares. For example, the 75% + 1 shareholder can agree to vote for an increase of the company’s authorized capital via the additional issuance of shares at the general assembly of shareholders only if certain conditions are met. Thus, if the qualified majority shareholder’s conditions are not met to his/her satisfaction, this shareholder can simply block the vote to increase the company’s authorized capital (which requires a $\frac{3}{4}$ majority vote) thereby rendering the additional issuance impossible.

II. Conclusion

The rights of shareholders have been in existence in the Law “On Economic Associations” since its inception in 1991. Although the Law is quite clear in determining the various rights of shareholders according to their shareholding percentages, in practice no shareholder was safe from share dilution as a result of the scandalous actions of the management bodies in Ukrainian companies and the vagueness of Ukrainian legislation regarding the issuance of additional shares. Formerly, the management of a Ukrainian company would offer additional shares to outsiders without offering them to the existing shareholders thereby diluting the shares of its shareholders without their consent.

However, in response to the various scandals, on October 16, 2000, the State Commission for Securities and the Stock Market of Ukraine issued Decision No. 158, entitled “Regulations on the Procedure for Increasing (Decreasing) the Size of the Authorized Capital of a Joint Stock Company,” which was registered with the Ministry of Justice of Ukraine on

October 27, 2000. These new regulations finally set forth a transparent procedure for increasing or decreasing the authorized capital of a company, which gives all shareholders the clear priority right to purchase all additionally issued shares of a company before such shares are issued to outside investors. Moreover, a new law “On Joint Stock Companies” is in the works, which will presumably and definitively clarify all shareholding issues.

Having battled unscrupulous management decisions to water down shareholding, stock owners in Ukrainian companies can feel more secure in knowing that the rights they hold via their shareholding percentages will not be unexpectedly swept away at a whim.

5. CHANGES IN THE AUTHORIZED CAPITAL OF JOINT STOCK COMPANIES AND MINORITY SHAREHOLDER RIGHTS

I. Introduction

For nearly a decade, the Law “On Economic Associations,” dated September 19, 1991, was the cornerstone in the formation and operations of joint stock companies in Ukraine. This task was relatively simple in the context of closed joint stock companies, but open joint stock companies were basically uncharted territory.

Concurrent privatization efforts introduced the actual appearance of publicly traded (or open) joint stock companies into Ukrainian economy, and the need to develop a legal framework for these new structures. These companies needed independent supervision and state intervention, which the Law “On Economic Associations” could never provide, to protect the shareholders (and the public at large) against unfair play. Soon enough, dirty laundry among the shareholders, such as arguments about increases/decreases in capitalization and questions of stock dilution, was aired in the public press (accompanied by an occasional assassination or a kidnapping). Something had to be done to remedy the growing cracks in the Ukrainian corporate world, and quickly.

Spearheading a much-needed effort to introduce even-handed, transparent rules, necessary to prevent a wide range of abuses prevalent among fellow stockholders, on October 16, 2000, the State Commission for Securities and the Stock Market (“SCSSM”) issued a Decision No. 158, entitled “Regulations on the Procedure for Increasing (Decreasing) the Size of the Authorized Capital of a Joint Stock Company.” By its express terms, this act focused solely on clarifying issues governing perhaps the most violated activity in joint stock companies: the procedure for increasing or decreasing the authorized capital.

The timing of the SCSSM’s decision cannot be overstated: until recently, in order to change the size of the authorized capital, shareholders employed the vague provisions of numerous laws, including the Laws “On Economic Associations,” “On State Regulation of the Securities Market in Ukraine,” “On Securities and the Stock Market,” and “On the National Depositary System and Peculiarities of Electronic Circulation of Securities,” among others. The overlapping provisions, contained therein, sometimes created more confusion than was absolutely necessary.

Note that the Regulations apply to both closed and open joint stock companies. However, they do not apply to cases when the increase or decrease

of the authorized capital is done through the exchange of obligations for shares or via the indexation of long-term (fixed) assets. These exceptional cases are regulated by other normative-legal acts of the SCSSM, which are beyond the scope of this discussion.

II. Discussion

A. Increasing the Size of the Authorized Capital of a Joint Stock Company

The Regulations set forth two methods for increasing the size of a stock company’s authorized capital: (i) via additional contributions (including buildings, natural resources, equipment); and, (ii) by reinvesting dividends. Additionally, increases in the size of the authorized capital can take place in one of two ways: (i) by increasing the quantity of shares in their existing par value; or (ii) by increasing the par value of existing shares.

Although the above methods are quite straightforward, the Regulations do apply some limitations. For instance, a joint stock company may not increase its authorized capital through both additional contributions and reinvestment of dividends. In other words, the joint stock company may only choose one source or the other, but not a combination thereof. Thus, shareholders who wish to both reinvest dividends and contribute additional capital to the company are faced with two separate increases and two separate share emissions, which will be subject to the registration and procedural requirements of the SCSSM.

Moreover, for each increase of the authorized capital of a company, the company must either increase the quantity of shares or alter the par value of such shares. Again, the company may not combine the methods for increasing the authorized capital. Thus, some form of minority shareholder protection is afforded by limiting the ability to strategically play with the proportional shareholding.

Several restrictions in increasing authorized capital exist. For instance, shareholders cannot increase the company’s authorized capital until full payment by all shareholders for all previously issued shares has been effectuated at a price no lower than par value. Additionally, shareholders are prohibited from increasing the size of the authorized capital if all previously issued shares have not yet been registered with the SCSSM. These procedural provisions particularly affect closed joint stock companies because they will not be able to increase their authorized capital without registration of their shares, a step that was widely overlooked in the past.

Taking into consideration the above limitations, the Regulations provide that increasing the authorized capital of a joint stock company at the expense of additional contributions may only be effectuated by increasing the quantity of shares in their existing par value. Conversely, an increase due to reinvestment of dividends may be effectuated by either (i) increasing the par value of shares or (ii) increasing the quantity of shares with their existing par value (with subsequent distribution between the shareholders, proportionate to their shareholding on the date of the decision to issue the additional shares). Unlike prior Ukrainian legal norms, these Regulations lay out the above procedures with surprising clarity and detail.

B. Increasing the Authorized Capital of a Joint Stock Company at the Expense of Additional Contributions

Because the shares of open joint stock companies are publicly traded, and are subject to more complex regulation than the shares of closed joint stock companies, the procedure for increasing the authorized capital at the expense of additional contributions in both types of companies slightly differ. For sake of convenience, we set forth the procedure for the two types of joint stock companies separately.

1. Open Joint Stock Companies

The first step towards increasing the authorized capital of an open joint stock company is to hold the general assembly of shareholders (the "General Assembly") in order to vote in favor of the increase. If a quorum is present and the General Assembly resolves to increase the authorized capital, such decision must be set forth in the company's minutes in order for this resolution to have been made "in accordance with Ukrainian legislation."

Due to the public nature of open joint stock companies, certain additional procedural steps must be taken prior to increasing the authorized capital. For instance, Article 23 of the Law "On Securities and the Stock Market," dated June 18, 1991, requires that information on the share issuance resulting from the increase be registered with the SCSSM. Then it must be published in the official publications of the Cabinet of Ministers and the Ukrainian Parliament, as well as in the official publication of the Ukrainian stock exchange, no less than 10 days before the subscription for the shares of stock.

Thereafter, a subscription for the shares must be carried out, and the results must be reported to the SCSSM. If the planned level of the subscription is not reached or is exceeded, or if the decision to increase the authorized capital is made by the management of the company, then the General

Assembly must subsequently approve the results of the subscription. Along with such approval, the General Assembly must also resolve to amend the company charter in connection with the increase of the authorized capital.

In the final steps, after the changes to the company charter are officially registered, the share issuance is registered with the SCSSM and a new permanent certificate is executed and deposited (if the shares are issued in non-documentary form). If the shares are issued in documentary form, the share information must be introduced into the register of owners of registered securities, the appropriate share forms must be prepared and, finally, the share certificates must be issued to the shareholders.

2. Closed Joint Stock Companies

The sequence of events required for increasing the authorized capital of a closed joint stock company is much simpler due to the fact that the shares of such companies are not traded publicly. Therefore, for example, the holding of an open subscription and the publication of the share information are unnecessary.

First, the shareholders must convene a General Assembly to increase the authorized capital of the company. As always, the results of this decision must be documented in the minutes of the shareholders' meeting. Next, the shares of the additional issuance must be distributed among the shareholders in proportion to their shareholding. Accordingly, the company must register the changes to its charter due to the increase of the authorized capital, and register the information concerning the additional share issuance with the SCSSM.

The final steps include the execution and deposit of a new certificate if the share issuance is in non-documentary form, or entry of the information concerning the share issuance into the register in case of share issuance in a documentary form. Then, and only then, stock certificates will be issued to the shareholders. Upon the completion of the above necessary steps, the increase of the authorized capital is completed.

3. General Considerations

In many cases, the charter of a joint stock company permits the management to increase the size of its authorized capital at the expense of additional contributions. This power is subject to two limitations: (i) the intended increase may not be for more than 1/3 of the amount of the existing authorized capital, and (ii) all holders of registered shares must be personally notified in writing, according to the method set forth in the company charter.

According to the Regulations, notice to the shareholders concerning such an increase must contain the following information: the name and location of the company, the telephone or fax number of the company, the amount of the increase, the date and number of the relevant decision on the additional share issuance, the general amount of the share issuance indicating the nominal value, the quantity and category of shares, information on the shareholders' right of first refusal and the timeframe for the first and second stages of subscriptions (if applicable).

For joint stock companies, the official protocol of the management's authorized body regarding the decision to increase the size of the charter must contain certain information in addition to the information required by Ukrainian securities legislation. Specifically, the protocol must contain the precise procedure for shareholders to exercise their right of first refusal for shares in the amount proportionate to their share in the authorized capital at the moment the decision was taken to issue shares.

Additionally, the protocol of an open joint stock company must contain the term for holding the open subscription where a shareholder can exercise the right of first refusal, the term for holding the subscription for other (third party) investors and existing shareholders to acquire shares that exceed the amount of shares for which a shareholder has a right of first refusal. In all cases, existing shareholders and third party investors may acquire shares at a price no lower than par value.

C. Increasing the Authorized Capital of a Joint Stock Company Via Dividend Reinvestment

The procedure for increasing the size of the authorized capital via the reinvestment of dividends (i.e., payment of dividends with the company's shares) is quite similar to the procedure for increasing the authorized capital by effectuating additional contributions. After publication of the announcement concerning the increase, however, the company must provide the SCSSM with a copy of the protocol on the decision to make the increase and a copy of the published announcement no later than 10 days after publication. Further, the shareholders must submit notices to the company regarding their consent to direct the dividends due and payable to them for the increase of the authorized capital.

In contrast with an increase at the expense of additional contributions, an increase via reinvestment of dividends does not entail registration of information on the share issuance and an open subscription for shares. Additionally, the management can decide to increase the authorized capital of the company (again, provided such power is delineated in the

company charter and the increase is for no more than 1/3 of the existing authorized capital) only on the condition that the General Assembly issues a decision on the procedure for distributing profits.

The general notice requirements regarding the increase of the authorized capital by reinvesting dividends practically mirror the notice requirements for increasing the authorized capital via additional contributions. However, such notice must specifically contain the term for accepting applications (statements) from shareholders, expressing their consent to direct the dividends payable to them for increasing the size of the authorized capital (if dividends are to be paid in stock). Further, the notice must state the volume of rights in connection with the issuance of privileged shares (if applicable) and the procedure and place for the receipt of the additionally issued shares. Accordingly, a notice of an increase via the reinvestment of dividends does not require information on the shareholders' right of first refusal and the term for share subscriptions.

D. New Standards in Shareholder Protection: Right of First Refusal

Pursuant to the Regulations, all shareholders in a joint stock company have an equal right of first refusal to acquire additionally issued shares in proportion to their share in the authorized capital of the company on the date of the decision to make the additional issuance. If a subscription is to be carried out for the additionally issued shares, then the open joint stock company is prohibited from providing different terms and conditions for the right of first refusal of one investor than for other investors (except in cases when shareholders exercise their rights of first refusal).

A subscription for additionally issued shares must be carried out in two stages. In the first stage, the shareholders exercise their rights of first refusal in proportion to their existing shareholding. In the second stage, third party investors and existing shareholders may exercise their right to purchase additionally issued shares. At this stage, the existing shareholders may purchase shares exceeding the amount of shares for which they exercised their right of first refusal in the first stage. Importantly, the existing shareholders have the right of first refusal over incoming investors to purchase the remaining shares for the subscription. This second-stage right of first refusal gives the existing shareholders the power to exclude new shareholders from entering the company.

Procedurally, the term for holding the first stage of the subscription may not be less than 15 calendar days. The second stage of the subscription will begin after the completion of the first stage. On the next day following the completion of the first stage, shareholders and other investors may demand information on the quantity of shares, which were sub-

scribed for in the first stage.

Any shareholder, who wishes to exercise his or her right of first refusal for additionally issued shares, must file an application to acquire the shares and pay for such stock in accordance with the terms and conditions of the issuance. Upon the exercise of a right of first refusal, the open joint stock company cannot restrict the use of cash by a shareholder as payment for the shares. Any applications received from investors (i.e., non-shareholders) will not be considered before the commencement of the second stage of the share subscription.

In describing shareholders' rights of first refusal, the Regulations set forth a mechanism which protects shareholders from dilution of their shares by prohibiting companies from selling shares to investors without offering shareholders an option to purchase the additionally issued shares first. Further, the Regulations also prevent open joint stock companies from selling additionally issued shares at steep discounts, thereby decreasing the value of existing shares.

E. Decreasing the Size of the Authorized Capital of a Joint Stock Company

Joint stock companies may decrease their authorized capital in one of two ways: (i) by decreasing the nominal value of existing shares or (ii) by decreasing the quantity of existing nominal value shares. Note again, however, that a joint stock company cannot decrease its authorized capital via a combination of the above methods. Further, a joint stock company may not decrease its share capital if (i) existing creditors, including obligation holders, object to the decrease, or (ii) the previous share issuance was not registered.

If the shareholders of a joint stock company intend to decrease the size of the company's authorized capital, the management body of the company must publish a notice aimed at creditors and shareholders regarding such intention. Such notice must be published in the official publication of the Ukrainian Parliament or the Cabinet of Ministers, or in the official publication of the Ukrainian stock market.

Along with the general information about the company, the notice on the decrease of the authorized capital of a joint stock company must contain the following: the motives for decreasing the authorized capital, the method for decreasing the authorized capital and the size of the overall decrease. Additionally, the notice must contain information on the quantity of the shares to be withdrawn and their total value, the term for withdrawing shares and the consequences as a result of a share-

holders refusal to exchange shares in connection with the decrease of the authorized capital in case of decreasing the nominal value of shares. Finally, the notice must state the term for which creditors may submit objections to the decrease, which cannot be less than 30 days from the date of publication. All creditors with objections to a decrease of the authorized capital must submit a copy of such objections to the SCSSM as well. Once the presence of objections is established, the authorized capital of a joint stock company may not be decreased.

The procedure for decreasing the authorized capital of a joint stock company includes a sequence of actions similar to the procedure for increasing the authorized capital. First, the general assembly of shareholders must convene and hand down the decision to decrease the authorized capital of the company. Thereafter, the relevant notice is published in one of the above-mentioned publications. Upon publication, the joint stock company must provide the SCSSM with the minutes of the General Assembly containing the decision to decrease the authorized capital of the company and a copy of the published notice no later than 10 days after its publication.

Accordingly, changes to the charter of the joint stock company must be introduced and registered in accordance with the established procedure, and the additional share issuance must also be registered. As with the procedure for increasing the authorized capital of a company, relevant information on the share issuance must be entered into the register and new share certificates must be prepared and issued.

Finally, in case of a decrease of the authorized capital of a joint stock company, information on the share issuance is not subject to mandatory registration and publication. Moreover, the joint stock company is not required to draft a report on the results of the decrease for submission to the SCSSM.

III. Conclusion

Fortunately, the Regulations are fairly narrow in their scope, and do not pretend to cure all ills that arise in a context of managing a joint stock company. Instead, the Regulations provide minority shareholders with a higher level of protection than ever before. While not all minority shareholders will actively seek to enforce their rights under the Regulations, at last Ukrainian and foreign stockholders alike will have a sound legal basis to prevent various abuses that routinely take place in the corporate setting. That, in itself, is progress.

6. COMPANY REGISTRATION: PRE-JULY 1, 2004

The registration of a business company in most Western countries is fairly straight-forward and relatively pain-free. Registration in Ukraine, however, can be an entirely different story.

Theoretically, the registration of a representative office or a business entity shouldn't take more than a month. In reality, the registration of a business entity or representative office can take significantly longer because usually 1 month is required just for the foreign investors to gather the required documents and legalize (or apostillize) them for purposes of registration with the Ukrainian authorities.

Immediately below we describe the various documents, necessary to begin the registration procedure, for (1) representative offices and (2) resident companies (joint stock and limited liability). We also briefly review the registration process itself. Importantly, please note that in spite of the passing of a new Civil Code and a new Economic Code, the current registration procedure continues to apply in the most part. However, on May 15, 2003, the Law of Ukraine No. 755-IV "On the State Registration of Legal Entities and Physical Entities-Entrepreneurs" was passed and will come into force on July 1, 2004. Therefore, the rules below related to the registration of legal entities (limited liability companies, joint stock companies, etc.) will lose their force. Interested readers should refer to the next chapter for the procedure, which will govern after July 1, 2004.

I. Registration of a Representative Office

Any foreign legal entity, engaged in on-going business activities in Ukraine, should register some sort of a presence in Ukraine. Many elect to register a permanent representative office by obtaining a registration certificate from the Ministry of Economy and for Issues of European Integration (which, due to administrative reforms, became the successor to the Ministry of Foreign Economic Affairs).

Obviously, one-shot import-export contracts do not require that a foreign investor open a representative office. However, a representative office must be registered if, for example, such import-export contracts require a continual presence in Ukraine for installation or servicing by a foreign legal entity's employees or the hiring of local staff.

Pursuant to Ukrainian law, in order to register a representative office, a foreign legal entity must submit to the Ministry of Economy and for Issues of European Integration the following documents:

1. An application in the form of a letter addressed to the Minister of Economy with a request to register a representative office, and indicating: the applicant's proposed activities, purpose of opening a representative office, number of foreign employees, and the legal address. This application must be on the applicant's official letterhead, signed by the applicant's representative (appointed pursuant to a power of attorney), and affixed with the company seal;
2. An extract from the government register of the country in which the parent company is registered, which evidences registration of the company;
3. A notarized bank letter of good standing in the bank where the parent company has accounts. This letter should state that the parent company has an account with the relevant bank and is a customer in good standing;
4. A resolution of the company's board of directors to register and open a representative office; and
5. A notarized power of attorney empowering the parent company's representative(s) in Ukraine "to act as the company's representative in Ukraine in registering and operating a representative office in Kiev, and performing all other activities related thereto, including delegating such rights to third persons." In practice, most companies issue a power of attorney to the attorney responsible for registration of the company and to the person chosen as the head of the representative office.

The last document, the power of attorney, must specifically state that the person appointed will be the company's "representative in Ukraine," otherwise the company may encounter problems with multiple entry visas and other related issues in the future. Further, the power of attorney should grant to the representative the right to sub-delegate certain functions, such as registration of the representative office and signature on banking operations, if the representative will not be present in Ukraine on a regular basis.

The aforementioned documents must be duly notarized, certified, authenticated with the appropriate government administration (i.e., the Ministry of Foreign Affairs or other authorized body depending on the specific country) and legalized in the Ukrainian Embassy located in the country where the parent company is registered. Thereafter, the documents must be translated into Ukrainian and the translation must be authenticated. Ukrainian legislation allows 60 work days for registration of a representative office, but representative offices are typically registered within two (2) weeks from the date of submitting the documents and proof of registration fee payment to the local authorities.

The Ministry of Economy's fee to establish a representative office is two thousand five hundred (\$2,500) US dollars or its equivalent in any other convertible foreign currency. The fee must be wired directly to the Ministry's account in the Ukrainian Import-Export Bank, and cannot be paid by a law firm or other agency carrying out registration on behalf of a foreign entity in Ukraine.

II. Registration of Joint Stock and Limited Liability Companies

Generally, foreign founders must prepare a series of background documents, which are described in greater detail below. Parallel to preparation of the background documents, the parties must also prepare a company charter (by-laws) and a shareholders' agreement in case of joint stock company registrations and a founders' agreement in case of limited liability companies. All of these documents will be submitted for registration with various local authorities, which can take up to 20 days after receipt of the duly prepared documents.

A. Foreign Partner's Background Documents

In order to register a company with private ownership, a foreign legal entity will need to prepare for submission to the Ukrainian authorities the following documents:

1. A copy of the parent company's Certificate of Incorporation with the government's seal placed thereon or an extract from the government or commercial register of the country in which the parent company is registered, evidencing registration of the company. This document should also reflect the companies date of registration, registered legal address, etc.;
2. A Power of Attorney bearing the parent company's seal to the individual appointed as the representative of the parent company in Ukraine with the authorization to execute all documents on behalf of the parent company, open and operate local bank accounts, etc. It is quite common for foreign entities to issue an additional power of attorney to a local attorney to act as the local representative for registration purposes only (i.e., to execute all documents on behalf of the company related to registration, to register the company, to open the company's bank accounts, to sign the founding documents, to sign an agreement with the proposed director of the company, etc.). Preferably, the company's own representative (i.e., proposed director or local representative) should also be provided with a power of attorney with the authority to delegate his/her authorities;

3. The original resolution of the parent company's Directors (or authorized body) to establish a company in Ukraine (affixed with the company's seal); and
4. A copy of the lease agreement or sale-purchase agreement evidencing the legal address (location) of the company in Ukraine or a guarantee letter from the owner of the premises to be leased/purchased by the company (this document can be obtained just prior to registration).

Note that documents 1, 2, and 3 above must be:

1. properly executed and notarized;
2. translated into Ukrainian;
3. the signature of the notary must be properly authenticated in the appropriate authority of the parent company's country; and
4. legalized in the Ukrainian Embassy (of the parent company's country). On December 22, 2003, the 1961 Hague Convention took effect in Ukraine whereby documents may now be certified by an Apostille in place of the sometimes cumbersome legalization procedure with the Ukrainian Embassy. However, the Apostille procedure is applied in countries, which recognized Ukraine as a member to the 1961 Hague Convention. For example, Germany and Belgium are amongst the countries, which expressed reservations as to Ukraine's membership status, and therefore legalization with the Ukrainian Embassy is still effective in these countries.

Once the foreign entity has duly prepared all of the registration documents, the foundation documents of the Ukrainian resident entity to be registered must be drafted and certified. If there is a physical entity (i.e., individual) amongst the founders, the foundation documents must be notarized in the physical presence of such individual (with passport available for notary purposes) or upon the presentation of a duly executed power of attorney issued by such individual. If the founders of the Ukrainian entity are all legal entities, the foundation documents must be affixed with the official company seal of such legal entities. The contents of the foundation documents are discussed further below.

In addition, the founders must hold an initial Founders' Meeting (or Constituent Meeting) and execute a protocol (resolution immortalized in minutes form) expressing the intention to create a Ukrainian legal entity. If the founders are legal entities, the minutes of the Founders' Meeting must express the intention to become a co-founder in the Ukrainian

enterprise. In all cases, the minutes of the Founders' Meeting must indicate who has the right to sign the foundation documents of the created company. Accordingly, the power of attorney for any authorized signatories must also include a provision to this effect.

B. Drafting Shareholders Agreement and Company Charter

The registration procedure in Ukraine, as long and tedious as it is, simply consists of registration of a company charter. In the past, if the company consisted of two or more founders, however, they were required to also draft a shareholders agreement (also known as a founders' agreement if shares of stock are not issued). This document is an ordinary contract that is notarized but not registered. Although similar, both foundation documents of the company serve different purposes. Since January 1, 2004, the Civil and Economic Codes of Ukraine have abolished the requirement of a founding agreement altogether, however the Law "On Economic Associations" has not been amended to this effect and some banks continue require the presentation of a founding agreement in order to open a bank account. Therefore, foreign investors should inquire regarding the current practice with respect to the requirement to draft a founding agreement in cases when two or more entities create a legal entity in Ukraine.

The primary purpose of the charter is to set forth the rights and obligations of the company and its founders and/or members. Much like by-laws of a U.S. corporation, a Ukrainian company's charter contains the goals, rights and activities of the company, its structure and administrative organs, internal procedures and the structure of the initial capitalization and contributions.

The charter also contains capitalization currency exchange rates, liquidation procedures, the method for dividing profits, and the name, address and type of company being formed. The charter must contain certain mandatory provisions listed in the laws, such as the creation of a 25% reserve fund, but can also be rather flexible in other matters. The charter serves as the company's blueprint and contains information which the Ukrainian authorities need to see before they issue a certificate of registration.

The shareholders agreement, on the other hand, secures the rights and obligations of the shareholders and/or founders amongst each other. A detailed description of the company's structure is not necessary. What is important, however, is a detailed agreement that outlines issues vital to the shareholders; namely, distribution of profits, ownership rights, transferability of shares and the right to assign shares, confidentiality, division

of assets upon liquidation and, of course, dispute resolution and arbitration procedures.

The shareholders agreement often serves as the rules of procedure in case of a conflict between founders. The registration authorities, much like Ukrainian partners, quite frankly do not care about many of these issues unless the provisions blatantly contradict applicable legislation. A carefully drafted agreement, however, is vital to the foreign investor if dispute resolution takes place in a foreign forum. This is so particularly in cases of joint ventures with state-owned enterprises where the State Property Fund is a legal founder.

To draft the foundation documents for a resident company, the following information is required:

1. The name of the parent company (full and abbreviation), company structure (i.e., joint stock company, limited liability company, etc.), city/country of registration, registration number (when finally available), registration date, the representative (i.e., the person for whom the power of attorney to sign and register the company is drafted), citizenship of founders, the issuer of each founder's passport, residence of the founders, passport validation dates, etc.;
2. The name of the company (in Ukrainian and English: full name and abbreviated name);
3. The company's Ukrainian legal address. For an address you must either own the premises or have the right to lease the premises in the district where the company is registered. Strangely, the Ukrainian registration authorities require the presence of a lease agreement before the completion of registration;
4. The company's purposes. Ukrainian law does not permit "catch-all" purpose clauses such as "any legal activity under Ukrainian law." Thus, the foundation documents must broadly detail all of the company's current and potential activities. Most companies choose the full range of possible activities in Ukraine just in case;
5. Amount of each founder's contribution to the authorized capital, which may consist of cash and/or in-kind contributions (if equipment will be provided, a list of such equipment must be included as an annex to the charter);
6. Governing bodies, management structures;

7. To whom should notices be sent and at what address; and
8. Definitions of any words that need to be defined in the foundation documents (i.e. industry specific terms).

On the basis of the answers to the above questions, a draft of the charter is prepared for the company's review and approval. Thereafter, the charter is translated into Ukrainian and the registration procedure is commenced.

C. Pre-Registration Capital Contributions

Under the Law "On Economic Associations," all stock companies and limited liability companies must make certain good-faith pre-registration deposits before they can be officially registered. In the event of closed joint stock companies, the founders must contribute no less than 50% of the nominal value of their respective shares of stock prior to the convening of the founders' assembly. Before registration of a limited liability company, the founders must make at least 30% of their contributions set forth the foundation documents prior to registration. However, this amount was increased to at least 50% in the new Civil Code. Therefore, changes to the said Law are most likely to be introduced in the near future. Proof of payment must be presented to the registering authority along with the registration documents.

The minimum capitalization requirement of a joint stock company is equivalent to 1,250 minimum monthly salaries, based on the rate of the minimum monthly salary effective at the time of the creation of the company. In turn, the minimum capitalization requirement of a limited liability company is much less: 100 minimum monthly salaries. As of January 1, 2004, one minimum salary is equivalent to 205 Ukrainian Hryvnias. The Ukrainian Parliament plans to increase the minimum salary, as of November 1, 2004, to 237 Ukrainian Hryvnias, and as of January 1, 2005 to 262 Ukrainian Hryvnias.

Note a peculiar exemption: the aforementioned "advance deposit" requirements apply *only* to companies with two or more founders (the company is then registered in accordance with the Law "On Economic Associations"). If there is only one founder, such as in a 100% wholly-owned enterprise, the law does *not* require any pre-registration deposit because such a company is registered in accordance with the Civil and Economic Codes, which do not provide for such advance deposits for company formation and do not provide for a minimum capitalization requirement.

For purposes of making the initially required portion of the founders' contributions, a temporary bank account must be opened in the bank which

will service the newly formed company. The representative of the company must present an application to open such account, along with his/her power of attorney evidencing the right to representation and a notarized copy of the founders' or shareholders' agreement. As mentioned above, the requirement of a founders' or shareholders' agreement has been abolished by the Civil and Economic Codes although many banks still require the presentation of a founders' or shareholders' agreement due to the National Bank of Ukraine's failure to bring their Instructions into compliance with the new Codes. If the contributions will be made in-kind, an act of appraisal and transfer of such property must also be presented.

Regardless of the level of pre-registration deposit, however, a newly formed enterprise has up to a year from the date of registration to contribute the full amount of its statutory capital, be it in-kind or cash contributions. The following discussion addresses cash contribution and in-kind contribution procedures.

(i) Cash Contributions

Capital contributions prior to registration must be deposited into a temporary account approved specifically for such purposes by an accredited bank. The purpose of such an account is limited exclusively for authorized capital deposits. The company's local representative must simply choose a bank and request the opening of such an account; no special applications or forms are required. A certified bank receipt or account statement of such contributions is sufficient for proof of the required pre-registration capital contribution.

When foreign currency is deposited into a temporary account, the entire balance is converted into a permanent account upon official registration of the company. None of the capital contributions in foreign currency are converted to Ukrainian Hryvnia. No deposit-only restrictions apply to a permanent account.

After registration of the company, conversion of a temporary bank account into a permanent account requires presentation to the bank of (1) a certificate of incorporation from the local state administration; (2) the company charter, and (3) and other registration documents (for example, from the Ministry of Statistics, the Tax Inspection Office, the Pension Fund, the social security funds, etc.).

(ii) In-Kind Contributions

The parties usually come to an agreement on the value of in-kind contributions on the basis of their own business decisions, and taking into ac-

count global market prices for such objects. Based on such agreement, the parties must prepare and submit to the city or oblast administration the agreement, attesting to any in-kind contribution. This agreement must describe the types, forms and value of in-kind contributions and state that they are part of the authorized capital and already have been contributed. Such an agreement must be signed by the representatives of the founders with appropriate powers of attorney (i.e., notarized and duly executed powers of attorney must accompany such an agreement). The agreement need not be notarized, but must bear the founders' company seals. However, the value reflected in the said agreement must coincide with the value of in-kind contributions reflected in the company's charter, invoices (if the in-kind contribution was purchased), the customs declaration, bills of lading, etc.

The above agreement is simply a show of faith between the founders of a company. The local administration does not question the signed and executed agreement between the two private parties. The issues, however, become significantly more complex in cases involving state-owned property and negotiations with the State Property Fund.

Ukrainian law requires the founders to submit either (a) the customs declarations attesting that the in-kind contributions either have crossed the border into Ukraine or are in a customs bonded warehouse storage facility (if the contribution physically may be sent to Ukraine) or (b) sale-purchase receipts signed by one or more founders (i.e., a receipt that requires signature, such as a company charge card receipt) proving that such property indeed has been purchased by a founder for contribution.

In order to avoid import duty on in-kind contributions to authorized capitals upon customs clearance, the company to which such contributions are designated has the right to issue a promissory note for a maximum term of 30 days (see Article 18 of the Law No. 93/96-VR "On the Foreign Investment Regime," dated March 19, 1996 and lastly amended on May 15, 2003). The promissory note will not be presented for payment, and consequently will be considered redeemed, if the registration of the in-kind contribution has been completed within a 30-day period from the date on the face of the promissory note. This formality is aimed at those entities who may attempt to avoid import duty by designating property as an in-kind capital contribution, only to sell the property as soon as it clears customs.

III. Registration Procedure

A description of the following stages in the registration process may serve as an explanation as to why most foreign companies choose to use the services of a law firm or local expert to effectuate registrations.

The first stage of registration involves the local State Administration, which reviews various documents, including the individual tax identification codes of each founder; the minutes of the founders' meeting with the decision to create the Ukrainian legal entity; the certificate from the bank where the temporary account was opened on the formation of the authorized fund (in case of formation by cash contributions); confirmation that the authorized fund has been formed by property (in-kind) contributions (act of appraisal, etc.); and a copy of the founders' (shareholders') agreement evidencing its official registration (if there is a legal entity amongst the founders).

The second stage is the receipt of a certificate, evidencing inclusion of the new company into the Unified State Register of Enterprises and Organizations at the Ministry of Statistics. This stage requires presentation of an application (which can be filled out on the spot by the authorized representative), the documents evidencing registration of the company with the local State Administration and the foundation documents of the company to be formed.

The third stage is registration with the local State Tax Inspection Administration. For this purpose, the authorized representative will be required to present an application (in the established form), a copy of the document evidencing state registration of the founders (for legal entities), the foundation documents (originals and copies certified by the State Administration), a copy of the certificate from the Ministry of Statistics and the tax identification codes of the founders. Upon review of all documents, the State Tax Inspection will place a stamp on the original charter of the newly registered company and issue a taxpayer's code to the newly created company.

After registration with the State Tax Inspection, the new company must be registered with the State Pension Fund. This simply requires presentation of the original foundation documents and the certificate of state registration from the local State Administration. Thereafter, the State Pension Fund places its stamp on the original charter of the new company. This procedure must be repeated for the social insurance bodies and the State Employment Center.

The fifth stage entails opening a permanent bank account for the new company. The National Bank of Ukraine requires that the following documents be submitted to open a permanent bank account for the new company:

- a) an application (established form);
- b) a copy of the new company's certificate of state registration (certified by the registration body or notarized);

- c) a copy of the charter (if applicable) with the stamps of the tax administration, the Pension Fund and the Ministry of Statistics (certified by a notary);
- d) a copy of the Tax Administration's certificate on the issuance of a taxpayer's code;
- e) a copy of the new company's founding agreement (certified by a notary); and
- f) a sample signature card (certified by a notary).

Within 3 days from the opening of the account, the authorized representative must inform the relevant local State Tax Inspection Administration about the opening of such account. The opening of a bank account usually takes no more than one hour. The opening of the bank account and the subsequent informing of the State Tax Inspection are vital because they must be done before moving on to the final stage of registration.

In the final stage of registration, permission from the regional department of the Ministry of Internal Affairs must be obtained in order to prepare an official company seal. Please note that representative offices receive such permission from the central office of the Ministry of Internal Affairs only. This stamp will be required on all banking documents, accounting documents, economic agreements, tax reports, etc. For purposes of obtaining the above permission, the following documents must be presented to the Ministry of Internal Affairs:

- a) an application (established form);
- b) the original and a copy of the new company's certificate of state registration (certified by the registration body or a notary);
- c) two examples (sketches) of the stamp;
- d) the receipt evidencing payment of the official fee for permission issuance; and
- e) a certificate from the new company's bank evidencing the opening of an account.

The seal of the Ministry of Internal Affairs will be placed on the new company's original certificate of registration within 5 days, and the permission to prepare an official company seal will be granted. Thereafter, the new company must prepare its official seal and place an impression

thereof on the new company's banking card. This procedure, however, is beyond the scope of this discussion.

IV. Conclusion

As Ukrainian legislation has intended it to be, the registration of a business company in can be quite time consuming and frustrating, even with professional assistance. Adherence to the registration procedure is no guarantee that unforeseen obstacles and issues will not arise during the registration process. Moreover, registration of a company in Ukraine is only half the battle. Once registered, the newly formed Ukrainian company will face the challenge of successfully operating in Ukraine.

7. COMPANY REGISTRATION AND LIQUIDATION — POST-JULY 1, 2004

I. Introduction

On July 1, 2004, the Law of Ukraine No. 755-IV “On State Registration of Legal Entities and Physical Entities-Entrepreneurs,” dated May 15, 2003 (hereinafter the “Law”), comes into legal force. Surprisingly, the Law was specifically tailored to correspond to the Civil and Economic Codes of Ukraine, which simultaneously came into force on January 1, 2004 notwithstanding their apparent contradictions. Before July 1, 2004, the old registration procedures will remain in effect regardless of the fact that they are not in full compliance with the new Codes. Needless to mention, this has created a bit of chaos for foreign investors seeking to register companies before July 1, 2004 and for the registration authorities in general. It has been said that there have been more roundtable discussions concerning company registration since January 1, 2004 than there have been in the past 5 years. With this bit of background information in mind, we briefly describe below the registration procedure of post-July 1, 2004.

II. Discussion

State registration in Ukraine evidences the fact of the creation or liquidation of legal entities and the fact of the acquisition or deprivation of the status of an entrepreneur-physical entities, as well as the any other registration activities which require the introduction of information into the Unified State Register of Legal Entities and Physical Entities-Entrepreneurs (hereinafter the “Unified State Register”). The registration procedure involves the verification of the completeness and contents of required registration documents and duly filled in registration cards, the introduction of information into the Unified State Register and the issuance of certificates of state registration and extracts from the Unified State Register.

Registration is performed at the place of location of legal entities or place of residence of physical entities desiring to register as subjects of entrepreneurial activity (hereinafter “entrepreneur(s)”) by a state registrar. State registrars are responsible for registering legal entities and entrepreneurs, reserving names of legal entities (a novelty in Ukraine), providing information to various state authorities from registration cards, creating and storing registration cards, filling out and issuing certificates of registration and extracts from the Unified State Register, registering amendments in the founding documents of legal entities or in the information on entrepreneurs, registering terminations of activity, etc. State registrars are

appointed and dismissed by city or state administrations only upon the consent of the specially authorized body for issues of state registration (hereinafter “Authorized Body”).

Interestingly, in sharp contrast to the typical employees of registration authorities, state registrars must have a higher education at the level of a master’s degree or specialist with at least one year of experience of state service or three years experience in another sphere of administration. State registrars must possess a certificate from the state and a personal seal for stamping registration documents and files.

The Authorized Body has multiple functions and ensures the implementation of state policies in the sphere of entrepreneurship. Its functions include:

- a) tracking the observance of legislation in sphere of state registration;
- b) generalizing the practice of enforcing the normative-legal acts on issues of state registration and developing draft normative-legal acts in this sphere;
- c) approving the normative-legal acts related to the formation and maintenance of the Unified State Register;
- d) ensuring the formation and maintenance of the Unified State Register;
- e) approving the form of registration cards, certificates and extracts from the Unified State Register;
- f) organizing the technical training and increase of qualification of state registrars and agreeing upon the candidates for the position of a state registrar;
- g) issuing certificates and seals of state registrars;
- h) ensuring orders, deliveries, accounting and reporting, which are related to the expenditure of blank certificates of state registration and blank extracts from the Unified State Register;
- i) issuing a special press publication for registration activities.

A. Documentation

All documents to be submitted for any registration activity must be personally submitted or sent by registered mail and must be written in

Ukrainian. This language requirement has caused quite an uproar in many parts of Ukraine where Russian is the more commonly used language (i.e., the Crimea, Odessa and Eastern Ukraine).

Registration cards must be typewritten or handwritten in print and signed (in case of dispatch by registered mail, the applicant's signature must be notarized). All founding documents (charters, founding agreements, if applicable, regulations, etc.) must completely conform with the requirements of Ukrainian legislation. Please note that documents, which are executed and issued in a foreign country, must be duly signed, notarized with a certification of the notary's signature by the authority in the foreign country authorized to certify such signatures and, finally, legalized with the Ukrainian Embassy in the foreign country or affixed with an Apostille provided that the foreign country has recognized Ukraine as a member to the 1961 Hague Convention Abolishing the Requirement of Legalization for Foreign Public Documents.

State registrars must use the established unified forms for certificates of state registration of legal entities and entrepreneurs. Each certificate of state registration is strictly accounted for and contains a registration serial and number. The certificate of registration of a legal entity contains the name of the company, its identification code in the Unified State Register of Enterprises and Organizations of Ukraine, its location, its place of state registration, its date of registration and the surname and initials of the responsible state registrar. In comparison, certificates of state registration of entrepreneurs contain the name of the entrepreneur, his or her tax identification code, place of residence, place of state registration, date of registration and the surname and initials of the responsible state registrar.

All certificates of state registration must be signed and sealed by a state registrar and may be replaced in case of amendments to the information contained therein or their loss or damage. If a certificate of registration is lost or damaged, a legal entity or entrepreneur must submit to the state registrar an application for replacement, the unfit-for-use certificate (if available), confirmation of payment of the replacement fee and for the publication of notice on replacement and the passport or power of attorney of the applicant. Documents submitted to the improper registration authority, improperly executed documents or an incomplete set of documents will be grounds for the refusal to replace a certificate.

B. Registration File

After a legal entity or entrepreneur is entered into the Unified State Register, the relevant state registrar will create a registration file and assign it a registration number. As an example, the following are kept in the registration file of a legal entity:

- a) the documents submitted for state registration of a legal entity, in particular one counterpart of the originals of the founding documents;
- b) the documents submitted for the state registration of amendments to the founding documents and/or one counterpart of a new version of the founding documents;
- c) the documents submitted for the introduction into the Unified State Register of information about separate subdivisions of a legal entity. Please note that separate subdivisions of a legal entity need not undergo state registration;
- d) the documents submitted for the replacement of a certificate of state registration;
- e) the documents submitted for the introduction into the Unified State Register of the entry regarding the decision of the founders (participants) or the authorized body or person thereby on the liquidation of a legal entity;
- f) court judgments on the cancellation of the state registration of amendments to the founding documents of a legal entity;
- g) the documents submitted for the introduction of a court decision regarding the cancellation of the state registration of the liquidation of a legal entity into the Unified State Register;
- h) copies of notices, in particular on the refusal to register amendments to founding documents;
- i) documents regarding a change of location of a registration file;
- j) copies of extracts from the Unified State Register;
- k) court decisions, which became the basis for introducing entries on the liquidation of a legal entity into the Unified State Register;
- l) resolutions on the seizure of documents from a registration file, samples of protocols of seizure and copies of the description of documents which were seized;
- m) court decisions on the demand of documents from a registration file, accompanying letters, the documents to which a court authorized a person to receive documents and copies of the description of documents which were seized.

Documents may be seized or removed from a registration file only in case of a justified request by an investigator or a court decision. The founders (participants) of a legal entity, entrepreneurs and duly authorized controlling and law enforcement bodies have the right of access to documents in a registration file. A registration file may be transferred if a legal entity or entrepreneur changes its place of location or residence or if the borders of the administrative unit responsible for the registration file change or such unit is liquidated.

Finally, registration files must be kept for 3 years after the fact of liquidation of a legal entity or the termination of entrepreneurial activities is entered into the Unified State Register. After 3 years have expired, the file will be transferred to a state archive institution, which must keep the file for a period of 75 years from the date of its transfer to such state archive institution.

C. The Unified State Register

For purposes of the practical implementation of the Law, a Unified State Register must be created in order to ensure the circulation of valid and true information about legal entities and entrepreneurs. According to the Law, the Unified State Register will be maintained on electronic carriers for compatibility with other state informational systems and will ensure complete and accurate information, the transfer of notices and information from registration cards to state statistics and tax bodies, the Pension Fund of Ukraine and the social security funds, the protection of data from unsanctioned access and the simple issuance of extracts and certificates. The Authorized Body will create and maintain the Unified State Register and, to the disappointment of many private database companies, it will be under state ownership, although such companies may be contracted in connection with its maintenance.

Each time a registration operation is executed (i.e., state registration, amendments, liquidation, etc.), a corresponding registration card must be completed and the information on the card will be entered into the Unified State Register. Once again using legal entities as an example, the Unified State Register must contain a wide array of information, including (but not limited to):

- 1) the full name of the company and abbreviated name, if available;
- 2) the identification code of the company;
- 3) the ownership form of the company;

- 4) the organizational-legal form of the company (i.e., limited liability company, closed joint stock company, etc.);
- 5) the state body responsible for management of a state-owned company or a company with a state share in its authorized capital of at least 25%;
- 6) the place of location of the company;
- 7) the list of founders (participants) of the company, including the name, place of residence and tax identification code if a founder is a natural person, and the name, place of location and identification number if a founder is a legal entity;
- 8) the company's principal types of activity;
- 9) the surname, name and patronymic of the person, who has the right to legally act on behalf of the legal entity without a power of attorney, including the signing of agreements, and such person's tax identification code;
- 10) information on existing restrictions related to representation on behalf of the legal entity;
- 11) information on the amount of the authorized capital (charter capital or start-up capital), including the share of each of the founders (participants), as well as the amount of paid authorized capital on the date of carrying out the state registration and the date of the completion of its formation;
- 12) the date and number of the entry on the state registration of the company and the dates and numbers of entries on the introduction of amendments thereto;
- 13) the grounds for the refusal to carry out state registration;
- 14) the series and number of the company's certificate of state registration and its date of issuance or amendment;
- 15) information regarding the company's foundation documents and the dates and numbers of entries on the introduction of amendments thereto;
- 16) the grounds for the refusal to carry out the state registration of amendments to the company's foundation documents;

- 17) The date and number of the entry regarding the cancellation of the state registration of amendments to the company's foundation documents;
- 18) information about the company's inclusion into the register and/or exclusion from the register in the state statistics and tax bodies, the Pension Fund of Ukraine and the social security funds;
- 19) information about the company's separate subdivisions;
- 20) information regarding the involvement of the company in the process of liquidation, in particular the date of registration of the decision of the founders (participants) or the body authorized thereby to liquidate the company and information about the liquidator and/or liquidation commission;
- 21) the date and number of the entry on the state registration of the termination of the company and the grounds for its introduction;
- 22) the date and number of the entry on the cancellation of the state registration of the termination of the company and the grounds for its introduction;
- 23) the place of state registration and the place of other registration activities;
- 24) the place of location of the registration file; and information about the issuance of extracts, excerpts and certificates from the Unified State Register;
- 25) the surname, name and patronymic of the state registrar, who entered into the Unified State Register the entry on the company's state registration, who entered amendments to such entry or who entered amendments on the state registration of the termination of the company; and
- 26) the date of the transfer of the registration file to a state archive institution and the address of its location (if applicable).

The information entered into the Unified State Register is deemed to be authentic, which means that it may be used in disputes with third parties. Even if the entered information is unauthentic, a third party may refer to it in a dispute unless it knew or should have known that such information is unauthentic.

Amendments to the information contained in a registration file should be registered in the Unified State Registrar. In all cases, a legal entity must annually submit a new registration card confirming the information about the company contained in the Unified State Register. If a legal entity fails to submit its annual registration card and the state registrar's subsequent notice does not reach the legal entity at its place of location, then the state registrar will introduce an entry on the absence of the legal entity at its place of location and/or an entry on the absence of confirmation of the legal entity's information included in the Unified State Register.

For the first time in its brief history, Ukraine will have a Unified State Register, which contains information open to the public with the exception of the tax identification codes of entrepreneurs. As mentioned above, information is released from the Unified State Register in the form of extracts and certificates signed by the relevant state registrar and affixed with his or her seal. All requests for information from the Unified State Register must be answered within 5 working days upon payment of a fee, which will be directed toward financing the maintenance of the register. Importantly, the release of information to third parties for commercial purposes (i.e., for collecting databases or mailing lists) is prohibited.

For the purpose of making the information about companies as public as possible, almost all registration activities must be published in the form of notices, including information on state registration, a change of location, a change of name, reorganization or liquidation, a decrease of the authorized capital, the loss or replacement of a certificate of registration, the initiation of bankruptcy proceedings, etc. All such notices must be published within 10 days from the moment of the introduction of a corresponding entry into the Unified State Register.

D. Registration of Legal Entities

Pursuant to Ukrainian law, all legal entities must possess a name containing its organizational-legal form (i.e., joint stock company, limited liability company, foreign enterprise, etc.). The founders of a company have the right to reserve a name for a period of two months before state registration. This novelty opens the possibility for extremely "entrepreneurial" individuals or companies to continually reserve the names of well-known companies without a presence in Ukraine and block the state registration of such companies unless an "agreement" can be reached to remove such reservation. An application to reserve a name of a legal entity will not be considered if the name is currently used by another legal entity or state organization or is an historical name, the name does not contain the proper legal-organizational form, the name does not meet the requirements established by the specially authorized body for issues of state registration (in practice,

the name of a company should be verified with such body prior to registration) or payment has not been made for the reservation of a name.

The registration of a legal entity entails submission of the following documents:

1. a duly filled in registration card for carrying out the state registration of the company;
2. a copy of the resolution of the founders or their authorized bodies on the creation of a legal entity;
3. two counterparts of the founding documents (according to the Civil and Economic Codes, the charter is the founding document of most types of companies, including joint stock companies, limited liability companies and enterprises);
4. the document evidencing payment of the registration fee for the state registration of a legal entity; and
5. for legal entities established by a foreign legal entity (foreign legal entities), a duly legalized ("apostillized") extract from the trade, banking or court register in such entity's (entities') country of location, which extract evidences registration in such country.

Please note that if the above documents are issued in a foreign country, then such documents must be notarized, certified and affixed with an Apostille stamp in accordance with the 1961 Hague Convention in order to use them officially in Ukraine. Importantly, "state registration" does not include mandatory registration with the social security funds, the Pension Fund of Ukraine, the Employment Center, the tax authorities, etc.

Other documents, such as the certificate on the reservation of a name, permission from the Antimonopoly Committee, the document confirming the introduction of contributions to the authorized capital of a company, a report on the subscription for shares of stock, etc., must also be submitted for purposes of state registration in the relevant cases. Registration documents may be left without consideration if they are submitted to the improper place of registration, they are not properly executed or the set of documents is incomplete. Upon the acceptance of registration documents, the state registrar will enter the date of receipt of the documents into its reporting book, send a confirmation of such acceptance to the applicant and begin the registration procedure.

The registration procedure consists of the verification of the absence of any grounds for the refusal to carry out the state registration of a company. These grounds include:

1. non-correspondence of the information indicated on a registration card with the information indicated in the documents submitted for carrying out the state registration of a legal entity;
2. non-correspondence of the founding documents with the requirements of the law;
3. violation of the procedure for the creation of a legal entity established by law, including the presence of restrictions on a person occupying an official position in the company;
4. non-correspondence of the information about the founders (participants) of a legal entity with the information related to them in the Unified State Register;
5. a founder of the company is subject to present liquidation proceedings;
6. the presence in the Unified State Register of a name, which is identical to the name of a legal entity, which possesses the intention to register;
7. the use in the name of a legal entity of a full or abbreviated name of a body of state power or city self-administration, or derivatives of such names or a historical state name, the list of which is established by the Cabinet of Ministers of Ukraine;
8. Other grounds for the refusal to carry out the state registration of a legal entity shall be prohibited.

If there are no grounds to refuse state registration, the state registrar will enter the identification code of the applicant from the Unified State Register of Enterprises and Organizations of Ukraine (maintained by the Ministry of Statistics) into the company's registration card and introduce an entry on state registration into the Unified State Register. The date of the entry on state registration into the Unified State Register will be deemed the date of the state registration of the company. Surprisingly, once all documents are duly executed, submitted and accepted by the state registrar, the Law provides for a 3-day term to complete state registration upon which a certificate of state registration and an original counterpart of the founding documents with the state registrar's notice on state registration will be issued to the founder(s) on the next working day after the term of state registration is complete.

In addition, the state registrar must provide to the statistics bodies, the state tax authorities, the Pension Fund of Ukraine and the social secu-

rity funds (hereinafter “Registration Authorities”) notice on the state registration of the company with an indication of the number and date of registration and all information in the company’s registration card. This act alone will be the basis for the inclusion of the company into the registers of the aforementioned state authorities.

As previously mentioned, there is no requirement for a legal entity to register its separate subdivisions (branches or representative offices). Rather, information on separate subdivisions of a company is included in the company’s registration file and the Unified State Register. This information includes:

1. the identification code of the company;
2. the identification code of the branch or representative office;
3. the full name of the separate subdivision;
4. the place of location of the separate subdivision;
5. the principal types of activity of the separate subdivision;
6. the surname, first name and patronymic of the person, who has the right to perform legal actions on behalf of the legal entity without a power of attorney, including the signing of agreements, and his or her tax identification code;
7. the date of inclusion into the register and exclusion from the register in the bodies of statistics, the state tax authorities, the Pension Fund of Ukraine and the social security funds;
8. the date and number of the entry on the inclusion or exclusion of information into/from the Unified State Register, and the date and number of entries on the introduction of amendments thereto;
9. the place of carrying out entries on the inclusion or exclusion of information into/from the Unified State Register;
10. the place of location of the registration file of the legal entity; and
11. the surname, first name and patronymic of the official, who entered into the Unified State Register entries on the inclusion of information on the separate subdivision of the legal entity, entered amendments to such entry or entered an entry on the inclusion of the separate subdivision of the legal entity.

Procedurally, the authorized representative of the company submits to the state registrar at its place of location a duly executed registration card on the creation of a subdivision and the resolution of the management body of the company to create a subdivision. Within 2 working days from the date of acceptance of such documents, the state registrar must add them into the registration file of the company, introduce the corresponding entry into the Unified State Register and send notice to the other Registration Authorities at the place of location of the subdivision.

Please note that the introduction of amendments to the founding documents of a legal entity is also subject to state registration pursuant to a very similar procedure. The term for the state registration of amendments to the founding documents of a legal entity is 3 working days from the date of acceptance of the duly submitted and executed packet of documents. A court of law may issue a decision to cancel the state registration of amendments to the founding documents of a legal entity in certain cases. Finally, the state registration of legal entities created as a result of a split up of a legal entity is subject to a slightly different procedure than the state registration of the creation of legal entities.

Individuals, who carry out commercial activities including the manufacturing and sale of products, the rendering of services or the performance of certain jobs, must also register as entrepreneurs for tax purposes. As a brief overview, the state registration of entrepreneurs includes the submission of a duly executed registration card and a copy of the individual’s certificate evidencing registration as a taxpayer and payer of other mandatory payments and the payment of the registration fee. Entrepreneurs are also entered into the Unified State Register and their information is publicly accessible with the exception of their tax identification codes.

E. Liquidation of Legal Entities

According to the current legislation on liquidation, the liquidation of a company is carried out in case of the transfer of all of its rights and obligations as a result of its merger or transformation or as a result of a corresponding decision by the founders (participants) of a company, by a court of law or by a state authority. A company is deemed liquidated from the date of the introduction of an entry on liquidation into the Unified State Register. While the legislation regarding liquidation has not changed significantly over the years, the procedure for the state registration of liquidations will change on July 1, 2004. The discussion below on liquidation pertains only to the new Law “On State Registration of Legal Entities and Physical Entities-Entrepreneurs” and does not detail the liquidation procedure as contained in other legislation such as the Law “On Economic Associations” (*please refer to the chapter on company liquidation*).

An entry on liquidation will be introduced into the Unified State Register upon the submission to the state registrar of a notarized copy of the decision of the company's founders (participants) to liquidate the company and the document evidencing payment for the publication of a notice on liquidation in the mass media. If the decision of the company's founders (participants) on liquidation is issued in a foreign country, then such decision must be duly notarized, certified and legalized with the Ukrainian consular office in such country or "apostillized" in accordance with the 1961 Hague Convention. In addition, if state consent is required for liquidation of the company, the document confirming such consent must be submitted.

Documents submitted for liquidation may be left without consideration if they were submitted to the improper place of registration, they do not meet the requirements of the Law or the full set of documents was not submitted. Once the documents are accepted, the founders (participants) of the company and the state registrar must agree upon the appointment of a liquidation commission and the procedure and term for liquidation within 2 days from the acceptance of the documents. If the applicant fails to agree upon a liquidation commission, the state registrar will simply appoint the chief executive or a founder (participant) of the company as the head of the liquidation commission within 3 days from receipt of the liquidation documents and send a corresponding notice to the relevant person.

If there are no grounds to refuse an application on liquidation, the state registrar must introduce an entry into the Unified State Register regarding the decision to liquidate the company and send notice to the other Registration Authorities. Once the corresponding entry is introduced into the Unified State Register, the company will be prohibited from registering amendments to its founding documents, registering amendments to the Unified State Register with respect to its separate subdivisions and registering as a founder of another company.

From the date of its appointment, the liquidation commission has the authority to transact all company business, settle with all debtors and creditors, sell off assets and, finally, prepare the company's final liquidation balance sheet. In order to register the liquidation of a company, after the completion of the liquidation commission's tasks, but no later than 2 months from the date of the official publication of the notice on liquidation, the head of the liquidation commission must submit to the state registrar the following documents:

1. a duly executed registration card on the liquidation of the company;
2. the certificate of state registration of the company;
3. the original founding documents;

4. the act of the liquidation commission with the liquidation balance, which was certified by decision of the founders (participants) or their authorized body;
5. a certificate of the corresponding body of the state tax authorities on the removal of the company from the register as a taxpayer;
6. a certificate of the corresponding body of the Pension Fund of Ukraine on the removal of the company from their registers;
7. a certificate of the corresponding social security bodies on the removal of the company from its register; and
8. a certificate of the archive institution on the acceptance of documents, which are subject to long-term keeping pursuant to law.

In certain cases, the law requires the submission of a conclusion of an auditor regarding the authenticity and completeness of the liquidation balance. The state registrar will refuse to consider liquidation documents if they are submitted to the improper place of registration, they do not meet the requirements of the Law, the liquidation balance was not confirmed by an auditor (if applicable), the full set of documents was not submitted or the documents were submitted earlier than required. If the documents comply with the requirements, the state registrar will introduce a corresponding entry into the Unified State Register within 3 days and the date of such entry will be deemed the date of the state registration of the company's liquidation. Finally, the state registrar will send one counterpart of the company's founding documents and certificate of state registration to the head of the liquidation commission with a special note indicating the state registration of the company's liquidation. An original counterpart of the company's founding documents with such special note will remain in the company's registration file as well.

The above-mentioned procedure describes the general procedure of voluntary liquidation pursuant to the decision of a company's founders (participants). The procedure and documentation requirements slightly differ in case of liquidation as a result of a merger, split up or reorganization and pursuant to a court decision (including bankruptcy). Therefore, we strongly recommend seeking professional assistance in case of liquidation in these cases. For example, in case of a merger, split up or reorganization, the following documents must be submitted:

1. a duly executed registration card;
2. the certificate of state registration of the company;

3. the original founding documents;
4. a notarized copy of the transfer act, if the liquidation is carried out as a result of a merger or transformation (reorganization), or a notarized copy of the separated (split) balance, if liquidation is carried out as a result of a split up (this document may require an auditor's conclusion as to authenticity and completeness and must be certified and notarized);
5. a certificate of the archive institution on the acceptance of documents, which are subject to long-term keeping in accordance with the law;
6. the document on consent to the plan of reorganization with the relevant tax authority;
7. a certificate of the corresponding tax authority on the removal of the company from the register as a taxpayer;
8. a certificate of the corresponding body of the Pension Fund of Ukraine on the removal of the company from its register; and
9. a certificate of the corresponding social security bodies on the removal of the company from their registers.

No later than the next working day from the date of the introduction of an entry on the state registration of the liquidation of a company, the state registrar must send notice to the other Registration Authorities with an indication of the number and date of liquidation as entered into the Unified State Register and the relevant information from the registration card. This notice will serve as grounds for the removal of the company from the above authorities' registers.

III. Conclusion

A cursory review of the Law "On State Registration of Legal Entities and Physical Entities-Entrepreneurs" does not reveal very many novelties in the area of state registration nor does it evidence the simplification of state registration. It does, on the other hand, make most information on companies and entrepreneurs public, which will be a godsend to many foreign investors hoping to obtain some background information on their Ukrainian counterparts. Taking into account the fact that the Law does not come into force until July 1, 2004 and the fact that Russia has now introduced a simplified procedure for the state registration of companies, amendments and additions to the Law are widely expected and may be forthcoming before it actually comes into

force. This being said, however, the implementation of the Law must be supported by the relevant instructions within the various registration authorities to avoid confusion during the state registration of companies after July 1, 2004 and to ensure the creation and effective maintenance of the Unified State Register.

8. NO MORE LEGALIZATION. FOR THE MOST PART...

I. Introduction

On January 10, 2002, the Ukrainian Parliament passed Law No. 2933-III (hereinafter the "Law"), according to which Ukraine acceded to the 1961 Hague Convention Abolishing the Requirement of Legalization for Foreign Public Documents (hereinafter the "Convention"). Thereafter, on December 22, 2003, this law came into force, effectively removing the need to legalize both foreign documents destined for official use on the territory of Ukraine and Ukrainian documents destined for official use in the countries which are signatories to the Convention (hereinafter "Contracting States").

II. Discussion

Article 12 of the Convention provides for a special six-month period following the deposition of the instrument of accession with the Ministry of Foreign Affairs of the Netherlands by the acceding State during which any of the Contracting States may raise an objection with respect to such accession. On the sixtieth day after expiration of the period of said six months, the Convention enters into force and effect between the acceding State and the States, which did not raise any objections to its accession.

On April 23, 2003, the Ministry of Foreign Affairs of the Netherlands, which is a depository for the Convention and related documents, informed the Contracting States of the receipt from Ukraine of the accession instrument with respect to the Convention.

Therefore, for Ukraine the above-mentioned six-month period started as of April 23, 2003 and expired on October 23, 2003. During that time, only Germany and Belgium expressed their objections. According to the above-mentioned Article 12 of the Convention, this means that documents originating from Ukraine and bearing an Apostille will not be accepted on the territories of the said two States. This also means that the currently applicable legalization procedure will remain effective in those two jurisdictions.

The Convention became effective for Ukraine as of December 22, 2003. Its rules apply to relations with the Contracting States that did not express any objections with respect to Ukraine's accession to the Convention. Those interested in viewing the list of the Contracting States, please refer to the text of the Convention provided on the Internet site of the Hague Conference on Private International Law (www.hcch.net).

As of December 22, 2003, documents, which must be presented in the territory of a Contracting State listed in the annex to the Convention,

are exempted from consular legalization. For purposes of the Convention, legalization means only the formality by which the diplomatic or consular agents of the country in which the document must be produced certify the authenticity of the signature, the capacity in which the person signing the document has acted and, where appropriate, the identity of the seal or stamp which it bears.

The only formality that will be required with the application of the Convention is the addition of an Apostille seal by the competent authority of Ukraine to the document(s) that must be presented in the territory of the Contracting States. By the same token, public documents of the Contracting States, which are presented on the territory of Ukraine for official use (such as for purposes of registration matters or powers of attorney), should bear an Apostille stamp issued by the competent authority of the Contracting State in question (usually, the Ministry of Foreign Affairs or State Department).

According to the Convention, the following are deemed to be public documents:

- a) documents emanating from an authority or an official connected with the courts or tribunals of a Contracting State, including those emanating from a public prosecutor, a court clerk or a process-server ("huissier de justice");
- b) administrative documents;
- c) acts of notaries; and
- d) official certifications which are placed on documents signed by persons in their private capacity, such as official certificates recording the registration of a document or the fact that it was in existence on a certain date and official and notary authentications of signatures.

An Apostille is a special certificate (stamp), which is placed upon public documents emanating from Contracting States. The said stamp certifies the authenticity of the signature(s) on a particular document, the capacity in which the person signing the document has acted and, where appropriate, the identity of any seals or stamps thereon.

According to the requirement of Article 6 of the Convention, the Cabinet of Ministers of Ukraine by its Resolution No. 6, dated January 18, 2003, has authorized the following bodies to place an Apostille on the territory of Ukraine:

1. the Ministry of Education and Science of Ukraine is authorized to place an Apostille on public documents issued by educational institutions, state bodies, enterprises, institutions and organizations related to the sphere of education and science;
2. the Ministry of Justice of Ukraine is authorized to place an Apostille on documents issued by the bodies of the judicial branch and courts, as well as on documents processed by Ukrainian notaries; and
3. the Ministry of Foreign Affairs of Ukraine is authorized to place an Apostille on all other types of documents.

According to the requirements of the said Resolution, on December 5, 2003, the Ministry of Education and Science, the Ministry of Justice and the Ministry of Foreign Affairs of Ukraine issued a joint Order No 237/803/151/5 approving the Rules of Placing an Apostille on Public Documents Intended for Use on Territories of Other States (the "Order"). The Order was registered with the Ministry of Justice of Ukraine and, therefore, enacted on December 12, 2003 (Registration No. 1151/8472).

Notably, certain international treaties to which Ukraine is a party abolish any other additional certification of public documents, which are presented to authorities of Contracting States of such treaty in connection with civil and criminal proceedings.

III. Conclusion

Where foreign investors are concerned, Ukraine's accession to the Convention is significant in that it will greatly simplify the preparation of documents destined for official use on the territory of Ukraine. By removing the need to legalize official documents, Ukraine and the other Contracting States have dramatically streamlined such basic business operations as company registrations, company liquidations, the preparation of Powers of Attorney issued by Ukrainian non-residents and the opening of Ukrainian bank accounts. This will surely constitute a welcome change for the foreign business community in Ukraine.

9. ANTIMONOPOLY LEGISLATION

I. Introduction

The Antimonopoly Committee of Ukraine (hereinafter the "AMC") is responsible for ensuring the state protection of competition in business activities within Ukraine. As part of the executive branch of government with a special status, the AMC is subordinate to the President and reports annually to the Ukrainian Parliament regarding its activity. In order to protect Ukrainian business from unfair competition and trade practices, the AMC requires that any business receive consent to a certain transaction if such transaction may or will lead to an economic concentration on a specific segment of the Ukrainian market.

Below we describe the thresholds for receiving the AMC's consent to move forward with a proposed transaction, as well as a summary of the practices, which the AMC deems to be unfair to competition.

II. Discussion

The following key pieces of legislation govern competition issues in Ukraine: (i) the Commercial Code of Ukraine; (ii) the Law of Ukraine No. 3659-XII "On the Antimonopoly Committee of Ukraine," dated November 26, 1993 (as lastly amended on November 27, 2003); (iii) the Law of Ukraine No.2210-III "On Protection of Economic Competition," dated January 11, 2001 (as lastly amended on November 27, 2003) (hereinafter "Law No. 2210"); (iv) the Law of Ukraine No. 236/96-VR "On Protection From Unfair Competition," dated June 7, 1996 (as lastly amended on May 15, 2003); and (v) Order No. 33-r "On Approval of the Regulations on the Procedure for the Submission of Applications to the Antimonopoly Committee for Preliminary Receipt of Permission for Concentration of Business Entities (Regulations on Concentration)," dated February 19, 2002 and registered with the Ministry of Justice on March 21, 2002 under No. 284/6572 (hereinafter "Order No. 33-r"). In addition, there are numerous other subordinate acts of legislation referred to from time to time in the above Laws, which must be taken into consideration.

The AMC's consent to a transaction is mandatory only upon the occurrence of certain triggering events. These events include mergers, the direct or indirect acquisition of shares of stock or assets, the acquisition of control in any manner, the expansion of an association of businesses and the creation of a business entity. For each category, Law No. 2210 and Order No. 33-r (in more specific detail) set forth the thresholds which require companies to receive the AMC's preliminary consent for a particular transaction.

In practice, the parties to a potentially “monopolistic” transaction usually include a provision in the relevant agreement to the effect that the closing of the transaction (i.e., the date when the agreement comes into force) is contingent upon procurement of AMC consent if applicable. Since the procedure for receiving the AMC’s consent is complicated and lengthy, the parties should begin the process of procuring such consent in the early stages of the transaction. Accordingly, the closing of a transaction will be suspended until the AMC clears the transaction and puts forth its consent in writing.

In order to receive the AMC’s consent, the relevant party must submit an application in the required form in accordance with Order No. 33-r. The party must include a vast amount of information about itself in the application, including, but not limited to, the founding documents of the applicant(s); the relevant agreement that could possibly result in a concentration on a market; registration, statistic, economic and financial information about the parties to the transaction; a description of the transactions and its targeted results; the principal activities of the parties; the balance sheet of the applicant(s); information on the entities controlled by the applicant(s), etc. On the whole, the process of simply gathering the above information and properly filling out the application itself can be both daunting and cumbersome.

A. Jurisdictional Thresholds

In a nutshell, the need for preliminary AMC consent for a specific transaction arises when a so-called concentration may be reached on a particular market. Article 24 of Law No.2210 and Article 2 of Order No.33-r provide that a business may attain a specific market concentration only after receipt of preliminary permission from the AMC **IF** the aggregate value of assets or aggregate volume of sales of the participants to a possible concentration, taking into consideration the relationship of control over the past fiscal year (which also includes operations abroad), exceeds a value greater than 12 million EURO, as determined at the exchange rate of the National Bank of Ukraine effective on the last day of the fiscal year), **and if**:

1. the value (aggregate value) of the assets or the volume (aggregate volume) of sales, including operations abroad, for at least two participants to the concentration, including the relationship of control, exceeds an amount equivalent to 1 million EURO, as determined by the exchange rate of the National Bank of Ukraine effective on the last day of the fiscal year for each participant, **AND IF**
2. the value (aggregate value) of the assets or the volume (aggregate volume) of sales in Ukraine for at least one participant to the concentra-

tion, including the relationship of control, exceeds an amount equivalent to 1 million EURO, as determined by the exchange rate of the National Bank of Ukraine effective on the last day of the fiscal year.

According to Article 22 of Law No. 2210 and Articles 1.2.1 and 2.1 of Order No. 33-r, “concentration” is defined as follows:

1. The merger of business entities or joining of one business entity to another;
2. The acquisition directly or through other entities of control by one or several business entities over one or several business entities or portions of business entities by way of the following:
 - a) the direct or indirect (through other entities) acquisition, or the obtaining into ownership by any other manner, of assets in the form of an integrated property complex or a structural sub-unit of a business entity; or the obtaining into management, leasing, concession or obtaining by any other manner of the right to use assets in the form of an integrated property complex or a structural sub-unit of a business entity, including the acquisition of assets of a business entity which is subject to liquidation;
 - b) the appointment or election into the position of director (chairman) or deputy director (chairman) of the supervisory council, the management board or any other supervisory or executive body of a business entity of a person which already holds one or several of the listed positions in other business entities; or the creation of a situation under which more than one half of the positions of the members of the supervisory board, management board or other supervisory or executive bodies of two or more business entities are held by the same persons;
 - c) the formation of a business entity by two or more business entities, which business entity will for an extended period of time independently carry out business activities provided that the said formation will not lead to coordination of competitive behavior between the forming business entities or between the forming business entity and the newly formed business entity;
3. The direct or indirect (through other entities) acquisition, acquisition into ownership by any other manner or receipt into management of interests (shares of stock), which ensures the achievement of 25 or 50 percent of the votes in the highest governing body of the corresponding business entity.

In addition to the above thresholds, the AMC uses other criteria for determining whether a certain transaction will lead to a monopoly on a particular market. For example, in regard to point 2 above, Law No. 2210 defines “control” as “a deciding influence of one or several affiliated legal and/or physical entities on the economic activity of a business entity or a part thereof, which influence is exercised directly or indirectly through the following:

- a) the right to possess or use all assets or a significant part thereof;
- b) the right which will ensure a deciding influence on the formation of the composition, voting results and resolutions of a business entity’s governing bodies;
- c) the conclusion of agreements and contracts which makes it possible (i) to determine the terms and conditions of economic activity; (ii) to give mandatory instructions; or (iii) to fulfill the functions of a business entity’s governing body;
- d) the occupation of the position of chairman or deputy chairman of the supervisory council or management board, or any other supervisory or executive body of a business entity by a person, who already occupies one or more of the above positions in other business entities; and
- e) the occupation of more than half of the positions of members of the supervisory council, management board or other supervisory or executive bodies of a business entity by persons, who already occupy one or more of the above positions in another business entity.”

Law No. 2210 defines “affiliated entities” as legal and/or physical entities, which jointly or by agreement carry out business activity, including those which jointly or by agreement impose influence on the business activity of a business entity.

As a side note, the new Civil and Economic Codes also provide guidance in determining control issues from January 1, 2004. Article 118 of the Civil Code of Ukraine defines an economic association (limited liability company, additional liability company or joint stock company) as “dependent” if 20 or more percent of the authorized capital or shares of stock of the company belongs to another (principal) company. At the same time, the Economic Code of Ukraine defines “associated enterprises” as a group of legal entities connected to each other by economic and/or organizational dependency in the form of participation in authorized capital and/or management. Dependency between associated enterprises may be either simple or deciding. Simple dependency arises if one of the associated enterprises

has the possibility to block the decisions of another enterprise, which must be taken in accordance with the law or the founding documents of such enterprise by a qualified majority of votes. Conversely, deciding dependency if “control-subordination” relations are established between enterprises at the account of the dominating participation of a controlling enterprise in the authorized capital and/or in the general assembly or other management body of another enterprise (i.e., daughter company), in particular the possession of a controlling packet of shares. Relations involving “deciding dependency” require consent from the AMC.

Further, the Economic Code of Ukraine adds that a company, which possesses a controlling packet of shares of stock of a daughter company or enterprise, will be deemed a “holding company”. Interestingly, if a daughter company concludes disadvantageous transactions or operations at the fault of its controlling enterprise, then the controlling enterprise compensates the losses caused to the daughter company. Moreover, if a daughter company becomes insolvent and will be recognized as bankrupt at the fault of its controlling enterprise, then the controlling enterprise will bear secondary (vicarious) liability before the daughter company’s creditors. This is a far cry from the pre-January 1, 2004 days when the controlling enterprise would simply be liable to the extent of its contributions into the authorized capital of a daughter company.

Law No. 2210 further provides that a monopoly (dominant) position of a business entity is reached if it does not have any competitors on a particular market or it does not have significant competitors as a result of the limited access by other business entities or the presence of privileges or other obstacles. A business entity is deemed to have a monopolistic (dominant) position if its share on a specific product market exceeds 35 percent if such business entity does not prove that it has significant competitors. The AMC may, at its own discretion, determine that a particular business entity has a monopolistic advantage even if that business’ market share is less than 35 percent if the business in question cannot demonstrate the existence of any significant competition on its particular market. The last statement in this definition encourages all foreign investors and Ukrainian businessmen to run their transactions by the AMC, even if there is only a remote possibility that the transaction will lead to a 35 percent concentration within a particular market or economic sector.

Interestingly, two or more business entities may be considered to have a monopolistic (dominant) position on a product market if they do not have any competitors with respect to a specific good or the competition is insignificant. In such situations, the two businesses’ activities may be measured collectively, and if, when calculated together, they meet the criteria for monopolistic advantage, then the AMC may determine that market

concentration has been achieved. Furthermore, several business entities may be deemed to have a monopolistic position if (i) the joint share of no more than three business subjects, which have the largest share on a particular market, exceeds fifty (50) percent; or (ii) the joint share of no more than five business subjects, which have the largest share on a particular market, exceeds seventy (70) percent; *and* they cannot prove the existence of other competitors or significant competition.

As opposed to its predecessor, Order No. 33-r also conveniently provides guidance as to which types of transactions do *not* constitute a “concentration.” These transactions include:

- 1) the creation of a business entity, the purpose of or the result of which is the coordination of a specific action between the business entities, which created the said business entity, or between the creating business entities and the newly-created entity (so-called “concerted action” or “collusive action”);
- 2) the acquisition of an interest stake (shares of stock) of a business entity by an entity whose primary business is the carrying out of financial operations or operations with securities, if such acquisition is carried out for purposes of their subsequent sale provided that the said entity does not participate in the voting in the highest governing body or other executive bodies of the business entity. In such case, the subsequent sale must be performed within one year from the day of acquisition of the share (shares of stock). Upon receipt of a petition of the aforementioned entity indicating grounds for the impossibility of the subsequent sale, the AMC may render a decision to extend the period for subsequent sale;
- 3) any transaction between affiliated entities which are already in compliance with the Ukrainian legislation on the protection of economic competition, or which already have AMC consent to conduct business; and
- 4) the acquisition of control over business entities or a part thereof, including acquisition resulting from the right of management or alienation of such business entity’s property by an arbitration administrator or a government official.

Finally, both Law No. 2210 and Order No. 33-r provide a list of those entities, which are considered participants in a “concentration.” These entities are as follows:

- 1) business entities which are engaged in a proposed merger or consolidation;

- 2) business entities, which acquire or intend to acquire control over another business entity, or business entities in relation to which control is being acquired or will be acquired;
- 3) business entities, the assets (property) or interest stakes (shares of stock) of which are being acquired into ownership or management (use), leasing or concession or will be acquired, and their purchasers or transferees;
- 4) business entities, which are or intend to be founders (participants) in a newly created business entity. In cases when one of the founders is a governmental or administrative body, the participant in the concentration will be also be deemed a business entity with assets (property) or interest stakes (shares of stock) related to the authorized capital of the newly created business entity;
- 5) physical and legal entities, which are related to the participants of a concentration, and such relations of control provide grounds to recognize the relevant group of entities as one single business entity in accordance with Law No. 2210.

Taking into account the above-described definitions and thresholds, as well as the application and the documents submitted therewith, the AMC will render its consent or non-consent to a particular transaction. Procedurally, the AMC compares the documents submitted by the requesting party with the above-listed thresholds. Moreover, the AMC examines the documentation in light of Order No. 49-r of the AMC “On Approval of the Methodology for Determining the Monopoly (Dominant) Status of Business Entities on the Market,” dated March 5, 2002 and registered on April 1, 2002 with the Ministry of Justice of Ukraine under number 317/ 6605 (“Order No. 49-r”).

Order No. 49-r sets forth the methods (formulae) for determining monopolies on the entire Ukrainian market and its regional markets in accordance with the Laws of Ukraine “On the Protection of Economic Competition,” and “On the Antimonopoly Committee of Ukraine.” The aforementioned methods are implemented by applying various complex formulae based on which the AMC calculates and determines the market share and monopoly position of a business entity. Such formulae are economic in nature and, therefore, beyond the scope of this legal analysis.

Generally, in determining the monopoly status of an applicant, the AMC takes into consideration such criteria as: (i) the list of products and consumers of such products; (ii) the interval of time during which the applicant carries out its activity on a specific product market; (iii) the territo-

rial and consumer limits of the relevant product market; (iv) the list of competitors on a specific product market; (v) market barriers and market status; and (vi) the list of other business entities with a monopoly or dominant position on the market. Of course, this list is not exhaustive.

Once an application has been filed and the AMC has accepted an application within a 15-day period, the AMC's final consent to a transaction is due within 3 months after acceptance of the application, provided that no grounds exist to prohibit an intended transaction (i.e., the applicant has provided all required documents and information, and the AMC has determined that there will be no market concentration). If the AMC fails to adopt a decision regarding a proposed concentration within 3 months, then the AMC is deemed to have approved the transaction.

B. Remaining in Compliance With Antimonopoly Legislation

Once a company or individual receives the AMC's consent to a particular transaction, such company or individual is not totally clear of the AMC's influence. There are certain horizontal and vertical restraints while acting on the Ukrainian market so as not to violate fair competition and antimonopoly legislation. The applicable laws regarding the above restraints are the Commercial Code of Ukraine and the Law of Ukraine No. 236/96 VR "On Protection From Unfair Competition," dated June 7, 1996 (as lastly amended on May 15, 2003). The above legislative acts determine the following activities by market participants as those, which create obstacles in competition:

- a) the discrediting of a business entity by way of providing any false, incorrect or incomplete information regarding such business entity or its activity, resulting in damage to its business reputation;
- b) the sale-purchase of goods, performance of works or provision of services on forced conditions by way of selling specific goods, performing specific works or providing specific services on the absolute condition that the counterparty or consumer will simultaneously purchase other goods or services not required by such counterpart or consumer;
- c) the inclination of a business entity toward boycotting due to its competitor's forcing of a third party, directly or via an intermediary, to refrain from establishing contractual relations with such business entity;
- d) the inclination of a supplier toward discrimination against a buyer (client), which occurs when a buyer's (client's) competitor forces, directly or via an intermediary, a supplier to provide such competitor with specific advantages over the buyer without reasonable grounds;

- e) the inclination of a business entity toward terminating an agreement with a competitor, which occurs when a competitor forces a business entity to breach or improperly fulfill its obligations under an agreement with such competitor's competitor by way of providing material remuneration or compensation to such business entity;
- f) the bribery of a supplier's employee, which occurs when a buyer's (client's) competitor offers, directly or via an intermediary, to bribe a supplier's employee in order to breach or improperly fulfill his or her duties, which arise out of or in connection with an agreement concluded between the supplier and the buyer (client), resulting in the competitor's receipt of specific advantages over the buyer (client);
- g) the bribery of a buyer's (customer's) employee, which occurs when a supplier's competitor offers, directly or via an intermediary, to bribe a buyer's (customer's) employee in order to breach or improperly fulfill his or her duties, which arise out of or in connection with an agreement concluded or to be concluded between the supplier and the buyer, resulting in the competitor's receipt of specific advantages over the supplier; and
- h) the achievement of illegal advantages in competition by violating applicable laws resulting in the receipt of illegal advantages over any business entity, provided that such violation is confirmed by a decision of the relevant governmental body.

Furthermore, Article 6 of Law No. 2210 sets forth the so-called "anti-competition collusive actions of business entities," which are prohibited and include the following:

- a) the establishment of prices or other conditions on the purchase or disposal of products;
- b) the restriction of production, product markets, technological development, investment or the establishment of control thereof;
- c) the division of markets or sources of supplies according to territorial principle, assortment of goods or volume of their sales or purchases of such goods, or by seller, buyers, consumers or by other characteristic indicators;
- d) the distortion of the results of sales, auctions, contests or tenders;
- e) the removal from the market or restricting another business entity's, buyer's or seller's access to a market (withdrawal from a market);

- f) the application of different conditions to equal agreements with other business entities, which places the latter into a disadvantageous position in competition;
- g) the conclusion of agreements which include the acceptance of additional obligations that are in no way related (in terms of substance or content) to the transaction in question; and
- h) the considerable restriction of the competitiveness of other business entities on a market without objectively justified reasons for such restriction.

C. Fines for Non-compliance With Antimonopoly Legislation

The Antimonopoly Committee may impose a penalty in the amount of 1 to 10 percent of the income (proceeds) obtained by a violating business entity from the sale of goods, performance of work or the rendering of services during the course of the last reporting year, depending on the type of violation of the Ukrainian legislation on the protection of economic competition. In addition, the AMC may file a claim with a court (commercial court) requesting divestiture or any other appropriate action with respect to unlawful transactions.

In addition, in case of unfair competition, the AMC may impose fines of up to 3% of the proceeds from the sale of goods or the performance of works or services, which proceeds were obtained by a violating business entity during the course of the last reporting year. If, however, the said proceeds cannot be determined (calculated) or are absent, then a fine in the amount of 5,000 non-taxable minimum incomes will be applied to such violating business entity. Further, all losses incurred in connection with unfair competition practices may be compensated in a court of law pursuant to Ukrainian civil law.

In case foreign investors are interested in the existing competition on a specific Ukrainian market, in accordance with Ukrainian law, the AMC prepares and maintains a list of enterprises, which possess a monopoly status on a specific market. The said list is published in the official Ukrainian newspapers "Uryadovy Kurier," "Golos Ukrainy," "The State Privatization Informational Bulletin," or other printed or electronic mass media.

III. Conclusion

The protection of homegrown industries and services is no easy task for any government. Consequently, the regulations governing such protection

are both intricate and complex. Though seemingly Byzantine in nature, these laws must not be ignored. As elsewhere in the world, it is risky for a foreign investor, or any Ukrainian resident for that matter, to ignore the AMC's legislative acts. If an influential organization such as the AMC submits a claim to a court or commercial court regarding a transaction, the consequences could be grave for the parties involved, including the annulment of the transaction, a demand to halt any competition or anti-monopoly violations, fines and penalties, etc. In fact, the AMC is even empowered to submit a claim to recognize the founding documents of a business entity as invalid, and cancel the state registration of such business entity. Thus, we recommend that you consult with an experienced attorney before undertaking any sizable transaction or any significant steps with the AMC.

10. COMPANY LIQUIDATION

I. Introduction

For foreign investors doing business in Ukraine, the liquidation of a Ukrainian company is the ultimate ‘fall back’ position, allowing the foreign investor(s) to leave the Ukrainian market in full compliance with Ukrainian legislation. As a general reference, the discussion below provides an overview of the documents and procedural steps necessary to liquidate a Ukrainian company.

II. Liquidation Procedure

A. Legislation

According to Article 19 of the Law “On Economic Associations,” No. 1576-XII, dated September 19, 1991, (the “Company Law”), company activities may be terminated by reorganization (including merger) or liquidation taking into account the requirements of the Antimonopoly Committee of Ukraine. Currently, Ukrainian law does not prescribe a specific legal procedure for winding up a company’s activities via reorganization, rendering further discussion on this topic meaningless.

On the other hand, Ukrainian legislation provides a painfully detailed procedure for liquidating a company. First and foremost, Article 19 of the Company Law states that a business company (including a limited liability company and a joint stock company) may be liquidated in the following circumstances:

- a) upon expiration of the term for which such company was established or after achieving the purpose stated at the time of the company’s creation;
- b) by resolution of the highest body of the company (voluntary liquidation);
- c) by decision of a court of law or arbitration court at the recommendation of agencies which exercise control over the activity of the business company in the event of repeated or gross violation of legislation by the business company; or on the basis of an arbitration court’s decision according to the procedure provided by the Law “On Bankruptcy” (which has since been amended and re-titled as the Law “On Restoration of the Solvency of a Debtor or Recognition of Debtor as Bankrupt,” dated June 30, 1999, No. 784-XIV); and

- d) for any other reason provided in the company’s foundation documents.

The following analysis focuses on the general liquidation procedure pertaining to points (a) and (b) above. An analysis of the liquidation procedure under bankruptcy proceedings or for other reasons provided in a company’s charter is beyond the scope of this overview.

B. Analysis

In all cases, the Company Law stipulates that liquidation must be carried out in compliance with the requirements of Ukrainian antimonopoly legislation if the SPF has ownership interest in the company (i.e., the company will be required to receive consent from the Antimonopoly Committee of Ukraine prior to liquidation).

Article 20 of the Company Law provides that business companies are liquidated by the so-called “liquidation commission,” which is appointed by the authorized body of such company. From the date of its appointment, the liquidation commission has the authority to transact all company business, up to the point of preparing the company’s final liquidation balance sheet.

Procedurally, within three days from its appointment, the liquidation commission must publish an announcement in one of the official publications, stating the term for filing creditor claims. Additionally, within the above time frame, the liquidation commission must appraise the company’s property, identify and settle with any of the company’s debtors and creditors, take all possible measures to repay debts to third parties and prepare the liquidation balance sheet for submission to the company’s highest governing body (or the body which appointed the liquidation commission).

According to Article 20 of the Company Law, the authenticity and completeness of the annual balance statement and reports of the company must be approved by an auditor or an audit firm, unless the company has an annual turnover of less than two hundred and fifty (250) non-taxable minimum incomes. For reference purposes, per Decree No. 762/96 “On Monetary Reform in Ukraine,” dated August 25, 1996, one non-taxable minimum income is currently equivalent to 17 Ukrainian Hryvnia (or just over \$3 US Dollars).

Article 21 of the Company Law provides the procedure for distributing a company’s assets during its liquidation. Accordingly, the first in priority are any unpaid wages and other salary obligations to the company’s employees and obligations to the company’s creditors. Next, the remaining non-

etary assets of the company, including all proceeds from the sale of its property during liquidation, must be distributed among the founders or shareholders of the company. Such distribution must take place within six months after the publication of the announcement of the company's liquidation pursuant to the terms and conditions for such distribution in the company's foundation documents and in the Company Law.

Any property the founders transferred for the company's use shall be returned to the respective founders without any compensation (i.e., for wear and tear, payment for use, etc.). In the final stage, the liquidation of the company will be deemed completed and the company will be effectively terminated upon its exclusion from the Unified State Register of Enterprises and Organizations of Ukraine.

C. Documentation Requirements

In order to wind up the liquidation procedure, all of the State registration authorities with which the Company was registered must be duly notified. These authorities include the Ministry of Statistics, the State Tax Inspection, the District Employment Center, the District Social Insurance Fund, the District Pension Fund, among others. For this purpose, the company must prepare the following documents:

- 1) An official resolution from the company's founder(s) (in case of legal entities) and/or an official notice from individual founders of the company to vote for liquidation of the company during the meeting of the company's highest governing body. Based on these documents, and the results of the vote on liquidation, an official resolution of the highest governing body of the company to undergo liquidation will be prepared and presented along with the above resolutions to all registration authorities; and
- 2) A power of attorney for each founder's legal representative, who will be authorized to notify all of the registration authorities regarding the official liquidation of the company's activities and sign all necessary documentation. The power of attorney must be presented to the various government administrations along with the relevant resolutions/notices to liquidate the company.

Importantly, the above documents must be duly notarized and certified, authenticated with the appropriate government administration (i.e., the Ministry of Foreign Affairs or other authorized body) and legalized in the Ukrainian Embassy located in the country where the documents will be issued. Once all documents are duly executed, the authorized representative of the company may begin the actual liquidation process.

Please note that after July 1, 2004, the liquidation of a company will be subject to state registration in accordance with the Law of Ukraine No. 755-IV "On State Registration of Legal Entities and Physical Entities-Entrepreneurs," dated May 15, 2003, which does not change the liquidation procedure itself.

III. A Note on the Closing of Representative Offices

The procedure for closing a representative office is similar to the voluntary liquidation of a business company. For this purpose, the parent company must prepare the following documents:

- 1) a resolution of the Board of Directors (or other authorized body) of the parent company resolving to close its representative office and terminate all existing contracts;
- 2) an official letter from the parent company, addressed to the Ministry of Economy and for Issues of European Integration (formerly the Ministry of Foreign Economic Relations and Trade of Ukraine) or the Ministry of Justice (in case of non-profit or non-commercial representative offices) notifying the relevant Ministry about its decision to terminate the activities of the representative office; and
- 3) a power of attorney for the authorized representative of the office in Ukraine to effectuate all of the steps necessary to close the representative office, including notifying all of the relevant registration authorities.

As in the case of voluntary liquidation of a business company, the above documents must be duly notarized, certified, authenticated and, finally, legalized at Ukrainian Embassy located in the parent company's country. All documents must be translated from English (or any other language) into Ukrainian for purposes of finalizing the closing of the office.

The Head of the Representative Office (or other authorized legal representative) will also need to address several letters to the bank servicing the representative office's account (along with an application to close the bank account), the local tax inspection (which will subsequently perform an audit on the financial activities of the representative office and check for any cash debts owed to the State budget), the pension fund, the social security fund and the employment center (to notify them of the representative office's closing). The customs authorities will also need to be notified if the representative office received customs accreditation and imported any office furniture, automobiles, equipment or other property into Ukraine.

A. Termination of Existing Contracts

The process of closing a representative office also involves terminating all existing contracts which the representative office signed on the behalf of its parent company. For instance, termination of the representative office's lease agreement, as well as any insurance agreements or other agreements to which the representative office is directly or indirectly a party, is necessary. To do so, the relevant agreements must be carefully reviewed in order to ensure that the agreed upon procedures for termination are observed.

B. Compliance with Labor Law

Representative offices typically employ both foreign and local staff. Ukrainian labor law requires that representative offices hire (and therefore, terminate) Ukrainian staff through the General Directorate for Servicing Foreign Representative Offices (or, simply, the GDIP). While most employers have ignored this requirement, those few who had the pleasure of hiring employees through GDIP must contact GDIP once again in order to properly terminate the employment contracts. In case of independent contractors or consultants of a representative office (i.e., those "employees" not registered with GDIP), the termination procedure in their contracts, if any, should be reviewed to avoid possible violation of Ukrainian labor laws.

In addition to maintaining labor contracts between Ukrainian employees and foreign representative offices, GDIP is also responsible for maintaining the labor records of Ukrainian employees. Accordingly, GDIP must make a proper entry in the labor books of all employees, stating the closing of the representative office as the reason for employment termination. In most cases, a copy of the duly executed Board of Directors' Resolution to close the representative office will serve as sufficient notice to GDIP.

C. Miscellaneous Matters

In the course of closing its representative office, the parent company may wish to sell some or all of the cars, office furniture or equipment which it does not wish to export from Ukraine. This entails not only the signing of sales-purchase or transfer agreements, but also a review of the customs documentation to ascertain whether any outstanding customs duties are due on the chattel which the representative office wishes to sell. Review of customs documentation will also uncover any potential problems (e.g., customs accreditation) in case the parent company decides to export its vehicles, equipment and/or furniture.

Importantly, in case the parent company decides to sell any equipment or furniture, its representative office may encounter the following issues:

- a) if the equipment furniture was temporarily imported into Ukraine, then either the representative office will have to clear the equipment/furniture with customs itself or add a provision in the sale-purchase agreement assigning this responsibility to the buyer of such equipment/furniture. However, if the equipment/furniture is more than 5 years old, then the representative office will be prohibited from clearing such equipment/furniture through customs;
- b) the sale of the equipment/furniture on the territory of Ukraine must be concluded in Hryvnia. If the total amount of Hryvnias earned is a significant amount and will not be used in Ukraine for any purpose, then it will be necessary to submit an application for converting the Hryvnia and transferring it abroad to the parent company; and
- c) the sale by a representative office of any kind of property on the territory of Ukraine may be deemed a commercial operation and may accordingly be subject to taxation at the rate applied to all Ukrainian resident entities. Additionally, the profit will be subject to taxation according the Law "On Taxation of Enterprise Profits." Issues connected with VAT may also arise.

It is difficult to accurately predict the duration of the closing procedure because it depends on the schedules of the Ukrainian authorities, which participate in the office's closure. For example, the tax administration's audit of the representative office is mandatory before liquidation can take place, and it may take a considerable amount of time. Once the application to close a representative office is submitted to the relevant tax administration, the representative office must cease all activities, and this must be reflected in its accounting books. However, until the tax administration completes its audit, the representative office will still physically exist, and none of its documents may be destroyed or taken from Ukraine.

IV. Conclusion

The voluntary liquidation of a business company or a representative office's activities is simply the reverse of the registration process. Once the proper documentation is prepared abroad by the foreign founders, the ground work can easily be performed by an experienced groups of lawyers, based on a duly executed power of attorney, of course.

B LABOR LAW

1. UKRAINIAN LABOR LAWS AND HIRING PROCEDURES

I. Introduction

One of the least understood (and most frequently violated) areas of Ukrainian legislation governs labor relations. It helps to categorize all persons residing in Ukraine into two groups of employment relationships: (1) labor employment agreements governed by the Labor Code of Ukraine; or (2) sub-contractual agreements governed by the Civil Code of Ukraine.

The first category is further divided into three different types of labor agreements: (1) labor agreements of indefinite duration; (2) labor agreements of specific duration; and (3) labor agreements effective for the duration of a specific project. One type of agreement of "specific duration" is called a "labor contract," which permits an employer to prematurely terminate such contract only for reasons provided by Ukrainian labor legislation. Therefore, special emphasis will be made to labor contracts as a separate type of labor agreement.

II. Types of Labor Agreements

A. General Requirements and Benefits

At the initial stages of employment, an employee is hired on the basis of a labor agreement, and may be placed on probation for a period not exceeding either three months or one month, depending on the classification of such worker under Ukrainian law. If the employee continues to work after such period has expired, the employee is considered to have "passed the test," and is entitled to all rights and protection under Ukrainian law.

Essentially, this means that Ukrainian employees are entitled to social security benefits as described below and must be paid at least the minimum monthly salary during the course of a normal work week of no more than 40 hours. Any additional time put in by the employee, even if he or she is hired on a temporary basis, is subject to overtime payment rates. Depending on the actual duration of the employment term, the employee also is entitled to vacation and sick leave, and a regular schedule of salary payments twice a month.

B. Social Security Benefits

By law, the Ukrainian government provides all employees (except sub-contractors or consultants) with certain social protection by requiring

all enterprises and organizations, except those specifically covered by relevant international agreements, to make deductions to the various social security funds on behalf of its employees. Thus, under the current legislation, 32% of actual expenditures of a company, which are allocated for the payment of wages subject to personal income tax, is paid to the Pension Fund, 2.9% is paid to the social security fund for cases of temporary disability, 1.9% to the social security fund for cases of unemployment, and from 0.86% to 13.8% to the social accident fund (depending on the type of activity of the company and the class of risk at work). While social security payments are excessive, resident companies must be grateful that the Ukrainian government cancelled the dreaded and much-criticized 10% payment to the Chernobyl Fund.

In total, Ukrainian employers (joint ventures, 100% subsidiaries and representative offices with commercial activities) must pay toward social security anywhere from 37.66% to 50.6% of its employees' monthly salaries depending on the employer's type of activity and level of risk at the workplace. Note that all social security payments are made by the employer, in Ukrainian Hryvnia, on top of the employee's salary (i.e., not taken out of the employee's paycheck). In the event that the employer fails to make such payments, the employee is still entitled to certain social security benefits, but the tax authorities will levy fines retroactively if such violations are discovered anytime in the future.

Importantly, each employee must also personally make obligatory payments to the various social funds. Specifically, an employee must pay (i) either 1% of his/her monthly salary (if the amount of his/her salary is less than 150 Ukrainian Hryvnia) or 2% of his/her monthly salary (if the amount of his/her salary exceeds 150 Ukrainian Hryvnia) to the Pension Fund; (ii) 0.25% of his/her monthly salary to the Disablement Insurance Fund (if the amount of his/her monthly salary is less than 150 Hryvnia or 0.5% if the amount of his/her salary exceeds 150 Hryvnias); and (iii) 0.5% of his/her monthly salary to the Unemployment Insurance Fund. In addition, employees are responsible for paying their own personal income tax. Please note that the above mandatory payments of employees working under labor agreements must be withheld from their relevant salaries (wages) by the employer's bank.

In summary, the employer pays its obligatory salary-related payments to the social funds in addition to the employees' salaries, while each employee also makes mandatory deductions to the social funds from his or her salary. Consequently, employees receive a net salary after payment of all relevant taxes and social payments.

C. Employee Compensation

As a rule, salaries must be paid at least twice a month in Ukrainian Hryvnia. In practice, many employers ignore this rule by providing some (or all) of its employees with supplementary income, typically in foreign currency on a monthly or quarterly basis.

Nevertheless, official salaries of employees are determined in accordance with the employment contract, but by law such salaries cannot be lower than the minimum monthly salary set by the Ukrainian government (the equivalent of 205 Hryvnia as of January 1, 2004, which is expected to increase to 237 from November of 2004 and to 262 from January 1, 2005). Incidentally, minimum monthly salaries are occasionally revised to allow certain segments of the Ukrainian population (for example, senior citizens and certain government employees) to keep up with the spiraling cost of living.

The Ukrainian Labor Code also requires additional compensation for overtime, holidays and nighttime work. Likewise, an employee is entitled to receive overtime payments in the amount of double such employee's hourly rate for each hour worked overtime. Unfortunately, an employer cannot compensate employees for overtime by giving time off from work.

III. Labor Contracts

Various employers, including wholly-owned foreign subsidiaries, joint ventures and even representative offices, employ so-called "labor contracts" as their favorite form of labor agreements because only a "labor contract" may contain provisions in addition to those contained in the Labor Code, including employment period, rights, obligations and responsibilities of the parties. For example, see Article 1 of the Cabinet of Ministers' Resolution No. 170-94-p, "On Perfecting the Application of the Contractual Form of Labor Agreements," dated March 19, 1994 (the "Labor Decree"), as amended on June 27, 2000, which provides that the contractual form of labor agreements is applicable to hired employees in cases specifically stated in the labor agreement and provided by law.

Importantly, Article 21 of the Labor Decree states that if a labor contract contains specific reasons for termination of employment which are otherwise absent from the Labor Code, then the dismissal of employees will be governed by Section 8 of Article 36 of the Labor Code. The nature of such labor contracts arguably permits the parties to include additional reasons for termination, such as disclosure of confidential information, harmful or competitive actions toward the employer, using company property for personal benefit, etc., which are not specifically provided in the Labor Code. On the other hand, dismissals cannot be arbitrary (e.g., for pregnancy or personal reasons unrelated to employment).

The labor contract affords the employer the widest latitude in instituting a labor relationship because all these additional rights and obligations are enforceable simply as contractual agreements of the parties. However, both Article 5 of the Labor Decree and Article 9 of the Labor Code provide one limitation: the terms of labor agreements should not deteriorate the status of hired workers of enterprises in comparison to conditions stipulated by effective Ukrainian labor legislation.

IV. Sub-Contractual Agreements

In contrast to labor agreements, sub-contractual agreements typically contemplate hiring a worker to complete a specific task, work or service at his or her own risk (i.e., free lance workers). As elsewhere in the world, the sub-contractor maintains relative independence in performing the designated task and typically receives payment upon completion of services.

Notably, the sub-contractor does not receive the benefits of social security, and is independently responsible for paying his or her own personal income tax. To legally act as a sub-contractor for foreign business entities, Ukrainian sub-contractors must register as so-called "subjects of entrepreneurial activity" for tax purposes. Most citizens ignore this requirement, which entails additional time, efforts and expenses, with impunity.

V. Foreign and Local Employee Hiring Procedures

A. Work Permits for Foreign Employees

Until 1998, no area of Ukrainian legislation was as thoroughly ignored as the requirement for foreign citizens, working in Ukraine, to obtain a work permit.

It all began on May 5, 1993, when the Ministry of Labor issued Regulation No. 27 (which was subsequently registered at the Ministry of Justice on July 9, 1993) that applied to foreign citizens employed by Ukrainian enterprises, institutions and organizations as well as foreign commercial entities. Regulation No. 27 clearly stated that companies may not employ foreign citizens without work permits. This prohibition notwithstanding, no foreign citizen sought to obtain such permits.

To help prod the reluctant expatriate community to obtain work permits, these regulations were amended numerous times: first, by the Ministry of Labor Order No. 68 "On Amending the Temporary Provisions On Conditions and Procedures of Granting Foreign Citizens Permits To Seek Employment in Ukraine," dated December 19, 1994. The second time, the Ministry of Labor issued its Order No. 14, dated March 24, 1995 (registered under the same title at the Ministry of Justice on April 5, 1995, No.

96/632), which cancelled its previous order (dated December 19, 1994). Subsequent revisions took place on May 22, 1995, when the Ministry of Labor signed Order No. 42, creatively entitled “On Amending the Temporary Provisions on Conditions and Procedures of Granting Foreign Citizens Permits to Seek Employment in Ukraine.” Still, no foreign citizen volunteered to obtain a work permit.

Finally, on November 1, 1999, the Cabinet of Ministers passed Resolution No. 2028 “On the Procedure for Executing Work Permits in Ukraine for Foreigners and Persons Without Citizenship” (as lastly amended on May 17, 2002), which establishes the “new” procedure for obtaining work permits for foreign individuals hired for labor in Ukraine. Resolution No. 2028 is effective from January 1, 2000, and basically restates the provisions of Regulation No. 27 of 1993. According to Resolution No. 2028, all foreign employees working in Ukraine must submit an application to obtain a work permit in Ukraine. This requirement specifically applies to foreign citizens who are sent to Ukraine by a foreign employer to work on the basis of a contract between such employer and a Ukrainian resident enterprise. The application for a work permit must be accompanied by various documentation, such as the employment contract.

The Ministry of Labor has become quite serious about enforcing its instructions, and many foreigners are complying. While in the past the foreign community routinely failed to comply with the permit requirements, these laws are being increasingly enforced for foreign employees of joint ventures, wholly-owned foreign subsidiaries, representative offices and non-profit organizations. In fact, on January 18, 2001, the Law of Ukraine No. 2247-III introduced amendments to the Administrative Code, calling for administrative penalties for a foreign employee’s failure to obtain a work permit. These penalties can be applied to the foreign employee and the employer itself in the amount of 10-20 non-taxable minimum incomes by the local police. Further, the state employment authorities may also apply a hefty fine on entities employing foreigners without work permits.

During the last half of 2003, the receipt of a permit to work in Ukraine by a foreign citizen became quite difficult. Whether for political reasons or for reasons of internal restructuring the employment authorities flat out began to refuse almost 90 percent of work permit applications. In practice, the authorities were able substantiate their reasons for refusal by simply stating “untimely payment of taxes” or claiming an “incomplete” set of documents. While such across the board refusal to issue permits could be a potential money maker for those with inside connections within the employment authorities, we do not expect this policy to last very long due to pressure from companies with foreign founders (participants) and international organizations.

1. Issuance of Permits

The State Center of Employment of the Ministry of Labor of Ukraine or its authorized regional or city bodies (the “Employment Center”) issues work permits. General work permits are not issued, and instead a foreigner obtains permission to work at a specific position at a specific enterprise, institution or organization. Significantly, Resolution No. 2028 now includes a provision that requires a substantiated need for employment of a foreign citizen. Work permits also must be registered at the appropriate regional Employment Center of the Republic of Crimea, the oblasts, or the cities of Kiev and Sevastopol.

Notably, Resolution No. 2028 does not specifically include the former exemption from obtaining employment permits given to foreign heads of representative offices, members of the foreign mass media accredited in Ukraine, etc. However, Resolution No. 227 of the Cabinet of Ministers of Ukraine of February 20, 1999 (as amended on July 28, 2003), approved the new procedure for issuing visas for persons entering Ukraine for employment purposes. According to this procedure, persons entering Ukraine as co-founders of joint ventures or representatives of companies (firms and associations) in the fulfillment of contracts and foreign specialists hired under production sharing agreements do not need work permits for employment in Ukraine.

In contrast, the Law of Ukraine No. 3929-XII “On the Legal Status of Foreigners and Persons Without Citizenship,” dated February 4, 1994, as amended November 18, 2003, provides that foreign individuals who immigrate to Ukraine to seek employment for a limited term, may work provided that they receive a properly issued work permit. Labor relations of foreign employees working in Ukrainian companies and representative offices are governed by applicable laws and international agreements of Ukraine.

Work permits are valid for up to one year, but may be extended if an application is filed with the Employment Center up to one month before expiration of the current term. A foreign citizen may be continually employed in Ukraine no more than four years. After a minimum break of six months, however, the individual again may return to work in Ukraine.

Finally, foreign employees of embassies and diplomatic missions clearly do not require typical work permits. Such employees and their family members are merely required to obtain diplomatic visas in order to enter into Ukraine. Specific issues regarding diplomatic employment of foreigners in Ukraine are governed by universal and bilateral international treaties, which is beyond the scope of this discussion.

2. Application Procedure

An application for a work permit from the Employment Center must include the following:

- 1) an application (no standard form necessary);
- 2) substantiation as to why the employee's work is important and how that individual will be housed and employed (i.e., assurance of work conditions);
- 3) a copy of the contract between the foreign and Ukrainian subject of business activity to carry out a specific volume of works or services (if such free-lance type of contract was concluded);
- 4) a copy of the charter of the Ukrainian legal entity, as well as a copy of its certificate of registration (certified pursuant to the established procedure);
- 5) a list of foreign employees, containing their full name, year of birth, passport number, specialty (occupation) and sex;
- 6) a copy of the employee's draft employment contract;
- 7) a power of attorney (or other similar document), authorizing the employer's representative to act on behalf of the employer before the employment authorities;
- 8) copies of documents confirming the employee's education and qualifications;
- 9) a certificate from the body of the state tax authority regarding the employer's payment of taxes and charges provided by Ukrainian laws; and
- 10) proof of payment of the official fee for obtaining a work permit.

The application and extension fees both cost the equivalent of ten non-taxable minimum incomes payable in Ukrainian Hryvnia. The Employment Center must issue a decision regarding the work permit within 30 days of receipt of the application. An application for a work permit may be denied for any one of the following six reasons:

- 1) the application packet contains provisions that violate Ukrainian laws or treaties;

- 2) the contract creates working conditions for the foreigner that are worse than working conditions for Ukrainian citizens in analogous occupations (a rare display of affection for the welfare of foreign workers in Ukraine);
- 3) the foreigner or employer submits false information or fraudulent documents;
- 4) the foreigner intends to occupy a position or to carry out an activity which is connected with Ukrainian citizenship according to Ukrainian legislation;
- 5) it is a proven fact that the foreigner has violated Ukrainian law during his stay on the territory of Ukraine; or
- 6) a year has not yet passed since the foreigner was denied a visa into Ukraine.

Ukrainian law allows foreign employees, who have been denied a work permit, to appeal to the State Employment Center or to a court of law, but few have solved their problems in this fashion. Instead, foreigners simply contributed the requested minimal amount (between \$200 to \$500) to the Employment Center's so-called "non-profit fund," allegedly for the Center's development. This requirement was later dropped as loud complaints of corruption made further collections impossible.

B. Representative Office: Ukrainian Employees and Hiring Regulations

1. Registration Procedure and Documentation

Under Ukrainian labor laws, in order to hire any Ukrainian citizen, an employer should receive from such prospective employee his or her labor book and passport. If the position requires special skills (e.g., driver), the employee must also submit the appropriate professional documents (e.g., a driver's license). No other documents are required from the Ukrainian employee. The Ministry of Labor issued an instruction on March 15, 1994, containing the model labor agreement generally acceptable for employment purposes in Ukraine. Many foreign companies, however, prefer to use their world-wide forms, slightly adjusted to fit Ukrainian legal requirements.

Importantly, all employers, including enterprises, institutions and organizations, must maintain labor books for all of their full time employees (i.e., everyone other than subcontractors or part-timers) including seasonal and temporary workers. Such labor books typically contain information about

the type of work performed, any awards and the duration of employment. In essence, labor books serve as a basis for ascertaining the employee's work longevity, which will determine his or her social security and pension rights after retirement.

In contrast, the labor books of all Ukrainian citizens working with foreign representative offices (technically including diplomatic missions) on a contractual basis must be kept with GDIP (the General Directorate for Servicing Foreign Representative Offices). Accordingly, GDIP registers all such Ukrainian employees. To register Ukrainian employees of foreign representative offices, the designated representative must enter into a formal service contract with GDIP. To enter into such a contract with GDIP, the representative office or diplomatic mission must present the following documents:

- 1) a formal written request to the GDIP to register employees (indicating the positions, the term of employment and, if possible, the potential employees as well);
- 2) the employment contract(s);
- 3) a standard application form;
- 4) labor book(s);
- 5) the domestic passport of the employee(s);
- 6) military identification card, if any (applicable to both men and women);
- 7) a copy of a professional Diploma or other professional licenses or certificates (i.e., a drivers license) if the job requires special skills;
- 8) the personal tax identification code of the employee(s);
- 9) two photographs of each employee; and
- 10) a photocopy of a medical certificate (for drivers only).

Upon review of the above documentation and permission from the representative office itself, GDIP can formally engage the employee and complete his or her associated paperwork. In this equation, GDIP, or its authorized bodies, simply function as mandatory personnel and account supervisors for the representative office. The representative office is ensured that its employment record-keeping is in proper order and the Ukrainian

government is ensured that the employment activity of foreign legal entities in Ukraine conforms to Ukrainian legislative requirements.

The costs of using GDIP's services vary, as do the services themselves. "Registrations" of employees can start at anywhere from \$100 and higher, taking into consideration the employee's position and experience. Additionally, however, GDIP will also take a small percentage fee from the employees' monthly salary as compensation for registering such employee and for continuing to provide various services regarding employee salary deductions or other services available through GDIP. This fee is paid throughout the duration of the employment contract, along with the social security deductions.

Whereas in the early years the GDIP system was reluctantly used, today most representative offices and diplomatic missions prefer to hire all of their staff directly, without resorting to GDIP's services.

VI. Conclusion

Today, the Ukrainian authorities are increasing their supervision over the activities of foreign commercial entities, particularly representative offices, suspicious that the representative offices might be concealing profit earned from "commercial activities." Therefore, in addition to typical tax dilemmas and currency regulations issues, strict compliance with labor laws also requires the close attention of the foreign investor.

2. REDUCING THE WORKFORCE

I. Introduction

In response to Ukraine's turbulent economic climate, many foreign companies find themselves in need of reducing their work force, pronto. Understandably, some employees often do not wish to leave voluntarily, and have to be carried out, screaming threats laced with obscenities. Although dismissing employees can become an emotionally charged undertaking, Ukrainian law provides a clear procedure for such terminations (whether for cause or due to company downsizing).

In Ukraine, an employer (owner of an enterprise, institution or organization) typically hires employees on a contractual basis. This agreement is referred to as a "labor contract." All relations (including those connected with employment termination) arising from a labor contract are governed in accordance with applicable labor laws and provisions of the collective agreement, where applicable. Such labor relations are documented in each employee's "labor book" as required by law.

The reasons, and hence, the procedure for the dismissal itself, can vary from case to case. Still, it all begins with Article 48 of the Labor Code, and paragraph 2.3 of the Instruction "On the Procedure for Maintaining Labor Books," as confirmed by joint Decree No. 58 of the Ministry of Labor, the Ministry of Justice and the Ministry of Social Protection, dated July 29, 1993. These documents provide for so-called "dismissal notes," which describe the date and reason for dismissal to be entered into an employee's labor book with a reference to the provision of the law used as the ground for dismissal. Such dismissal notes must be inscribed using the terminology contained in relevant provisions of the labor laws.

Immediately below we describe the different approaches to firing redundant employees, including amicable, hostile and "neutral" terminations. We also describe the procedure for legally terminating unwanted employees and consequences for wrongful termination.

II. Discussion

A. Amicable Termination

Though such situations seldom arise, sometimes parties to a labor contract may peacefully agree to terminate their contractual relations and part ways due to:

- 1) mutual consent of the parties;

- 2) expiration of the labor contract, except in cases when labor relations actually continue and neither party has any objections as to termination;
- 3) military draft or recruitment of an employee;
- 4) termination of the labor contract at the initiative of the employee, the owner, a body authorized thereby, a trade union, several trade unions or other bodies which are authorized to represent the workers' collective;
- 5) in case the employee agrees to be transferred to another enterprise, institution or organization or the transfer of the employee to another chosen position;
- 6) refusal of the employee to be reassigned to another location of the enterprise, institution or organization, or the employee's refusal to work due to significant changes in labor conditions;
- 7) court order for imprisonment of the employee or other type of punishment, which excludes the possibility of performing work; or
- 8) any other grounds provided by an agreement between the employer and the employee.

The last point allows the parties to a labor contract to include provisions regulating termination in addition to those already contained in the Labor Code. This loophole cannot be abused too much, however, because Article 9 of the Labor Code provides that "the terms of employment agreements and contracts shall not reduce the status of hired workers in comparison to the requirements defined by the current Ukrainian labor legislation." Thus, for example, regardless of anything to the contrary stated in the labor contract, pregnant women and other specific categories of women may not be fired by an employer, except in cases of complete liquidation of the enterprise, institution or organization.

B. Unilateral (Hostile) Termination

In the more usual situations involving termination, the relationship between the parties has a tendency to become quite unpleasant rather quickly. Of course, the employer/owner will justifiably seek to unilaterally dismiss a disgruntled employee as quickly as possible. Under Ukrainian law, such unilateral termination is permissible, but only in the following cases:

- 1) changes in production and labor structure, including liquidation, reorganization, bankruptcy or changing of the company profile accompanied by staff reduction;
- 2) inability of the employee to carry out his/her responsibilities due to insufficient qualifications or health-related reasons;
- 3) an employee's failure, on a regular basis, to perform his/her obligations as provided by the labor contract and the rules of internal procedure, in case such employee has previously been cited for disciplinary or civil penalties;
- 4) truancy, including absence from work without reason for more than three (3) hours during any business day;
- 5) absence from work for more than four (4) months consecutively due to the employee's temporary disability;
- 6) reinstatement of an employee who previously held the relevant position (i.e., such reinstated employee was on temporary leave for known reasons);
- 7) appearance at work under the influence of alcohol, narcotics or any other toxic substances; or
- 8) theft (including pilferage) of the employer's property as determined by a court of law or by resolution of the investigative body authorized to carry out administrative or civil penalties.

Note that employees may be terminated for reasons described in points (1), (2) or (6) only if they refuse to be transferred to other jobs. However, it is expressly prohibited to dismiss employees who are on vacation or temporarily disabled, except for cases provided in point (5) above. Importantly, these limitations do not apply in case of a company's liquidation.

As anywhere else in the world, Ukrainian law requires an employer to take certain steps to legally fire an employee, which can prove to be time-consuming. For instance, any employee subject to dismissal must be personally notified at least two (2) months prior to such dismissal. Formerly, in case of staff reduction and/or a company's restructuring, the employer (owner) was required to pay the dismissed employee's average salary for a period no longer than three (3) months following the effective dismissal date. However, Law No. 2213-III "On the Contribution Rates for Certain Types of Mandatory State Social Insurance," dated January 11, 2001 (as lastly amended on November 27, 2003), cancelled Article 49-3 of the

Labor Code, which required 3 months severance pay, and it appears that the employer is only required to pay severance for a one-month period.

C. Priority Right to Remain Employed

Ukrainian legislation sets forth a priority list for dismissal of redundant employees. In accordance with Article 42 of the Labor Code of Ukraine, in case of staff reduction due to changes in the production profile and labor structure, the following persons will have preferential rights to continue their work with the employer:

- 1) married persons who have two or more dependants;
- 2) persons whose families do not have other members with independent salaries;
- 3) employees with a long length of experience at the enterprise;
- 4) employees who simultaneously work and study in higher or secondary scientific institutions;
- 5) military veterans, invalids of wars and individuals who are subject to the Law of Ukraine "On the Status of Veterans of War, Guarantees and Social Securities;"
- 6) authors of inventions, utility models, industrial designs and rational proposals;
- 7) employees from the enterprise who received work-related injuries or illnesses;
- 8) persons deported from Ukraine within 5 years of the date of their return to their permanent residence in Ukraine;
- 9) employees, who have formerly served in the military or have served in other alternative (non-military) organizations within two years from their completion of service; and
- 10) other individuals who have such rights in accordance with special legislation.

The main factor in resolving the issue of who will continue working in the enterprise after reducing the workforce, however, is the qualification (experience) of the employee. Therefore, the employer (owner) of the enterprise is entitled to make relevant substitutions within similar professions and

positions. In other words, the employer may transfer a more qualified employee whose position has been cancelled, upon such employee's consent, to another lower position and at the same time dismiss the lesser qualified employee from that position.

D. "Special Case" Terminations: Gross Violations and Crimes of Moral Turpitude

Ukrainian labor legislation allows an employer to terminate a labor contract prior to the expiration date in the following "special" cases:

- 1) if a director, deputy director or chief accountant of an enterprise, institution or organization (branch, representative office, division or other separate unit) fails to fulfill his/her obligations under the labor contract;
- 2) if the acts of a director of an enterprise, institution or organization leads to the untimely payment of salaries or the payment of salaries in an amount lower than the minimum monthly salary established by law;
- 3) if an employee who directly handles cash or a company's material assets commits an act, which provides grounds for distrust towards such employee on the part of the employer (owner); or
- 4) if an employee "performing educator functions" (i.e. instructors or teachers who work at the enterprise) commits an immoral indiscretion which is incompatible with the further performance of his/her functions.

In the aforementioned cases, employment termination requires specific proof of gross violations or immoral acts. Such proof may be difficult to substantiate because of subjective opinions about moral values, loyalty towards the victim/perpetrator, etc. The above "special" cases rarely succeed in terminating employment, except in certain professions that require a higher sense of moral behavior, such as teachers, instructors or trainers. In such cases, evidence of moral turpitude is easier to establish.

III. Procedure for Dismissing an Employee at the Employer's Initiative

As could be expected, the most common procedure for dismissing a redundant employee involves cases where such an employee refuses to leave and, instead, seeks to legally protect his or her rights. In such cases, the employer should, first and foremost, clearly identify the legal grounds for dismissing the employee. In cases where the employer must offer the employee other work at the enterprise before dismissing the employee, the former must do so provided there is a vacancy for the employee's specialty.

An employee must be forewarned of his or her dismissal no later than two months before the day of dismissal. Such a warning consists of simply "familiarizing" the employee with the order of dismissal, which the employee must personally sign and date. If a court proceeding ensues due to the employee's dismissal, and it is discovered that the employer did not give the proper warning, then the court, in the absence of any grounds for restoring the employee to his former post, will change the date of the dismissal, taking into account the two month warning period, and order the employer to pay salary to such an employee for those two months. The law provides for no exceptions to the two month warning period, even during an employee's vacation or temporary disability.

Article 116 of the Labor Code of Ukraine provides that the dismissed employee must be paid any monies due to him or her by the employer on the day of dismissal. If the employee is absent from work on the final day, the above sum must be paid no later than the next day after the employee makes demand for payment. If the employer does not make timely payment, the employer must pay the employee's average salary for the entire time of the delay until final settlement is actually made.

If an employee's reason for dismissal is due to changes in the production and labor structure, the employer must pay a severance payment in an amount no less than the employee's average monthly salary. In addition, according to Article 49³ of the Labor Code, the employer should in some cases pay the dismissed employee's average monthly salary until the employee finds other work, but for no more than a period of three months. According to Article 44 of the Labor Code of Ukraine, employees dismissed due to (i) the inability to carry out their responsibilities; and (ii) in connection with the reinstatement of an employee who previously held the relevant position, must be paid a severance payment in an amount no less than the employee's average monthly salary. The term average monthly salary is used to protect individuals whose salaries vary from month to month over the course of a year. Therefore, if the salary is fixed, the average monthly salary will be equivalent to the employee's monthly salary.

If the employer and employee come to a mutual agreement regarding the termination of the labor contract in a period less than two months, then the grounds for dismissal can be documented as a "mutual agreement between the parties" in both the order of dismissal and the employee's labor book. In any event, however, the employer must make a duly executed entry into the employee's labor book no later than the day of an employee's dismissal.

Point 4.1 of the Instruction "On the Procedure for Maintaining Labor Books" states that in case the employer delays in entering the dismissal

notice, the employee will be paid his/her average monthly salary for the time of his involuntary absence from work. In such cases, the day of dismissal will be considered the day that the entry is finally made into the employee's labor book. Such "new" day of dismissal must be accompanied by a new dismissal order and must also be entered into the employee's labor book.

If an entry is made into a labor book earlier than the actual day of dismissal, such entry will be considered invalid. If the employee is absent from work on the day of dismissal, the administration responsible for dismissal must send notice to the employee by mail requesting the necessary receipt of such employee's labor book for purposes of entering the relevant dismissal order and date.

Just before being fired, many Ukrainian employees (even the now-imprisoned former Prime Minister Pavel Lazarenko) cite the Ukrainian Supreme Court's position that an employer may not dismiss an employee during temporary sick leave or vacation. This is the case even if the employee is given medical papers, confirming the employee's temporary disability to work, on the day of termination. By law, the employer must wait for the employee's term of disability to end and his or her return to work before dismissing such employee. Again, this rule does not apply to cases of dismissal in connection with an enterprise's liquidation or an employee's absence from work for more than four months in connection with temporary disability.

IV. Trade Unions

Many production enterprises, especially privatized plants with redundant employees, involve specific problems related to trade unions. If a trade union functions in the company, then dismissal on the basis of points 1 (except liquidation), 2-5 and 7 of the unilateral termination list (and points 3 and 4 of the list of "special" cases) can take place only with the consent of the trade union. The trade union will review the statements of the owner of the company and, within a 15-day period, give a written report informing the owner of its decision.

The owner has the right to dismiss an employee within a period of one month after receiving consent from the trade union. If an employee files suit against an owner for wrongful dismissal, and it is discovered that the owner acted without the consent of the trade union, the court must ask the trade union's permission to proceed with the dismissal. If the trade union refuses to give its consent to the employee's dismissal, the court will order the owner to pay the salary of the employee for the period of his/her involuntary truancy.

If there is a dispute regarding the dismissal of an employee in the case of changes in the enterprise's production and labor structure, (i.e., liquidation, restructuring or changing of profile), the court of law will inquire as to whether the company has been "restructured" or any other changes have taken place, and if so, whether such changes necessitated termination of the workforce. The court will also determine whether the employee was wrongfully dismissed in violation of his rights to remain at work.

V. Consequences of Wrongful Dismissal

In case of wrongful dismissal, the only way for an employee, whose rights have been violated, to fight back is by initiating legal proceedings against the employer. Because of the lingering Soviet mentality, where all persons were guaranteed a right of unconditional employment, many Ukrainians cling to the illusion that they cannot be fired at will. As a result, many employees tend to submit their labor-related disputes to the regional or city courts of general jurisdiction, regardless of the existence of any justifiable labor disputes.

As in the Soviet system, the employee may file a lawsuit with the said courts within one month from the day he or she receives a copy of the dismissal order or the labor book. If no entry regarding dismissal appears in the labor book, then a law suit may be filed within 3 months of the day when the employee should have become aware of the violation of his rights. Should the employee fail to file a law suit within the above time frames due to substantiated reasons, such terms may be extended by the court.

In the meantime, the employer/owner must be pay the average salary of the employee for the entire period of involuntary truancy, but for no longer than one year. If the legal proceedings continue for over a year, however, then the court will order the employer to pay the average salary of the employee for the entire period of the employee's involuntary truancy without placing a limit on such period. In addition, the court may order the employer to pay the employee's average salary if inadequate reasons for the dismissal were entered into the employee's labor book that prevented the employee from finding gainful re-employment.

VI. Conclusion

The procedure for terminating redundant employees in Ukrainian enterprises still embodies many of the socialist ideas that existed before Ukrainian independence, when the average employee's right to work was guaranteed by extensive legislation. To this day, the courts lean heavily in favor of the employee in dismissal suits. At first glance, this system of worker protection may seem overwhelming to foreign businesses who

wish to streamline their operations in light of the currently existing economic situation. On a more realistic note, however, a careful adherence to the rules, and prudent legal preparations for effective termination, makes the process of dismissing employees as simple as the hiring of such employees.

C MISCELLANEOUS TAX LEGISLATION

1. TAXATION IN UKRAINE

I. Taxation in Ukraine

CONSTITUTIONAL PRINCIPLES

As required by the Constitution of Ukraine, within the tax system of Ukraine, any taxes or levies, as well as sanctions for tax violations, may only be established by the laws enacted by the Ukrainian Parliament (the “Verkhovna Rada”).

The Verkhovna Rada may not delegate its constitutional powers to establish a tax system, taxes or levies, and sanctions for tax violations to the government or any other authority.

In terms of the Constitution, the general laws and tax laws, in particular, enter into effect only after their proper promulgation (e.g. having been approved in a third reading by the Verkhovna Rada and signed by the President). Tax laws may not have a retroactive effect if their provisions adversely affect natural persons, but may have a retroactive effect in respect of legal entities.

TAX SYSTEM

Ukrainian taxes, levies, and general tax principles are established by the Law “On the Taxation System of Ukraine”. In terms of this law, all taxes or levies are classified either as national or local.

As a basic legal principle, taxes or levies, their rates, tax collection procedures and tax incentives may be established only through the laws of Ukraine.

National taxes such as Corporate Income Tax (CIT), Value Added Tax (VAT), Personal Income Tax (PIT), Customs Duties, and Excise Taxes account for the largest portion of budget revenues.

Local authorities may also collect revenue from a number of local taxes, such as advertisement tax, community development tax, hotel tax, parking tax, recreation tax, and other taxes.

The Ukrainian system of taxation contains the following principle taxes (mandatory payments):

- Corporate Income Tax (CIT);
- Value Added Tax (VAT);
- Personal Income Tax (PIT);
- Pension Fund and Social Security Fund Contributions;
- Excise Duty;
- Customs Duty;
- State Duty;
- Land Tax;
- Vehicle Owners Tax;
- Payments for Licenses/Patents;
- Other Taxes.

II. Taxation of Businesses in Ukraine

CORPORATE INCOME TAX (CIT)

1. Tax Jurisdiction

Legal entities incorporated to and operating under the legislation of Ukraine are normally treated as tax *residents* and are taxable on their worldwide income.

Legal entities incorporated abroad and operating under the laws of another country are normally treated as foreign tax residents ("*non-residents*") and are taxable on two sources of income:

- a. Business income received from carrying out trade or business in Ukraine, and
- b. Other non-business income received from Ukrainian sources.

According to the Law of Ukraine No. 334/94 "On Taxation of Profits of Enterprises," dated December 28, 1994 (hereinafter the "Profit Tax Law"), the tax on companies is known as *corporate income tax*. Currently, this tax is calculated at a flat rate of 25% as of January 1, 2004. Please note, however, that separate tax rules pertain to agricultural enterprises, operations with securities and insurance companies.

2. Taxation of Resident Entities

(1) Tax Accounting Rules

Under domestic tax accounting rules, tax items (including gross income and gross expenses) are normally recognized on the basis of the cash-or-accrual method (e.g. first event rule). Under this method, income is rec-

ognized within the reporting period upon the occurrence of one of the following events, whichever occurs earlier:

- a. the date of the transfer of funds from the purchaser (customer) to the bank account of the taxpayer as payment for goods sold or services (works) rendered or, in case of payment in cash, the date of receipt of cash as payment for such goods, works or services; OR
- b. the date of the unloading of the goods sold or, for works or services, the date of the factual provision of the results of the works or services by the taxpayer.

Expenses are recognized upon the occurrence of the one of the following events, whichever occurs earlier:

- a. the date of the write-off of goods from the bank account of the taxpayer as payment for goods, works or services and, in case of payment in cash, the date of the withdrawal of cash from the cash register or cash reserves of the taxpayer; OR
- b. the date of the receipt of goods by the taxpayer or, for works and services, the date of the factual receipt of the results of such works or services.

The tax year corresponds to the calendar year. Taxpayers must submit tax returns for a calendar quarter, half year, three quarters, calendar year and make quarterly tax payments. Quarterly tax returns must be submitted within 40 days following the last calendar day of each calendar quarter, half year and three quarters and the fourth (i.e., last) quarter. There is no additional annual tax return.

If the filing deadline date falls on a holiday or a weekend, the deadline is automatically moved to the following operational (e.g. banking) day.

(2) Taxable Income

Resident entities are taxable on their worldwide income received or accrued within a reporting period. The amount of taxable income is determined by subtracting allowable deductible expenses and capital allowance from gross income.

(3) Gross Income

Gross income is defined as any income from domestic or foreign sources received or accrued by the taxpayer from any activity. Such income may

be in monetary, tangible or intangible form. The following items are specifically included in taxable income:

- Overall income from the sale or exchange of goods, works or services, including securities (except with respect to their initial issuance or final extinguishment);
- Income from banking, insurance and other operations involving the provision of financial services, currency sales, securities and debt instrument sales;
- Property and services received free of charge;
- Income from joint activity and in the form of dividends from non-resident companies, unlike dividends received from resident companies, as well as interest, royalties, debt instruments and income from leasing operations (lease);
- Amounts of contract penalties received;
- Foreign exchange gains realized or losses incurred as a result of revaluation of taxpayer indebtedness, including principal amounts and interest on loans, cost of financial lease objects, financial lease liabilities and the book values of securities;
- Income from returnable or non-returnable financial aid.

Please note that the above list is not exhaustive.

The following items are specifically excluded from gross income:

- Amounts of VAT received (accrued) by the taxpayer on top of the cost of goods/services, except in cases when the taxpayer is not a payer of VAT;
- Income received from joint activity on the territory of Ukraine without the creation of a legal entity, including dividends received from resident companies, unlike dividends received from non-resident companies, which dividends are taxed according to a special procedure;
- Monetary or in-kind contribution of capital to an entity or partnership in exchange for an equity interest therein, irrespective of whether the investor acquires a controlling interest following such contribution;
- Actual damages received pursuant to a court decision;

- Cash or property received pursuant to the complete liquidation of a company or partnership. The value received may not exceed the nominal (e.g. par) value of shares of the liquidating entity.

Please note that the above list is not exhaustive.

(4) Deductible Expenses

Any current business related expenses are deductible unless such deduction is restricted or disallowed by the Profit Tax Law. The following items are specifically included as deductible expenses:

- Compensation for goods or services to be used by a taxpayer in its business;
- Any current expense in connection with starting-up, managing and carrying out of business;
- Capital asset improvement costs of up to 10 percent of the total book value of all capital assets at the beginning of the reporting year. Excess costs are capitalized;
- Charitable contributions of more than two percent but less than five percent of the taxable profits of the previous tax year;
- Foreign exchange gains realized or losses incurred as a result of revaluation of indebtedness, including principal amounts and interest on loans, cost of financial lease objects, financial lease liabilities and the book values of securities.

Please note that the above list is not exhaustive.

Deductibility of the following expense items is specifically disallowed:

- Expenses incurred in connection with amusement, entertainment, or recreation activities. This restriction does not apply to expenses incurred by the taxpayer whose main business activity is furnishing amusement, entertainment, or recreation;
- Corporate and personal income tax payments, as well as VAT amounts included in the price of purchased goods (services);
- Penalties and fees paid;
- Dividend payments;

- Unsupported compensation to related persons for goods or services performed. If documentary proof is available, deductible compensation may not exceed the regular prices (e.g. fair market prices) for such goods or services;
- Losses from the exchange or sale of goods, works or services to related persons at prices below the regular prices;
- Any expense which is not supported by documentary evidence.

Please note that the above list is not exhaustive.

i) Deductibility of Interest Expense

Any interest expense paid or incurred by a taxpayer in carrying out business is generally deductible. However, there are interest deductibility limitations for resident taxpayers if:

- a) A debt obligation (loans, deposits) is provided by an entity with 50 percent or more of its statutory capital owned or managed, directly or indirectly, by a non-resident; OR by a legal entity that is tax exempt;

AND

- b) The taxpayer is an entity with 50 percent or more of its statutory capital owned or managed, directly or indirectly, by a non-resident; OR is a legal entity that is tax exempt.

In this case, the expense deduction is limited to the extent of the taxpayer's interest income, plus 50 percent of its net non-interest income. Excess interest expenses may be carried forward to future tax periods without limitation.

If a corporate income taxpayer is a Ukrainian resident entity, then the interest expense is fully deductible. In addition, if the entity providing the loan is a Ukrainian resident corporate income taxpayer, then the interest is also fully deductible.

ii) Offshore Countries Restrictions

As a measure for the avoidance of taxation, Ukraine has established restrictions on the deductibility of expenses incurred by resident taxpayers as consideration for goods, works or services received from or provided by non-resident entities located in offshore zones.

This restriction applies to expenses paid for the benefit of non-residents with "offshore status" or settlements made through such non-residents (their bank accounts). In these cases, only 85% of such expenses incurred or paid are deductible or depreciable/amortizable. In addition, gross expenses are recognized at the moment of payment thereby excluding the application of the first event rule.

The official list of offshore jurisdictions is published by the Cabinet of Ministers of Ukraine. It is periodically updated, with the last update issued on February, 24 2003. The list of offshore jurisdictions currently includes the following territories (total — 37):

• Guernsey Island	• Cayman Islands
• Jersey Island	• Montserrat
• Isle of Man (UK)	• Dutch Antilles
• Alderney Island	• Puerto Rico
• Bahrain	• St Vincent and Grenadines
• Belize	• St. Kitts-Nevis
• Panama	• St Lucia
• Andorra	• Dominica
• Gibraltar	• Turks and Caicos Islands
• Monaco	• Liberia
• Anguilla	• Seychelles
• Antigua and Barbuda	• Vanuatu
• Aruba	• Marshall Islands
• Bahamas	• Nauru
• Barbados	• Niue
• Bermuda	• Cook Islands
• British Virgin Islands	• Samoa
• Virgin Islands (USA)	• Republic of Maldives
• Grenada	

iii) Inventory Expense Adjustments

In order to match expenses with inventories for accounting and tax purposes, the Profit Tax Law requires that the acquisition cost of inventory acquired within a tax period be adjusted for changes in the book value of these inventories.

An estimation of the changes in the book value of inventory, including finished goods and work in progress, should be calculated based on either the "first in-first out" rule or a specific identification of cost valuation methods for tax accounting purposes. These adjustments must be included in either gross income or deductible expenses depending on whether the book value of such inventories at the end of the relevant tax period exceeds or is less than their book value at the beginning of such tax period.

(5) Depreciation & Amortization Allowance

Any amount paid or incurred for the acquisition, construction or improvement (in excess of 10 percent of the total book value) of capital assets for business use may not be deducted immediately. Instead such amounts should be capitalized and depreciated or amortized over time. Generally, depreciation allowances are permitted for all capital assets, including fixed and intangible property, except for land, goodwill and non-business related capital assets.

i) Fixed assets

Fixed assets are defined by the Profit Tax Law as tangible property intended for use in a taxpayer's business for a period exceeding 365 calendar days from the date of putting such property into operation and the value of which gradually decreases in connection with wear and tear. For depreciation purposes, fixed assets acquired after January 1, 2003 are divided into four groups:

- **Group 1** — Buildings, structures, their structural components and transmitting devices, including residential buildings and their parts (apartments, common areas and the value of capital improvements to land);
- **Group 2** — Motor vehicles and their parts (spare parts), office furniture and equipment, household electronics, optical, electromechanical instruments and equipment;
- **Group 3** — Any tangible capital assets not included into Groups 1, 2, and 4;
- **Group 4** — Computer equipment, software, telephones, information systems, data-handling equipment, etc.

ii) Tax Accounting

Pursuant to the Profit Tax Law, the term “amortization” (depreciation) of fixed assets and intangible assets means the gradual carrying forward of expenses for the acquisition, manufacturing or improvement of such fixed and intangible assets and for decreasing the adjusted profit of a taxpayer.

Fixed assets in Group 1 are accounted for on an individual basis. Property in Group 2, 3, 4 is accounted for on a group basis. As of **January 1, 2004**, quarterly depreciation rates are as follows:

- Group 1** — 2 %;
- Group 2** — 10 %;
- Group 3** — 6 %;
- Group 4** — 15 %.

iii) Intangible assets

Each item of intangible capital assets is accounted for separately and is amortized using the straight-line method over its useful life, but for a period not exceeding 10 years of uninterrupted use.

(6) Operations with Land

Separate accounting must be maintained for transactions with land. Expenses attributed to the purchase of land cannot be deducted or amortized. In future sales of land, gains realized must be included as taxable income; however losses incurred in the sale of land may not be used to increase the deductible expenses of a taxpayer.

(7) Net Operating Loss Carry-Forward

According to the amendments to the Profit Tax Law of December 24, 2002 (p. 11 of the transitional provisions of Law No. 349-IV) net operating losses incurred after January 1, 2003 are carried forward indefinitely. All losses accumulated before January 1, 2003 are carried forward for 12 calendar quarters only, starting from the period when such losses were incurred. If the 12 allowable quarters have already passed, the remaining losses will be used to offset taxable income in the first quarter of 2003, after which they will expire.

However, Article 95 of the Law of Ukraine No. 1344-IV «On the State Budget of Ukraine for 2004,” dated November 27, 2003, changed the rules with respect to losses incurred in 2002. In 2004, losses, which were accounted by a taxpayer as of January 1, 2002 and were not paid off on January 1, 2004 pursuant to the procedure established by the amendments to the Profit Tax Law of December 24, 2002, may not be used to offset taxable income as a result of the tax periods (quarters) of 2004.

3. Taxation of Non-resident Entities

(1) Tax Jurisdiction over Non-residents

Non-resident entities are subject to taxation on two types of income in Ukraine:

- a) **Business income** derived from carrying out business in Ukraine; and
- b) **Non-business income** received from Ukrainian sources.

Importantly, the taxation of both business and non-business income is subject to the provisions of various international double taxation treaties between Ukraine and other countries. Therefore, preferential tax treatment or provisions may be available to a non-resident taxpayer under an appropriate double taxation treaty of their respective domestic jurisdictions.

(2) Taxation of Business Income

Business income of a non-resident obtained through a permanent establishment situated in Ukraine is subject to taxation that is similar to the taxation of Ukrainian residents. The term “permanent establishment” has a similar meaning under the domestic tax legislation to the term defined in Article 5 of the OECD Model Income Tax Convention. Therefore, a non-resident’s income, attributable to Ukraine via the activities or assets of its permanent establishment, is subject to taxation in Ukraine on a net basis at a rate of 25 percent.

i) Permanent Establishment

In Ukraine, the permanent establishment of a non-resident is defined as a permanent place of business through which a non-resident partially or completely performs its entrepreneurial activities. The term permanent establishment includes branches, places of management, offices, factories, workshops, mines, oil or gas wells, open-cast mines or any other place of extraction of natural resources.

It is important to mention that under domestic tax rules, the activities of any resident agent with the authority to conclude contracts on a non-resident’s behalf lead to the creation of a permanent establishment for the non-resident, irrespective of whether the agent has a dependent or independent status.

ii) Calculation of Attributable Income

• *Direct Method*

This method is used when the entity can easily determine the amount of income attributable to the activities or assets of its permanent establishment. Allowable expenses are deducted from gross income, and the difference is reported as taxable income. Interestingly, such expenses are deductible irrespective of whether they are incurred within or outside of Ukraine, provided that they are supported by proper documentation.

• *Split Balance Sheet Method*

This method is used for nonresident companies with activities in multiple countries that do not have readily available gross income figures that can be allocated to their operations in Ukraine.

As a result, a special formula is applied to calculate attributable taxable income. It uses the Ukrainian share of the resident’s worldwide gross income, deductible expenses, number of employees, and book value of its assets to determine the taxable income.

• *Indirect Method*

The indirect method is used by companies who could not feasibly determine the amount of attributable income under the direct method, and could not provide necessary documents under the split balance sheet method.

To calculate attributable taxable income, a 25 percent profit margin is applied to gross income attributable to the permanent establishment.

(3) Taxation of Non-Business Income

Non-business income from Ukrainian sources is normally subject to withholding tax on a gross basis, provided such income is not attributable to a non-resident’s permanent establishment in Ukraine. Withholding is made by a resident taxpayer when income is paid to a non-resident.

i) Ukrainian Source Income

For withholding tax purposes, the following items of income are treated as received from a Ukrainian source:

- *Interest Income* – interest on debt obligations issued by a resident entity;
- *Dividends Income* – dividends from a resident entity;
- *Rents* – rental (leasing) income received from a resident entity;
- *Income from Immovable Property* – income from the sale of immovable property located in Ukraine;
- *Insurance Income* – premiums for insuring or reinsuring Ukrainian risks or risks of resident entities abroad;

- *Royalty Income* – royalties received from a resident entity;
- *Winnings* – income from lottery (except state) winnings and from operating gambling businesses;
- *Commissions, Broker or Agent Fees* – income received from residents or PE of nonresidents for the services provided by nonresident (or its PE) on the territory of Ukraine.
- *Other Income* – certain other types of income.

ii) Withholding Tax Rates

The following withholding tax rates normally apply (unless other more favorable rates are provided by relevant double taxation treaties). Non-business income items are payable to non-residents from Ukrainian sources, provided that such income is not attributable to a non-resident's permanent establishment in Ukraine:

Item of Income from Ukrainian Sources	Withholding Tax Rate
Dividends	15%
Interest	15%
Royalties	15%
International freight income	6%
Interest income from certain state securities	0%
Other items of income from Ukrainian sources	15%

As of January 1, 2003, special treatment was prescribed to income payable to non-residents from Ukrainian sources related to taxation of insurance income and income from advertising services provided within Ukraine. Both types of income are no longer subject to a withholding tax, rather the tax is accrued on top of the payment at the following rates.

Item of Income from Ukrainian Sources	Tax Rate
Insurance income	0%/15%
Income from advertising services	20%

4. Corporate-Shareholder Taxation

The Profit Tax Law entitles Ukrainian resident companies to pay dividends to its shareholders regardless of whether the paying entities have recorded income or losses for the tax period. Moreover, the Profit Tax

Law further provides that there is no distinction between accounting and taxable income/loss for the purposes of this rule.

Ukrainian tax law treats tax on dividends as a constituent part of corporate income tax and not as a separate tax.

(1) Corporate Income Tax

Corporate income tax is paid on dividends distributed to residents and non-residents alike at the rate of 25 percent as of 1 January 2004. The tax is accrued on top of a dividend payment and is made from the funds of the issuing company (e.g. corporate entity's funds). This means that when the distribution is made (or before such distribution is made) a tax payment of 25 percent of the dividend is remitted to the State, and the full value of the dividend is paid to the shareholder.

At the end of the tax period, the taxpaying company is entitled to use the amount of previously contributed tax on dividends as a credit against its corporate tax liabilities. If the taxpayer does not have a sufficient corporate tax liability for the period, the amount of remitted tax on dividends may be carried forward indefinitely into future taxable periods.

(2) Withholding Tax

Unless there is a better rate provided by the respective tax treaties, dividend payments made to non-resident taxpayers are subject to a 15 percent withholding tax described above (e.g. *Taxation of Non-business income*). The amount withheld should be remitted to the State at the time of the dividend distribution.

Currently, there is no withholding tax for resident shareholders.

(3) Concluding Remarks

In cross-border distributions, when resident shareholders receive dividends from *non-resident companies*, such payments are taxable at shareholder level.

In contrast, dividends received by resident shareholders (including natural persons) from *resident companies* are subject to no further taxation. As of 1 January 2004, however, dividends received by resident individuals from resident companies are subject to personal income tax.

VALUE ADDED TAX

1. Taxable Transactions

In accordance with the Law of Ukraine No. 168/97 "On Value Added Tax," dated April 3, 1997, value added tax ("VAT") is imposed on:

- (a) Domestic sale transactions of goods or services, including payment for services under lease agreements and operations involving the transfer of ownership rights to pledged objects to a creditor to extinguish debt;
- (b) Import of goods or services for use or consumption in Ukraine, including the import of property under leasing agreements, pledge agreements and/or mortgage agreements;
- (c) Export of goods or services for use or consumption outside of Ukraine.

VAT is levied at a rate of 20 percent of the taxable amount for domestic sales and imported goods or services. For exported goods or services the VAT rate is zero percent.

The general rule is that the taxable amount is defined on the basis of the contractual value of the goods or services supplied.

2. Exempt Transactions

(1) Transactions Specifically Exempt from VAT

Certain transactions subject to the provisions of the "Law on Value Added Tax" ("the VAT Law") are exempt from VAT. These include, but are not limited to:

- The supply/import of medical or medical-related products, provided that such products are registered in Ukraine as medical products (suspended for 2004 except for the sale of pharmaceuticals and medical products permitted by the Cabinet of Ministers);
- Sale of domestically produced baby food products;
- Sale and delivery of domestically published periodicals, student notebooks, textbooks, books, and supplementary study materials (suspended for 2004 except for the sale of student notebooks, textbooks and elementary school books of national production);

- Provision of educational services by institutions with special permission (license) for provision of such services;
- Sale of special-purpose goods for disabled individuals;
- Delivery of pensions and monetary assistance to the population;
- Provision of health care services by institutions with the respective licenses (suspended for 2004 except for certain services listed by the Cabinet of Ministers);
- Public transportation services;
- Religious organization services and sales;
- Transfer of land, unless the transaction is disallowed by the Land Code of Ukraine (suspended for 2004);
- Privatization of state and communal property (suspended for 2004 except for the gratuitous privatization of the residential fund);
- Sale or transfer of newly built living space to individuals (suspended for 2004);
- Charitable contributions and financing of scientific research and design efforts;
- Research and development activities performed at the expense of the State Budget of Ukraine;
- Support of Olympic and para-Olympic sport activities.

(2) Transactions Not Subject to VAT

According to the VAT Law, certain transactions are not subject to VAT. These include, but are not limited to:

- Issuance of securities by enterprises, the National Bank of Ukraine, the Ministry of Finance of Ukraine, and by local authorities;
- Insurance and reinsurance services, including social and pension insurance;

- Transfer of lease property by a resident lessor to a lessee and the return of the lease property by the lessee to the lessor; the payment of interest or commission in lease (leasing) payments calculated on the value of the leased object (without calculating the portion of leasing payments provided as compensation of a part of the value of the leased object pursuant to agreement); the pledge of property to a creditor pursuant to a credit agreement and the return of the property; the transfer by a resident creditor of a mortgaged object into possession or use by a borrower; and cash payments of the principal amount and interest under a mortgage;
- Payment of salary, pensions, stipends, subsidies and other cash or in-kind payments to natural persons at the expense of budgets or social and insurance funds;
- Payment of dividends and royalties in monetary form or in the form of securities;
- Provision of commission (brokerage) and dealer services for the sale or management of securities;
- Transfer/import of fixed assets as a contribution to the authorized capital of a legal entity in exchange for equity interest therein, provided that these assets are used to form a business (or part thereof) as a going concern.

3. Taxable Persons

Any legal entity or individual carrying out, within the last twelve calendar months, business operations (e.g. sale of goods or services) of a value exceeding 3,600 non-taxable minimum incomes (UAH 61,200 or approximately USD 11,547) is required to register for VAT purposes.

Additionally, there are several types of taxable persons defined as VAT-payers, based on the kind of business activity they perform. These VAT-payers include, but are not limited to:

- a) persons or entities, which import goods onto the customs territory of Ukraine or receive works or services from a non-resident for use or consumption on the customs territory of Ukraine with the exception of natural persons, who are not registered as VAT-payers in cases when such persons import goods in volumes not subject to taxation pursuant to law;
- b) persons or entities, which carry out business activities on the customs territory of Ukraine involving the trade for cash, regardless of the vol-

ume of sale, with the exception of natural persons, who carry out trade provided that they pay market fees pursuant to law;

- c) persons or entities, which provide services on the customs territory of Ukraine in connection with the transport of passengers or freight via the customs territory of Ukraine.

In practice, however, foreign legal entities are able to register as VAT-payers in Ukraine only if they carry out business in Ukraine through a permanent establishment.

4. Taxable Amount

(1) Domestic Sales

For any taxable domestic sale, VAT is chargeable on the contractual value of money, goods/services or any other consideration received or accrued in connection with the sale.

Should a taxable supply be made to a related person, to a non-registered VAT person, or for any consideration other than money (in-kind consideration), VAT is chargeable by the supplier on the factual or normal price ("fair market value") of goods or services being sold or provided.

(2) Imports

i) Import of Goods

For import of goods, VAT is chargeable on the contractual value of the goods imported. However, if their contractual value is less than their customs value, the taxable amount is their customs value.

The customs value of any imported goods is equal to their value in terms of the customs laws of Ukraine, including expenses for transportation; loading, unloading, reloading and insurance up until the customs crossing point of Ukraine; payment of brokers, agency, commission and other fees connected with the import of such goods, payment for use of related intellectual property, excise duty, import duty, and other fees and duties included into the price of such goods.

ii) Import of Services

Should services be imported for use or consumption within Ukraine, VAT is chargeable on the contractual value of services received under the "reverse-charge mechanism". This mechanism is defined by the VAT law as follows: "For works or services performed or provided by non-residents on the customs territory of Ukraine, the basis for taxation is the contractual value of such works or services taking into account excise

duty and other taxes and fees (mandatory payments), which are included into the price of such works or services, excluding VAT. The determined value is recalculated into Ukrainian Hryvnia according to the currency exchange rate of the National Bank of Ukraine effective at the moment of the appearance of tax obligations.”

5. VAT Administration

(1) Remittance

VAT on domestic supplies and importation of services is administered by the tax service, while VAT on the importation of goods is administered by the customs service.

Any taxable person should assess the amount of VAT to be remitted to the budget by reducing (“crediting”) its output VAT liability (VAT collected on outward taxable sales) with input VAT credit (VAT incurred on inward taxable sales and import sales).

VAT on imported goods is payable by the importer in cash at the customs border. A taxable person responsible for paying import VAT and meeting certain requirements may defer such payment by issuing a VAT promissory note. This VAT promissory note should either be settled within a 30-day period or included in output VAT liabilities.

(2) VAT Credit

Any input VAT incurred by a taxable person on inward domestic sales and import sales is creditable against output VAT liabilities provided that such input VAT was incurred:

- In connection with the acquisition of goods, works or services, the cost of which is either immediately deductible or depreciable/amortizable for CIT purposes; and
- In connection with supplies intended to be used in that person’s taxable outward supplies.

If input VAT is incurred in connection with sales, which are not intended to be used or are not used in taxable outward sales, such VAT is not creditable, but may be deductible or depreciable/amortizable for CIT purposes.

If input VAT is incurred in connection with the acquisition of supplies, the cost of which is neither deductible nor depreciable/amortizable for CIT purposes, such VAT is neither creditable nor deductible/amortizable for CIT purposes.

(3) Tax Refunds

Since export sales are zero rated, any taxable person making sales of goods/services for use or consumption outside of Ukraine may claim as a credit its input VAT incurred in connection with exported supplies.

Although the excess credit is refundable, very strict requirements for such refunds are established. In fact, such requirements make VAT refunds very difficult to obtain or at least delay them considerably. Needless to say, some very entrepreneurial Ukrainians have made a profitable business out of the refund of VAT; however they do charge high percentages in achieving the return of VAT in a quick manner.

6. Tax Accounting Rules

For VAT accounting purposes, the cash-or-accrual method is normally used. Under this method, output and input VAT in connection with domestic sales are imposed in the reporting period when goods/services are supplied or payment for this supply is received.

For VAT purposes, the tax period, depending on the volume of taxable turnover, is either a calendar month (if the volume of operations for the previous calendar year exceeds 7,200 non-taxable minimum incomes) or a calendar quarter (if the volume of operations is lower than 7,200 non-taxable minimum incomes, then the taxpayer may choose the calendar quarter or calendar month). VAT taxable persons must therefore submit tax returns and remit VAT either monthly or quarterly no later than the 20th of the month following the tax period.

PAYROLL TAXES

1. Tax Base / Rates

Salary or similar employment compensation payable to domestic employees by Ukrainian entities or by branches or subdivisions of foreign companies located in Ukraine is subject to the following payroll taxes:

Social Insurance	Fund Tax Rate (%)	
	Employer's contribution (accrued by the employer on the amount of compensation paid)	Employee's contribution (withheld by the employer from the compensation paid)
Temporary Disability Fund	2.9 ¹⁾	0.25—0.5 ¹⁾
Unemployment Fund	1.9 ¹⁾	0.5
Pension Fund	32.0 ¹⁾	1.0
Professional Accident and Sickness Fund ²⁾	0.86—13.8	(if salary lower than 150 UAH per month) or 2.0 (if salary higher than 150 UAH per month)
	(depends on level of risk at workplace)	
Total	37.66—50.6	1.75—3.0

1) *Special lower rates apply to handicapped employees and organizations employing a certain number of handicapped individuals.*

2) *Rates vary for enterprises with different classes of professional accident and sickness risk.*

2. Tax Base Cap

The taxable base for the above payroll taxes is currently capped at UAH 2,660 (approximately USD 500) per employee's monthly salary or other similar compensation.

3. Requirements for Hiring Disable Persons

Irrespective of the organizational form, every company is required to hire disabled individuals. The number of handicapped persons should constitute at least four percent of the total workforce of the company. In cases where the organization employs between 15 and 25 individuals, at least one handicapped person should be employed, unless otherwise provided by specific laws.

Employers that do not comply with the above rules are required to pay annual penalties. The penalty is calculated as the average annual salary of employees of that company for each work place that should be but is not occupied by a disabled person.

4. Tax Administration

The employer is normally responsible for assessing, withholding and paying employees' payroll tax contribution. The employer is also responsible for assessing, accruing and paying its payroll tax contribution. This is sometimes referred to as the PAYE (pay-as-you-earn) system.

OTHER TAXES

1. Excise Duty

In late April of 2001, the President of Ukraine signed the Law of Ukraine "On Amending the Decree of the Cabinet of Ministers of Ukraine 'On Excise Tax,'" No. 2324-III, dated March 22, 2001. Proponents of the amendments agreed that the amendments eliminated the so-called "tolling schemes," used by certain businesses to evade payment of excise tax in the process of manufacturing and selling alcohol and oil products. On May 22, 2003, Parliament by virtue of law once again amended the Decree "On Excise Tax" (hereinafter the "Decree") in an attempt to further eliminate violations of excise taxation legislation.

Formerly, businesses that received goods subject to excise tax from manufacturers (hereinafter the "Goods"), which were manufactured from materials provided by the said businesses, did not pay excise tax by virtue of Article 2 of the text of the Decree before its amendment. According to the Decree, such businesses did not fall under the category of excise taxpayers.

At the same time, the manufacturers of the said Goods previously refused to pay excise tax because, according to Article 3 of the Decree, they simply did not formally generate a basis of taxation. In practice, when the tax authorities demanded that the business (i.e., the provider of materials) or the manufacturer of the Goods pay excise tax, arbitration courts would rule against the tax authorities. In the year 2000 alone, arbitration courts dismissed more than UAH 100 million worth of the tax authorities' demands for Tax payments.

The authors of the Law asserted that under the former circumstances, other manufacturers of the Goods, as well as the state budget, suffered grievous injuries. The authors further argued, correctly, that other manufacturers were discriminated against if they worked with purchased materials and paid excise tax.

Accordingly, such other manufacturers of the Goods filed numerous petitions with the Parliament, demanding that such discriminating tax payment system be abolished. Alternatively, they argued, the Goods in question would become more expensive and would not be able to compete with the Goods manufactured under the "tolling schemes."

The provisions of the laws amending the Decree "On Excise Tax" (as lastly amended on May 22, 2003) are meant to eliminate such inequality. Specifically, the Decree determined that, in addition to other excise taxpayers, businesses ordering the Goods on tolling terms must also pay the Tax.

The Decree simultaneously expanded the range of tax agents, i.e., the entities responsible for collecting excise tax from taxpayers and transferring it to the state budget. According to the amended version of paragraph 2 of Article 1 of the Decree, such tax agents are defined as businesses established in the form of an enterprise with foreign investment, as well as their subsidiaries, branches and other separate sub-units, authorized to charge and collect excise tax and transfer the amounts collected to the state budget.

The goal of the legislators, therefore, was to abolish another scheme of excise tax evasion, which was carried out by structuring transactions via structural sub-units of joint ventures. Prior to the enactment of the amend-

ments to the Decree, the subsidiaries of joint ventures and their branches were not required to collect excise tax from the buyers of their products. At the same time, certain subsidiaries enjoyed excise tax privileges obtained as a result of arbitration court orders. Therefore, neither party would pay excise tax provided that the transactions involving the Goods were carried out via the sub-units of joint ventures.

Now that the Decree requires joint ventures' sub-units to act as tax agents (i.e., excise tax collectors), the situation has changed. Under the new requirements, excise tax will be credited to the state budget for the import of Goods or the state and local budget in case of the manufacture of Goods in Ukraine regardless of the legal form of the party participating in a transaction involving disposal of the Goods.

Moreover, the amendments to the Decree excluded paragraph 3 of Article 1 from the Decree. Prior to the enactment of the amendments in 2001, this paragraph authorized the government agencies, which carried out disposal, confiscation or withdrawal of Goods from circulation, to act as tax agents. This particular amendment, however, was made only to ensure that the Decree is in compliance with other laws and regulations, because the disposal of such confiscated Goods was already prohibited earlier.

The procedure for charging excise tax has also been changed considerably. According to the amended version of Article 4 of the Decree, for the purchase of imported Goods, excise tax is calculated from the value of such Goods at the maximum retail prices established by the importer of Goods without VAT and excise duty, but no less than the customs value of such goods including the amount of import duty without VAT and excise duty. In this manner, the State is expanding the tax base in order to increase the budget revenue at the expense of the Tax. For Goods produced on the customs territory of Ukraine, excise tax is calculated from the value of such goods at the maximum retail prices of the Goods established by the manufacturer without VAT and excise duty.

There is another unpleasant rule in the amended version of the Decree. Paragraph 3 of Article 4, among others, deems tax liability to arise as of the date the Goods were transferred. In other words, the legal transfer of Goods will occur only upon crediting the amount of excise tax by the buyer to the account of the manufacturer of the Goods. This could easily result in situations when the State will be generating revenues even before the excise taxpayer itself because such taxpayer may not be able to dispose of the purchased Goods soon enough.

Not all of the amendments introduced to the Decree are negative: the definition of excise tax has changed for the better. For example, excise tax is

now defined as an indirect tax on certain goods determined as excise goods by law, which is included into the value of such goods. In contrast, the prior version of the Decree defined excise tax as an indirect tax on the consumers of certain groups of goods determined as such by law. The old version was confusing and unclear whether the consumers or the goods purchased by such consumers were subject to taxation. The newly introduced definition clarified this misunderstanding.

Below is a general description of the rules applying to excise duty:

(1) General Rules

Excise duty is imposed on taxable items produced in, or imported into, Ukraine and is included in the price of such goods. In addition, excise tax at the rate of zero percent is imposed on export sales. Since excise duty works as an indirect tax, any excise duty paid in connection with exported items produced in Ukraine can normally be refunded to the exporter.

Excise duty is imposed on alcohol and tobacco products, motor fuels, motor vehicles, beer and jewelry. Excise duty is normally imposed when a taxable item is sold for domestically produced articles or prior to its entering Ukraine for imported articles.

(2) Taxable Products

a) Alcohol

Excise duty is imposed on alcoholic articles covered by Harmonized System numbers 2204 (wine from fresh grapes), 2205 (vermouth and other wines from fresh grapes flavored with plants or aromatic substances), 2206 (other fermented beverages), 2207 and 2208 (undenatured ethyl alcohol, spirits, liqueurs and other spirituous beverages). Excise duty for alcoholic products is levied at various rates in UAH per liter.

b) Tobacco

Excise duty is imposed on tobacco articles covered by Harmonized System numbers 2402 (cigars, cheroots and cigarettes), 2403 (other manufactured tobacco and tobacco substitutes, tobacco extracts and essences). Excise duty for tobacco products is levied at various rates in UAH per 100, or per 1,000 items, or per kg.

c) Motor Fuels

Excise duty is imposed on certain motor fuels covered by Harmonized System number 2710 (diesel, gasoline, aviation and jet engine fuels). Excise duty for motor fuels is levied at various rates in EURO per 1000 kg.

d) Motor Vehicles

Excise duty is imposed on motor vehicles covered by Harmonized System numbers 8703 (motor cars and other vehicles designed for the transportation of persons), 8711 (motorcycles) and 8716 (trailers and semi-trailers). Excise duty for motor vehicles is levied at various rates normally in EURO per cm³ of the vehicle's engine capacity.

2. Land Tax

There is a land tax imposed on owners and users of land. The amount of tax depends on the use (e.g. farmland) and location of the land. If there is a value estimate attached to the land, then the land tax is calculated as 1% of that estimate. Otherwise, the amount of land tax ranges from UAH 0.015 per square meter in towns populated with less than 200 people to UAH 0.21 per square meter in cities populated with more than 1 million people. For regional centers, zone coefficients from 1.2 to 3 are applied and from 1.5 to 3.0 for rest and recreation areas.

3. Customs Fees

Under the rules of the tax and customs laws of Ukraine, customs fees are collected for customs registration of goods and other articles in zones of customs control that are located on the premises of the enterprises storing these goods (i.e., customs bonded warehouses). Customs fees are also charged for the storage of goods and other articles under the jurisdiction of a customs warehouse in cases when their detainment on the territory of the customs-house is not obligatory.

The Rates of Customs Fees are established by Resolution No. 65 of the Cabinet of Ministers of Ukraine "On Customs Fees Rates," dated January 27, 1997, and also from January 1, 2005 by Resolution No. 93 of the Cabinet of Ministers of Ukraine dated January 18, 2003.

4. Local Taxes

On a local level, Ukraine imposes a number of local taxes, which include the following: advertisement tax, community development tax, hotel tax, parking tax, recreation tax, and certain other local taxes.

III. Transfer Pricing

Under the Profit Tax Law, the tax treatment of transactions between related persons is subject to special rules. These rules apply to both cross-border and domestic transactions.

Income received in transactions between related persons may not be less than the normal value (price) of property transferred or services provided on the date of such transactions. Deductible expenses incurred in such transactions may not exceed the normal value of property or services acquired on the date of such transactions.

The Law states that with regard to the determination of the "regular price" and "fair market price," the burden of proof rests with the tax authorities.

1. Related Person

The term "related person" includes:

- (1) any legal entity, which controls, is controlled by or is under common control with a taxpayer;
- (2) any natural person or members of his or her family, who carries out control over the taxpayer; and
- (3) officers authorized to carry out on behalf of the taxpayer legal actions directed at the establishment, change or termination of the taxpayer's legal relations or legal relations of a family member.

One entity is treated as controlling another entity if such entity directly or indirectly possesses a controlling interest in the equity or management of the other entity, including controlling 20 percent or more of the equity of the entity. For natural persons, the total amount of ownership of a portion of the authorized capital of a taxpayer (votes in the governing body) is established as the total amount of corporate rights, which belong to such natural person, the members of his or her family and legal entities, which are controlled by such natural person or his or her family members.

2. Normal Value (Price)

"Normal value (price)" is defined as one which is stated in a contract between participating parties. To determine "normal price," the parties subject to a contract must use as a benchmark a contract involving transactions with similar goods and under similar market conditions. Unless proven otherwise, the contract price is deemed to be the "fair market price."

3. Fair Market Value (Price)

"Fair market price" is defined as the price charged to a purchaser of goods (and/or services) by a seller under conditions, according to which the sell-

er sells and the purchaser purchases the goods (and/or services) freely and both parties are legally and factually independent of each other and have adequate information regarding the goods (and/or services) concerned and the market prices for identical (or similar) goods (and/or services).

IV. Taxation of Cross-Border Transactions

1. Outbound Transactions

Since resident entities are taxable on their worldwide income in Ukraine and may also be taxable by foreign countries on their income derived from sources within that country or from carrying on business in such countries, the same income is potentially subject to double taxation.

In order to avoid this double taxation, Ukraine uses a foreign tax credit method in its double taxation treaties. Under this method, foreign taxes paid by a resident taxpayer on foreign source income may be credited against its Ukrainian tax liabilities on such foreign source income.

Excess foreign tax credit may not be offset against a resident taxpayer's Ukrainian tax liabilities on any domestic source income, nor may it be carried forward or backward.

2. Inbound Transactions

Double Taxation Treaties

Ukraine has a reasonably extensive treaty network and, to date, has concluded double taxation treaties with over 50 countries, which generally follow the OECD Model Income Tax Convention. Ukraine also has become the legal successor to a number of double taxation treaties concluded by the former Soviet Union.

Withholding Tax Rates for Treaty Countries					
Country of Recipient	Dividends			Interest	Royalties
	Major Rate (%)	Minor Rate (%)	Major Holding (%)	(%)	(%)
Armenia	5	15	25	10	—
Austria	5	10	10	2/5	5
Azerbaijan	10	10	—	10	10
Belarus	15	15	—	10	15
Belgium	5	15	20	2/5	5
Bulgaria	5	15	25	10	10

Canada	5	15	20	10	10
China (P. Rep. of)	5	0	25	10	10
Croatia	5	10	25	10	10
Cyprus	—	—	—	—	—
Czech Republic	5	15	25	5	10
Denmark	5	15	25	10	10
Egypt	12	12	0	12	12
Estonia	5	15	25	10	10
Finland	5	15	20	5/10	5/10
France	5	15	10/20	2/10	10
Georgia	5	10	25	10	10
Germany	5	10	20	5	—
Hungary	5	15	25	10	5
India	10	15	25	10	10
Indonesia	10	15	20	10	10
Iran	10	10	—	10	10
Italy	5	15	20	10	7
Japan	15	15	—	10	10
Kazakhstan	5	15	25	10	10
Korea	5	15	20	5	5
Kyrgyzstan	5	15	50	10	10
Latvia	5	15	25	10	10
Lithuania	5	15	25	10	10
Macedonia	5	15	25	10	10
Malaysia	15	15	—	15	10/15
Moldova	5	15	25	10	10
Mongolia	10	10	—	10	10
Netherlands	5	15	20	10	10
Norway	5	15	25	10	5/10
Poland	5	25	25	10	10
Portugal	10	15	25	10	10
Romania	10	15	25	10	10
Russia	5	15	—	10	10
Slovak Republic	10	10	—	10	10
Spain	18	18	—	—	5
Sweden	5	10	20/25	10	10
Switzerland	5	10	20/25	10	10/15
Turkey	10	15	25	10	10
Turkmenistan	10	10	—	10	10
United Kingdom	5	10	20	—	—
United States	5	15	10	—	10
Uzbekistan	10	10	—	10	10
Vietnam	10	10	—	10	10
Yugoslavia	5	10	25	10	10

V. Taxation of Individuals

TAX JURISDICTION

On January 1, 2004, the new law “On Personal Income Tax” (the PIT Law) came into effect. Notwithstanding the number of notable changes, the law inherits certain key principles established by preceding acts of legislation, among which is tax jurisdiction.

Individuals, who are tax residents in Ukraine, are subject to personal income taxation on their worldwide income. Non-resident individuals are subject to taxation only on income from Ukrainian sources.

TAXATION OF RESIDENT INDIVIDUALS

1. Tax Residency

A tax resident of Ukraine is an individual, who has permanent residence in Ukraine. If an individual has a permanent residence in more than one country, he or she will be qualified as Ukrainian tax resident in case he or she has closer personal or economic ties (e.g. center of vital interests) in Ukraine.

If it is impossible to determine the country in which the individual has his center of vital interests or if the individual does not have a permanent residence in any country, the individual will be considered a Ukrainian tax resident if present in Ukraine for at least 183 days of the tax period (including days of arrival and departure). Furthermore, if tax residency is impossible to determine based on the above provisions, the individual will be a tax resident of Ukraine if he or she is a legal Ukrainian citizen.

2. Tax Rates

Over the period from January 1, 2004 to December 31, 2006, the personal income tax rate will be a flat tax rate of 13 percent. However, the rate will be increased to 15 percent as of January 1, 2007.

In addition, from January 1, 2004 there will be five percent income tax on interest income received on deposits and deposit certificates. Furthermore, income derived from gambling, winnings, etc. will be taxed at a rate equal to double the flat rate (i.e. during the period from January 1, 2004 to December 31, 2006 the rate will be 26%).

3. Taxable Income

Resident individuals are taxable on their worldwide income, i.e., on income “received” from both domestic and foreign sources. Income is taxable irrespective of whether it is received in cash or in-kind.

If a resident individual receives benefits in-kind, the amount of taxable income is determined on the basis of the fair market value of the property, services or other benefits received.

Exemptions from Taxable Income — The following benefits received by a resident individual are specifically excluded from personal income taxation:

- State social insurance and state welfare payments, housing subsidies, and other payments and compensations payable from the state budget, the Pension Fund and social security funds;
- Income from state bonds issued by the Ministry of Finance and state lottery winnings;
- State Pension and social security insurance payments;
- Alimony;
- Gifts made by spouses;
- Dividends payable in shares (stocks, etc.) issued by a resident entity, if such issuance does not change the proportion of shares in the charter fund of such resident entity;
- The value of state-owned apartments (buildings) received by individuals on a no-charge basis.

The PIT Law contains a list of items specifically included in the gross income of an individual. These include, among others, gifts, insurance payments and premiums, rental income, fringe benefits (including the cost of received rent, property, food, assistance of home servants, expense reimbursements, amounts of financial aid), amounts of punitive (vs. actual) damages received, forgiven debts and obligations, interest and dividend income, investment income, and inheritance.

The new law specifically allows the following deductible expenses: mortgage interest, charitable contributions to registered organizations, educational expenses for a taxpayer and his immediate relatives, medical expenses not covered by insurance for the taxpayer and his immediate family members, life insurance premiums paid by the taxpayer, artificial insemination and adoption expenses, etc.

Since 2004, the new law also allows each taxpayer to reduce his or her income by one minimum salary (calculated on a monthly basis) available on January 1st of the respective tax year. This is similar to a tax exemption

and is called “tax social benefit.” This benefit has been fixed in 2004 at 30 percent, and in 2005 will be at 50 percent, in 2006 at 80 percent, and in 2007 at 100 percent. Special groups of taxpayers (e.g. students, single mothers, WWII veterans, etc.) are eligible for an increased tax social benefit.

4. Taxation of Foreign Citizens Resident in Ukraine

Foreign citizens who are tax residents of Ukraine are taxable under similar rules to Ukrainian tax resident-citizens.

In addition, resident foreign citizens can enjoy the following employer-provided allowances, which are specifically excluded from their taxable income:

- a. Car, travel and housing allowances; and
- b. Social security contributions and state pension.

(1) Assessments and Payments

Tax forecasts are to be filed by tax agents on a quarterly basis. Under the PIT Law, a tax agent is a person responsible for withholding and paying taxes to the budget. Tax forecasts should be filed with the tax authorities within 40 days from the end of a tax reporting period. In 2004, such forecasts must be submitted by May 11, August 9, November 9, and February 9.

(2) Taxation of Non-resident Individuals

Non-resident individuals are taxable only on income received from Ukrainian sources. Under the PIT Law, an income is considered to be derived from Ukrainian sources if it is received or earned in Ukraine.

The new PIT Law states that income paid to non-resident individuals will be taxed at double the tax rate of tax residents. Specifically, the PIT rate for non-resident individuals will be 26 percent from January 1, 2004, and 30 percent from January 1, 2007.

An exception to this rule is made for dividends, royalties, and interest payments. These types of income are taxed at the same rates as those applicable to resident individual taxpayers.

VI. Customs Duties

TAXABLE GOODS / TAX RATES

Customs duties are imposed on most goods imported into Ukraine and certain goods exported from Ukraine. Customs duties are normally levied on the customs value of taxable goods in accordance with the Unified Customs Tariff of Ukraine.

Under the current Unified Customs Tariff, goods are classified through the harmonized system of numbers, which is similar to the European Union's harmonized customs classification. Customs duties are normally levied at rates ranging from 2 to 50 percent, with most rates ranging from 5 to 20 percent.

It should be stressed that a new Customs Code was approved and became effective as of January 1, 2004. This Customs Code introduces new concepts of customs value determination, an amended procedure for determining the country of origin of goods, etc. Please note that paragraph 13 of Article 71 of the new Customs Code (re: customs clearance of goods and transportation means outside of the location of customs bodies or during non-working hours) comes into effect on January 1, 2005. Further, pursuant to the Law “On the State Budget of Ukraine for 2004,” the following provisions of the old Customs Code will only lose their force on January 1, 2005: Articles 47 (Joint Customs Control at the Customs Border of Ukraine), 85 (Declaration Terms), 86 (Acceptance of Customs Declarations), 87 (Declarants) and Chapter 2 “Customs Fees” of Part IV “Duties and Customs Fees”.

Below we provide a description of the existing customs rules, as well as the changes to customs legislation effective as of January 1, 2004.

TAXABLE RULES FOR CUSTOMS VALUE DETERMINATION

1. Past Provisions

In the past, customs duties were calculated based on the customs value of goods. Therefore, it was important to define the procedure for determining the customs value of goods. Under the old rules, the customs value meant the price actually paid for goods or the price established at the moment the goods crossed the customs border of Ukraine. The following expenses, provided that they were not included in the original payment for goods, should have also been added to the customs value of the goods to determine the duties:

- Transportation costs, loading, reloading and unloading expenses, as well as insurance up to the point of entry to the customs territory of Ukraine;
- Commission and brokerage fees;
- License and other fees for the use of intellectual property attributable to the imported goods that should have been paid by the importer or exporter either directly or indirectly as a condition of importation of these goods.

If the declared customs value was substantially misstated or if it was impossible to verify the appropriateness of the customs value declared, then the Customs Authority had the authority to determine the customs value based on the value of identical goods, or if not available, based on the value of similar goods that are usually established in the main countries — exporters of the goods in question.

2. Provisions of the New Customs Code

The new Customs Code introduces a new concept of customs value which follows the standards of GATT/WTO. In terms of the general definition, the customs value of goods shall mean the value of goods at the moment they cross the customs border of Ukraine as declared by the declarer (the importer or his agent) or as calculated by the customs authorities. In addition to the general definition, the Customs Code also provides 6 methods for the determination of customs value as follows:

Method 1: According to the value in the agreement under which the goods were imported;

Method 2: According to the value of an agreement for identical goods;

Method 3: According to the value of an agreement for similar (analogous) goods;

Method 4: On the basis of subtraction of the value;

Method 5: On the basis of addition of the value; and

Method 6: Reserve method (GATT).

For determining the value of goods exported from Ukraine, the rules similar to the old Customs Code are applied (see above “Past Provisions”).

MOST FAVORED NATIONS

Ukraine has formed special custom unions and signed most-favored-nation treaties with a number of countries. If imported goods originate from countries that have signed such an agreement with Ukraine, the customs duties are applied to these goods at preferential tax rates, which constitute only half of the normal rate. Countries that have most-favored-nation status include the following:

• Algeria	• Azerbaijan	• Canada
• Argentina	• Belarus	• Czech Republic
• Armenia	• Belgium	• China
• Australia	• Brazil	• Croatia
• Austria	• Bulgaria	• Denmark
• Egypt	• Kazakhstan	• Russian Federation
• Estonia	• Korea	• Slovakia
• Finland	• Kyrgyzstan	• Slovenia
• France	• Latvia	• South Africa
• Germany	• Libya	• Spain
• Georgia	• Lithuania	• Sweden
• Greece	• Lebanon	• Switzerland
• Guinea	• Moldova	• Tunisia
• Hungary	• Mongolia	• Turkey
• India	• Netherlands	• Turkmenistan
• Indonesia	• Norway	• Vietnam
• Iran	• Poland	• United Arab Emirates
• Ireland	• Portugal	• United Kingdom
• Israel	• Republic of Chile	• USA
• Italy	• Romania	• Uzbekistan

VII. Currency Control

GENERAL REGULATIONS

In terms of the general foreign currency regulations, binding for all Ukrainian entities, 50% of hard currency received as revenue for rendering of goods or services is subject to compulsory sale (exchange to Hryvnia) on the inter-bank currency market.

CURRENCY CONTROL REGULATIONS

The Hryvnia (UAH), the Ukrainian legal tender, has limited convertibility. Residents and nonresidents may hold hard currency and UAH accounts with authorized banks and may import and exchange currency in accordance with the procedures established by the National Bank of Ukraine (NBU).

- Currency operations on the territory of Ukraine, however, are under state currency control. A key feature of currency control is the concept of residency. For the purposes of currency regulations and control requirements, a resident of Ukraine is defined as:
- Any physical person, including foreign citizens, permanently residing in Ukraine, including those citizens temporarily staying outside of Ukraine;
- Legal entities, branches or other structural subdivisions thereof located and performing business activities on the territory of Ukraine;
- Ukrainian diplomatic, consulate, trade and other official governmental institutions abroad that enjoy diplomatic privileges and immunity;
- Branches or other structural subdivisions of Ukrainian companies and organizations abroad if such subdivisions perform representative functions and are not engaged in business.

Any other person or structural subdivision, which is not a resident of Ukraine, is treated as a non-resident for the purposes of exchange control regulations. The currency restrictions imposed on residents are more severe than those for non-residents. In particular, foreign currency control regulates the following relations:

- As a general rule, only local currency may be used in business transactions between residents;
- Foreign currency is generally regarded as the means of payment between residents and non-residents involved in international transactions in connection with trade and investment activities through authorized banks;
- 50% of foreign currency proceeds received by a resident company are subject to mandatory conversion into the local currency (this provision, however, does not apply to loans and financing in the form of direct investments);
- Additionally, foreign currency proceeds received by a company from its foreign customers must be credited to a local bank account no later than 90 days after the day of export of the services/goods. Failure to comply with this provision renders the Ukrainian company liable to a penalty of 0.3 percent of non-received proceeds per day;
- Moreover, goods must be imported into Ukraine within a period of 90 days after prepayments have been made by a Ukrainian company to its suppliers. Failure to comply with this provision renders the Ukrainian company liable to a penalty of 0.3 percent of non-received proceeds per day.

There are other transactions with local and foreign currency that are subject to licenses from the National Bank of Ukraine (e.g. settlements in foreign currency on the territory of Ukraine). Ukrainian residents are also required to obtain an individual license for making investments abroad, opening an account with a foreign bank and issuing or taking out foreign currency loans. If one party to a currency transaction has obtained the required license, the other party is also treated as having acquired this license.

An NBU license is issued for a certain period of time and with a limited amount of foreign currency specified. The procedure for obtaining an individual license is quite troublesome and requires a specific set of documents to be submitted to the NBU for approval. Normally, a license can be obtained within 4-6 weeks from the date of filing the required set of documents with the NBU unless the latter finds sufficient grounds to reject the application.

The NBU establishes the exchange rates of UAH to other currencies on a daily basis. Authorized banks when trading in currencies may establish different rates to those established by the NBU; however the rates used by the banks do not usually differ dramatically from those established by the NBU.

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2. UNIFIED TAX

I. Introduction

Ukrainian tax legislation has never been known for its consistency. In fact, most foreign investors doing business in Ukraine continue to marvel at the number of taxes Ukrainian companies must pay. Unable to supervise (i.e., tax) the activities of the ever-growing number of smaller companies, the taxation authorities had to unify the dizzying array of taxes in order to collect any money at all.

Faithfully following the Russian tax model, which has recently undergone liberal reforms, Ukraine implemented its own brand of tax reforms. As a result, like their Russian colleagues, today many Ukrainian small-size entrepreneurs have switched to the unified tax system, allowing them to pay a single, lower tax rather than the multitude of taxes prescribed by the general taxation system. This new approach is documented in the Presidential Edict No. 727 "On Simplified Taxation, Accounting and Reports of Small-Scale Entrepreneurs," dated July 3, 1998, as amended on June 28, 1999 (the "Edict").

And unified tax system means just that: one flat tax rate instead of VAT; profit tax; personal income tax (only for individual entrepreneurs); land tax; the fee for the specific use of natural resources; the innovation fund fee; the social insurance fee; fees for the construction, re-construction and repair of public roads; communal taxes; trade tax; pension fund fees; contributions to the social protection fund for disabled persons; contributions to the employment fund; and special patent payments, if any.

Since its implementation, the unified tax system proved to be fairly popular with all types of small-time businesses. Of course, the same taxation rules are extended to all Ukrainian resident companies, including joint ventures and 100% foreign-owned subsidiaries, provided they will: (i) employ less than 50 employees during a calendar year; and (ii) earn annual proceeds of less than one-million (1,000,000) Ukrainian Hryvnia.

Note that foreign investors, who establish Ukrainian resident entities in the following legal and organizational forms, may also enjoy the benefits of the unified tax system:

1. **A private enterprise**, formed by a single private entrepreneur (physical person). The benefits are obvious: such enterprises are not subject to a specific minimum capitalization requirement. Therefore, a significantly minimal amount of funds is sufficient for a private entrepreneur to form the charter fund of a private enterprise. Conveniently, the founder enjoys the complete protection of corporate liability.

2. **A limited liability company**. This company form requires at least two founders: either (i) two physical persons or (ii) one legal entity (whose capital contributions cannot exceed 25%) and one or several physical persons whose aggregated capital contributions will equal 75%. The minimum capitalization requirement for such companies under Ukrainian law is currently 11,800 Hryvnia (or just over \$2,000 US Dollars).
3. **A closed joint stock company**. The formation requirements for closed joint stock companies are the same as for limited liability companies (as described above), however the minimum capital contribution is 147,500 Hryvnia (or just over \$27,000 US Dollars).

In sharp contrast, Ukrainian companies formed either by Ukrainian or foreign legal entities are prohibited from applying the unified tax system if the contributions of such legal entities exceed 25% of the total amount of the authorized capital of the created Ukrainian company. This is significant because, historically, 26% ownership gives an investor the right to exercise a somewhat degree of control over several so-called "fundamental" issues of a company.

For your convenience, below we provide you with the legislative analysis governing unified tax system.

II. Discussion

According to the Edict, only the following categories of Ukrainian entrepreneurs may file tax reports under the unified tax system:

- (i) individuals, who carry out business activities without registering a legal entity and who employ no more than ten persons during one calendar year (including family members). In this case, the individual's annual proceeds from the sale of products (goods, work or services) may not exceed five hundred thousand (500,000) Ukrainian Hryvnia; and
- (ii) legal entities, regardless of their organization forms, which employ no more than fifty persons during one calendar year, including part-time employees and employees of affiliated representative offices and branches. In this case, the annual proceeds from the sale of the entity's products (goods, work or services) may not exceed one million (1,000,000) Ukrainian Hryvnia.

The Edict quite reasonably requires companies under the unified tax system to make and/or receive payments pursuant to any of its transactions only through cash registers (if payments are made in cash) or via its accounts with an authorized Ukrainian bank. In other words, such com-

panies cannot engage in barter transactions because such transactions involve an exchange of goods rather than traceable cash or wire transfers.

The local state authorities set the unified tax rates for physical persons, which can vary between twenty (20) and two-hundred (200) Ukrainian Hryvnia per month, depending on the type of business activity. If a physical person carries out several activities which are taxable at different rates, then this individual will still pay the unified tax. However, the amount of the individual's tax cannot be higher than the highest rate of the unified tax (the monthly amount of the unified tax cannot exceed 200 Ukrainian Hryvnia). Significantly, if a physical person (private entrepreneur) hires employees, the unified tax rate will be increased by 50% for each employee.

In contrast, legal entities have the choice of one of the following unified tax rates:

- (a) 6% of the amount of proceeds from the sale of products (goods and services), excluding excise duty, if they pay VAT pursuant to the Law of Ukraine "On Value Added Tax;" or
- (b) 10% of the amount of proceeds from the sale of products (goods and services), excluding excise duty, if VAT is included into the unified tax.

Note that any entrepreneur who fails to comply with the requirements regarding the limited number of hired employees, the established volume of annual proceeds, and/or the payment procedure may be required to file tax returns under the general taxation system for the following reporting quarter.

Both physical persons and legal entities must make monthly payments on or before the 20th day of the following month to the designated account of the Ukrainian State Treasury Department. Entrepreneurs are liable for the accurate calculation and timely payment of the unified tax in accordance with Ukrainian law.

The procedure for issuing certificates, which establish the right to pay the unified tax, are established by the State Tax Administration of Ukraine. In order to receive such a certificate, a company must file a written application with the local tax authorities at the business entity's place of state registration no later than fifteen days prior to the beginning of the subsequent reporting period (tax quarter). Such certificates are routinely issued, provided that all obligatory taxes and duties for the previous reporting term have been paid in full.

Based on extensive experience with certain types of activities, Ukrainian legislation strictly prohibits specific types of business entities from reaping the benefits of the simplified taxation system, including trust companies, insurance companies, banks, financial institutions, individuals trading in alcoholic drinks, tobacco, oil and lubricant products, etc. Similarly, legal entities are not considered to be true small-scale entrepreneurs, and therefore any legal entity that owns more than 25% in the authorized capital of another Ukrainian business entity is not permitted to reap the benefits of the unified tax system.

III. Conclusion

The unified tax system has proven to be very popular. Even the hardened tax evaders admit that in its current form, this law is acceptable to businessmen and therefore beneficial for the Ukrainian government. However, with the passing of a new flat tax rate for citizens and a lower corporate tax rate in 2004, there has been a lot of talk about canceling the simplified tax procedure. Although there have been mere threats up to the present, a lot of small companies and entrepreneurs have publicly expressed their objections to the cancellation of the Edict. As it is, the unified tax system is still very popular and continues to live on...

3. QUESTIONING UKRAINIAN TAX AUTHORITIES

I. Introduction

Increasingly, Ukraine has found itself looking towards Poland for foreign (or Western) investment, and towards Russia for Russian capital. Investment bankers and venture capitalists refer to such moves as the creation of a “converging Europe.” As the edges of the European Union expand, the investment spillover into new the EU borderstates expands as well. While Ukrainian tax and investment law must come a long way before they will be in close enough compliance with Western standards to allow accession into the European Union, already we see the first steps in this direction.

In mid-February 2001, President Kuchma signed the Law of Ukraine No. 2181-III “On the Procedure for Discharging Taxpayers’ Obligations before the Budget and State Target Funds,” dated December 21, 2000 and lastly amended on November 27, 2003 (the “Law”). While not a laughing matter, the majority of this new legislation took effect on April 1, 2001, at which point it began to regulate basic relations between taxpayers and government tax agencies (including the Pension Fund of Ukraine and the social security funds). The Law also introduced changes to a dozen other laws, including the laws on profit taxation of businesses and value added tax, the Law “On the State Taxation Service,” the Arbitration Procedure Code, etc. The Law is significant because it offers fundamentally new definitions of such key terms as “taxpayer,” “tax debt,” “penalty,” “tax declaration,” etc. Altogether, more than 17 new definitions have been added to the Ukrainian tax legislation as a result of this Law.

II. New Provisions

Importantly, the Law replaces the previous notion of uncontested recovery of tax debts, as determined by the tax authorities. In other words, it suspends further action by the tax administration for the duration of the appeals process and gives Ukrainian residents and resident companies a legal methodology with which they may dispute their tax liability, including liabilities before the Pension Fund and the social security funds. At long last, gone are the days when the tax administration could simply debit your account.

Because the Law introduces a new procedure, which allows a taxpayer to appeal the tax administration’s determination of tax liability, it weakens the tax administration’s stranglehold on the Ukrainian population, and brings Ukrainian tax policy into closer conformity with Western concepts and

practice. Ultimately, policy shifts such as this may lead to greater faith in the Ukrainian tax collection system, and to a reduced rate of tax evasion.

To say that a taxpayer’s assets can be forcefully recovered only as a result of a court decision, however, would be a bit of an exaggeration because such court proceedings must be undertaken at the taxpayer’s initiative. Still, the very possibility of initiating court action enables taxpayers to apply pressure against the tax administration.

III. Adjustment of Liabilities

Adjustment of a taxpayer’s tax liability comprises a key component of the Law, and serves as a starting point in the process of discharging tax liabilities. If a taxpayer calculates everything correctly, and in a timely fashion, then his or her tax liability is considered to be adjusted and such a taxpayer is responsible for his or her calculations. Should the tax administration find any irregularities with these calculations, or should they simply believe that irregularities exist, the adjustment process will then begin. What course this process takes thereafter depends largely on the taxpayer’s approach to the adjustment process.

During the first stage of the adjustment process, the tax administration will determine its own calculation of the taxpayer’s tax liabilities, and will seek recovery of same. Should the taxpayer disagree with this calculation, he/she must initiate the procedure of appellate adjustment: the taxpayer files complaints with the tax administration and they must respond within tight deadlines. It is important to remember that during the appellate adjustment procedure, the tax administration must comply with the newly-introduced “conflict of interests” rule, which states that in the event of legal ambiguities, the tax administration must decide in favor of the taxpayer.

Please note that if a taxpayer fails to file his/her complaints within the established deadlines, then the appellate adjustment procedure ceases and the taxpayer’s tax liabilities are deemed adjusted, i.e., payment is considered due and pending. By the same token, if the tax agency fails to comply with the deadlines, or to notify the taxpayer of the review extension, then the taxpayer’s complaint is deemed satisfied. The tax debt will not be forgiven, but the taxpayer may win some time.

The following tax liabilities can be adjusted:

- 1) tax liabilities, as determined by the taxpayer in his/her tax return, provided the tax return reflecting such adjustments is accepted by the tax agency as filed;

2) if a dispute arises regarding the taxpayer's tax return, then the tax liabilities, as calculated by the tax agency, will be considered adjusted in the following circumstances:

- (a) if the taxpayer failed to file his or her complaint in a timely fashion;
- (b) if the tax agency satisfied the complaint in full; or
- (c) if the parties reached a tax compromise; and

3) tax liabilities which have been formally postponed or deferred.

As long as the appellate adjustment procedure is still pending, the tax administration may not enforce its decision to recover tax debts. As soon as the appellate adjustment procedure is over and the taxpayer has decided to move the dispute from the administrative stage to the judicial stage, then the tax administration will commence the recovery procedure. If this happens, the taxpayer must be sure to seek suspension of the tax administration's resolution regarding said recovery by notifying the tax administration of his or her appeal to a court of law regarding the tax administration's conclusion as to a tax debt amount.

IV. Tax Notices and Tax Claims

When tax liabilities are calculated by a tax agency, this agency serves a tax notice upon a debtor. Such notice contains basic information such as the basis for calculating the tax liabilities, the amount due, the amount of fines, the deadline for discharge, the possible consequences of failure to respond, and the deadlines for contesting the calculated amounts (including fines), if applicable.

Should the taxpayer disregard such notice and/or fail to discharge the adjusted liability within the set deadlines, then the tax agency will serve the taxpayer the first tax claim containing the amount due plus fines, as well as the first "warning" (i.e., a notification that the taxpayer's assets have become subject to tax pledge). If the taxpayer fails to respond properly within one month, he or she will receive a second tax claim, which, in addition to the information laid out in the first claim, may contain information on the date and time set for taking inventory of the taxpayer's assets, as well as the date and time set for public auction of said assets.

It would be wise for a taxpayer to determine which of his/her assets may not be earmarked as a source for discharging a tax debt. One may even take steps to make such assets unattainable. Those assets which may not be used as a source for discharging tax debts include: (i) the taxpayer's

assets pledged to other persons; (ii) assets owned by other persons and granted for temporary use to the taxpayer; (iii) property rights of other persons and granted for temporary use to the taxpayer; (iv) cash deposited by other persons with the taxpayer; (v) loans granted to the taxpayer, etc.

V. Tax Pledge

A separate Article of the Law is dedicated to tax pledge. Under such a pledge, a taxpayer's assets become subject to tax pledge if: (i) a taxpayer fails to file or untimely files his or her tax return; (ii) a taxpayer fails to discharge those tax liabilities which he/she calculated; and (iii) a taxpayer fails to discharge those tax liabilities which were calculated by the tax agency and laid out in the tax notice.

Items subject to tax pledge may not be bought, sold or formally loaned to other parties. Nor may they be used to satisfy other debts, as tax pledges have preferred status over other pending settlements. This notwithstanding, a taxpayer may use some of those assets which are subject to tax pledge without the consent of the responsible tax agency. Such assets include finished products, stocks of goods and other current assets. A taxpayer can use other assets subject to tax pledge upon consent of the tax agency. If the taxpayer fails to comply with this requirement, his/her assets may be subject to administrative arrest and the taxpayer may face additional fines, or even formal charges of tax evasion.

VI. Disposal of Assets

The tax agency will wait thirty days from the date of its second tax claim before taking action against a taxpayer who has failed to contest said claims. Not surprisingly, the tax agency will first attempt to seize the taxpayer's cash. If there is not enough cash to satisfy the tax debt, the tax agency will then start selling the taxpayer's assets. The Law stipulates that it is the taxpayer's responsibility to select and earmark the assets subject to disposal and the price thereof. Should the tax agency decide that the price of the assets subject to disposal fails to cover the amount of the tax debt, the tax agency itself will choose the assets which are subject to sale and determine the price at which those assets will be put up for sale. Unless otherwise stipulated, the tax agency will continue selling a taxpayer's assets until his or her tax debt has been completely extinguished. Assets subject to disposal will be traded or sold at auctions on an appointed commodity exchange. Again, taxpayers may contest the selection and the pricing of assets subject to auction, but this action must be taken in accordance with the terms and the deadlines, as defined in the Law.

VII. Compromises, Postponed and Deferred Liabilities

The Law offers a taxpayer three avenues to negotiate/reschedule his or her tax debts with the relevant tax agency. The first is a so-called tax compromise, meaning that, within the administrative appellate procedure, the tax agency may offer the taxpayer a compromise or discount. Under this scenario, a portion of the taxpayer's complaint will be applied toward the repayment of the taxpayer's tax debt, provided that the taxpayer accepts the remaining tax liabilities as calculated by the tax agency.

On the one hand, this new rule improves the taxpayers' position and expands his or her options with respect to defining relations with the tax agency. Then again, this new rule may be used as yet another vehicle for extortion and corruption.

The same may be attributed to deferred and postponed tax liabilities. Deferred tax liabilities are defined as an interest bearing budget loan granted to the taxpayer for the principal amount of his or her tax liabilities. *The interest on such a loan is equal to the amount of the applicable penalty, which is calculated in the amount of the tax debt (including the amount of penalties) with a calculation of 120% of the annual discount rate of the National Bank of Ukraine on the day of the appearance of the tax debt or on the day of its repayment (partial repayment), depending on which rate is the larger rate, for each calendar day of delayed payment.* The principal of the loan and the interest thereon must be repaid in equal portions, commencing on the tax period immediately following the granting of the loan.

Postponed tax liabilities are defined as an interest bearing transfer of payment of the principal tax liabilities to a later date. The interest on such liabilities is calculated pursuant to the same method for calculating interest on deferred tax liabilities (see above). As noted above, the principal of such liabilities and the interest thereon must be repaid in equal portions beginning on any taxation period as determined by the tax agency. However, these amounts must be repaid within 12 calendar months from the date of the appearance of the original tax liabilities.

Of course, the Law requires that the taxpayer seeking deferred or postponed status, substantiate his or her ability to repay the tax debt at a future date. As always in Ukraine, the taxpayer's ability to secure postponement or deferment of tax liabilities will depend, in large part, on his or her ability to creatively negotiate with the responsible tax administration.

VIII Administrative Arrest

If all else fails, a taxpayer's accounts and assets may be arrested. An administrative arrest is defined as a prohibition for a taxpayer to take any action

with respect to his or her assets, except for the protection and maintenance thereof. According to the Law, administrative arrest is an exceptional method of securing the repayment of a taxpayer's debt.

An administrative arrest may be either complete or conditional. A complete arrest is an unconditional prohibition for a taxpayer to use or dispose of his or her assets in any manner, with an option for seizure of such assets. A conditional arrest is a restriction for a taxpayer to exercise his/her ownership rights with respect to such arrested assets, although such rights may be exercised upon consent from the tax agency.

IX. Write-Offs

Finally, the Law prescribes that all tax debts, which were accumulated prior to December 31, 1999, must be written off. The tax debts accumulated during the year of 2000 may be restructured (deferred). This provision may help those taxpayers, who have accumulated debts to the state budget, avoid subjecting their assets to tax pledge and further disposal. The rule regulating the write-offs has become effective as of the date of publication.

The estimated amounts of the tax debts which are subject to write-off vary from 9 to 14 billion Ukrainian Hryvnias (US\$1.6 billion — US\$2.6 billion), depending on the source. It should therefore come as no surprise that the President of Ukraine has sent the Parliament numerous bills with amendments to the Law. In particular, these bills propose cancellation of write-offs for excise tax, personal income tax and payments to the pension and social security funds. The bills also propose decreasing the period for restructuring corporate tax debts.

X. Conclusion

It is still difficult to observe and gauge how the Law works in practice as many taxpayers prefer to negotiate individually with the tax authorities before taking legal matters into their hands. On the one hand, the Law offers a wider range of options which (if they continue to be implemented judiciously) could serve to protect taxpayers. On the other hand, the Law is rather complicated, which may make it difficult for a regular taxpayer to both comprehend and work within its myriad of rules. Therefore, the Law is subject to constant amendment as, for instance, the VAT law is.

Still, the Law must be seen as a step in the right direction for the following reasons:

- 1) it allows taxpayers to question the calculation of their tax liability;
- 2) it permits taxpayers to renegotiate their tax liability with tax authorities;

- 3) it prevents the tax authorities from seizing taxpayer assets without due process;
- 4) it gives taxpayers some ability to control which assets will be subject to auction, as well as the valuation of said assets; and
- 5) it gives taxpayers some latitude to restructure their debts with the tax administration.

Admittedly, the Law is both imprecise and subjective in nature. As a result, it may be abused by greedy or unscrupulous tax officials. Still, the Law removes the unilateral nature of the past relationship between taxpayers and tax administrations. The Law also permits the introduction of due process if a mutually acceptable arrangement cannot be reached. Finally, the Law provides taxpayers with more protection for their assets, and gives them a greater voice as to how and when their final tax bill will be settled. Therefore, while the Law remains somewhat imperfect, it must be viewed as a noteworthy step towards a more democratic and transparent method for settling tax disputes — one which brings Ukrainian tax legislation into closer compliance with Western concepts, standards and practice.

D CURRENCY REGULATIONS

1. CURRENCY REGULATIONS: FROM COUPON TO HRYVNIA'S CONVERTIBILITY

I. Introduction

As a legal matter, Ukraine left the Soviet ruble zone on July, 2 1992, by introducing a temporary currency, known as the “karbovanets” (more affectionately known for what it had subsequently become, the “coupon”).

In its relatively brief tenure, the coupon suffered a variety of economic perversions at the hands of then-President Kravchuk, starting with the August 12, 1993 telegram, which was the Kravchuk administration's first of many major detours from the road of currency reform. This telegram created two legally recognized rates of exchange: “official” and “auction.” The “official rate” was set at 5,970 karbovantsi to 1 U.S. dollar, which soon paled in comparison with the more realistic (but still very low) Interbank Currency Exchange Auction rate of November 4, 1993, which was 31,150 karbovantsi to 1 U.S. dollar.

The “old timers” may recall that on December 23, 1993, the Kravchuk-controlled Ukrainian Interbank Currency Exchange held its first auction. This took place nearly two months after the suspension of its activities in November of 1993. This rather anticlimactic event was conducted in accordance with an equally exciting instruction entitled the “Temporary Procedure for Conducting [by the Center] of Clearing Accounts at Ukrainian Interbank Foreign Currency Exchange Currency Sales and Purchase Operations on a Tender Basis.”

This otherwise simple instruction drastically changed the role of the Interbank Currency Exchange: the Exchange no longer conducted an “auction” but merely effectuated an administrative function of receiving karbovantsi and transferring foreign currency to purchasers of currency. This was a complete reversion to the Soviet-like monopoly currency “auction” system employed by the National Bank. Many legitimate businesses were turned away from the “auctions” and had to obtain foreign currency by alternative methods, most of which flatly contradicted the then existing legislation.

With time, everyone established “alternative” means of transacting business commonly known as the “shadow economy.” As a result, the official Ukrainian economy suffered the biggest financial losses while the

shadow economy profited proportionately. The benefits, gained by implementing dual exchange rates, befell a comparatively small group of companies and/or individuals, as most of the average Ukrainian entrepreneurs typically transacted business at the most favorable exchange rate offered on the black market.

The abuses of the “shadow market economy,” enhanced by the differences between the official and black market exchange rates, continued unimpeded until President Kuchma’s unexpected arrival as the undisputed leader of Ukraine in the summer of 1994. Largely unnoticed by outsiders, Ukraine’s fiscal reforms quietly began on September 22, 1994, with President Kuchma’s execution of the Decree “On Perfecting Currency Regulations.” This decree reversed many of former President Kravchuk’s previous decisions that directly contributed to (if not actually caused) an increase in the already healthy shadow economy in Ukraine.

In particular, Kuchma’s Decree de-centralized the function of the Ukrainian Interbank Currency Exchange, once again restoring its previous autonomy in setting the market rate. This decision squarely reversed Kravchuk’s November 2, 1993, Order No. 502/93 “On Additional Measures to Manage Currency Regulations,” which suspended the Ukrainian Interbank Currency Exchange system as well as other operations involving the sale and purchase of foreign currency at auctions. This decree also called for a unification of the dual rates of exchange, finally canceling the infamous August 12, 1993 decision by the National Bank to set a fixed rate of 5,970 karbovantsi to 1 U.S. dollar.

Below we analyze the development of currency regulations, under both the Kravchuk and Kuchma tenures and analyze the legislative reforms which have resulted in the Hryvnia becoming an almost convertible currency.

II. Currency Reforms

A. IMF-Subsidized Rate Unification

On October 24, 1994, the National Bank issued Instruction No. 174, which required that a unified rate of exchange for the karbovantsi be determined as a result of trading at the Ukrainian Interbank Currency Exchange. On the same day, Ukraine received the first half of a rather large loan from the International Monetary Fund to provide sufficient foreign currency to absorb the excessive karbovantsi mass. A part of the loan was funneled into the currency exchange in order to stabilize the karbovantsi exchange rate.

In addition to creating a more stable fiscal environment, the rate unification was moderately successful in legitimizing at least some of the formidable shadow economy. Thus, the first step, required for stabilization of Ukrainian currency had taken place.

B. Ban on the Use of Foreign Currency

To give some credibility and value to the Ukrainian karbovantsi, and in order to maximize the success of the 1995 introduction of the Hryvnia in November of 1994, the National Bank issued a telegram with President Kuchma’s support, banning foreign convertible currency from official circulation as of February 18, 1995. However, this first effort to implement a ban on foreign currency (commonly perceived as an interim move to pave the way for introduction of the Hryvnia) failed miserably.

Retreating from its die-hard position, the National Bank imposed a partial ban on foreign currency operations on May 16, 1995, by requiring then-valid “foreign currency” license holders to re-register under the more rigorous standards: foreign currency licenses were granted only to companies with a monthly turnover at least \$70,000. Justifiably expecting rejection, about 75% of the licensees wisely did not bother to apply for re-registration notwithstanding the National Bank’s generous extension of time for accepting application from May 16 to June 20, 1995.

The gradual elimination of foreign currency from circulation seemed to work: from May 30, 1995, until August 8, 1995, of the 1,900 firms which previously had licenses, only 353 firms applied for license confirmation, and only about 260 license-holders had the right to accept foreign currency. As of June 1, 1995, the remaining 1,650 firms (whose licenses were not re-registered) could trade only in Ukrainian currency. In addition to implementing a partial ban on foreign currency, this was an effective measure in screening out those companies operating in the cash-based “shadow economy.”

On July 26, 1995, President Kuchma repeated that the long-awaited Hryvnia would be put into circulation no later than October of that year. He also warned that strict monetary and budget policies would be put into place to assure the stability of the new currency. The National Bank followed up with its official Telegram No. 260, dated June 8, 1995, which was aimed at completely squeezing out foreign currency. In this document, the National Bank formally announced a complete ban on foreign currency as of August 1, 1995.

To enforce the ban on foreign currency, the National Bank established a so-called “coordination council.” This council decided to create workgroups at the regional branches of the National Bank to monitor compliance. These workgroups were staffed by the representatives of the National Bank as well as tax, police and SBU (State Security Service) officials, and were authorized to audit local businesses and initiate criminal and administrative penalties and fines.

As a result of these steps, the total foreign currency ban, originally scheduled for February 18, 1995, actually took place on August 1, 1995, having undergone a major “screening” in May. The elimination of foreign currency led to an increased reliance upon (and circulation of) the karbovantsi, which indeed proved to be a key stabilizing measure for realizing financial reforms and in particular, the implementation of Hryvnia.

C. Hryvnia Replaces Karbovantsi

On August 15, 1996, the Ukrainian press reported that the National Bank had again threatened to conduct monetary reforms. Most Ukrainians, vacationing in their summer “dachas” during August, dismissed this as yet another rumor. To everyone’s great surprise, however, the monetary reforms actually took place.

Unbeknownst to many, the International Monetary Fund delegation was visiting Kiev in mid-August to discuss the creation of a stabilization fund for Hryvnia, and gave Ukraine the necessary green light to proceed with the monetary reforms. Predictably, some of the Parliament’s finest deputies tried to attach various confiscatory methods of exchange (e.g., limitations on amount and number of exchanges, applying regressive exchange rates, etc.).

Fortunately, the deputies relented, and shortly thereafter Presidential Order No. 762/96 “On Monetary Reform in Ukraine,” dated August 1996, proudly announced that the Hryvnia would be the official Ukrainian national currency. According to the Order, Hryvnia would be available for exchange as of September 2, 1996; further, the exchange rate would be 100,000 karbovantsi for 1 Hryvnia. The Order required that karbovantsi must be removed from circulation by September 16, 1996.

The Cabinet’s supporting regulations assured that the currency exchange would proceed smoothly, such as the Cabinet of Minister’s Resolution No. 1002, dated August 26, 1996, “On Revaluation of Commodities and Services and Control Over Reconsidering Prices and Cost Indices During the Monetary Reform.” Among other matters, Resolution No. 1002 required the conversion of cost indices to Hryvnia. This Resolution also froze prices for one month following the introduction of Hryvnia, thereby preventing possible consumer panic and inflation, which could have resulted from the likely price increases. Another Cabinet decision required that all companies accept both karbovantsi and Hryvnia as payment and give change only in Hryvnia as of September 10, 1996.

Predictably, on the first day of the exchange, many shops did not have enough Hryvnia notes to give people the necessary change and many

commercial kiosks and shops were simply closed. In the next few days, the necessary steps were taken with reference to re-pricing and supplying enough Hryvnia notes to the stores, banks and exchange points. As a result, on September 11, the Cabinet cancelled the price limits imposed two weeks earlier because, according to Deputy Economy Minister Victor Kalnyk at the time, the “price situation is under control and preventive measures are no longer needed.”

Time extensions were granted following the Hryvnia’s introduction, and the exchange process finally ended on February 1, 1997, lasting about 5 months. In total, the government received about 305 trillion karbovantsi (more than 97% of the issued cash) in exchange for 3,243 million Hryvnia. In doing so, the Kuchma government partially legalized money in the “shadow economy” and simplified the payment structure system. Most importantly, however, Ukraine finally had its own, somewhat stable national currency.

D. Hryvnia’s Convertibility?

Building further on the Hryvnia’s success, on December 18, 1998, the National Bank adopted the Instruction “On Opening Bank Accounts in National and Foreign Currency,” confirmed by the National Bank’s Resolution No. 527. This Instruction has been subsequently abolished by the passing of Resolution No. 492 of the National Bank of Ukraine “On the Approval of the Instruction on the Procedure for Opening, Using and Closing Accounts in National and Foreign Currencies,” dated November 12, 2003. Further, on July 12, 2000, the National Bank established the new procedure for the transfer of Ukrainian and foreign currencies, bank metals, payment documents, other banking documents and payment cards through the customs border of Ukraine (approved by NBU Resolution No. 283, dated July 12, 2000).

Many of the new rules significantly liberalized the further convertibility of the Hryvnia. In the past, free unlicensed currency conversion was allowed only for payments involving business activities, such as import-export operations. The rules for the wire transfer of foreign currency outside of Ukraine, approved by NBU Resolution No. 245, dated September 23, 1996 (as amended on April 10, 1997), permit both residents and non-residents to effectuate payment from Ukraine in foreign currency for personal reasons, such as assisting relatives living outside of Ukraine, payment for education, insurance or medical services abroad, alimony payments, etc. This requirement complied with Article 8 of the IMF Charter, which provides for the free unlicensed convertibility of national currencies. Resolution No. 245 has since been replaced by the National Bank’s Resolution No. 18 “On Approval of the Rules for Executing Orders of Foreign

Currency Pursuant to the Instructions of Physical Entities and the Receipt by Physical Entities in Ukraine of Foreign Currency Ordered Thereby from Abroad and On Introduction of Amendments to the Normative-Legal Acts of the National Bank of Ukraine,” dated January 17, 2001 (as lastly amended on November 12, 2003).

Against this background, below we briefly review Ukrainian currency regulations.

III. Currency Regulations

On February 19, 1993, the Cabinet of Ministers desperately sought to stabilize the plunging exchange rate between Ukrainian karbovantsi and foreign currency by ratifying the following three decrees: (1) “On the System of Currency Control and Currency Regulation;” (2) “On the Temporary Procedure for Using Foreign Currency Deposits;” and (3) “On the Procedure for Executing Payments in Foreign Currency.”

The above Decrees came into effect as of March 9, 1993, and in that time suffered dramatic changes, even in comparison with other legislation, or were simply cancelled. In fact, only Decree No. 15-93 of the Cabinet of Ministers of Ukraine “On the System of Currency Control and Currency Regulation” is still in effect (as lastly amended on January 16, 2003). The other Decree of February 19, 1993 “On the Procedure for Executing Payments in Foreign Currency” was replaced by a Law of the same name on September 23, 1994 (as lastly amended on May 15, 2003). The Decree “On the Temporary Procedure for Using Foreign Currency Deposits” was simply cancelled on June 3, 1997. Initially, most entrepreneurs ignored this legislation, encouraged by the absence of enforcement (notwithstanding the forced exchange mechanism applicable to all currency transactions resulting from business activities).

The currency regulations categorize companies and individuals as “residents,” which are defined as entities residing in Ukraine for 183 days per year or more, and “non-residents,” which are entities residing less than 183 days per year in Ukraine or representative offices. Significant restrictions upon currency operations exist in each category, and each restriction carries its own exceptions.

For instance, as a general rule, non-residents can transact business with Ukrainian residents only in foreign convertible currency. Subsequently, one amendment (Presidential Decree No.139/95-BP, dated April 11, 1995) created an exception, stating that non-resident employers must pay a Ukrainian resident employee in Ukrainian currency only. In order to effectuate such payment in local currency, however, a non-resident must open a bank account in local currency at a local bank.

Further, all residents must effectuate transactions in Ukraine only in local currency. In the past, residents had to procure a special “currency license” to receive foreign currency in Ukraine. Such licenses allowed trading in foreign currency, as well as additional privileges that flowed therefrom (e.g., exemption from 20% value added tax). All currency licenses (and exemptions) have been cancelled as of August 1, 1995, and foreign currency transactions are only allowed at national border crossings, in hotels catering to foreign tourists, etc., or under foreign economic agreements between Ukrainian residents and non-residents. In all cases, we extremely encourage foreign investors to verify whether their Ukrainian counterparts may execute foreign economic agreements, whether they have the proper licenses if required and whether the form of the agreement complies with Ukrainian legislation.

Procedurally, all residents must carry out foreign currency transactions through a Ukrainian bank that is licensed to perform currency operations. Residents may purchase foreign currency from such banks for a specific business purpose, which must be declared at the time of the purchase. This includes procurement of foreign currency for payment under an import contract.

Until recently, a company could only have its bank accounts in one bank of their choice (one in Hryvnia and one in foreign currency). This changed on August 1, 1997, when the IMF insisted that the National Bank allow companies the opportunity to open several accounts at commercial banks (as one of the conditions for an extended financing loan worth \$2.7-2.9 billion). As briefly mentioned above, accounts in Ukrainian banks are opened in accordance with the Instruction on the Procedure for Opening, Using and Closing Accounts in National and Foreign Currencies, approved by Resolution No. 492 of the National Bank of Ukraine, dated November 12, 2003.

Significantly, Ukrainian residents are prohibited from opening and maintaining off-shore bank accounts, unless they have permission from the National Bank of Ukraine. Similarly, they cannot effectuate any investments abroad without first obtaining a corresponding license from the National Bank. In practice, however, many Ukrainian residents violate both rules without feeling the wrath of the law. The currency regulations provide other fairly stringent requirements, many of which are still ignored because they are unrealistic in their enforcement.

For instance, all residents must declare their ownership of currency and property located outside Ukraine, must declare their worldwide income and must submit monthly reports regarding their foreign currency operations to the oblast branch office of the National Bank, as well as to the

local tax inspections. Failure to disclose such ownership is subject to a fine set by the Ukrainian National Bank. In practice, however, very few, if any, Ukrainian residents voluntarily disclose the existence of his or her off-shore investments and bank accounts and, to the best of our knowledge the application of any penalties or fines in this regard is extremely rare.

Another similar example: failure to use a licensed Ukrainian bank for transacting currency operations is punishable by a fine equal to the total amount of the currency used in such operations. Other penalties exist. Recently, the Ukrainian government exhibited a tendency to enforce the more blatant violations, generally involving political opposition that illegally engaged in large import-export deals involving oil and gas. However, semi-legal transactions by many companies are quite seldom detected and punished.

IV. Conclusion

Although the Ukrainian currency regulations have gone through only very small changes in the last five years, the Ukrainian tax authorities and border control are constantly on the look out for violations of currency regulations. With Ukraine's reputation as a country conducive to money-laundering, it must be careful to comply with international standards and the Financial Action Task Force (FATF), which has hit Ukraine with sanctions in the past for its failure to bring the Law No. 249-IV "On the Prevention of and Countermeasures to the Legalization of Incomes Held Illegally (Money Laundering)," dated November 28, 2002, into compliance with the FATF's standards. In spite of these sanctions and due to the sometimes harsh application of taxation in Ukraine, it is highly doubtful that Ukrainian residents will begin to disclose their offshore activities and accounts even if the Ukrainian government promises amnesty in order to attract Ukrainian capital back into the country. The trust in the Ukrainian tax authorities and banks is just not there yet...

2. FOREIGN CURRENCY CHECKING OPERATIONS

I. Introduction

Occasionally, foreign businessmen in Ukraine have inquired "do you accept checks?" They may as well have asked "where is the nearest moon?"

With the passing of the Resolution of the National Bank of Ukraine No. 520 "On Approval of the Regulations on the Procedure for Carrying Out Checking Operations in Foreign Currency on the Territory of Ukraine," dated December 29, 2000 and registered with the Ministry of Justice on February 21, 2001 under No. 152/5343 (hereinafter the "Regulations"), however, foreign businesses and entrepreneurs are now legally able to use checks (instead of cash or wire transfers) to pay Ukrainian businesses for their goods and/or services. And yet, the question remains: how will Ukrainians react to the appearance of negotiable instruments?

Although the practical effects of the Regulations remain relatively unknown, below we provide a discussion on the legal aspects of the Regulations as they pertain to payable checks. The discussion below does not touch upon travelers checks, however, although the Regulations also govern the use of travelers checks on the territory of Ukraine.

II. Discussion

First and foremost, the Regulations do not establish the actual mechanism for Ukrainian residents to pay with checks for goods or services amongst themselves. In fact, as in transactions involving foreign currency between residents, the Regulations strictly point out that such operations are expressly prohibited. This is not to say that in practice Ukrainian residents are completely precluded from using checking operations. After all, many Ukrainian residents own offshore, non-resident companies that may use checks to pay for goods or services provided by Ukrainian residents.

Barring transactions between residents, the Regulations set forth the circumstances under which settlements between residents and non-residents may be effectuated by issuing a check in foreign currency, including:

- (i) if a foreign economic agreement indicates that settlement will be made by writing out a check from a non-resident to a Ukrainian resident;
- (ii) if a non-resident writes out a check to a Ukrainian resident to pay for goods or as collateral or a guarantee to fulfill obligations before a resident (in this case the purpose of payment must be indicated

directly on the face of the check or in documents accompanying a check); or

- (iii) the non-resident check drawer is a bank, government, international organization, corporation or insurance company.

In the last case, the drawer must have an international, long-term rating, which is confirmed by a world leading rating agent (as an example, the Regulations mention Fitch, Standard & Poor's, Moody's and Thomson Bank Watch). The above provisions do not apply to checks written out by a non-resident to a resident, which is a representative in intellectual property affairs (patent attorney). In this case, a check will be accepted by a bank only upon the presentation by the resident of a certificate evidencing his or her right to represent the non-resident in the realm of intellectual property rights (i.e., as a patent attorney).

As in most countries, checks must contain certain information, including an order to pay a certain sum to the holder (payee), the drawer's (payor) and drawee's (i.e., foreign bank or foreign company who is ordered to pay by the drawer) full information, the name of the payee, the currency and amount of the check, the date and number of the check, the place of issuance, the signature of the drawer, etc. If any of the above requisites are absent, a Ukrainian bank will refuse to accept a check for payment. Interestingly, checks made out for cash (i.e., payable to a bearer) are not acceptable in Ukraine, rendering all checks traceable and payments thereon accountable.

If a term of validity is not indicated on a check, its validity term is deemed 6 months, unless the legislation of the drawer's country provides otherwise. If a foreign investor pays a Ukrainian resident by check, however, such resident must ensure that the amount of the check is credited to its account no later than 90 calendar days from the date of customs clearance of exported goods or from the moment of signing the transfer certificate or any other document confirming the provision of services. In such cases, therefore, a six-month or more term of validity is rendered useless by the provisions of the Law of Ukraine No. 185/94-VR "On the Procedure for Effectuating Payments in Foreign Currency," dated September 23, 1994.

Checks may be handwritten or printed out. Facsimile checks, however, are prohibited for purposes of placing a signature thereon. As a narrow exception, facsimile checks are accepted for signature in cases where foreign governments transfer pensions to Ukrainian residents. Further, any indication of an interest rate on a check is invalid and such an instrument will not be accepted by the paying bank. If there are any discrep-

ancies between the amount written in numerals and in words on a check, the check will still be considered valid, but the amount written in words will prevail.

Checks are paid out upon presentation to a bank from the funds of the check's drawer via the check collection system. Checks may be presented for collection to a Ukrainian bank in accordance with the Regulations or to a foreign bank in accordance with the legislation of the country where payment is effectuated. During the term of validity of a check, the drawer is prohibited from revoking such check before it is presented for payment thereon. If the name of a specific Ukrainian bank is indicated on a check, the check holder or payee must present such a check to the indicated bank only. If a specific Ukrainian bank or institution is not indicated, however, the payee may present the check to any bank.

Ukrainian banks will transfer funds and issue cash pursuant to a check only after they receive compensation for the check from the relevant drawee. According to the Regulations, a drawee may be a foreign bank or foreign company, which effectuates payments according to checks payable on demand through the check collection system. As in the West, the transfer is made either to the account of the payee or to the bank where the check is presented for payment. Accordingly, if the payee does not have an account in the said bank or any other bank, payment on the check will be carried out no later than on the third banking day after the receipt of the corresponding funds by the paying bank.

If the drawee refuses to pay the funds on a check, such drawee must indicate so on the back-side of the check with a reference to the date of presentation and the reason(s) for refusal. A drawee is not free, however, to simply state the reason(s) for refusal as it must certify the facts of refusal before the end of the check's validity term. Any disputes which arise regarding the non-payment of a check must be resolved between the drawer and the payer according to the procedure established by the legislation of the country where the drawee is located.

This requirement could present both legal and practical problems for some Ukrainian exporters because: (i) while in theory Ukrainian courts are able to resolve disputes according to the law of a foreign country, in practice, they are almost never able to do so; and (ii) it can be financially and practically difficult for Ukrainian exporters to submit a suit abroad.

The procedural details associated with clearing checks are fairly straightforward and simple. Checks in freely convertible foreign currency are accepted for collection by Ukrainian banks from legal entities-residents and

representative offices of legal entities non-residents on the basis of an application and an accompanying letter (in 3 copies signed by the director and chief accountant with the company seal attached thereto). The bank returns one copy of the letter to the payee and sends a second copy to the drawer along with the collection instructions of the drawer and any other accompanying documents.

After the bank verifies the date of drawing of a check with its term of validity, and receives the legal entity's seal and signature of the authorized individual on the backside, an authorized bank employee executes duplicate receipts in the required form and sends a signed, sealed receipt to the payee. On the basis of the receipts retained by a bank, each bank must maintain its own register of checks accepted for collection in foreign currency. The bank stores the accepted checks until they are photocopied and organized for return to the drawee. The bank keeps the photocopies of the checks for purposes of collecting payment from the drawee in the likely event that the originals are lost during transportation.

Once the Ukrainian bank receives the relevant funds on a check, such bank will contact the payee regarding receipt of the funds and the instructions as to how to collect such funds. For private entrepreneurs receiving foreign currency from non-residents, the funds may be sent to their personal foreign currency accounts as indicated in the collection application. If the said individual does not maintain a foreign currency account, the Ukrainian bank will issue the funds in the currency indicated on the check (however, the individual will be responsible for payment of the relevant taxes on the check amount).

For legal entities-residents, the local bank sends the funds to such legal entity's distribution account, where 50% of the foreign currency funds are sold on the interbank currency market of Ukraine (pursuant to Resolution No. 349 of the National Bank of Ukraine "On Introduction of Mandatory Sale of Funds Received in Foreign Currency in Favor of Residents," dated September 4, 1998 and lastly amended on November 3, 2003) or to the account of the representative office of a legal entity-non-resident according to special rules determined by the National Bank of Ukraine. Finally, the sum of the check is paid out after payment of all commission fees.

The procedure for accepting checks in freely convertible foreign currency for collection by Ukrainian banks from resident individuals is quite similar, with additional requirements regarding the methods for determining identity, legal capacity, acceptance of checks under collateral, etc. A detailed discussion on this procedure, as well as the provisions governing travelers checks, is beyond the scope of this article.

III. Conclusion

As with any piece of Ukrainian legislation, the Regulations seems deceptively simple and not very difficult to implement, primarily because it contains the bare minimum information required for normal checking operations.

As with very few Ukrainian legislative acts, however, the practical implementation of the Regulations has proved to be almost pain-free even in consideration of the actions of those who began to use checking operations at their own peril. Taken in this context, the Regulations serve as evidence that Ukraine is willing to put such novel concepts as checks into effect. It goes without saying, non-residents paying for Ukrainian goods, works and services from abroad need not ask anymore whether checks are accepted in Ukraine. Their problem now lies in negotiating the acceptance of checks by the Ukrainian provider of goods, works and/or services, who may feel a bit strange in accepting a piece of paper in place of the transfer of cash funds onto a bank account. Obviously, the establishment of trust between the parties will be a principal factor.

3. ALTERNATIVE BUSINESS RELATIONS

a. Debt Financing:

Procedure For Obtaining Foreign Currency Loans From Foreign Creditors

I. History

Much to the ongoing dismay of the Western financial world, debt financing was not even an option for most Ukrainian companies until May 7, 1997. Until then, the now-cancelled National Bank's Provision No. 329, dated December 29, 1995, strictly required all Ukrainian residents to obtain a special license prior to receiving loans in foreign currency from foreign creditors.

Subsequently, the National Bank's telegram No. 19013/1093, issued on May 5, 1995, affirmed that transactions involving foreign currency loans must first be licensed by the National Bank, and can only be effectuated through Ukrainian licensed banks on a non-cash transfer basis. Of course, such licenses were not generally granted to the average Ukrainian company, barring most Ukrainian enterprises from dealing with foreign creditors altogether.

Perhaps that is why the National Bank's Resolution No. 144 was revolutionary: it finally signaled the beginning of debt financing practices in Ukraine. Cleverly entitled "On Adoption of the Regulations 'On the Procedure of Registration of Loans in Foreign Currency Received by Residents From Foreign Creditors,'" dated May 7, 1997, the Resolution specifically granted Ukrainian resident legal entities the right to obtain loans in foreign currency from foreign creditors to conduct activities provided for in their foundation documents. Of course, all borrowers-residents were able to repay all of their obligations under the loan agreement (including interest and any fines) by purchasing with Hryvnia the necessary amount of foreign currency on the Interbank Currency Market and transferring it abroad.

On June 27, 1999, the President of Ukraine issued Edict No. 734/99 "On Performing the Procedure for Obtaining Credits and Loans in Foreign Currency by Residents from Non-residents and Application of Fines for Violation of Currency Legislation." Based on this Edict, on December 22, 1999, the National Bank approved Resolution No. 602 (registered with the Ministry of Justice on January 13, 2000 under No. 15/4236 and lastly amended on December 30, 2003), entitled "Regulations on the Procedure for Registering Agreements Which Provide for the Fulfillment of Debt

Obligations by Residents to Non-residents Under Credits and Loans in Foreign Currency Procured From Non-residents." Resolution No. 602 rendered Resolution No. 144 of May 7, 1997 ineffective.

Resolution No. 602 supports its predecessor (Resolution No. 144), and sets forth the mechanism for Ukrainian residents to obtain funds from non-residents in order to carry out their business activities. Importantly, the above Presidential Edict contains sanctions for the failure to register loan agreements. Specifically, if a loan agreement is not registered as provided by law, the resident debtor will be subject to a fine in the amount of 1% of the principal of the loan. The fine must be paid in Ukrainian currency according to the official exchange rate established by the National Bank as of the date of the receipt of the loan. Further, payment of a fine does not relieve the debtor from the mandatory registration of the loan agreement.

II. The New Resolution

Resolution No. 602 contains a procedure for the mandatory registration of loan agreements, which require Ukrainian residents to repay foreign currency to non-resident creditors. Once such agreements are registered, the resident will receive a registration certificate, allowing it to conduct foreign currency transactions per a specific agreement.

According to Resolution No. 602, any entity (including joint stock companies and limited liability companies with foreign investment) or physical person (hereinafter collectively referred to as "Resident" or "Residents") may receive loans in foreign currency from non-residents, including financial aid. Because the loan/credit agreements must be registered with the National Bank, it is difficult for resident debtors to deny the receipt of the loan, especially since credits may only be received in non-cash form. By registering such agreement, however, the National Bank does not take any obligations upon itself before the parties to an agreement.

Procedurally, the Operative Settlement Department of the National Bank and the territorial departments of the National Bank issue registration certificates to Residents at the location of the authorized branch ("Territorial Department") and the authorized financial-credit institution ("Servicing Bank"), which must service the operation of the Resident according to an agreement.

Obviously, Residents are required to register loan/credit agreements before they can receive the credit itself. The credit may be transferred only through authorized banks. If, however, the loan/credit agreement provides for the receipt of credit without requiring repayment from the

Resident's Ukrainian bank, and/or on the condition that the repayment of the debt shall be effectuated from the Resident's foreign bank, then the National Bank must issue an individual license to open a correspondent account in a foreign bank.

III. Registration Certificates

In order to receive a registration certificate, residents are required to submit the following documents to the appropriate Territorial Department:

- 1) a letter-petition (application) to the head of the relevant Territorial Department;
- 2) the original agreement or a notarized photocopy of the agreement prepared on the territory of Ukraine in its original language of execution. If the agreement is concluded in a foreign language (except Russian), then a notarized translation into Ukrainian must be prepared on the territory of Ukraine and submitted with the agreement;
- 3) a so-called "notice of the agreement," providing for the fulfillment of debt obligations by a resident to a non-resident under a credit/loan ("Notice") in two copies. The form for such Notices can be obtained from the Territorial Departments or directly from the text of Resolution No. 602;
- 4) a written confirmation of the consent of the authorized bank for servicing the operation according to the agreement; and
- 5) the document confirming the payment for the issuance of the registration certificate pursuant to the official fee established by the normative-legal acts of the National Bank.

In the above-mentioned cases, where the Resident must procure an individual license for opening a bank account in a foreign bank, the application for such an individual license must also be submitted along with the other required documentation.

Moreover, if an agreement with a non-resident provides for the provision to a resident of a loan by way of payment by a foreign creditor (without transferring such funds onto the account of the resident in an authorized bank) for works, services and intellectual property rights pursuant to a foreign economic trade contract for a total amount of over 50,000 Euro or an equivalent of such amount in another currency at the official exchange rate of Ukrainian Hryvnia to foreign currencies established by the National Bank of Ukraine on the day of the conclusion of the contract, then the

resident debtor in addition to the above-listed documents must submit the original or a copy of the appraisal act of the State Informational-Analytical Center of Monitoring of Foreign Trade Markets (the "Center") on the correspondence of contract prices for works, services or intellectual property rights under a foreign economic trade contract (except in limited cases) certified by the said Center or by a notary. If the Center refuses to conduct an appraisal, the consent of the National Bank of Ukraine shall be submitted in its place.

Upon receipt of the documentation, the Territorial Department verifies the form and completeness of the documents presented, as well as their conformity with (i) the terms and conditions of the agreement with the non-resident and (ii) applicable Ukrainian legislation. The Territorial Department will also verify whether the interest rate under the agreement complies with (i.e., does not exceed) the average interest under which Ukrainian banks grant loans to residents on the internal credit market. The Territorial Department must register and issue the registration certificate within 7 working days from the date of receipt of the appropriate documentation. Thereafter, the Territorial Department will either issue the original registration certificate directly to the Resident or to its authorized representative (upon proof of authority). A copy of the registration certificate shall be sent to the bank servicing the agreement with the non-resident, together with a copy of the resident's information, within 5 working days from the day of issuance.

If any changes are made to the terms and conditions of the agreement (i.e., changes in the amount of credit, the term for repayment or the interest rate) or to any information which appears on the registration certificate, the resident must apply to the Territorial Department to introduce the corresponding changes no later than one month from the date such changes arose (unless well-grounded reasons are presented for any delay). In this case, the Territorial Department will issue an appendix to the registration certificate (individual license) at no charge to the resident. Appendices are deemed an integral part of the original registration certificate and indicate the number and date of the original registration certificate, as well as the amendments or additions themselves.

In case of changes, the Resident must present the following documents:

- 1) a letter-petition (application) to the head of the appropriate Territorial Department;
- 2) originals or notarized photocopies prepared in Ukraine of the corresponding documents pursuant to which amendments or additions will be made to the agreement, in the language of the original(s), as well

as a notarized translation into Ukrainian prepared on the territory of Ukraine if the documents are concluded in a foreign language (except Russian);

- 3) a statement of the amendments (additions);
- 4) written confirmation to the head of the corresponding territorial department of the consent of the servicing bank to continue undertaking the operations in the agreement in light of the amendments or additions; and
- 5) the original agreement or a notarized photocopy of the agreement in the original language (prepared in Ukraine). If the agreement is concluded in a foreign language (except Russian), then a notarized translation into Ukrainian must be submitted (in case of the introduction of changes to the registration certificates and the individual licenses, which were issued before Resolution No. 602 came into force).

Residents may also elect to change the bank that services the loan/credit agreement at anytime and for various reasons. This is done by simply submitting the following documents to the relevant Territorial Department:

- 1) a letter-petition to the head of such Territorial Department; and
- 2) the corresponding letters of the servicing banks (written to the name of the head of the territorial department):
 - a) with confirmation from the original bank about the client's transfer for servicing at another bank, and with confirmation of the amount of credit on the account of the Resident-debtor in Ukraine;
 - b) with confirmation of the consent of the new bank to further service the operations in the agreement; and
- 3) notice regarding the agreement in the established form (Appendix 3 of Resolution No. 602), except in cases when notice regarding the agreement of a resident-borrower was already submitted with the documents required to receive a registration certificate.

Resolution No. 602 lists three reasons for denying a registration certificate or an appendix to such certificate. First, an application may be rejected if any of the required documents for registration, amendments or changing of the servicing bank are absent or improperly executed (i.e., requisite blanks are not filled out, missing signatures, stamps, etc.). Second, if any

false or conflicting information is presented in the documents. Finally, if the size of the interest rates in the relevant agreement exceeds the size of the average interest rate by which Ukrainian banks grant credit to business entities in foreign currency on Ukraine's credit market, the Territorial Department also has grounds for refusal to issue a registration certificate.

If the Territorial Department refuses to issue a registration certificate, it must inform the Resident in writing within 7 working days from the date of presentation of the documents. A registration certificate is valid upon the presence of a registration number, a date and the seal of the relevant Territorial Department. A registration certificate is valid for the entire term of the credit/loan arrangement only if the Resident receives the credit/loan in full or in part within 180 days from the date of such certificate's issuance. If the Resident is unable to commence use of the credit/loan within this term, it must appeal in writing to the appropriate Territorial Department, claiming that a substantial need exists to extend the validity term of the registration certificate. Importantly, the Resident must be able to identify a so-called "valid reason" (although Resolution No. 602 does not describe what such valid reasons may be).

If, for some reason, the Resident does not receive the credit/loan for which it received a registration certificate, the Resident must return the unused registration certificate to the issuing Territorial Department. Any non-extended or returned registration certificates are annulled by the Territorial Department and sent to the relevant Servicing Bank no later than the 5th day of the month following the pending reporting quarter.

Certain caveats exist, however, for those residents who obtain registration certificates for the receipt of foreign currency loans/credit. First, the registration certificate is non-transferable to third parties. Second, a registration certificate is good for only one loan agreement (transaction). In other words, once issued, the certificate cannot be used to receive other loans, increase the loan amount or perform other undisclosed loan operations.

IV. Conclusion

Regulation No. 602 provides Ukrainian residents with a wider avenue for obtaining foreign currency loans than ever before, all the while building their creditworthiness on international markets. As one beneficial consequence, foreign investors no longer need to invest large amounts of cash into the authorized capital of their Ukrainian business entities. Instead, they may contribute the absolute minimum statutory amount to their business venture's authorized capital while concurrently providing loans/credits for the expansion of the Ukrainian business venture's activities.

b. Franchising

I. Introduction

As a general observation, Ukraine takes a somewhat European approach to franchising whereby a franchise is viewed as an economic relationship, regulated by several contracts between franchisors and franchisees, rather than one straight forward franchise agreement, cut and dry, on a franchisor's fill-in-the-blank form. These various agreements include:

1. a franchising agreement;
2. a license agreement for the use of the trademark of the franchise;
3. a license agreement for the transfer of know-how;
4. a sales-purchase (supply) agreement for equipment; and
5. a supply agreement for raw materials, disassembled products and accessories required for the production of a franchise's products.

Since these agreements more or less deal with import-export transactions, they must be formalized in writing in accordance with Article 6 of the Law of Ukraine "On Foreign Economic Activities." Accordingly, if an individual enters into an international contract, only the signature of the individual is necessary. If a legal entity concludes an international contract, then the individual authorized by the charter of such legal entity must sign on to the transaction.

The parties to an international contract have the right to choose foreign arbitration for settlement of disputes. The rights of the parties and other substantive law issues likewise can be resolved in Ukraine under foreign law by agreement of the parties. If the parties do not agree as to choice of law, however, then Ukrainian law applies by default. One notable exception applies to agreements for construction or the acquisition of immovable property in Ukraine: such agreements must be governed by Ukrainian laws.

Order No. 201 of the Ministry of Economy and Issues of European Integration "On Approval of the Form of Foreign Economic Agreements (Contracts)," dated September 6, 2001, registered with the Ministry of Justice on September 21, 2001 under No. 833/6024, sets out the form of foreign economic agreements to be observed with respect to franchising agreements as well.

II. Discussion

A. The Franchising Agreement

A typical franchising agreement made in Ukraine should include such provisions regarding the long-term goals pursued by the parties, the term

and the territory of the franchise, among others. Significantly, Ukrainian law does not permit general purpose clauses such as "any legal activity under Ukrainian law." Thus, the franchise agreement must detail all of the franchisor's current and potential activities.

Because the law does not permit "catch all" clauses, the description of the franchise's purpose should be very broad. The franchise agreement should state that for each stage of relations the parties will enter into separate contracts, specifying such stages, and that such contracts will be an integral part of the franchising agreement. Importantly, all of the legislative restrictions and special provisions the parties agree upon should be set forth in the original franchising agreement. This way, all subsequent contracts will not contradict the original intent of the parties.

The franchising agreement is concluded in the form of a joint activity agreement, in accordance with Article 23 of the Law of Ukraine "On the Foreign Investment Regime." This joint activity agreement more closely mirrors corporate by-laws than the classic franchising agreement because Ukrainian law views each franchise as a corporate structure, whereby the franchisor earns income not from the franchise itself, but from its business activities on the territory of Ukraine.

B. License Agreement for the Use of the Trademark of the Franchise

Intellectual property is accorded protection by the Laws "On Protection of Rights to Inventions and Utility Models", "On Protection of Rights to Industrial Designs" and "On Protection of Rights to Marks for Goods and Services," as well as by the Presidential Edict "On Approval of the Temporary Regulation of Legal Protection of Objects of Industrial Property." Intellectual property is given additional international protection via Ukraine's participation in the 1883 Paris International Convention on Protection of Industrial Property and the 1891 Madrid Convention on Registration of Trademarks.

In order to effectively protect intellectual property such as trademarks, names, patents, etc., it is necessary to register such intellectual property with the State Department for Intellectual Property at the Ministry of Education and Science of Ukraine. Additionally, all licensing agreements for the transfer of any intellectual property between non-resident franchisors and Ukrainian franchisees must be registered with the appropriate state authorities.

The state registration of intellectual property and licensing agreements allows a franchisee (Ukrainian resident) to convert Hryvnia into foreign cur-

rency in order to effectuate payments for the use of intellectual property as part of the franchise agreement. As a result of such licensing agreements, the franchisor can obtain regular payments from the franchisee in the form of royalties or such form of payments as agreed upon in the provisions of the said agreements.

Among other items, the licensing agreements should determine the territory of the franchise and, where applicable, the volume and quality of the franchising products. A separate clause in the trademark licensing agreement should provide that if the franchisee fails to meet the quality requirements, the franchisor will be entitled to terminate the agreement and all other relations with the franchisee.

In addition to the use of intellectual property, the franchisor may also need to enter into contracts for the use of patents by the franchisee in the production of franchising products. Apart from any contractual protection, such patents enjoy legislative protection pursuant to the aforementioned legislation. The remaining requirements for the use of patents mirror the requirements, which apply to trademarks and trade names in Ukraine.

C. License Agreement for the Transfer of Know-How

Another possible type of intellectual property transfer agreement is the know-how license. Since know-how is not protected by any legislation or international conventions, it is crucial that a franchisor provide for the protection of know-how in a separate contract (i.e., know-how agreement).

This agreement should include specifications for the territory of the franchise, the term and procedure for using the know-how and the procedure for transferring know-how to third parties. Additionally, the agreement should provide for confidentiality and liability in case of non-compliance with the terms and conditions of the license agreement.

Because the transfer of the know-how license is embodied in a separate contract, a separate arbitration clause should provide for a choice of law and forum. Naturally, it is advantageous for the franchisor to choose the substantive law and forum of a country with a great amount of experience in resolving disputes arising from know-how agreements (i.e., England).

The know-how itself should be described in written form for declaration purposes even though it might only exist in an intangible form (i.e., in the mind of the franchisor). Importantly, when crossing Ukrainian customs, the description of the know-how must be declared in the franchisor's customs declaration and must have a specific value attached thereto.

Sale-Purchase (Supply) Agreements for Equipment, Raw Materials, Accessories and Disassembled Products

As part of the franchise package, the franchisor and the franchisee usually enter into sale-purchase agreements for equipment and supply agreements for raw materials, accessories and disassembled products in order to successfully manufacture the franchise's products. These agreements allow the franchisor to earn significant profit in foreign currency by selling to the Ukrainian franchisee necessary supplies and equipment, which allow the franchisee's business to run smoothly. In negotiating such agreements, the franchisor must consider currency regulations, as well as customs and fiscal limitations applicable to all importers in Ukraine.

Generally, Ukrainian currency regulations permit a Ukrainian franchisee's bank to convert Hryvnia into freely convertible currency and then transfer freely convertible funds to the franchisor's account, based on a properly executed sale-purchase (supply) agreement, which provides for acquisition of the necessary equipment, raw materials, disassembled products and accessories.

The National Bank provides the registration procedure for foreign currency loans. As a result, a resident will have to obtain a registration certificate from the National Bank before receiving such loan, but only after the loan agreement has been signed. If the National Bank refuses to grant the certificate, the loan agreement will be considered invalid. Importantly, the National Bank requires from companies, wishing to purchase foreign currency, documents which confirm the actual delivery of goods or services to be paid in a foreign hard currency.

In order to clear the equipment, raw materials and any disassembled products through customs, a properly executed franchising agreement must be submitted with the customs authorities where the goods are registered. Once the customs clears the goods and equipment, all such goods and equipment transferred under the franchising agreement are considered to be owned by the Ukrainian franchisee regardless of whether it is paid for or not. Also of importance are the fiscal restrictions which require that a Ukrainian franchisee pay customs duties, customs fees and value added tax (VAT) on all imported equipment, raw materials, disassembled products and accessories.

Pursuant to Articles 2 and 4 of the Law of Ukraine No. 185/94-BP "On the Procedure for Effectuating Payments in Foreign Currency," dated September 23, 1994 (as lastly amended on May 15, 2003), if any imported products (goods), which were pre-paid for by Ukrainian residents, will be delayed in delivery to Ukraine for more than 90 calendar

days from the effective prepayment date, such Ukrainian resident must receive an individual license from the National Bank. Should a Ukrainian resident violate the above 90 day period, it will be liable for payment of a fine in the amount of 0.3% of the customs value of the undelivered products.

The sale-purchase (supply) agreement must include standard clauses pertaining to the price, terms for transferring products, product specifications, packaging, basic delivery terms, the procedure for acceptance of products, the procedure for serving claims, the responsibilities of the parties, dispute resolution, force majeure, and the choice of law and forum governing the agreement. Under Ukrainian law basic delivery terms under the sale-purchase (supply) agreement are construed in accordance with Incoterms-1990 developed by the International Chamber of Commerce in Paris. However, if the parties wish to use Incoterms-2000, then they must concisely state so in the agreement.

III. Conclusion

Although franchising still requires quite a bit of pioneering, with sound business planning and proper legal advice, the opening of a franchise in Ukraine can be a profitable venture. The level of consumption of everyday goods and services in Ukraine is progressively reaching that of international standards and the population of the country still hovers around 50 million, which could potentially be a lot of consumers. As the Ukrainian market is becoming more receptive to Western standards of quality and service, franchising will develop into a viable alternative business form.

c. Franchising Under the New Civil and Economic Codes

I. Introduction

Ukraine has not been traditionally known for its accessibility for franchising. In fact, Ukraine has always adhered to the notion that franchising is nothing more than a series of separate agreements between two parties. Therefore, in the past, franchising involved the conclusion of various agreements, each of which should have been drafted in accordance with the different laws to which they relate. However, with the passing of a new Civil and Commercial Code, a new concept has been introduced into Ukrainian law known as “commercial concessions.” While commercial concessions are not explicitly titled “franchising”, an analysis of both the new Civil and Commercial Codes of Ukraine reveals that franchising will become an even more viable option for foreign investors in Ukraine in the near future. In our discussion below, we indicate where one of the Codes provides provisions additional to those contained in the other Code.

II. Discussion

According to the new Civil Code (No. 435-IV, dated January 16, 2003, effective January 1, 2004) and the new Commercial Code (No. 436-IV, dated January 16, 2003, effective January 1, 2004) of Ukraine, parties interested in implementing a franchising arrangement on the territory of Ukraine may conclude so-called “agreements on commercial concession”. Under an agreement on commercial concession, one party (a right holder) grants to another party (a right user) *on a payment basis* the right to use a complex of rights belonging to the right holder for the production and/or sale of a certain type of product and/or the provision of services. While both Codes imply that the granting of such use rights will be regulated by the Codes and other laws, no other laws have been passed with respect to commercial concessions.

In a nutshell, the subject of an agreement on concession is the right to use objects of intellectual property (trademarks, industrial designs, inventions, works, commercial secrets, etc.) and the commercial experience and business reputation of the right holder on a payment basis. The Commercial Code provides that remuneration under an agreement on commercial concession may be paid as a one-time payment, periodical payments or in any other form provided by the agreement. An agreement on commercial concession may contain provisions regarding a specific territory of use of the rights, however this is not a mandatory provision of such agreements.

Both natural persons and legal entities may be parties to an agreement on commercial concession provided that they are so-called “subjects of entre-

preneurial activity” (i.e., they carry out business for a commercial purpose). The form of an agreement on commercial concession is quite simple: it must be in writing and is subject to state registration. A failure to comply with the requirement that such agreements must be in writing will lead to their invalidity. The Commercial Code further provides that an agreement on commercial concession must be concluded “in the form of one document”. Thus, the classic franchising agreement may be tweaked to comply with the requirements of an agreement on commercial concession.

At present, the Ukrainian business community awaits the necessary legislative acts and instructions, which will allow for the state registration of such agreements. In any case, the registration of agreements on commercial concession must be carried out by the body, which carried out the state registration of the right holder. If the right holder was registered in another country, then the body, which carried out the state registration of the right user, will be responsible for the state registration of the agreement on commercial concession. In all relations with third parties, the parties to an agreement on commercial concession may not refer to such agreement until the complete state registration of the agreement. The Commercial Code adds that the absence of the state registration of an agreement on commercial concession will remove the parties right to refer to the agreement in case any disputes arise.

Both the Civil and Commercial Codes also provide for commercial sub-concessions in cases provided by an agreement on commercial concession or otherwise agreed upon by the right holder. If an agreement on commercial concession (or other arrangement with a right holder) permits the user to conclude an agreement on commercial sub-concession, then the user may provide another party (a sub-user of rights) with the right to use the complex of rights or a part thereof granted to it by the right holder. Unless a commercial sub-concession arrangement is separately agreed upon by the parties, the agreement on commercial concession, which grants the right of commercial sub-concession to the original user, must be attached to the agreement on commercial sub-concession. Under commercial sub-concessions, the user and the sub-user are jointly liable to the right holder for any damages incurred thereby. In case an agreement on commercial concession is deemed invalid for any legitimate reason, an agreement on commercial sub-concession in connection with such invalidated agreement will also be deemed invalid.

In general, pursuant to agreements on commercial concession, the right holder must transfer to the user of rights all of the technical and commercial documentation and/or other information necessary for exercising the granted complex of rights. The right holder must additionally inform the user and its employees regarding all issues connected with the exercise of

such rights. Further, the right holder is responsible for the state registration of the agreement on commercial concession (unless he/she/it is registered in another state), providing the user with a constant flow of technical and consulting assistance in the training and increase of qualifications of employees, and controlling the quality of goods (works or services) produced (performed or provided) by the user under the agreement. Finally, the Commercial Code specifically adds that the right holder must issue to the right user any licenses or permissions required by the agreement and ensure their proper execution.

In turn, and taking into account the peculiarities of user's activity, the user is responsible for using the trademark and any other marks of the right holder in accordance with the agreement on commercial concession. The user must also ensure that the quality of goods (works or services) with the agreement on commercial concession and the quality of analogous goods (works or services) produced (performed or provided) by the right holder. Further, the user must adhere to the instructions and directions of the right holder with respect to the compliance of the character, method and conditions of use of the complex of granted rights with the use of such rights by the right holder. The user is obliged to provide customers with the additional services upon which they might rely in purchasing directly from the right holder and make such customers aware of the use of the trademark and other intellectual property of the right user as set forth in the agreement on commercial concession. Of course, the user must refrain from disclosing the production secrets and other confidential information of the right holder. The Commercial Code concretely specifies the right user's obligation to pay remuneration to the right holder for the use of the complex of rights.

The Civil and Commercial Codes specify special terms and conditions, which may be inserted by the parties into an agreement on commercial concession, including:

- 1) the obligation of the right holder to refrain from providing to other parties analogous complexes of rights for their use on the territory reserved by the user or to refrain from its own analogous activity on such territory;
- 2) the obligation of the user to refrain from competing with the right holder on the territory on which applies the effectiveness of the agreement on commercial concession with respect to entrepreneurial activity carried out by the user with the use of the rights belonging to the right holder;
- 3) the obligation of the user to refrain from obtaining analogous rights from competitors (potential competitors) of the right holder;

- 4) the obligation of the user to agree with the right holder upon the place of location of premises for the sale of goods (performance of works or provision of services) provided by agreement, as well as the internal and external appearance of such premises.

The Civil and Commercial Codes both prohibit the right holder from determining the price of the goods (works or services) provided by an agreement on commercial concession or establishing a maximum or minimum limit on such price. If an agreement is concluded with such terms and conditions, such agreement will be null and void. The Commercial Code embellishes that any restrictive conditions may be deemed invalid if such conditions contradict the effective Ukrainian legislation.

Interestingly, the Civil Code refers to terms and conditions in agreements on commercial concession whereby the user has the right to sell goods (perform works or provide services) exclusively to a certain category of customers or exclusively to customers located or residing on the territory established in an agreement on commercial concession. However, to all appearances, it seems that the Parliamentary Deputies failed to finish drafting the said provision of the Civil Code due to the lack of a conclusive closing to the provision. Although the Civil Code has been officially published for quite some time, there have been no amendments or explanations issued by the Ukrainian Parliament and it is still unclear whether such terms and conditions are permissible or not. Taking into consideration the structure of Article 1122, in which the provision is set forth, it appears most likely that such terms and conditions will render an agreement null and void, but we must wait until the proverbial period is placed at the end of the sentence.

Under agreements on commercial concession, the right holder bears vicarious liability for claims asserted against a user in connection with the non-compliance of the quality of goods (works or services) sold (performed or provided) by the user. If a claim is asserted against a user as the manufacturer of goods of a right holder, then the right holder bears joint liability along with the user.

If all goes well under an agreement on commercial concession and the user duly performs all of its obligations, then such user has the right to conclude an agreement on commercial concession for a new term on the same terms and conditions. However, no further laws or supporting legislation have yet been passed setting forth the terms and conditions under which a right holder may refuse to conclude an agreement on commercial concession for a new term. This provision of the Civil Code is clearly advantageous for the user and leaves the right holder in the dark regarding a possible ending to its relations with diligent users. One would assume that the supporting

legislation will be put into place pursuant to which right holders may terminate relations with users at least in extreme cases.

Amendments to agreements on commercial concession may be executed pursuant to the general rules established by the Civil and Commercial Codes for amending any agreement. While such rules are beyond the scope of this brief overview, it is important to note that any amendments to agreements on commercial concession are subject to state registration. In relations with third parties, the parties to an agreement on commercial concession may not refer to any amendments to such agreement until the amendments are duly registered unless they can prove that the third party knew or should have known about the amendment(s).

If a term is not established for the termination of an agreement on commercial concession, each of the parties thereto may withdraw from the agreement at any time having informed the other party no less than six months prior to such withdrawal, unless a lengthier term is specified by the agreement. As with the conclusion and amendment of an agreement on commercial concession, the termination of the agreement is also subject to state registration. Termination may occur if the right of the right holder to the trademark or other intellectual property determined in the agreement on commercial concession is terminated without a substitution of an analogous right. Termination may also occur if the right holder or the user is deemed insolvent (bankrupt).

In case of the transfer of the exclusive right to the intellectual property object in an agreement on commercial concession from the right holder to another party, the Civil Code simply states, without further explanation, that such transfer will not be grounds for terminating or amending the agreement on commercial concession. However, the same Article 1127 of the Civil Code refers to the death of the right holder and the transfer of its rights and obligations under an agreement on commercial concession. In such case, the said rights and obligations will transfer to a successor on the condition that he/she is registered or, within six months from the day of the opening of inheritance, will be registered as a subject of entrepreneurial (business) activity. Alternatively, the successor may transfer the rights and obligations to an entity/person with the right to carry out entrepreneurial activity.

In certain cases, a trademark or other intellectual property object of a right holder, which is included in the complex of rights provided to a user under an agreement on commercial concession, may be replaced. According to the Civil and Commercial Codes, such replacement will not automatically lead to the termination or amendment of the agreement, rather the agreement will remain in force with respect to the new mark of

the right holder unless the user demands termination of the agreement and the compensation of damages. In other cases, a certain right of a right holder may terminate during the validity of an agreement on commercial concession. In such cases, the validity of the entire agreement will not terminate, rather those of its provisions related to the right which terminated will become invalid and the user will have the right to demand a corresponding decrease of payments to the right holder unless otherwise provided by the agreement.

III. Conclusion

As one may see, the foundation has been laid for future franchising in Ukraine. In the midst of the chaos of the coming into force of many new Codes and laws since January 1, 2004, the Ukrainian Parliament must find the time to focus on a specific law for franchising (commercial concessions), as well as the various supporting legislation which must be in place for the recognition and registration of agreements on commercial concession.

IV. Real Property Transactions: Buildings and Land

A COMMERCIAL AND RESIDENTIAL REAL ESTATE

I. Introduction

Ever since 1991, foreigners have routinely purchased all kinds of real estate. Some acquired large communal apartments for personal use while other converted them for office use. Still others purchased free-standing buildings and have obtained that coveted “free and permanent use of land” thereunder. In other words, the real estate market in Kiev reached its peak a long time ago.

In the early years of 1991—1996, only three Western-quality residential and commercial properties existed: Maculan, Regina Center and Kiev-Donbass. Each charged near-extortionate fees ranging from \$65 to \$85 per square meter per month, and used their monopoly positions to lock up multi-national companies in a lease for up to 5 years.

Competitors quickly followed in their steps, often demanding an up-front 6-month rent payment, typically wired to an offshore company. Due to the City of Kiev’s concurrent intensive construction efforts, the Ukrainian real estate market was already saturated when the regional economy crashed rather abruptly in early August of 1998.

Many foreign lessees, including those unfortunate multi-national companies who locked in early at unreasonably inflated rents, tried to renegotiate their rent rates, and many succeeded. Today, due to increased availability of quality residential and commercial properties, the prices have dropped significantly, ranging from \$15 to \$40 per square meter per month (cable TV included). However, prices are currently beginning to rise once again.

One thing has remained consistent in the ever-changing Ukrainian real estate market throughout the financial upheavals, and that is legislation, which expressly allows foreigners to purchase real estate.

II. Documents Confirming Property Title and Lessor’s/Seller’s Identity

In all cases involving real estate (purchase or lease), questions of security in the property’s title and ownership rights predominate the agenda, frequently causing great confusion and distrust. The reason is quite simple: fraudulent transactions are abound and, as a consequence, all issues connected with title transfer and identity of the true owner must be flushed out before the actual execution of a sale-purchase (or lease) agreement in front of the relevant officials (notary public or commodity exchange).

In the past, gullible companies incurred significant financial losses after effectuating substantial pre-payment (up to 6 months’ of lease price) to false lessors, only to find that their newly leased apartment actually belonged to an innocent third party. Other cases involved premature termination of fake lease agreements (often following repairs at the lessee’s expense). Of course, recourse to the law has minimal, if any, effect on reimbursement of the expenses or provisions for alternative office space.

To avoid the various pitfalls, any potential purchaser or lessee must insist on reviewing the background documentation, which serves as the ultimate proof of ownership. The various documents include:

1. sale-purchase agreement, gift agreement or privatization certificate for the property;
2. “technical characteristic” certificate from the Kiev City Bureau of Technical Inventory; and
3. certificate from the 1st Kiev City Notary Public that the property is not secured by collateral or subject to encumbrances (i.e., it has no liens or “arrests” placed on it).

Other documents may be necessary, such as a waiver of the children’s rights to the property. In case the alleged owner is a legal entity, the seller’s foundation documents, among other documents, are most helpful. Of course, if the alleged owner is a physical person (individual), his/her passport must be verified.

Various excuses, such as lost documents necessary to confirm ownership rights, or that a particular document original is somehow inaccessible, is an indication of a potential problem. Contrary to a popular misperception, property ownership records are kept in meticulous order somewhere in the state archives. In fact, we once tracked a complete set of documents dating as far back as 1944, which granted land rights to a Soviet army general, whose children wanted to sell his house to a foreign investor before immigrating.

All of the above documents should contain the relevant seals of the state authorities, and should be collected within 3 months from the date of their presentation for professional review. Based on these documents, a legal opinion will be drafted, confirming or rejecting the ownership rights to any given property.

A title search, however, is only a part of the chain of legal dilemmas surrounding procurement of property. The supporting legislation concerning

currency regulations and taxation, can also play a large role in deciding the best way to structure real estate transactions and secure long-term possession and quiet enjoyment of the premises.

III. Procedure for Purchasing Real Property

Procedurally, the Article 657 of the Civil Code of Ukraine states that real estate transactions must be executed before a notary public in written form and are subject to state registration. Alternatively, the Law "On Commodity Exchanges" permits certain commodity exchanges to execute real property sale-purchase agreements.

In the past, purchasers had significant difficulties with state-employed notary publics and, because an alternative existed, 99% of all property transactions were executed at commodity exchanges. Since then, Ukraine has introduced a system of "private notaries" to undertake this role, with varying degrees of success. Currently, sale-purchase agreements are executed either before a state notary public or before a private notary. Below we review both alternatives.

A. Closing Before a State Notary Public

With reference to real estate, the Ukrainian government is represented by various entities, such as notary publics (state and private), the Kiev City Bureau of Technical Inventory and the local ZHEK (literally translated as "Residential Exploitation Committee"). These state bodies attest to the Ukrainian seller's ownership and occupancy rights to any property.

State notary publics are usually state officials and, as a rule, use their own standard forms for most transactions. In the context of real property transfers, the standard 2-page notary form for sale-purchase agreements recites only the most fundamental information concerning the property transfer, such as the names of the parties, the property's address, etc., and bears the parties' signatures and the notary's seal. Negotiated provisions, including representations and warranties, are viewed as irrelevant.

To encourage sellers and purchasers to state realistic sales price in the sale-purchase agreements (instead of a fraction of such value, as was the long-standing practice to avoid property tax), in the spring of 2000, the government decreased the state fee for notarization of agreements on the alienation of immovable property from 5% to 1% of the amount of the transaction (i.e., the total amount indicated in the sale-purchase agreement).

B. Private Notary Public

Ukrainian legislation generously permits the existence of private notary publics. Once licensed, their powers are equal to those of state notary

publics without the drawbacks of the bureaucracy. By law, private notary publics cannot charge less than the current state fee to notarize real estate sale-purchase agreements. Although private notaries are permitted to take a higher percentage, most private notary publics do not charge higher than the State notary publics due to the tight competition between private notary publics these days.

In all cases, however, follow-up registrations must take place with the Kiev City Bureau of Technical Inventory (establishing the new owner's identity), the notary public (central and rayon) and ZHEK.

IV. Conclusion

Today, due to the abundance of privately owned, Western-quality property in Kiev, foreign investors can easily purchase (or lease) virtually any real estate object at a reasonable price. Reviewing ownership documents, drafting (and executing) the sale-purchase agreement, and registering the property at the Bureau of Technical Inventory, are the necessary technical details that accompany any transfer of property rights. And, unlike the old times, such follow-up registrations have become routine and quite easy to perform.

B OPTIONS FOR ESTABLISHING LOCAL PRODUCTION FACILITIES

The August 1998 crisis caused many foreign investors to halt their projects or withdraw altogether. This resulted in a sharp drop in real estate prices, especially for industrial plants (whose asking prices decreased by as much as 40%). Since then, the prices for real estate, including production facilities, have gradually risen once again. In light of the integration of a number of former Soviet block countries into the European Union in 2004, Ukraine is quickly becoming a significant target for companies looking to move east due to the rising prices of labor and real estate as a result of European integration. For example, many Polish and Hungarian companies are looking to move their production facilities into Ukraine because it offers lower wage requirements and cheaper real estate than the European Union requirements allow.

Today, many of the Ukrainian mid-size enterprises are already privately owned, and therefore the State Property Fund (and its notorious bureaucracy) is no longer an impediment to acquiring stock in production facilities. As a result, many investors (primarily Russian companies) are returning to snap up the bargains, which have become relatively wide-spread and fairly easy to accomplish.

As always, with more than 48 million product-hungry people, Ukraine continues to provide a significant market for consumer goods. It is no wonder, therefore, that many foreign companies are reviewing their long-term positions in the vast yet vacant market with a view to establish inexpensive local production facilities in Ukraine. Unlike a few years ago, today the foreign investor has several options in establishing local production facilities, including:

- I) The acquisition of shares of stock in a Ukrainian enterprise;
- II) The establishment of a joint venture (with private and/or state-owned enterprises);
- III) The leasing of local factory space;
- IV) The undertaking of a greenfield project; and
- V) The establishment of local assembly of goods (including software programs and/or components thereof) on a contractual basis.

Below we discuss in brief detail each of the above options.

I. Stock Acquisition in a Ukrainian Enterprise

As a legal matter, the standard open joint stock company charter allows foreign and Ukrainian private legal entities, as well as natural persons, to

purchase its existing stock. The shareholders can include any number of parties, such as former employees who purchased stock on preferential terms for privatization certificates and any third party purchasers who have acquired stock on a competitive basis through a tender or on a stock exchange, among others.

The transfer of existing shares to a foreign investor normally takes place on the basis of a sale-purchase agreement, but theoretically can be effectuated also by a barter agreement, inheritance certificate or a court decision. Such shares must be subsequently re-registered in the name of the purchaser by submitting a transfer order and a certified, notarized copy of the agreement (which will be kept by the registrar), indicating that the title is transferred to the new owner. If the agreement is concluded by a third party or the documents are submitted by a third party, the original documents confirming the authorized powers of such third party, or a certified copy thereof, should be submitted to the registrar as well.

A proper legal review of the foundation documents of any given Ukrainian enterprise will reveal the procedure, and any potential restrictions, regarding employee stock transfer rights. As a practical matter, purchasing existing stock (a) usually results in a very limited control by the foreign stock purchaser over significant matters of the enterprise, and (b) a Ukrainian enterprise's management can easily view such attempt to purchase the existing stock as a hostile takeover attempt.

Instead, most factory management bodies prefer to issue and sell additional stock to investors by offering a significantly larger stock package because private factory administrations are usually interested in obtaining an immediate infusion of capital and know-how. Therefore, strategic investors usually are asked to increase the company's capitalization in lieu of (or in addition to) acquiring existing stock.

In summary, the procedure for issuing additional stock begins with a general meeting of the shareholders. At the general meeting, the shareholders officially resolve in a protocol form to issue additional stock and approve the information and conditions of the public subscription. The information is then registered with the State Commission for Securities and Stock Markets (the "SCSSM"), and thereafter, it is published in one of the official governmental newspapers.

After such publication, an open subscription period allows foreign investors to purchase the additionally issued stock of the joint stock company after existing shareholders have exercised their rights of first refusal. Finally, the issuance results are published with the SCSSM and the general meeting of shareholders must formally approve the results of the subscription. Note

that in consideration for the issued shares, the foreign investor can contribute virtually anything of value, including foreign currency, equipment and intellectual property.

II. Joint Ventures

Once upon a time, the most popular option for foreign investors to enter the Ukrainian market was by forming a joint venture with a Ukrainian partner that was able to contribute property and, hopefully, shared a complementary production profile for joint local production. Today, in many cases the shareholders in privately-owned companies fear bankruptcy as the factory employees (who are also often its stockholders) face termination in the absence of foreign investment. In fact, many newly privatized enterprises often cannot even pay their outstanding debts, such as bills for gas, heat and electricity, among other obligations.

In such situations, well-informed investors are able to negotiate far better terms with a private company than with a state-owned enterprise undergoing or about to undergo the complicated (and often politically charged) process of privatization. The reason is quite simple: under Ukrainian legislation, a private stock company is able to independently dispose of any or all of its property, sell its stock to foreign or Ukrainian buyers, and enter into joint ventures, subject to certain case-specific exceptions. The legal ability of a privatized stock company to enter quickly and easily into all types of transactions, including real estate transfers, makes them a particularly attractive source of industrial real property.

III. Leasing Factory Space

Another possible option is to lease the existing factory space (on a 3 to 50 year lease, preferably with a buy-out option) and set up a production line by registering a 100% foreign subsidiary. This option simply requires the execution of a lease agreement between the foreign investors and the owners (shareholders) of the local factory.

Even state-owned enterprises can lease a portion of their property to interested foreign investors. Most foreign investors, however, do not widely use this option because they are weary of investing in premises where the lease can be terminated arbitrarily for any number of reasons.

With the passing of a new Land Code of Ukraine, which became effective on January 1, 2002, foreign legal entities with permanent representation in Ukraine (i.e., limited liability companies, joint stock companies, etc.) are able to acquire into ownership non-agricultural land on which their real estate is located. During the first two years of its validity, the Ukrainian

authorities have yet to clearly and effectively implement the Land Code in favor of foreign investors. The expected rush towards the purchase of land by foreign companies has been delayed by the vague provisions of the Land Code and the expected introduction of amendments thereto. While a discussion of the new Land Code of Ukraine is beyond the scope of this brief overview, foreign investors should keep in mind that they have the right in most instances to purchase land under their production facilities. Notably, Ukrainian and foreign entities alike are prohibited from contributing the rights to land parcels into the authorized capital of a company until January 1, 2005.

IV. Greenfield Projects

The favored option by many multi-national companies (including the U.S. multinational, Cargill, and McDonalds) is a greenfield project (the construction of a 100% foreign owned building on a parcel of land). While this alternative certainly fulfills many foreign investors' dreams of bypassing the central government bureaucracy, it is a relatively new practice because the newly passed Land Code just recently legalized the allocation of land for industrial use (production purposes).

Cognizant of the tremendous investment amounts greenfield projects could generate, on July 12, 1995, President Kuchma signed Decree No. 608 "On Privatizing and Leasing Non-Agricultural Land for Business Purposes." Hailed at the time as a great leap forward in economic reforms, this decree called for privatization and leasing of the so-called "non-agricultural" (industrial) land. Unfortunately, the conservative Parliament ruled (several times) that President Kuchma overstepped his bounds by issuing such a decree without having the requisite legal authority to allocate Ukrainian land (industrial or not) for privatization to foreign investors. However, with the passing of the new Land Code, many of the provisions of the Decree No. 608 have come to life.

Another realistic way to organize a viable greenfield project is by analyzing the benefits (and stability) of various free economic zones, and then reaching an agreement directly with the parties that have the requisite authority to delegate industrial land for greenfield use (much like Cargill did with its greenfield factory in the Donetsk region).

V. Local Product Assembly on Contractual Basis

Some foreign companies prefer to start their local production by entering into agreements with existing facilities for the assembly of goods on the territory of Ukraine. There are two separate ways to implement such projects. A foreign company may import raw materials and execute a

contract for the assembly of goods in Ukraine, with the final product to be exported and sold abroad (also known as toll manufacturing, which is subject to a special regime of tax, customs and other benefits). Alternatively, the assembled goods could be sold in Ukraine. The tax consequences vary, depending on the option and the transaction structure that the foreign company chooses. In more recent times, many high-tech companies have been hiring Ukrainian programmers to assemble computer program components in Ukraine, which are then transferred to the company for final assembly and sale abroad.

VI. Conclusion

The most difficult part of setting up local production facilities used to be obtaining access to industrial property for production purposes. The new Land Code has made this difficulty almost obsolete. Now, the focal and most vital issue is performing extensive due diligence in screening the right partner and verifying title documents to land.

C FORMING JOINT VENTURES WITH STATE-OWNED ENTERPRISES

I. Selection of a Ukrainian State-Owned Partner

Signing a joint venture's foundation documents is usually the last step in a long and extensive preparation process. Presumably, the foreign investor has selected the state-owned Ukrainian company based on an informed decision concerning its legal status and property rights. In this process, due diligence must be performed which will take the form of a comprehensive report concerning the Ukrainian partner's state of affairs and ownership rights. In fact, it is an indispensable tool in structuring any investment.

Sometimes, foreign partners entering into a joint venture with the Ukrainian government or quasi-government entities, including state-owned factories, face two separate yet related issues: (1) compatibility of interests with the Ukrainian partner; and (2) the scope of the partner's authority to make the necessary capital contributions to the joint venture.

First, a foreign investor needs to perform due diligence to determine the identity and composition of the Ukrainian partner (e.g., a private company, a state-owned enterprise or mixture). In the case of state-owned companies, Ukrainian partners claiming rights to real property may fall into two categories: (1) an individual factory complex to which a state body has the right of administration; or, (2) an "association," typically uniting several sub-units or factories, only some of which are competitive and therefore profitable. Both types of government organizations may (i) be legal entities under Ukrainian laws (subordinate to the body of state power which created the company), (ii) maintain a corporate seal and bank accounts, and (iii) execute some (but not all) agreements and carry out obligations on their own behalf.

Depending on their legal form, such organizations may have temporary rights to use, and perhaps sub-lease, the real property in their possession. In any case, the Ukrainian partner's property rights should be confirmed in conjunction with its legal status. To avoid unpleasant surprises that may jeopardize future operations, the foreign investor should at least obtain and review a copy of the Ukrainian partner's charter (by-laws) to confirm its legal status. Among other things, the charter will reveal whether the Ukrainian partner is a separate legal entity and has its own bank account, or whether it is an association or a sub-structural unit of an association with an internal financial/governing board. The charter will also reveal the relationship between the association and each of the member factories.

If examination of the charter reveals that the Ukrainian partner is an association, the foreign partner may be faced with a politically difficult choice: either to marry an entire association (and suffer the consequences of dealing with bureaucracy and uncertainty) or to pursue a relationship with an individual member factory and/or sub-unit of the association (and possibly incur the wrath of the still powerful parent association holding supply contracts).

Generally, foreign investors prefer to enter into a long-term business relationship with an individual state-owned factory rather than a state-owned association. The main reasons for this preference include (1) the greater commonality of interests among the partners; (2) an association's longevity is more questionable than that of an individual factory; and, perhaps most importantly, (3) associations frequently have a limited right to contribute or lease the property necessary for production purposes.

The discussion below provides an overview of some of the issues involved in structuring and negotiating joint ventures with a Ukrainian partner, whereby such partner's real or in-kind property (not only Hryvnia) is contributed to the joint venture's authorized capital.

A. Commonality of Interests Between Foreign and Ukrainian Partners

By way of background, associations were formed as a mechanism for protecting the non-competitive Ukrainian factories from facing bankruptcy during harsh economic times. The economic relationship amongst the association's members was similar to that of Ukraine's failing central administrative economic model: the association is designed to sacrifice efficiency and competitiveness in return for preservation of the status quo in light of impending bankruptcies and massive unemployment.

Under a typical arrangement, all of the association's members contributed their income to the association's central managing organ, which retained some of the money and re-distributed the remainder among all of its members to ensure longevity of the non-competitive members at the expense of the very efficient members. As a result, a typical association's governing board was more politically oriented to satisfy the demands of the non-competitive members, and frequently had a highly bureaucratic and inefficient board of directors.

In contrast, the foreign partner and an individual factory naturally have an easier time in the future resolving certain key issues connected with growth and profitability of the joint venture. For instance, they are able to quickly resolve key questions, such as the foreign partner's option to

increase the joint venture's capitalization (and, correspondingly, adjust upward its share in the ownership of the stock in relation to the Ukrainian partner) or issues connected with the reinvestment of profits.

B. Ukrainian Partner's Longevity

A foreign partner should consider the relative stability of its potential Ukrainian partner to avoid the possible termination of a joint venture's operation due to the Ukrainian partner's privatization or liquidation in the future.

In the past, entering into a long-term relationship with associations proved to be an unfortunate experience given the tendency of similar Ukrainian quasi-governmental structures to dissolve. Dissolution of associations may occur for various reasons. Typically, the more profitable member enterprises of the association directly enter into joint ventures or undergo small-scale privatization by its employees. Naturally, as the profitable member enterprises exit the association, the remaining (unprofitable) member enterprises' struggle to survive as an association may ultimately fail and result in formal bankruptcy and unemployment. Obviously, the prospect of having a bankrupt partner is not appealing to most investors.

In summary, the relative stability of each association and individual factory should be separately evaluated on the basis of the general industry climate as well as its individual membership.

C. The Ukrainian Partner's Right to Contribute Property

The first of many property laws, the Law "On Enterprises, Institutions, and Organizations Under Union Subordination Located within the Territory of Ukraine," effective as of September 10, 1991, transferred all property rights of Soviet enterprises in the territory of Ukraine to the State Property Fund (the "SPF"). The SPF's Instruction "On the Procedure for Alienating State-Owned Production Facilities [Listed on the Books] of State-Owned Enterprises," dated December 2, 1992, specifically required the SPF or its branches to issue permission prior to any state-owned factory's contribution or sale of any state-owned assets to private parties.

As a general rule, when state-owned property is alienated (either by privatization or contribution to joint ventures), the SPF is responsible for granting the final approval for such property transfer. Notwithstanding this fundamental legislative requirement, many directors of state-owned enterprises or quasi-governmental associations regularly exceeded their

authority by disposing of buildings and equipment without the official knowledge of their so-called “higher-standing organizations” (i.e., Ministries, the SPF, etc.).

In summary, to avoid any subsequent misunderstandings concerning the Ukrainian partner’s legal status and its property rights, it becomes quite important to perform extensive due diligence at an early stage in a project’s development.

II. Negotiation with the State Property Fund

In negotiating the various provisions in a joint venture’s founders’ agreement and charter (by-laws), a foreign investor must understand the areas of competence of the SPF and the state factory itself. The SPF not only plays a crucial role in the approval process, but also becomes a joint venture shareholder and the foreign investor’s partner. Practically speaking, however, it is incapable of participating in the day-to-day operation of the joint venture.

In turn, the role of the state enterprise was that of a dependent production unit of the Ukrainian government, whose operational and managerial components are necessary to the creation of the joint venture, but which had neither the ownership nor the decision making powers related to the shares issued by the joint venture. Fortunately, this has changed since the advent of “corporatization.” Corporatization is the re-organization of a state-owned enterprise into a stock company prior to privatization, allowing the factory management to make most of the decisions (except alienation of property).

Generally, entering into a joint venture with a state-owned enterprise can be a time-consuming and unsatisfying experience, especially if the investor selected a unique factory (i.e., military conversion factory), or several other potential investors are interested in the same opportunity. Thus, foreign investors should be prepared to spend months in negotiation sessions with the factory management and the SPF.

One of the many issues, which may arise during negotiations, is the SPF’s refusal to contribute the ownership rights to the state factory’s real property into the joint venture’s authorized capital. Instead, the joint venture typically receives a “right to use” such property (i.e., free lease agreement) for the duration of the joint venture’s existence. In most cases, the SPF carefully scrutinizes any provision relating to property contributions, comparative valuation, accounting rules and international arbitration. Other provisions are also subject to long and heated debates, depending on the nature of the transaction (e.g., joint ventures in the energy sector).

In negotiating access to state-owned industrial property, an investor should remember that the SPF disposes only of state-owned buildings, which means that the land continues to be under the jurisdiction of the local Council of People’s Deputies. Accordingly, the SPF cannot transfer ownership of the land nor lease rights thereto, even if it wanted to.

III. Procedure For Entering Into a Joint Venture With a State Owned Enterprise

In 1991, joint ventures with state-owned enterprises were negotiated almost exclusively with the state enterprise chosen by the foreign investor and the relevant ministry in charge of the enterprise. Predictably, this led to near-criminal situations where, for instance, state-owned property was transferred/launched, via a unique accounting method called “from balance to balance,” to private Ukrainian companies on an extraordinarily favorable basis. Subsequently, such properties would be sold to foreign investors outright (e.g., office buildings) or contributed to the joint venture’s authorized capital (e.g., small and mid-size factories).

Today, however, two separate decrees govern the procedure for entering into a joint venture with any state-owned entity, including Ukrainian private companies with more than 25% state-owned participation. As of January 13, 1993, Decree No. 24-92 of the Cabinet of Ministers “On Regulating the Activities of Legal Entities Created by State-Owned Enterprises,” dated December 31, 1992, flatly prohibits state-owned enterprises (except for construction companies participating in joint ventures abroad) from establishing any enterprises, regardless of their form and type of activity. Further, state-owned enterprises may not participate in any business associations or cooperatives, which means that they are not only barred from entering into any ventures with foreign investors, but also with domestic companies.

Further, Decree No. 8-92 of the Cabinet of Ministers “On Administration of State-Owned Property,” dated December 15, 1992, requires the appropriate ministry to give consent to the SPF to form a joint venture between such ministry’s subordinate factory and the foreign investor. Although these decrees initially may appear to create additional barriers to the formation of joint ventures with state-owned enterprises, in reality they merely affirm the previous legal concept that ownership of state-owned property lies with the SPF.

From a procedural viewpoint, formation of a joint venture with a state enterprise has several components: first, the state enterprise must be chosen by the foreign investor for its technical compatibility, management, assets to be contributed and production capacity. Fundamental

issues must be negotiated and documented in the form of a draft founders' agreement and charter.

Second, the state enterprise must review such documents with the relevant ministry and obtain its approval. This may be difficult in the case of more competitive and profitable Ukrainian factories because, in effect, the decrees cause assets of a state-owned enterprise to be contributed to the joint venture company without the receipt of the corresponding shares by the relevant ministry in return.

Upon obtaining the necessary ministerial consent, the foreign partner must negotiate with the real owner of the property, the SPF, regarding the contents of the founders' agreement and charter. Thereafter, the SPF becomes an official founder in the joint venture, and the state-owned factory will carry out the day-to-day activities of the joint venture.

The aforementioned bureaucratic difficulties are not, by themselves, a sufficient reason for refusing to enter into a joint venture with a state-owned enterprise. A more significant reason is the change in control and the uncertainty with respect to the future partner due to privatization. In view of the imminent privatization of state-owned stock, provisions limiting the right to transfer the joint venture company's shares to third parties must be directly negotiated with the SPF.

IV. Miscellaneous Considerations in Forming a Joint Venture with a State-Owned Enterprise

A. Privatization of the State Property Fund's Shares in Joint Ventures with Foreign Ownership

As previously mentioned, Ukrainian legislation allows only the SPF to enter into joint ventures with foreign investors with respect to state-owned enterprises. Thus, shares of the state's stock in a joint venture will be issued to the SPF and not to the state enterprise that participates in the operations of the joint venture company. The SPF has been inserted in the joint venture approval process as the owner of the state's shares in joint ventures for one reason: the SPF is the principal vehicle for privatizing the state's assets and, in particular, stock the state holds in joint ventures created with foreign investors.

Although Ukraine saw precious little privatization before 1995, the SPF was always intended to serve as merely a temporary holding entity prior to privatization. By its very function, the SPF is responsible for selling state-owned property. Much like state-owned buildings, the SPF's shares of stock in joint ventures are being privatized.

On August 22, 1997, the SPF issued Order No. 913, entitled "Provision on the Procedure for Preparing Shares (Equity, Stock) [That] Belong to the State in the Property of Enterprises with Foreign Investments and Other Companies for Privatization and Sale," which was registered with the Ministry of Justice on October 1, 1997 under registration No. 450/2254. This Order provided a fairly straight-forward procedure for acquiring state-owned stock in joint ventures. Order No. 913 was subsequently replaced by the SPF's Order No. 1138 of the same name on June 16, 1999 (registered with the Ministry of Justice on August 8, 1999 under No. 525/3818). Essentially, state-owned shares can be purchased by the co-founder(s) in a joint venture or by the employees (workers' collective) in a joint venture, with the consent of such co-founder(s), in exchange for cash only.

Any foreign investor, interested in entering into a joint venture with a state-owned enterprise, must protect itself from potentially unforeseen consequences of privatization. This can be done by providing for a right of first refusal to purchase shares of stock and restrictions on the sale of stock to competitors, and also by selecting the method of sale and valuation of shares of stock. Unless these issues are specifically addressed in a founders' agreement, a foreign investor's project may face uncertainties. For the investor, privatization of the SPF's stock will result in a new partner (or in case of the open sale of stock, several hundred new partners) in the joint venture.

This concept always presented problems for foreign investors, particularly where the investor makes available to the joint venture competitive technology or intellectual property. Without adequate precautions, such confidential information could easily be disseminated to competitors through minority shareholders.

Below we address in greater detail some of the issues relating to the possible future privatization of state-owned ownership in a joint venture.

B. Controlling Change of the Joint Venture Partner in the Event of Privatization

Typically, partners in joint venture companies seek to maintain control over a change in their chosen partner, imposing mutually binding limits on transfer of the joint venture company's shares to third parties (e.g., rights of first refusal). This way, in the event a Ukrainian partner is subject to a change of control, the sensitive foreign investor will have the option of insisting that its shares in the joint venture company be purchased by the other partner(s).

Short of a fundamental government restructuring, a change of control in the SPF is a highly unlikely scenario given the fact that the SPF has been

created exclusively to privatize state assets. Therefore, change of control provisions are probably not necessary in a joint venture entered into with a completely state-owned enterprise. In light of the imminent privatization of state-owned shares in most joint ventures, however, restrictions on transfers to third parties, such as rights of first refusal and prohibitions of sale to competitors, become vital.

In any case, the provisions limiting the right to transfer the joint venture company's shares to third parties must be directly negotiated with the SPF. Foreign investors should be careful to negotiate not only for the right of first refusal and restrictions on sale to competitors, but also for the method of valuation. In the past, privatization legislation offered complex and frequently unclear methods of valuation, including special provisions applicable only to foreign investors that caused foreign bidders to pay significantly higher prices than local bidders.

In conclusion, a right of first refusal, granting the foreign investor a buy-out option subject to special valuation, should be made patently clear in the joint venture agreement. However, while the SPF routinely agrees to a right of first refusal for sale of stock, it almost always rejects a call option.

D UKRAINIAN PRIVATIZATION EFFORTS

I. Introduction

Since the beginning of economic reforms, the number of privatization advocates has dropped significantly. Coincidentally, the privatization of large-sized enterprises received the least public support.

In general, privatization analysts negatively appraise privatization results, due to factors such as:

- (a) the lack of a positive effect on economic efficiency and production output increase;
- (b) dilution of ownership as a result of a certificate-driven privatization; and
- (c) the formation of inefficient insider ownership and fictitious corporate ownership as a basis of a shadow market economy, which is utterly corrupted and uncivilized.

Among the main causes of unsuccessful privatization are the following:

- (a) the selection of a poor privatization model (the certificate-driven component of privatization is especially criticized) that did not allow global experience to assist Ukrainian enterprises;
- (b) the start of privatization during a period in which the necessary privatization environment has not yet been created; and
- (c) infrastructural (the lack of a securities market, as well as of the lack of a sufficient legal framework protecting property rights and mechanisms for the transparent redistribution of property, etc.) and macroeconomic deficiencies (liberalization and stabilization of the economy have not been implemented in full, which is a pre-condition for successful privatization).

Nevertheless, the results of the conducted analysis revealed that despite the subjective mistakes of the policy-makers, the selected initial privatization model (including a certificate-driven approach) was objectively and rationally substantiated.

At the time, the key factors for the selection of the initial model included:

- (a) implementing high rates of privatization in order to achieve the political goal of assuring that the transformation to the market economy will be irreversible, based on the predominant position of the private sector;
- (b) acknowledging the impossibility to directly apply the methods that are typical for developed countries, (i.e., selling on the securities and real estate markets because those markets were not formed);
- (c) lack of sufficient national private capital accompanied by the public's lack of preparation with respect to the dominance of foreign capital in the process of privatization; and
- (d) the necessity to apply a compromise model that would ensure broad public support for privatization.

Much worse than in the other European post-socialist countries (with the exception of neighboring Belarus), the results of privatization could be explained not by the drawbacks of the selected model, but rather by the rather unique conditions in which privatization in Ukraine has been implemented.

Objectively, Ukraine had the worst starting conditions for market reforms in general, and for privatization in particular. Below we list the main reasons for this conclusion:

- (a) Ukraine's economy was structurally based on the highest level of centralization and industrial production concentration in the world (even in comparison to Russia);
- (b) Ukraine has a critically low share of the light industry and the service sector in comparison to its excessively developed raw materials and primary processing industries, as well as the military-industrial complex, which did not have any prospects for development after the collapse of the Soviet Union; and
- (c) the insignificant size and role of the Ukrainian small enterprise sector.

Despite the State's key role in slowly furthering the process of reforms, in the early 1990's there were no formed state institutions in Ukraine. Ukraine did not have the historical experience in building up the state (in contrast to the Baltic states) and it also did not inherit the developed state machinery from the USSR (as was the case with Russia).

Ukraine also suffered from unfavorable sociopolitical conditions: the predominance of socialist and collectivist stereotypes in the minds of the majority of the population prevailed. Long term domination of overt opponents to privatization in the governmental bodies, including the Parliament, was routine.

Due to a number of objective causes, other Central European countries were able to commence the process of radical market reforms not from privatization, but from so-called «marketization,» which included liberalization and stabilization of the economy. Unfortunately, this was not so with Ukraine.

In contrast to Central European countries, where enterprises were privatized in an already prepared market environment and could demonstrate their advantages from the first steps, the creation of a powerful non-state sector in Ukraine was a necessary politico-economical condition for the implementation market reforms to an extent when such reforms begin to bear fruit.

Thus, due to the fact that Ukraine was less prepared to implement radical market reforms, mass privatization turned out to be the locomotive that helped to haul other reforms.

Despite the peculiar character of privatization, the difficult conditions and the non-traditional approaches to its implementation (compared to the privatization experience of other countries), mass privatization in Ukraine began to positively affect the economic efficiency and production growth only in recent years.

Numerous negative opinions concerning the results of privatization are often based on the wrong ideas of the quantitative and qualitative parameters of the privatization process, its structure and its scale.

Below is a list of the major factors that distort the actual situation concerning privatization:

- (a) insufficient attention is paid to the depth of privatization. As a result, in many cases when we focus on the inefficient work of the non-state (private) sector, we actually evaluate the performance of state-owned enterprises with a part of privately owned property in their authorized capital;
- (b) privatized enterprises can realize their advantages only after a certain period of time during which they restructure their production, replace management, etc. The official statistics almost completely fail to take this factor into account;

- (c) a significant number of privatized enterprises remain in the sphere of total state paternalism and excessive state regulation (i.e., a segment of formally privatized, albeit state-run, enterprises emerged); and
- (d) the state economy sector is still directly and indirectly supported from the budget. Actually, private enterprises are discriminated by the state, which distorts the actual situation reflecting the efficiency of the state and non-state sectors' performance.

Selective studies clearly prove that enterprises with a high concentration of property rights are more efficient and, since 1997, indicators showing better performance of the non-state sector compared to the state sector are carefully observed. Since 1998, thorough research of the financial and economic indicators of industrial enterprises (fuel and energy complex excluded), conducted within the framework of the joint project of the Harvard Institute of International Development and Market Reforms Center, demonstrated a sufficient and statistically significant advantage of the non-state sector according to indicators characterizing the economic behavior of enterprises.

The above analysis has shown that, compared to state-owned enterprises, privately-owned enterprises:

- (a) worry more about their solvency, debt collection and payment of debts;
- (b) turn over money more quickly by reacting to unfavorable situations via the acceleration of turnover;
- (c) are more inclined to save and invest;
- (d) almost do not accumulate past due and tax indebtedness; and
- (e) increase their volume of loans received on market-like terms.

In fact, in 1999–2000, the state sector accounted for almost all of the increase in the volume of past creditor indebtedness.

A positive correlation between the production indices in industries and the amount of privatization in such industries, and a negative correlation between the production indices and the share of state-owned property, were first observed in 1999. In 2000, this correlation was stable, strong enough and statistically significant, regardless of the privatization depth evaluation methods of the industry. Industrial growth in 2000 is, to a considerable extent, the direct result of mass privatization in the mid 90s.

Although the initially selected privatization technology could not quickly create the necessary financial and infrastructural preconditions for the concentration of capital and secondary redistribution of property, these processes are rather intensive.

The thesis that the volume of the secondary share market is insignificant in Ukraine does not correspond with the reality. If we evaluate it in comparison with the economy as a whole, of course, this market is smaller than in developed countries. However, it is smaller only by several times, not by dozens and hundreds of times as some critics claim.

Thus, on the one hand, privatization was the key factor in the formation of the market infrastructure and the system of legal relations that regulate the market. On the other hand, the creation of this infrastructure and the system of relations makes it possible to significantly intensify and speed-up privatization processes, and allows the private sector of the economy to realize its advantages.

In the same way, privatization created conditions for implementing a more-or-less efficient macroeconomic policy, and private enterprises most adequately react to this policy. A widely spread reduction of privatization solely to the privatization of enterprises distorts the actual scale and structure of the privatization process. Privatization of land and available housing played a more important role in the process of privatization than is generally recognized (as to the total volume of privatization).

In recent years, the importance of new capital for the formation of the private sector is rapidly increasing. New non-privatized, non-state enterprises are more rapidly increasing their production volume than privatized enterprises.

II. Conclusion

In 1999–2000, privatization became one of the most important factors of economic growth in Ukraine and, in general, privatization was successful. In an historically short period, the importance of the non-state sector could be compared with the Government's position in the economy. This is a key pre-condition to the irreversibility of economic and sociopolitical changes.

During the last two years, the improved performance of the non-state sector, in comparison with the state sector, is clearly observed. As the willingness of the population to work for a private entrepreneur increases, a majority of the population is seeking out jobs in the private sector. This is a significant factor, indicating that the public has recognized new socioeconomic realities caused by privatization, and this is by far more important than the negative appraisals of privatization results.

E PRIVATIZATION PROGRAMS

Virtually no privatization took place during President Kravchuk's three-year tenure: only the Ukrainian employees, uniting under a "leasing collective" umbrella, were allowed to buy out their place of employment, on non-competitive basis at that! These lucrative "buy-outs" occurred in accordance with special provisions in the lease agreements, signed between the leasing collective and the State Property Fund (the "SPF").

When President Kuchma came to power in 1994, real privatization efforts slowly began, three long years following Ukraine's independence. Today, all of Ukraine's small and most mid-size factories are privately owned due to so-called "mass privatization" efforts. Many of the large enterprises (some of strategic importance) are currently subject to privatization, hopefully with foreign investment (e.g., Oblenergo's).

Below we provide you with a brief historical overview of several Ukrainian privatization programs, each one containing its own set of peculiarities.

I. The 1994 Privatization Program

The long-awaited 1994 Privatization Program optimistically promised to privatize some 1,300 large and mid-size enterprises and about 9,000 so-called "small scale objects." At that time, large-scale privatization was planned to take place in two waves: 300 in February and 1,000 in August, 1994. Deadlines expired, but very little was privatized.

In fact, the year-end results revealed that only 28.4% of the factories slated for sale were actually privatized (with a total of 7,967 objects privatized in 1994, mostly small-scale). The short 6-month time frame for completion of the stock distribution, required by the Law "On Privatization of State-Owned Enterprises," was breached in the absolute majority of cases due to an unrealistically cumbersome distribution mechanism and the lack of qualified personnel.

Foreign investors quickly discovered that the 1994 Program applied an especially unfair exchange rate to foreign investors, requiring them to pay for shares of stock obtained in the privatization process, in foreign currency, at a rate of 420 karbovantsi to 1 U.S. dollar. In comparison, the official currency auction rate was about 40,000 to 1 U.S. dollar and the commercial rate was approximately 50,000 karbovantsi to 1 U.S. dollar. In contrast, Ukrainian residents could pay the final price in local currency, and without any "special" rates or other silly coefficients.

To artificially inflate the asking prices, valuation intentionally failed to take into consideration such factors as future profitability, which would significantly lower the price. Naturally, reasonable foreign investors were not interested in acquiring stock through the official privatization process. Instead, many chose to enter into joint ventures with the SPF, or for that matter, any private enterprise that would give them access to their industrial property for production purposes.

Clearly, competitive privatization did not work until 1995, as evidenced by the fact that most of the Ukrainian privatized enterprises escaped from state ownership through the back door. Some entered into leasing agreements with the SPF and promptly exercised their right to buy-out the property on a non-competitive basis. Others were transferred "from balance to balance." In fact, these (and other non-competitive) privatization avenues became so widely abused, that the Parliament passed a resolution on July 29, 1994, ironically entitled, "On Perfecting the Mechanism of Privatization in Ukraine," which officially placed a moratorium on all sale-purchase agreements with the SPF.

Of course, all privatization efforts of large and mid-size enterprises, including buy-outs by leasing associations, stopped dead in their tracks. In fact, only objects designated as "communal property" (small scale objects) were allowed to continue with their privatization. At this stage, only technical assistance projects (notably, the British Know-How Fund and TACIS) continued their privatization activities.

II. The 1995 Privatization Program

On January 17, 1995, the Cabinet of Ministers approved another overly ambitious draft privatization program for 1995, calling for privatization of 22,700 large, medium and small enterprises and 1,200 unfinished construction sites by the end of 1995. However, the Parliament rejected this program as insufficient and sent it for redrafting while it scrambled to prepare a list of "objects that are not subject to privatization" (which would then legally lift the moratorium on privatization).

The Parliament may have won a postponement, but the President won the battle when he executed an Edict "On Measures for Ensuring Privatization in 1995," dated June 23, 1995, and effective July 5, 1995. This Edict served effectively as the 1995 Privatization Program, setting forth the planned numbers of privatization objects, classified in 6 groups (e.g., small scale, medium objects, foreign investment, unfinished construction, shares of state-owned stock in factories, etc.).

Baffling the Parliament and foreign observers alike in the breadth of its scope, the 1995 Privatization Program presented a simplified administra-

tive system. The new, pro-active approach consisted of setting up a nationwide network of 26 regional privatization centers to facilitate the auctions where Ukrainian citizens can obtain share(s) of stock in exchange for their individually named privatization certificates. Acting as facilitators in a reluctant market, these centers were designed to provide information about the various stocks available for sale, accept applications from Ukrainian citizens and financial intermediaries (e.g., trust companies), collect the privatization certificates and provide consultations regarding all aspects of the privatization process.

Lending political support to President Kuchma's aggressive reforms, in July of 1995, the SPF issued an unusually candid 6-month report, which contained very little good news. Whereas the SPF planned to privatize a total of 13,618 enterprises (consisting of 9,647 small and 3,971 medium and large-scale objects) only 2,166 small scale objects and 1,087 large scale enterprises were actually privatized in the first half of 1995. Worse, most of the privatization continued to take place by non-competitive means (e.g., worker buy-out or leasing association buy-out). As a result, much of the state property escaped to the private sector without an opportunity for Ukrainian citizens to invest their privatization certificates.

Instead of uniting all political fractions to resolve the obvious problems, the SPF's frank disclosure of the dismal numbers, and the privatization methods in use, caused severe public tongue-lashing from all sides. As a result, no significant privatization took place for the next two years.

III. The 1997 Privatization Program

On May 6, 1997, President Kuchma submitted his draft of the 1997 Privatization Program to the Parliament, Decree No. 385/97, and to everyone's surprise, on June 3, 1997, the Parliament actually passed it (the first Privatization Program which Parliament approved in 3 years).

Unfortunately for foreign investors, however, the draft which the Parliament passed differed greatly from President Kuchma's version because it excluded all clauses that would allow the privatization of land under the privatized factories (leaving the investors open to undefined future liabilities). Still, the 1997 Program scheduled a total of 5,562 enterprises (including a mere 1,440 medium and large enterprises) for privatization, concurrently applying different methods to the groups.

For instance, under the 1997 Program, 80-100% of enterprises categorized as group B must be sold for privatization certificates and cash to their employees on a favorable (priority) basis. At least 70% of the shares of group V are to be sold to employees on favorable terms and the remain-

ing 30% for cash only. In group G, a controlling stake of at least 51% was to be sold via non-commercial competition.

Foreign investors must always keep in mind that enterprises that are to be privatized with direct foreign investment are classified in group "G." To accommodate the investors' interests, on August 8, 1997, then Acting Chairman of the SPF, Mr. Lanovoi, signed Order No. 76-154, which accelerated the transformation of state companies to open joint stock companies. Specifically, this Order applied to the notorious group G (also containing the largest state-owned companies and monopoly enterprises) of which, according to the 1997 Program, not less than 25% were to be privatized under a commercial or non-commercial tender.

The primary difference, according to Lanovoi's rules, was that a commercial tender presumes at least 26% stock of an entire enterprise will be sold, and the income must go to the national budget (not to the privatized factory). Also, the winner of a commercial tender would be required to fulfill additional conditions and complete an investment program (and/or undertake to repay the company's debts to the state). In a non-commercial tender, on the other hand, an investor could acquire at least 51% of the stock, and the money would be invested in the actual production.

On December 24, 1997, when most Parliament deputies were enjoying their Christmas vacation, the SPF launched a new offensive by announcing fifteen tenders at once, offering shares of large enterprises, including nine energy distribution companies. The shares were to be sold in large blocks, 20-25% of total ownership, and investors also had to contribute money directly to the enterprises. The SPF also announced that 35 more tenders would take place, offering 12 energy distributing and 4 energy generating companies. This noble attempt to re-activate the privatization process had mixed results (see discussion regarding privatization of the energy sector, below).

On December 25, 1997, the SPF signed an Order No. 1520, "On the Procedure for Preparing the Conducting of Open Tenders," which was registered in the Ministry of Justice on December 31, 1997. This Order governs the privatization process where at least 25% of a company's stock is sold to any one investor, and provides for two types of tenders: (a) the winner is selected based on the highest price paid per stock and the investment sum; and (b) the winner pays the highest price, in cash (in Hryvnia).

In summarizing the 1997 privatization results, Deputy Prime Minister Tigipko noted that the state budget received 440 million Hryvnia less than was expected. This statement was echoed by the deputy chief of the SPF, Yuri Grishan, who stressed that the main priority for 1998 is to sell state-

owned property for cash. These welcome statements are perfectly consistent with the overly optimistic requirements contained in all previous privatization programs, giving investors a glimpse of hope that Mr. Grishan's priorities would be implemented in the New Year.

IV. The 1998 Privatization Program

On January 14, 1998, President Kuchma submitted his draft of the 1998 Privatization Program to the Parliament for ratification. On February 12, 1998, the Parliament reviewed Kuchma's program and once again promptly cancelled all provisions concerning privatization of land.

The Parliament's version of the 1998 Privatization Program also reduced the number of privatization objects from 1,440 to 973 medium and large enterprises and from 1,000 to approximately 400 unfinished construction sites. The President then approved the diluted version of his Law "On the State Privatization Program [for 1998]" No. 124/98-VR, on February 12, 1998. The 1998 Privatization Program was officially published on March 17, 1998, rendering it legally effective thereafter.

Generally, the 1998 Program attempted to increase the turnover of state-owned property into private hands, and contained many new concepts and provisions to implement this illusive and seemingly unachievable, goal. The 1998 Program cleverly provided for several new mechanisms within the framework of categories previously described in the earlier privatization programs.

Thus, all state-owned enterprises continued to be placed into one of seven categories, listed by the first letters of the Ukrainian/Russian alphabet (e.g., A, B, V, G, D, E, Zh) ranging from small-scale mom-and-pop shops to large military conversion complexes. The groups continued to be defined as follows:

Group A: small-scale enterprises or structural sub-units with capital assets worth less than 1 million Hryvnia;

Group B: small to mid-size enterprises capital assets between 1 million and 170 million Hryvnia with shares per employee less than 12 times the privatization certificate's nominal value;

Group V: mid-size to large enterprises with capital assets between 1 million and 170 million Hryvnia with shares per employee in excess of 12 times the privatization certificate's nominal value;

Group G: enterprises with capital assets over 170 million Hryvnia, as well as enterprises acquired by foreign capital, monopolies, etc.;

Group D: unfinished construction objects;

Group E: shares of stock, which the State Property Fund has in companies with mixed (private and state) ownership, including joint ventures;

and

Group Zh: objects of social infrastructure including education, sports or medicare facilities. This is a new category, which includes property of sanitariums, resorts, health care institutions, culture facilities, arts facilities, press facilities, sports facilities, TV and radio broadcasting, and publishing concerns.

The 1998 Program provided a wide variety of privatization methods, including the mandatory "favorable subscription" by employees (both primary and secondary); sale to Ukrainian citizens for privatization and/or compensation certificates; sale on the stock exchange and through financial intermediaries; sale on commercial and non-commercial competitions; and sale via open tenders, announced by the SPF and organized by consultants.

Before the 1998 Program, the privatization process could proceed only after the "favorable subscription" to employees and management was completed, which greatly slowed down the process. To eliminate these unwarranted delays, the 1998 Program required that all privatization methods take place concurrently, not consecutively. Dealing with this previously unacknowledged, yet significant, barrier (i.e., the greedy management) became necessary after the 1998 Program reduced the management's incentive (to purchase company stock at favorable prices) from 10% of the company's statutory fund to 5%. As a retaliation for this reduction, the management of some companies tried to block privatization efforts.

Another new goal was to finish the seemingly endless process whereby Ukrainian citizens redeem their privatization and compensation certificates for shares of stock. Thus, the 1998 Privatization Program wisely limited the issuance of privatization and compensation certificates through July 1, 1998, with the goal of terminating this restrictive system of redemption once and for all on December 31, 1998. The 1998 Program expressly referred to a procedure for "extinguishing" privatization securities which have not been received by Ukrainian citizens.

Further, as state-owned property seemed to disappear without the average Ukrainians receiving any benefits from such sale, the quotas for applying the privatization securities changed. The 1998 Program required that up to

60% of shares in group B, up to 50% in group V, and up to 25% in group G be sold to Ukrainian citizens for privatization and compensation certificates. This increase in quotas was designed to somehow absorb any remaining privatization securities. Interestingly, unlike the named privatization certificates, the 1998 Program specifically permitted foreign investors to use a new instrument called "compensation certificate," recognizing that local financial intermediaries consistently used this method on the behalf of their foreign clients anyway.

For the privatization of large and/or strategic and/or monopoly enterprises in 1998, the State Property Fund openly declared its previously unwritten policy toward retaining a certain percentage ownership in such an enterprise. The 1998 Program provided that privatization plans of open joint stock companies were required to provide for sale of either 100% of stock; 75% of stock; or 50% of stock. The SPF used the latter two options to exercise control by retaining ownership either in 25% stock (plus one voting share) or 50% stock (plus one voting share).

Such stock retention would typically occur in cases of monopoly or other enterprises that have "strategic value to the economy and safety of the state," and may last for a period of up to five years. Some of the enterprises in which the SPF decided to retain 26% stock were identified in the Cabinet's Resolution No. 616-r, dated October 28, 1997. They included the Poltava Diamond Factory, the Shipbuilding Plant "Ocean" (in Nikolaev) and Lvov Autobus Factory. By retaining at least 25% stock ownership (plus one vote) the SPF retained the right to veto all issues about the company's participation in other enterprises, alienation of property via lease or pledge/collateral agreements, etc.

A large section of the 1998 Program was devoted to post-privatization assistance. In this regard, the Program wisely tried to protect the rights of minority shareholders against the probable abuses of their fellow shareholders. Thus, a new shareholder could not be denied the registration of his or her ownership. Similarly, no limitations on stock sale to third parties could be placed in the context of open joint stock companies. The SPF also was to create post-privatization assistance involving loans on a favorable basis (up to 5 years).

The more interesting provisions for foreign investors dealt with valuation and favorable tax treatments, granted by the 1998 Program to assist in the privatization process. For instance, for the first time in the history of privatization, a fair mechanism for setting "fair market value" was defined. The 1998 Program allowed sufficient upward and downward price adjustments to assess the fair market value and meet demand (if any).

With reference to tax holidays, according to the 1998 Program, all privatized property was free from property taxes, as well as from taxation of investments in stock companies (if effectuated as part of fulfilling investment conditions). Tax also would not be levied from customs payments on import and export of capital, which was used for acquiring property within the privatization process.

The 1998 Privatization Program also contained various miscellaneous provisions concerning privatization of state-owned stock in joint ventures with foreign ownership (in accordance with foundation documents) and hotels (to be privatized strictly through tenders, non-commercial competitions and auctions in accordance with the Law "On Privatization of Small Scale Enterprises").

V. The 2000-2002 Privatization Program

A. Introduction

On May 18, 2000, the Ukrainian Parliament approved the latest state privatization program for 2000-2002 (the "2000 Program"). As of March 10, 2004, this privatization program is still effective and a new privatization program for 2004 and beyond has yet to be approved despite the entire passing of the year 2003. As one could predict, the stated lofty goal of the 2000 Program is "to create proper conditions for increasing the efficiency of enterprises, institutions and organizations, creating a competitive environment and ensuring the inflow of funds to the state budget." Unlike its predecessors, however, the 2000 Program's priority is privatization exclusively for cash, with due regard to the individual peculiarities or deficiencies of each enterprise, institution or organization.

Pursuant to the 2000 Program, Ukraine plans to privatize approximately 600 objects within the groups V and G described below during 2001 and 2002. To accomplish this, however, the President, the Parliament, the Cabinet of Ministers, the SPF, the Antimonopoly Committee and the State Committee for Securities and the Stock Market must exercise strict control over the fulfillment of the surprisingly ambitious 2000 Program.

B. Discussion

Like its predecessors, the 2000 Program segregates all privatization objects into the following groups:

1) Group A: (i) integrated property complexes of state-owned enterprises, leasing associations or structural sub-units isolated from independent enter-

prises, including those in the process of restructuring of state enterprises, which employ up to 100 employees, or those enterprises which employ more than 100 employees, but the value of their fixed assets is insufficient to form the minimum authorized capital of open joint stock companies; and (ii) hotels, sanatoriums, resorts and “rest houses,” which are credited to separate balance sheets; and separate individually designated property (including property which did not go to the authorized capital of an open joint stock company, buildings, structures and non-residential premises, property of enterprises liquidated pursuant to a decision of a commercial court and property of enterprises liquidated pursuant to the decision of the body authorized to manage such property); and property of enterprises which were not sold as property integrated complexes;

2) Group V: (i) integrated property complexes of enterprises, which employ more than 100 employees and the value of their fixed assets is sufficient to form the authorized capital of an open joint stock company; (ii) shares of open joint stock companies whose share issuance was registered or whose shares were offered for sale prior to the effective date of the 2000 Program; and (iii) shares of open joint stock companies created on the basis of agricultural enterprises, provided that the value of their fixed assets is sufficient to form the authorized capital of an open joint stock company;

3) Group G: integrated property complexes of enterprises or packets of shares in open joint stock companies, which are considered to be monopolies on a certain market or strategically important for the economy or state security;

4) Group D: unfinished construction objects;

5) Group E: state-owned shares of stock or interest in business entities (including enterprises with foreign investments) which are located in Ukraine or abroad; and

6) Group Zh: social infrastructure objects, including health, education, culture, art, sports or medicare facilities, with the exception of sanitariums, resorts and “rest houses,” which are credited to separate balance sheets.

Notably, the 2000 Program pays particular attention to the privation objects included in group G. Specifically, before the decision regarding the privatization of enterprises within group G is made, the SPF:

1. publishes in the press and electronic mass media (i) the financial reports of the enterprise to be privatized, including its balance, capital flow, own capital and the information regarding the financial and proprietary condition of such enterprise; (ii) the amount of shares which may be

retained by the State; and (iii) a questionnaire to be filled in by potential buyers, indicating the preferred privatization method chosen by such buyers;

2. conducts an analysis of the potential buyers' demands and publishes the results of such analysis within one month from the receipt of the above questionnaires; and
3. determines the privatization method for each enterprise based on the results of the above analysis.

If there are one or more offers to acquire a state-owned enterprise with less than 1,000 employees, or to purchase a so-called “controlling packet of shares” of an open joint stock company, the SPF will hold an auction, or the “controlling packet of shares” will be sold at a public tender. Importantly, the 2000 Program defines a “controlling packet of shares” as shares of stock totaling more than 50% of the authorized capital of an open joint stock company, which allows a legal entity or a physical person to make fundamental decisions regarding the company's activity.

Note that the buyer of a controlling packet of shares of a company in the fuel, energy, metallurgical, oil and chemical industries, as well as in the aviation, transport and machinery construction branches, must be a so-called “industrial investor.” According to the 2000 Program, an “industrial investor” is defined as a local or foreign investor (or their association) which is interested in preserving the enterprise's market share of the relevant product. For example, this classification means that for a period of three (3) years, industrial investors must manufacture products or render services, which are analogous to those products or services rendered by the enterprise subject to privatization. Further, having learned from past experiences, Ukrainian legislation provides that the industrial investor cannot be a company registered in an offshore zone (Cayman Islands, Bahamas, etc.).

If no potential industrial investors express interest in purchasing the enterprise or the controlling packet of shares of an open joint stock company, then the SPF conducts a simplified analysis of such enterprise's financial condition, somehow calculating the mysterious coefficients associated with the company's liquidity, business activity, profitability, solvency and capital structure. Based on the results of the above analysis, the SPF will either decide to transform such enterprise into an open joint stock company with further sale of its shares of stock or restructure such enterprise in order to separate property which will be subject to further privatization.

Importantly, the 2000 Program allows the SPF to retain either 25% or 50% stock ownership (plus one voting share) by the State in open joint

stock companies that have strategic value to the economy and security of the State. The SPF must first agree upon the privatization terms and conditions for such enterprises with the Cabinet of Ministers.

The 2000 Program also states the obvious: that monopoly enterprises must be privatized in accordance with antimonopoly legislation. The list of such enterprises is prepared and revised by the Antimonopoly Committee of Ukraine. All antimonopoly requirements must be incorporated into the terms and conditions of tenders, auctions or public sales. If the potential buyer is subject to antimonopoly requirements, it will need to obtain the relevant consent from the Antimonopoly Committee before participating in privatization.

VI. Conclusion

In the summer of 1997, the SPF began to exhibit a more open, sometimes even lenient, attitude to attracting foreign investors by offering controlling packets of stock to strategic partners. This “thawing” resulted in an influx of investors, until the crash of August 1998, drove many away. The subsequent negative press reports assured that any remaining Western investors would put their expansion plans on hold, leaving the field open for Russian investors, who are welcomed with open arms by Ukrainian factories.

F THE TENDER PROCEDURE FOR THE PURCHASE OF BLOCKS OF SHARES OF STOCK IN OPEN JOINT STOCK COMPANIES

As an observation, pushing economic reforms through the Parliament can be extraordinarily frustrating. And yet, President Kuchma somehow managed to quietly implement changes vital to reform Ukraine’s stagnant economy.

The announcement regarding the sale of blocks of shares in large Ukrainian enterprises kept rolling off the State Property Fund’s bulletins: Zaporizhia Aluminum Plant, Pivnichny Ore Enrichment Plant, Kramatorsk Steel Plant, Nikopol Ferroalloys Plant, KhersonNaftoPererobka Oil Refinery, Khartron and TurboAtom Plants, to name a few.

Certainly, many of the above companies offered for sale were initially over-valued. Others proved to be barely efficient and sought investors to help modernize their facilities and equipment. Still others, such as energy companies, required a major legislative overhaul of distribution practices and the implementation of the ability to disconnect non-paying customers before serious investors would be willing to take responsibility. And yet, even with these deterrents, the largest state-owned enterprises are finally up for sale.

Immediately below we review the procedure for conducting and participating in tenders for blocks of shares of open joint stock companies.

I. Introduction

The tender procedure for the sale of stock in open joint stock companies is regulated by Order No. 1908/11/271 “On Approval of the Regulation of the Procedure for Conducting Tenders for the Sale of Packets of Shares of Open Joint Stock Companies Created During the Process of Privatization and Corporatization,” jointly prepared by the State Property Fund of Ukraine, the Antimonopoly Committee of Ukraine and the State Commission for Securities and the Stock Market, dated September 13, 2000 (hereinafter the “Order”). The Decree was developed in accordance with the Law of Ukraine “On Privatization of State-owned Property,” the Law of Ukraine “On Privatization of Small State-owned Enterprises (Small-scale Privatization),” the Law of Ukraine “On the State Privatization Program” and other normative acts of Ukraine, and was registered with the Ministry of Justice on September 28, 2000, registration No. 665/4886.

The Order defines “tender” as the method of selling shares in open joint stock companies to a tender winner, who is defined as the tender candidate who offers the highest price for such shares and is willing to assume the obligation to fulfill all of the fixed terms and conditions of the tender. The Order further provides that advisors may be brought in to facilitate the effective sale of stock during these tenders.

In conjunction with this provision of the Order, the Cabinet of Ministers passed Resolution No. 1320 “On the Procedure for the Sale of State-owned Packets of Shares of Open Joint Stock Companies, Created in the Process of Privatization, in the Form of Depository Receipts on International Stock Exchanges,” dated July 21, 1999. Resolution No. 1320 makes it possible for investors to buy packets of shares from designated OJSCs on international markets in the form of depository receipts.

As briefly mentioned, the sale of shares may be effectuated on a tender basis with the participation of advisors. Such advisors are selected according to the procedure approved by the State Property Fund’s Order No. 1745, dated August 21, 2000.

The discussion below describes the general procedure for holding tenders for the sale of stock in the context of privatization. Importantly, the specific tender procedure for each OJSC subject to privatization may vary, depending on the privatization list on which it was included and its strategic importance to the Ukrainian economy. Therefore, interested investors should consult an experienced advisor if a specific business opportunity arises.

II. General Tender Terms and Conditions

Pursuant to the Order, a tender may be conducted when even one candidate is competing to purchase the desired shares of stock. In this case, the State Property Fund (the “SPF”) may propose that such candidate conduct an expert appraisal to reconsider the initial price of the packet of shares which was published in the information announcement about the tender. If the candidate agrees with such proposal, the privatization body will effectuate the expert appraisal of shares and negotiate the price of shares with the candidate. If the candidate refuses the proposal to conduct an expert appraisal of the share packet, then the privatization object will be removed from the tender and the tender will be deemed to have not been conducted.

Importantly, the holding of a tender for shares of an open joint stock company pertains to only one single packet of shares in accordance with the SPF’s allocation plan. In other words, the participants must bid for an

entire packet of a given factory’s stock, not separate shares or a certain percentage thereof.

Payment for acquired shares may be carried out in two installments. Specifically, at least 50% of the stock price must be paid within thirty (30) calendar days from the date the sale-purchase agreement for the stock is signed, while the remaining 50% can be paid within sixty (60) calendar days following the signature date of the sale-purchase agreement.

Tenders are organized by a commission, created by the relevant privatization body in charge of privatizing the OJSC. The tender commission has several functions, including: (i) reviewing the recommendations of the relevant privatization body regarding the initial price of the packet of shares, determining such initial price and submitting the initial price for the privatization body’s approval; (ii) working out the fixed terms and conditions of the tender and filing them for the privatization body’s approval; (iii) drafting the information announcement about the tender and filing it for the privatization body’s approval; (iv) preparing a protocol regarding the offers of the tender participants; and (v) determining the winner of the tender.

Among others, the following terms and conditions of a tender may be included in the list of the participants’ obligations:

- a) complete or partial repayment or restructuring of the OJSC’s outstanding debt, if any;
- b) partial payment or restructuring of the OJSC’s outstanding debt with respect to loans granted by commercial banks;
- c) technical reconstruction of the OJSC’s production facilities;
- d) preserving the existing work places or the creation of new jobs for a certain period of time;
- e) preserving the production profile of the OJSC;
- f) fulfillment of government sanctioned tasks for the OJSC;
- g) compliance with the requirements of antimonopoly legislation;
- h) the creation of safe working conditions;
- i) preserving social infrastructure units (for example, day-care centers, sports facilities, housing, etc.);

- j) performing certain steps for environmental protection and compliance with environmental legislation; and
- k) other specific requirements.

The above list is subject to expansion, depending on the specific activities of the OJSC offered for sale. Furthermore, certain of the above requirements must be fulfilled within five (5) years after the date the sale-purchase agreement is signed. The applicable requirements for each OJSC will be set forth in a so-called "privatization plan" for the packet of shares to be sold.

III. The Terms and Conditions for Participation in a Tender

In order to participate in a tender, potential buyers must submit their tender offer along with the so-called "confirming documents," which the Order defines as the documents which confirm that the prospective investor falls within the criteria of candidates listed in the terms and conditions of the tender.

The aforementioned documents must be written in the Ukrainian language and must be submitted personally by the potential buyer, or its authorized representative, to the SPF's relevant privatization body. Upon submission, the privatization body will register such documents and mark them with a registration number and the date and time of registration. The potential buyer will receive a corresponding certificate, which will specify the number, date and time of registration and the surname, first name and patronymic (if applicable) of the potential buyer.

A. The Confirming Documents

The confirming documents include the following:

- 1) a signed and properly stamped application to participate in the tender (the authenticity of the signature of an individual on an application must be notarized);
- 2) documents which confirm the payment of the participation deposit and registration fee for filing the application in the amount specified by legislation and set forth in the tender announcement;
- 3) duly executed documents which confirm the following:
 - a) the surname, first name and patronymic (if applicable) of the physical entity and/or representative of the legal entity and a list of their authorities;

- b) an income declaration (for physical entities);
- c) for legal entities, notarized copies of their foundation documents and the document which confirms the amount of the state-owned share in their authorized capital (if applicable). Resident-buyers must submit copies of the financial reports for the previous reporting year and quarter. Non-resident buyers must produce an annual report for the previous year, which must be certified by an auditor;
- 4) information regarding additional terms and conditions of participation in the tender;
- 5) a copy of the Antimonopoly Committee's decision, granting consent to acquire the stock, or a copy of the application for the acquisition of the packet of shares with confirmation (stamp, date, signature) of the Antimonopoly Committee's receipt of such copy within no less than eight (8) calendar days prior to the final acceptance of tender documentation, unless otherwise provided by the terms and conditions of the tender; and
- 6) for potential buyers of stock in an OJSC which is of strategic importance to the economy and security of the State, the confirmation documents must also contain the full information about the entities which exercise control over the buyer or are controlled by the buyer.

Tenders for the sale of blocks of shares, the size of which does not exceed 50% of the authorized capital of an OJSC, are held in accordance with a privatization plan, and are documented in a draft sale-purchase agreement with the changes and amendments to the version suggested by the SPF. Tenders for stock, which exceeds 50% of the authorized fund of an OJSC, include a privatization plan, a draft sale-purchase agreement, as well as a business plan describing the enterprise's future development.

The tender offer and the confirming documents are simultaneously submitted to the relevant privatization body, but they must be filed in separate envelopes and marked accordingly. For some tenders, the face of the envelopes may only contain the address of the SPF's privatization body and the name of the tender; candidates may not write anything on the face of the envelope which will aid in identifying such candidate. If the above protocol is breached, the envelopes will remain sealed and the tender offer and documentation will not be accepted for consideration.

B. Preliminary Matters

Before a tender is actually held, the SPF, the Antimonopoly Committee and the relevant privatization bodies must go through a series of time-

consuming but necessary steps to prepare for the tender. For instance, an announcement must be approved and published in the newspaper "Privatization News." Such notice must be published between thirty (30) and fifty (50) calendar days before the tender is conducted.

After publication of the notice, all potential buyers have the right to request the tender documentation from the relevant privatization body. This documentation must contain the following information:

- 1) information on the OJSC which is necessary for the future buyer to evaluate the company's financial-economic condition, including:
 - (a) a copy of the OJSC's charter (by-laws);
 - (b) the share allocation plan of the OJSC and the results of its status at the time the tender is announced;
 - (c) the accounting report for the last reporting year and period;
 - (d) the documents and information necessary for submitting an application with the Antimonopoly Committee for the acquisition of the packet of shares; and
 - (e) advertising information on the OJSC (if available);
- 2) permission to visit the OJSC (if required).

In order for a potential buyer to obtain this documentation, such potential buyer must enter into a non-disclosure agreement with the SPF. The non-disclosure agreement is usually a standard agreement, which may be read and signed upon requesting available tender documentation (i.e., information regarding the targeted OJSC available at the SPF's offices).

The day after the acceptance period for tender offers has expired, the SPF's relevant privatization body will open all envelopes received and begin to ascertain whether or not any required documents are missing. Within five (5) days after the acceptance period expires, the relevant privatization body will carry out an expert assessment of the confirming documents and present the tender commission with a list of qualified candidates and all of the confirming documents.

If the privatization body refuses to permit a candidate to participate in a tender, it will return all unopened documentation and the tender deposit to such candidate within ten (10) days after the commencement of the tender. The reasons for refusal to permit participation in a tender can be any one of the following:

- 1) the candidate cannot be a "purchaser" in accordance with applicable Ukrainian laws;
- 2) the absence of required confirming documents;
- 3) the candidate has submitted documents which are not properly executed;
- 4) the tender offer and confirming documents were not submitted by the deadline;
- 5) the additional terms and conditions for participation, if applicable, were not fulfilled;
- 6) the qualification requirements were not met; and
- 7) the entities which will exercise actual control over the future activity of an OJSC of strategic importance to the economy or the security of the State cannot be determined by the contents of the confirming documents.

IV. The Tender Procedure

The investor selection procedure begins on the day when the tender commission gathers to open the tender offers regarding the proposed price of the packet of shares and enters the offers into its official minutes. The tender commission determines the winner based on the proposed price for the packet of shares and sends the minutes of their meeting for approval by the relevant privatization body within two (2) working days. Thereafter, the relevant privatization body must approve the minutes within three (3) working days.

If two or more candidates submit offers with equally advantageous terms and conditions, the winner will be the candidate who submitted their offer first. As previously mentioned, the winner of a tender is the candidate who offered the highest price for the packet of shares subject to sale at the tender, unless other conditions are provided for in the tender rules.

Within ten (10) days from the date of the approval of the winner, the SPF verifies the presence of the Antimonopoly Committee's consent, conducts any necessary follow up negotiations with the winner and, finally, signs the sale-purchase agreement.

Note that the Antimonopoly Committee has 50 days to send a notice to the privatization body regarding its permission or refusal to grant consent

for the acquisition of the packet shares by a potential buyer. Depending on the Antimonopoly Committee's decision, there are three possible outcomes:

- 1) the Antimonopoly Committee expresses its consent regarding the acquisition and, as a result, the privatization body signs a sale-purchase agreement with the winner of the tender;
- 2) the Antimonopoly Committee declines to accept the application to acquire the shares or refuses to give its consent. As a result, the privatization body will cancel the results of the tender if such decision concerns the winner of tender; and
- 3) the Antimonopoly Committee sends notice that it will review the outstanding matter or accepts a repeat application from the sender. In this case, the privatization body can conclude an agreement with the winner of the tender under a condition precedent, namely the receipt of the Antimonopoly Committee's consent by the winner within fifty (50) days from the date the sale-purchase agreement is concluded. If the winner does not receive the consent of the relevant consent from the Antimonopoly Committee within the above term, the sale-purchase agreement will be deemed null and void.

Moreover, the results of the tender can be deemed void by the SPF in the following circumstances:

- a) non-fulfillment of the requirements regarding the completeness and authenticity of the information contained in the tender announcement;
- b) the OJSC is included onto the list of enterprises prohibited from privatization according to effective legislation;
- c) the winner cannot legally become a "purchaser of OJSC shares in the process of privatization" according to Ukrainian legislation; and
- d) the rules for preparing and conducting the tender for the sale of the packet of shares in the process of privatization were somehow violated.

The SPF's privatization body must prepare and publish an announcement concerning the results of the tender in the SPF's newspaper "Privatization News" within ten (10) days from the conclusion of a sale-purchase agreement with the winner. The privatization body is also responsible for informing the State Commission on Securities and the Stock Market on the results of the tender. Finally, the privatization body must inform all tender participants of the results of the tender and return their tender deposits within ten (10) days after official confirmation of the tender results. Of course, the above tender deposit is not returned to the winner of the tender.

V. Formalizing the Ownership Rights to the Shares and the Sale-Purchase Agreement

Under Ukrainian law, the ownership rights to the newly acquired stock transfer to the tender winner of the tender from the date the sale-purchase agreement is signed, and the actual shares of stock, which were issued in documentary form, are transferred to the winner. If the acquired shares of stock were issued in electronic form (i.e., non-documentary), then the ownership rights thereto will transfer from the date such shares are credited to the owner's account with a share custodian. The above transfer or credit of shares to the owner's account with a custodian must be effectuated within three (3) days upon full payment of the price of such stock.

The sale-purchase agreement must be notarized, and all expenses incurred in connection with notarization should be covered by the buyer. The basic contents of such sale-purchase agreement include the following information:

- a) the name and address of the OJSC;
- b) information on the buyer and seller;
- c) the quantity and par value of the shares sold at the tender;
- d) the price of the packet of shares;
- e) the payment period for the packet of shares;
- f) the obligations of the seller and the buyer;
- g) the name, address and bank account information of both the buyer and the seller;
- h) the liability of the parties for non-fulfillment of the obligations;
- i) legal consequences resulting from the non-fulfillment of the obligations;
- j) the procedure for the parties' effectuation of control over each other's obligations; and
- j) other obligations agreed upon by the parties.

The relevant privatization body is entitled to cancel the tender at any time based on any of the substantiated grounds provided by applicable Ukrainian laws. The packet of shares in an OJSC may be proposed for a

repeat sale at another tender. In case of such repeat sale, the tender commission may render a decision regarding the reduction of the price for the shares of stock. However, in any event, such reduction cannot be more than 30% of the initial price for the shares of stock offered at the original unsuccessful tender.

VI. Conclusion

Although the above procedure may seem overwhelming at first sight, with proper legal guidance and careful legal due diligence, the purchase of Ukrainian blocks of shares is not as risky nor as difficult as one may think. Contrary to popular belief, Ukrainian law actually provides a comprehensive mechanism for concluding transactions for the purchase of Ukrainian controlling shares of stock by foreign investors, and numerous precedents exist. Fortunately, privatization is no longer feared in this part of the world, and the practical application of the above tender procedure has already been put to the test, and surprisingly, it proved to be sufficiently fluid to accommodate foreign investors. Although the days have finally arrived when investors are allowed to compete for controlling shares in some of Ukraine's most lucrative enterprises, the process of privatization has been slow, if not dead, over the past 3 years. The modernization of the legislation base in Ukraine has provided other opportunities for foreign investors to enter the market on a private and small-scale basis in order to test the waters.

G PRIVATIZATION VIA DEPOSITORY RECEIPTS

I. Introduction

Some argue that it was ING's threat to hold Ukraine in default (declaring the nation to be insolvent) which finally forced Ukraine into an interesting series of economic reforms, leading to privatization of its large enterprises. Regardless of the rumors, the Ukrainian Cabinet of Ministers approved the procedure for selling state-owned shares in open joint stock companies on international markets. This theoretically allowed foreign investors to assemble their portfolios by simply buying shares of a Ukrainian enterprise on international stock exchanges without investing the enormous time and energy in finding Ukrainian partners.

While it sounded good, cynics justifiably asked: is it finally possible to follow the stock exchange rates of Ukrainian enterprises and freely buy and sell Ukrainian stocks as the market rises and falls? Optimists resoundingly declared "yes, of course," exemplifying their blind faith in the effectuation of Resolution No. 1320 of the Cabinet of Ministers of Ukraine "On the Procedure for the Sale of State-owned Packets of Shares of Open Joint Stock Companies, Created in the Process of Privatization, in the Form of Depository Receipts on International Stock Exchanges," dated July 21, 1999 (the "Resolution").

Until the publication of the "Schedule of the Selection of Advisors to Provide Services for Preparing and Conducting Tender Sale of Packets of Shares in the Year 2000," however, this optimistic viewpoint seemed absurd. Immediately below, we review Resolution No. 1320, and discuss its potential impact on foreign investors.

II. Discussion

In an effort to find funds for the cash-strapped State budget (which was supposed to come from privatization), the Cabinet of Ministers passed the Resolution, making it possible for foreign investors to buy stock in Ukrainian open joint stock companies on international markets in the form of depository receipts. Attached to the Resolution was an announcement of the Schedule, containing 43 enterprises in need of advisors to help with the sale of their shares of stock. This attachment, more than the Resolution itself, revealed that Ukraine had finally chosen its product and put it up for sale.

Procedurally, the State Property Fund (the "SPF") must first make a formal decision to sell shares of an open joint stock company in the form of depository receipts on international stock exchanges. A depository

receipt is the security which confirms the right of an investor to shares of stock located in a specific depository institution, and gives the receiver the right to own the securities to which they hold the receipt.

After rendering its final decision to sell shares in the form of depository receipts, the SPF must appoint a so-called "advisor" to organize the sale of such shares. The advisor is chosen on the basis of a tender held by the SPF, and it concludes an agreement with the SPF regarding its specific obligations. The advisor must be a legal entity which will prepare a plan of distribution of the depository receipts onto the international market. The advisor is responsible for such matters as advertising the shares to potential investors, substantiating the best market and form of depository receipts for sale, estimating the price ratio between the actual shares and the depository receipts and approximating the expenses related to effectuating the final stock sale.

Upon performing its obligations under the contract with the SPF, the advisor presents its conclusions to the SPF for approval of the program for issuing the depository receipts and the minimum price of the block of shares to be sold. Thereafter, the SPF chooses an international depository institution on the basis of the advisor's suggestion and the proposal of the open joint stock company whose shares will be sold. The SPF then must choose a share distribution agent (the "Agent") the based on the advisor's conclusions.

The function of the Agent, similar to the function of an underwriter in the west, is to find a buyer for the shares according to the program set forth by the advisor. The Agent can be a legal entity or a group of legal entities. The chosen Agent must conclude an agreement with the SPF for the sale of shares of the specific enterprise targeted for share distribution on international stock exchanges.

Before the sale of the shares is commenced, the SPF and the foreign depository institution must select a custodian of the shares. A custodian is appointed for each regional department of the SPF to hold securities until the stock is sold. Custodians can be commercial banks or duly-licensed securities traders. All shares that will be sold must be in the possession of the custodian before actually commencing the procedure for sale of the shares on international stock exchanges. If the shares are in documentary (paper) form, they must be deposited by the SPF with the custodian, where the shares are kept under lock and key. For this purpose, the SPF and the foreign depository institution must open securities accounts with the custodian.

At this point, the Agent may begin to search for any interested buyers of the targeted shares. The Agent must finalize the execution of sale-purchase agreements with any interested investors. If an investor decides to buy a Ukrainian open joint stock company's shares, it must also open an account with the custodian. Thereafter, the investor transfers the agreed-upon sale price to the account of the SPF with the custodian, and the custodian theoretically transfers the funds back to the SPF's authorized bank in Ukraine.

Upon receipt of the notice of transfer to the SPF's account with the custodian, the SPF instructs the custodian to transfer the shares from its securities account with the custodian to the investor's securities account with the custodian. Finally, the investor instructs the custodian to transfer the shares to the foreign depository institution's securities account with the custodian. Once the custodian gives notice to the foreign depository institution that the transfer of shares to its securities account from the investor's securities account has occurred, the foreign depository institution must issue the depository receipts, evidencing ownership rights of the investors to the block of shares, and transfer them to the lucky investor.

III. Conclusion

In concept, the Resolution is beneficial to all parties, assuming the attractiveness of the state-owned shares offered to the investor. The procedure also allows Ukrainian open joint stock companies to be exposed to and advertised in the western financial markets. Despite the enthusiasm, important caveats exist. For instance, the Cabinet of Ministers needs to set up the necessary infrastructure to accomplish many of the noble goals passed in the Resolution. Up until 2004, it has been difficult to measure the success of the Resolution and very few, if any, major announcements have been made evidencing success stories in the press.

H POST-PRIVATIZATION INVESTMENT AND DUE DILIGENCE

I. Introduction

Dealing with any government, especially the Ukrainian government, can be extremely frustrating. Probably the single most difficult aspect of effectuating investments in Ukraine is getting access to real property for production purposes. As a result, investors often enter into joint ventures or case-specific agreements (licensing, import-export, joint cooperation, joint production, etc.) in order to introduce their products to the 48 million-strong Ukrainian market.

In the past, foreign companies were allowed (but not actively encouraged) to participate in the privatization process, in which the government's first priority has always been to distribute state property to employees and Ukrainian citizens for privatization certificates, not "selling out" to foreigners. It is not surprising, therefore, that for many investors the more lucrative opportunities arise in the private, so-called "secondary" market, after the first privatization wave has passed.

In the secondary market, neither the new shareholders nor the old managers have the requisite management or marketing experience necessary for a new company to prosper in today's complicated economic environment. Their survival depends on the ability to independently adapt to the market rules of the game or seek outside assistance (investors, post-privatization consultants). Alternatively, without having the benefit of the necessary post-privatization assistance (in the form of foreign investment) they face premature bankruptcy.

For that reason, today foreign investment often takes place following privatization, even in cases when foreign investors have acquired initial shares by officially participating in privatization. In many cases, initial foreign investment only serves as a prelude to a drastic increase in capitalization following privatization (causing dilution of the Ukrainian shareholders' ownership in the company).

Below we will limit the discussion to direct investment in Ukrainian private enterprises by acquiring existing stock and increasing the company's capitalization.

II. Acquisition Strategy

As Ukrainian privatization picked up speed, a wide variety of real property has begun to appear on the secondary market, where prices are

ruled by supply and demand instead of politics. For many foreign investors, waiting for a factory to finally become privatized has proved to be a wise decision.

Many investors have learned that negotiations with a factory's management (also usually stockholders), who are facing termination, can be quite easy, especially if the investor has conducted due diligence which revealed, among other things, that the newly private enterprises cannot pay its electric bills, etc. In such situations, well-informed investors are often able to negotiate better terms with private factories than with state-owned enterprises undergoing or about to undergo the complicated process of privatization.

Under Ukrainian legislation, a private stock company is able to dispose of any or all of its property, sell its stock to foreign or Ukrainian buyers, and enter into joint ventures, subject to certain case-specific exceptions. In fact, one of the main advantages of dealing with a privatized stock company is that it can enter into all types of transactions, including real estate transfers, fairly easily.

Before undertaking any financial commitment, however, an interested investor should review all necessary documents, which together will provide a legal and business overview of the company's status and possible continuing obligations. At a minimum, the investor should learn of any restrictions in the privatization plan and confirm that the private open stock company is at least 61% privately owned (and identify all of the shareholders).

To increase the chances of successful acquisition on the behalf of our clients, we routinely perform extensive business and legal due diligence concerning a particular investment opportunity prior to a client's commitment of a significant amount of time and resources to a given project. Typically, a team of local and foreign consultants visits the factory to research the various business and legal documentation. The resulting analysis is documented in a corporate profile and includes details concerning the company's structure, financial records, conflicting commitments, etc.

Based on the information contained in the due diligence report, as well as preliminary interviews with the Ukrainian partners, the principals can agree on the basic business conditions suited to their transaction (e.g., business form, share distribution, percentages of ownership, valuation of respective contributions, access to local and/or foreign markets, etc.). Only after this work is substantially completed will the investor seek legal advice to document the results of these negotiations. This process often involves a significant time investment, which is not always possible in cases with tight deadlines for the initiation of production.

Nevertheless, prior to acquiring any stock, it is important at least to have a reliable overview of the existing shareholders. The most common groups of stockholders include: (1) employees; (2) third party investors (e.g., via trust companies); (3) Ukrainian citizens who used cash and/or registered privatization certificates; and sometimes, (4) the SPF. Each group has different interests, and therefore consideration of their respective voting powers becomes important.

The proportionate share of ownership among the stockholders differs greatly from one enterprise to the next, depending on the balance value of each factory and the sector involved (e.g., agro-industrial complex and military-conversion enterprises are governed by a special legal regime). In small to mid-size enterprises, however, relatively few shareholders will have the “controlling package” of stock necessary to resolve certain fundamental decisions, such as calling for an increase in capitalization by issuing additional stock or a decrease in capitalization by contributing (alienating) real property to a newly formed joint venture (subject to the consent of the enterprise’s creditors).

Careful review of an open joint stock company’s charter, as well as its privatization documentation, is absolutely vital to make an informed decision regarding investment. The importance of due diligence cannot be over-emphasized in today’s market environment because many private enterprises have significant debts from their activities while under state ownership that an incoming investor may have to bear. In the past, for instance, we have reviewed documents revealing factory debts running into several hundreds of thousands of dollars, consisting of salaries, unpaid electricity and water bills and several large unpaid bank loans. Naturally, an investor may use this information to carve out a much better deal.

With reference to structuring the direct acquisition of shares in any privately-owned, open stock company, a foreign investor has two options: (1) purchase stock from its owners (i.e., employees, financial intermediaries and/or Ukrainian citizens); and/or (2) purchase additionally issued stock from the company with approval of the company’s general assembly of shareholders. Strategically, most investors choose both options, which are briefly described below.

A. Stock Purchase From Existing Shareholders

As a legal matter, the standard open joint stock company charter allows foreign and Ukrainian private legal entities, as well as physical persons, to purchase its stock. Stockholders in a private factory can be employee purchasers on preferential terms for privatization, the factory’s “workers’ collective” or “purchaser’s association,” or any third party purchasers on a

competitive basis, depending on the transaction. Review of the factory’s privatization documentation, including its charter, all official “protocols” (minutes) and other documentation, will also provide details concerning the employees’ stock transfer rights.

In closed joint stock companies, the general assembly usually has an opportunity to block the transfer of stock and to require the factory administration’s cooperation in purchasing existing or future factory stock. True, while the sale of such stock may greatly benefit the particular employee, the factory or other shareholders may rebel. Accordingly, the charter in closed joint stock companies (and sometimes even open joint stock companies in violation of legislation) often contains specific provisions that restrict employee stock transfer.

In our review of one privatized large-scale factory’s internal documentation, the factory’s management and other stockholders required all employee shareholders to offer their stock to the remaining shareholders prior to transfer. Similarly, the existing shareholders had a priority right to acquire additionally issued stock. Such options are common in privatization where the workers’ collective has the right to purchase stock through closed subscription.

B. Acquiring Additionally Issued Stock

Private factory administrations are often desperate to obtain an infusion of capital and know-how, and therefore insist that the investor increase the company’s capitalization. This translates to authorizing and issuing additional stock to the interested foreign investor. Note that in consideration for the issued shares, the foreign investor can contribute virtually anything, including foreign currency, equipment, and intellectual property. The procedure for issuing additional shares is vaguely described in the Laws “On Economic Associations” and “On Securities and the Stock Exchange,” but can be found in precise detail in the Securities Commission’s Decision No. 158 “Regulations on the Procedure for Increasing (Decreasing) the Size of the Authorized Capital of a Joint Stock Company.”

III. Due Diligence

In pursuing various investment opportunities in Ukraine, one must remember that successful market entry is preceded by document review, analysis and, only thereafter, principled negotiations. Foreign investors often request the preparation of a due diligence, which contains a legal and fiscal analysis of any given enterprise, prior to committing a significant amount of time and resources to a given project.

Our standard due diligence report usually includes background review of the following matters:

1. A description of the company or factory (historical overview and current status update);
2. The legal status of the company or factory, including:
 - a) The corporate structure (General Assembly of Shareholders, Board of Directors, Management Board, Audit Commission, etc.);
 - b) The management's internal resolutions;
3. The company's or factory's production (facilities, output, capabilities);
4. Property rights overview (buildings and land rights, sub-units, movable and immovable property, etc.);
5. Liabilities and obligations, including existing employment and contractual relations (long-term loans, contracts, employee benefits, etc.);
6. Plans for capital investment; and
7. Accounting and financial condition.

In order to cover all of the aspects listed above and compile a complete due diligence of a company or factory, the targeted entity is asked to provide the following documents:

1. The charter (by-laws) of the entity (all existing and formerly existing versions from the date of the entity's creation, including all amendments and additions);
2. The founding agreement of the entity (all existing and formerly existing versions from the date of the entity's creation, including all amendments and additions);
3. The resolutions of the meetings and decisions of the highest authoritative body of the entity (i.e. the general meeting of the shareholders or founders);
4. The resolutions of the meetings and decisions of the management body of the entity;

5. The composition of the supervisory council (if applicable), the executive body (management) and the controlling body of the entity;
6. The register of shareholders (if the entity is a stock company), evidencing the size and amount of each block of shares;
7. Documents which confirm the ownership rights to the buildings and structures of the entity;
8. Documents which confirm the rights to the use of land;
9. Agreements on long-term credit;
10. Long-term agreements (contracts) with suppliers and consumers, as well as any other material agreements (contracts);
11. All documents related to corporatization (if applicable) and privatization (if applicable), specifically: all decisions, resolutions, etc. regarding the existence and activities of a so-called "leasing enterprise" and/or a "leasing association," the privatization plan of the entity, the share acquisition plan, share sale-purchase agreements, etc.;
12. All available registration certificates of the entity regarding the issuance of shares and obligations, all state registration certificates, etc.;
13. Resolutions (charters, regulations, etc.) on the basis of which structural subdivisions of the entity were created and act (representative offices, subsidiaries, etc.).

Of course, the above list of documents is not exhaustive. The necessity to review additional documents often arises in the course of performing due diligence, depending on the specific targeted entity. In addition to reviewing the various foundation documents, including the company's initial privatization plan and valuation by the State Property Fund (the "SPF"), due diligence may also require informal interviews with employees, which often conclude with unexpected results.

Review and analysis of the above documents results in a corporate profile, which includes details concerning the company's structure, financial liabilities, conflicting contractual commitments, among others. This document provides the basis for negotiations, and a foreign investor can speak intelligently regarding the business terms suited specifically to the intended transaction only after the due diligence results are reviewed.

IV. Alternative Post-Privatization Investment Options

A. Entering Into a Joint Venture With a Privatized Enterprise

As an alternative to direct investment in privatized enterprises, a foreign investor may simply enter into a joint venture with an enterprise on the basis of a particular production line. The old term “joint venture” may be assumed to include the formation of companies with a Ukrainian enterprise as a shareholder or participant, the conclusion of a joint activity agreement or simple foreign economic agreements for specific transactions. Note that the old and proven joint venture vehicle can be employed regardless of whether the factory is state-owned or privately held. Admittedly, the private status of the Ukrainian party all but eliminates most of the bureaucratic procedures typically associated with entering into joint ventures with state-owned enterprises.

In most cases, a privatized factory’s charter specifically authorizes the factory to enter into joint ventures and to lease or alienate its property. Accordingly, a foreign investor can enter into a joint venture whereby the private factory contributes its real property and equipment to the joint venture’s authorized capital. Effectively, entering into a joint venture with a private enterprise may have the same result as the separation of a factory sub-unit.

B. Purchase of Assets Through Bankruptcy Proceedings

Purchasing a factory’s assets in accordance with bankruptcy proceedings may be a foreign investor’s best (least expensive) option to invest into an enterprise. As a legal matter, foreign investors have the right to participate in the auctions where bankrupt factories’ property will be sold to repay the various creditors.

Unfortunately, to the best of our knowledge, bankruptcies and the resulting auctions rarely take place (especially in cases of state-owned enterprises). This fact exemplifies the Ukrainian government’s unwillingness to face the consequences often incurred in a free market economy. Hence, Ukraine’s bankruptcy legislation focuses on restoring an enterprise’s solvency, and only in the most extreme cases will bankruptcy proceedings reach the actual liquidation stage.

I THE OLD LAND CODE (PRE-JANUARY 1, 2002)

I. Introduction

In the past, the distinction between ownership of the fixtures (buildings, warehouses, etc.) on land, and ownership of land itself became apparent as soon as an investor tried to obtain access to a bare plot of land. The former Land Code only allowed Ukrainian citizens to own parcels of land for limited purposes (e.g., farming, private dachas, but not yet factory construction), and specifically prohibited foreign citizens from purchasing land. The Land Code failed to provide for ownership of land by foreign-owned organizations, presuming such a concept as too preposterous to mention.

Affirming this xenophobia, the failure to specifically provide for land ownership by enterprises with foreign capital in the Land Code was consistently interpreted by Ukrainian officials as a flat prohibition on land ownership by joint ventures and foreign subsidiaries.

II. Discussion

It used to be very difficult to ascertain the party directly responsible for leasing land. The general rule that the “Ukrainian State” owns the land is very vague, and no longer automatically holds true.

The old Land Code allowed local councils of people’s deputies to transfer land to collective or private ownership. Further, land could be allocated for two purposes: (1) agro-industrial; and (2) industrial. In practice, land allocations under the old Code were granted only in the former category, and therefore the following review is limited to the topic of agro-industrial land.

In order to obtain access to land, an investor should ascertain the identity of the land owner and any other parties that may have rights or claims to that property. In the past, three options existed with reference to ownership rights: (1) the land could still belong to the State without any third party claims (such as farmers’ collectives); (2) the land may be used by “zovhos,” which was a government enterprise employing farmers and has been since been reorganized into a joint stock company; or (3) the land is used by a “kolhoz,” which was an independent group of farmers and has been since reorganized into a collective agricultural enterprise.

In the first case, the land belonged to the State and could be leased directly from the government to a joint venture or foreign-owned

subsidiary. In the last two cases, these types of agricultural companies typically had legitimate possession or ownership claims to the land under Ukrainian laws, and such rights were usually clearly documented. If so, a foreign investor had the right to deal directly with an agricultural company in regard to the land rights. The above progression confirms once again that, as in most other areas, dealing with the private sector is the easiest way to invest into an agro-industrial complex.

A. Land Under State Ownership

Notwithstanding the increase in private land ownership, especially in Western Ukraine, much of the land is still owned by the State. Therefore, the following discussion presumes that the State or regional governmental administrations manage land.

Under the old Land Code, if land was state (federally) owned, as a general rule, the right to dispose of such land rested with the Parliament. District, rayon, city, and village councils of people's deputies were and still are responsible for disposing of land located within their territories (communal land), except land considered to be completely state-owned. The Land Code divided the lines of authority between each level of government so that the city council of people's deputies allocated land within its city limits; the village council of people's deputies allocated land within its village limits, etc.

Depending on the specific land rights sought by the foreign investor, the corresponding Council of the People's Deputies in the region was usually the appropriate governmental body for granting a temporary or permanent right to use or lease land. Prior to the enactment of the new Land Code, when executing land lease documents, the lessee should always have insisted on a right of first refusal to buy the land with the hope that the Ukrainian legislation would be adopted finally authorizing enterprises with foreign participation to purchase land. This was particularly important in greenfield projects, where the lessee made significant improvements to immovable property during the term of its lease.

In all cases, land was classified under the old Land Code as either usable or not usable for farming; the latter category would be easier to allocate to joint ventures or subsidiaries. Under Ukrainian legislation, each site within the jurisdiction of the appropriate council of people's deputies could be leased or sold for its intended purpose only. Therefore, if the proposed site was previously leased to farmers for agricultural purposes, the lessee could not use it for industrial purposes (i.e., to build a factory). A council of people's deputies would need to re-allocate farm land for non-farm use by approving this decision and making a corresponding entry into the land registry.

B. Land Rights

The old Land Code allowed three forms of land rights: ownership, use and enjoyment, and lease. Ownership could be further broken down into state, collective (which no longer exists under the new Land Code) and private. Initially, all land was under the jurisdiction of local councils of people's deputies. Fortunately, the local councils could transfer the land to collective or private ownership at anytime. Unfortunately, they refused to do so with great resolve.

Please note that each form of land possession carried its own rights and restrictions. For instance, land transferred to collective or private ownership could not be sold or transferred (except for inheritances) for 6 years after the initial transfer. Also, all of the above forms of land possession required payment of either land tax (by owners) or rent (established by contract) as is still the case.

Since foreign investors were not yet permitted to outright own land, only two options existed: (1) use of land; or (2) lease of land. The practical distinction was two-fold. First, in contrast to leasing the land, which was limited to a maximum of two 50-year terms, the "use" of the land could have been either for a definite period or permanent. Second, in the case of land use, the party using the land only paid nominal taxes; in the case of leasing, the lessee paid rent, which was usually significantly higher.

Under the old Land Code, temporary land use could be granted for a short term (up to 3 years) or for a long term (3-25 years). The old Land Code specifically authorized land use rights to joint ventures or wholly-owned subsidiaries. In practice, however, land use rights were usually granted to a foreign purchaser in very limited circumstances, (such as land under a foreign owned dacha near Kiev). Instead, and by process of elimination, long-term land leasing was the rule in greenfield projects for industrial purposes.

Private citizens, joint ventures, subsidiaries and public associations also were able to lease land either from the state or from private parties. Such leases could be either short term (up to three years) or long term (up to 50 years) with the right of lease renewal for another term of up to 50 years. Leases may even provide the lessee with the right of first purchase, (which was aimed to please foreign investors in case new Ukrainian legislation came into effect allowing such purchase).

The Law No. 2535-XII "On Payment for Land," dated July 3, 1992 (as lastly amended on December 20, 2001), provides generally that land leases are established by contract and may not be less than the appropriate land tax. Note that Ukrainian legislation is constantly revised with

respect to the basic lease rates, and any interested investors should ascertain the legislative status at the time of the contemplated investment.

C. Loopholes in Legislation

As with most other Ukrainian legislation, the old Land Code had certain inconsistencies and resulting loopholes: on the one hand, foreign citizens could own Ukrainian buildings and apartments, but they could not own land. On the other hand, transfer of rights to buildings by one enterprise to another usually carried with it transfer of the land rights. Therefore, foreign legal entities could purchase buildings and enjoy a permanent and free right to use the land thereunder (subject to relevant taxation), but did not have actual ownership rights.

Relying on such laws, in the past we have successfully transferred permanent land use rights to foreign purchasers when such investors purchased separate buildings on land from private homeowners. Such land-possessors were effectively land owners, and had to pay a yearly land tax. In our past experience, however, as a matter of Ukrainian law and government policy, foreign citizens and legal entities could not purchase state-owned land by participating in privatization, and permanent land use rights were not be granted to foreign investors at least until land ownership by foreign investors would be specifically permitted.

Finally, note that land rights could be suspended for: (1) failure to pay land tax; (2) use of the land for a non-designated or non-certified purpose; (3) breach of lease agreement terms; or (4) the land user's bankruptcy. The city councils, courts of general jurisdiction and arbitration courts settled any disputes over land use. City council decisions could be appealed to courts of law or arbitration courts.

III. Conclusion

Recognizing the need to bring the Land Code up to new standards, a new draft Land Code was prepared by the Cabinet of Ministers. On June 6, 2000, the Parliament passed the first reading of the new draft Land Code in its Resolution No. 1846-III. Finally, a new Land Code was adopted on October 25, 2001, and came into effect on January 1, 2002, significantly changing the face of Ukrainian legislation for the new millennium.

J THE NEW LAND CODE

I. Introduction

While no shots were fired from the proverbial battleship Aurora, the passing of Ukrainian land into the hands of the "peasants" was accompanied by its own mini-revolution: on the day Parliament was to vote on the adoption of a new Land Code, Communist factions surrounded the podium in a futile effort to block the deputies from casting their votes. On October 25, 2001, however, justice prevailed as the Parliament finally adopted a new Land Code, which was subsequently signed by the President. Since then, many have dubbed this event as the "Great October Land Revolution."

According to the new Land Code, land is finally deemed as an "object of private ownership rights." In other words, landowners have the right to sell, exchange, donate or pledge their land plots. Although these words are valiant, they do not have an immediate effect for all landowners: new owners of agricultural lands will not be able to exercise these rights until January 1, 2005, and until 2010, they will not be able to sell more than 100 hectares of land. In spite of this moratorium, with agricultural land in the hands of private landowners and the introduction of a new law governing mortgages of land, the quality and condition of such land is likely to improve in the nearest future.

At last, foreign investors will now feel secure in that they will be dealing with actual owners of land, not the former chairmen of collective farms who were able to illegally grant land use under a shadow land market. Foreign investors will also be able to receive something of real value as collateral if their Ukrainian counterparts fail to fulfill their contractual obligations since land, unlike cash or other movable property, is extremely difficult, if not impossible, to move or otherwise hide. This process will also contribute to the much-needed development of credit and loan terms in Ukraine.

With this brief overview in mind, we immediately below discuss in further detail the impact of the new Land Code on foreign investment.

II. Discussion

Since January 1, 2002, the new Land Code has taken full effect in Ukraine, expanding the rights of foreign governments, foreign legal entities, foreign citizens and persons without citizenship in the sphere of land

rights. While this expansion of land rights is significant, it does not give the green light to foreign investors to take the fertile, black earth of Ukraine. In fact, the new Land Code still contains certain limitations on the purchase of land by foreign governments and investors alike.

The new Land Code places land into several categories, including agricultural land, land for residential and public construction, natural reserve lands, historical-cultural lands, water and forest reserves, recreational lands, lands designated for sanitary/health purposes (i.e., health resorts, sanatoriums) and, finally, lands for industrial, transport, communication, energy, defense and other purposes. The new Land Code permits land to be transferred from one category to another upon a decision of the executive bodies of government or bodies of local self-regulation to transfer such land into ownership, use, the historical-cultural fund or natural reserve fund. If the land is owned by a citizen or legal entity, the category of such land may be changed upon the initiative of such citizen or legal entity. This is quite important as many attractive land plots are not currently designated for private or business use (i.e., they are designated to other zoning areas).

There are three categories of land, which are of most importance for foreign investors and governments: agro-industrial, industrial and residential land. The new Land Code strictly prohibits foreign citizens, legal entities and governments from acquiring agricultural lands into ownership, making lease arrangements the only way for foreign investors to get access to agro-industrial land (including land for personal farming or gardening). Notwithstanding this restriction and the Land Code's moratorium on the sale of land until 2005, Ukrainian owners of agricultural land may still use their agricultural land plots as security in order to obtain credit or loans.

Interestingly, a foreign legal or natural entity may receive agricultural land into inheritance, however such land will be subject to alienation within one year from the time of inheritance or the ownership rights thereto will be revoked. While the importance of agro-industrial land should not be underestimated, an analysis of the possibilities within the agricultural sphere is beyond the scope of this discussion. Interestingly, there still have been no significant movements towards the liberation of agricultural lands for purchase by foreign investors.

As a general overview, residential land includes land plots within populated areas, which are used for construction of residential buildings, public constructions and other structures of public use. Industrial land includes lands provided for the allocation and exploitation of principal and auxiliary buildings and structures of industrial, mining, transportation and other enterprises, including their means of access, communication networks, administrative-infrastructure buildings and other structures.

1. Ownership Rights to Land

Under the new Land Code (hereinafter the "Land Code"), the right to ownership of land includes the rights of possession, use and disposal of land plots, which are acquired and exercised on the basis of the Ukrainian Constitution, the Land Code and other laws issued in accordance therewith. For the first time since Ukraine's independence, the Land Code clearly provides that land can be privately owned.

The Land Code defines a land plot as a part of the land surface with established borders, a defined location and certain designated rights thereto. The ownership rights to a land plot apply within its borders to the surface (soil) layer and any water objects, forests and long-standing plantation thereon. Further, ownership rights to a land plot apply to any space above or below the surface of the plot of a height or depth "necessary for erecting residential, production and other buildings and structures." The new Land Code does not further explain this vague provision.

Formerly, all bodies of water and forests belonged to the State. Therefore, the Land Code has significantly extended the meaning of ownership rights to a land plot. However, if the land to be purchased will be used in connection with the use of its minerals, then the new landowner will have to receive all licenses and permissions for the use of minerals and the restoration of land in accordance with an approved re-cultivation plan or concession agreement.

Ukrainian citizens may acquire the ownership rights to a land plot on the basis of (i) a sale-purchase, gift, barter or other civil agreement; (ii) gratuitous transfer from state or communal ownership; (iii) privatization of land plots previously allocated to them for use; (iv) inheritance; and (v) an in-kind share to which they are legally entitled. In contrast, foreign citizens may acquire non-agricultural land plots by way of (i) sale-purchase, gift, barter and other civil agreements; (ii) buyout of land plots on which real estate under their private ownership is located; or (iii) inheritance. However, a foreign citizen may only acquire ownership rights to a non-agricultural land plot outside the limits of populated areas if they have privately owned real estate already located on such land plot.

Foreign legal entities may acquire ownership rights to land plots of a non-agricultural designation:

- a) within the limits of populated areas in case of the acquisition of real estate and for purposes of constructing objects connected with their business activities in Ukraine (i.e., they must have the right to carry

out commercial activity in Ukraine, which excludes non-commercial representative offices);

- b) outside the limits of populated areas in case of the acquisition of real estate already located on the plot.

Likewise, foreign governments may acquire land plots into ownership for the allocation and construction of diplomatic missions and other organizations of equal standing on the basis of international agreements.

In essence, these provisions of the Land Code are what foreign investors have been waiting for since Ukrainian independence. When the moratorium on the sale of land is lifted in 2005, foreign investors will have the right to purchase the land under their privately owned production and storage facilities, provided, however, such land is not designated as agricultural or other land restricted for foreign citizens and businesses. Buyer beware, however, because foreign investors with real estate will have to carefully assure that the land on which the real estate is located is not re-allocated at a later date as agricultural land. If this happens, the land on which the real estate is located will be subject to mandatory sale or disposal within one year.

2. The Right to Use Land

The Land Code permits two basic rights to land use: (i) the right to permanent use; and (ii) lease rights. The former gives the right holder the right to possess and use a land plot under state or communal ownership without an expiration term. Unfortunately, this right may only be acquired by enterprises, institutions and organizations, which are “related” to state or communal ownership.

Fortunately, the right to lease plots of land is a viable alternative for foreign investors, international organizations and foreign governments. Under the Land Code, leases may be either short-term (no more than 5 years – the old Land Code defined “short-term” as no more than 3 years) or long-term (no more than 50 years). The Land Code also allows the lessee to sub-let the land plot upon consent from the lessor. All other issues in connection with the lease of land are regulated by Law of Ukraine No. 161-XIV “On Lease of Land,” dated October 6, 1998 (as completely rewritten on October 2, 2003 pursuant to Law No. 1211-IV). Apart from the mention of concessions, which also must involve lease arrangements and Law No. 997-XIV “On Concessions,” dated July 16, 1999, the Land Code does not contain many novelties on leasing, therefore a cursory review of the Law “On Lease of Land” is required in order to comprehend land lease arrangements in Ukraine.

3. The Sale of Land Plots Under State or Communal Ownership

The governmental bodies and bodies of local self-regulation carry out the sale of land plots under state or communal ownership to Ukrainian citizens, legal entities-residents (i.e., joint ventures and resident companies) and, in some cases, foreign governments on a competitive basis (auction, tenders), except for the buyout of land plots on which real estate objects are located under the ownership of the buyer. For this purpose, the interested buyer submits an application (petition) to the relevant body of the executive power or local council, indicating the desired location of the land plot, the purpose of its use and its size. The following documents must be attached to the application (petition):

- a) the State act on the right of permanent use of land or a lease agreement;
- b) the land plot’s layout and the document, evidencing the issuance thereof in case of the absence of a State act; and
- c) the certificate of registration of a subject of entrepreneurial activity.

The relevant governmental body must review the application within a month and render a decision on the sale of the corresponding land plot or a substantiated refusal. If the applicant wishes to acquire land that is not currently under its use, then the sale of the land will only take place after its application is accepted and no later than 30 days after the development of a land allocation draft by a land management organization.

The grounds for refusal to permit the sale of a land plot in the above scenario are as follows:

- a) the absence of documentation necessary for rendering a decision on the sale of such land plot;
- b) the discovery of unauthentic or false information in the applicant’s documentation; and
- c) if bankruptcy proceedings or other proceedings on the termination of the applicant’s entrepreneurial activities have been initiated.

Once the decision has been rendered by the relevant governmental body, the applicant may proceed with the conclusion of a sale-purchase agreement. Upon its conclusion, the sale-purchase agreement must be notarized and the document on the payment of the notary fees must be pre-

sented in order to receive the State act on the ownership right to the land plot and complete state registration.

The procedural rules change a bit if the land is under state or communal ownership. If land is under state ownership, then the land will be sold to foreign states or foreign legal entities by the Cabinet of Ministers of Ukraine only upon the consent of the Ukrainian Parliament. However, if the land is under the ownership of a territorial community, the territorial community need only receive the consent of the Cabinet of Ministers to sell such land to foreign states and foreign legal entities. One can only imagine the bureaucratic process and lengthy negotiations involved in receiving the consent from the Cabinet of Ministers of Ukraine or the Parliament of Ukraine. Once again, in these cases a foreign legal entity must register a permanent representation with the right to carry out commercial activity (i.e., no representative offices) on the territory of Ukraine in order to obtain consent to their purchase of communal and state owned land.

Procedurally, foreign legal entities, interested in acquiring land plots, must submit a petition to the relevant state body (Council of Ministers of the Autonomous Republic of Crimea; the regional, Kiev and Sevastopol city state administrations or the relevant local council), along with a lease agreement for the land plot and a copy of the certificate of registration of a permanent representative office by the foreign legal entity with the right to carry out business activities on the territory of Ukraine. As mentioned above, the relevant state body will review the application only after it receives the consent from the Cabinet of Ministers.

Having acquired a land plot in Ukraine, a purchaser is guaranteed the protection by the State of the right to own land, the right to demand the removal of any violations on its land or compensation due to damages caused by third parties, etc. Ukrainian courts, bodies of local self-governance and the executive bodies in charge of issues of land resources are responsible for deciding land disputes within their competence.

III. Conclusion

While foreign legal entities and individuals are not yet entitled to own land of an agricultural nature, they may now freely own the land parcels where their Ukrainian factories and plants are located. Still, the State retains the right to exercise control over the use of land by its owners and can deprive such owners of their ownership rights if violations are revealed.

Incidentally, with the passing of the new Land Code, more than 11 million Ukrainian citizens finally became lawful owners of their privatized

lands due to the provision in the Ukrainian Constitution stating that full ownership to privatized land will only occur after a new Land Code is passed. While of no practical consequences for foreign investors, it is excellent news to those pensioners who may lease their land plots for much-needed income or as collateral for a loan.

Now that one of the biggest hurdles has been cleared in relation to land ownership rights, the Ukrainian government will be hard at work in lending credibility to the provisions of the new Land Code with the passage of various supporting legislative acts. Of essential importance will be the law establishing the state land register (which promises to be fully available to the public), while other laws on the protection of land, a state land (mortgage) bank, the land market, etc. will be just as vital. The Parliament has already passed a new law on mortgages (as promised for years) and a law on the appraisal of land. These laws are beyond the scope of this cursory review of the Land Code.

K INDUSTRIAL LAND LEASE

I. Introduction

Until the recent passage of the new Land Code, which came into effect on January 1, 2002, foreign investors in Ukraine long dreamed of the time when they could by-pass the central government bureaucracy and run things on their own terms. As Cargill's foray into the unchartered Donetsk free economic zone confirmed, constructing a 100% foreign owned pre-fabricated building on a parcel of land has numerous advantages. Now that such treatment is equally extended to other Western investors, greenfields will surely become one of the favorite methods for the foreign investors to establish quality production in Ukraine.

Until recently, no parcel of Ukrainian legislation dared to raise the topic of land allocation for industrial use (production purposes). True, the old Land Code governed the many questions concerning land rights, but these were concerned primarily with agricultural or "datcha" land allocations. Once, President Kuchma made a half-hearted effort to allow investors access to land for industrial use, but it was virtually unenforced notwithstanding any attempts by foreign investors to secure its benefits. Several years later, in the crisis-ridden fall of 1998, a law on land lease was adopted, which once again attempted to grant some land rights to foreign and local investors alike.

Below we briefly compare the laws passed in 1995 and 1998 (which was subsequently re-written upon the passage of the new Land Code).

II. The Decree "On Privatization and Leasing of Non-Agricultural Land for Business Purposes"

At the height of his power, on July 12, 1995, President Kuchma signed a very promising Decree No. 608 "On Privatization and Leasing of Non-Agricultural Land for Business Purposes" ("Decree No. 608"). This decree specifically permitted privatization and leasing of the so-called "non-agricultural" (industrial) land and, therefore, was potentially quite interesting for foreign investors. Unfortunately, to the best of our knowledge, the Decree was completely ignored. Even foreign investors did not complain, realizing it was simply too good to be true.

For the record, the purpose of the Decree was to increase foreign and Ukrainian investment by finally opening access to industrial property for production purposes. The Decree expressly promised foreign investors clear

land ownership rights, giving them greater security in controlling their investments. The Decree also aimed at solving the duality of real property rights, whereby an investor could formerly privatize a building located on a plot of land, but could not actually privatize the land thereunder. The land rights always remained with the State, as represented by the Local Councils of People's Deputies.

Decree No. 608 was unique because, for the first time, it expressly granted the purchasers of buildings the right to purchase the land underneath. Unfortunately, such rights were not extended to non-residents. However, by forming a Ukrainian resident company, the non-resident was theoretically able to effectively participate in the privatization process through its Ukrainian resident company.

Also, Decree No. 608 provided that many land parcels would be privatized on a competitive basis. The Decree further provided that new owners of privatized industrial land would enjoy full rights to their property, including the right to possession, use and disposal of by any means (sale, gift, will, exchange, collateral, lease, etc.). The owner of land could also contribute the land to the authorized capital of any business entity.

Indeed, the Decree was a breakthrough in land ownership rights. The only problem was the complete lack of its application and enforcement in practice. The Decree gave potential investors false hope that they would finally be able to purchase Ukrainian land and obtain full control over their production facilities, but this time nobody was surprised.

Because this precedent-setting, but useless, legislation found no application whatsoever, we will devote the bulk of our discussion to the more recent legislation (which has proved to have at least some effect).

III. Law "On Lease of Land"

A. Introduction

On October 6, 1998, President Kuchma once again attempted to provide land rights by signing Law No. 161-XIV "On Lease of Land." On October 2, 2003, this Law was completely amended under Law No. 1211-IV "On Amendments to the Law of Ukraine 'On Lease of Land'" (the "Lease Law"). The Lease Law permits anyone, Ukrainian or foreign legal entities and natural persons, including international associations and organizations and foreign governments, to lease land.

The Lease Law specifically states that the lease of a land parcel does not affect the rights of third parties with regard to that land parcel. In other

words, protection of a third party's interests in land, such as collateral or debts, is theoretically in place in Ukraine. Upon concluding a lease agreement, a lessor is obligated to make known any existing liens, encumbrances and third party rights connected to the relevant land parcel. Moreover, land parcels subject to pledge may not be transferred into lease without the consent of the pledge holder.

As with most Ukrainian laws, the Lease Law refers back to the Land Code for the rights of lessees to lease and, eventually, own land. Fortunately, under the new Land Code, foreign entities can now officially obtain ownership rights to Ukrainian land. The Lease Law also refers to the Civil and Economic Codes as the basis for the lease of land and it refers to the Law of Ukraine No. 2269-XII "On the Lease of State and Communal Property," dated April 10, 1992, for further peculiarities related to the lease of state or communal property.

B. Legal Requirements

The legal requirements for entering into a valid lease agreement are quite straightforward: lease agreements must be in writing and may be certified by a notary public if the parties so desire. The Cabinet of Ministers of Ukraine has released a model form of a lease agreement taking into account all of the requirements of the Lease Law. Once a lease agreement is concluded, it must be registered with the proper state authorities. Land can be leased for any term agreed upon between the parties to the lease agreement, but cannot exceed 50 years.

The Law provides the material terms and conditions which must be included in all lease agreements. These mandatory terms and conditions include:

- 1) The object of lease (location and size);
- 2) The validity term of the lease agreement;
- 3) The lease payment (amount, indexation, form of payment, terms and procedures for payment and reconsideration and liability for failure to pay);
- 4) The terms and conditions of use and the purposeful designation of the land parcel;
- 5) The conditions for maintaining the condition of the parcel;
- 6) The conditions and term for the transfer of the parcel to the lessee;

- 7) The terms and conditions for the return of the parcel to the lessor;
- 8) All existing limitations and encumbrances with regard to the use of the land parcel;
- 9) The party (lessor or lessee) that bears the risk of accidental damage or destruction of the leased object, or any part thereof; and
- 10) The responsibility of the parties.

The absence of any one of these essential terms may serve as grounds for the refusal to register a lease agreement, and such lease agreement may thereafter be deemed invalid. In addition to the mandatory terms and conditions, the parties may include any other terms and conditions in the lease agreement concerning the quality of the land condition, the procedure for carrying out the obligations of the parties, the obligation to procure insurance for the land, security measures, circumstances which can change or terminate the lease agreement, among others. In summary, lease agreements can be very flexible, as long as the above obligatory terms are covered therein.

In addition, a lease agreement must also contain certain documents, which become an integral part of the agreement. These documents are (i) the plan or map of the leased property, (ii) the land survey plan with an indication of restrictions (encumbrances) related to the use of the land, (iii) the act determining the natural boundaries of the land parcel, (iv) the transfer-acceptance act (this is a mandatory document in all cases of lease, which basically evidences that the lessor transferred the land parcel to the lessee and the lessee accepted the land parcel for possession and use pursuant to the lease agreement), and (v) the separation plan in case a part of the land parcel is being leased out. If a lease agreement calls for measures connected with the protection and improvement of the land parcel, then an agreement with respect to the compensation of the lessee's expenses for such measures must also be attached to the lease agreement.

C. Procedure For Executing Lease Agreements

The procedure for concluding a lease agreement is also deceptively simple. The lease agreement is concluded between the owner (lessor) of the land parcel and the entity (individual) who wishes to lease the land (lessee). If the lessee wishes to lease a parcel of state-owned or communally owned land, the lessee simply submits an application to the relevant executive body or body of "local self-governance" at the land parcel's location.

According to Article 124 of the new Land Code, the transfer of a land parcel owned by the state or under communal property must be executed based upon a decision by the local authorities and must be concluded in the form of a lease agreement. The transfer of a privately owned land parcel for lease must be executed according to a lease agreement formed by and between the owner of the land and the lessee.

If the lease agreement provides for a use of the land that is essentially the same as the owner's use, without physically changing any boundaries, a simple lease agreement is all that is required. On the other hand, if the lessee intends to use the land for a different purpose, or if the land parcel was taken from the so-called "reserve fund" and is intended for use in construction, a land allocation project must be prepared in accordance with the form and procedure provided by Articles 118 and 123 of the new Land Code. Such land allocation project becomes an integral part of the lease agreement.

If two or more applications for the lease of state or communal land are submitted simultaneously, then the corresponding state body must conduct an auction or tender unless otherwise established by law. The procedure for conducting an auction or tender for the lease of land is determined by law and is beyond the scope of this discussion.

After the lease agreement is concluded and notarized, if one of the parties requires notarization of the agreement, it must go through formal state registration. State registration of the lease agreement is evidenced by a stamp from the appropriate state registration authority, the signature of the authorized officer of the state registration authority and an indication of the date of registration. One registered copy of the agreement is kept by the state registration authority. In case of the lease of state or communal property, a copy of the registered lease agreement must be sent to the tax authorities as well.

Of course, the parties to the lease agreement have the right to amend their agreement by mutual consent. If an agreement cannot be reached, however, the dispute will be judicially resolved. A lessee, who fulfills all of the rights and obligations contained in a lease agreement, also has the right of first refusal to renew such lease agreement. If the lease agreement is extended for a new term, its terms and conditions can be modified according to the mutual agreements of the parties, unless the original lease agreement states otherwise.

D. Payments

The issue of lease payments is subject to the agreement of the parties. Lease payments may be made in cash, in-kind (according to a certain quantity

or a part of the production on the leased land parcel) or by so-called "working-off" (i.e., the lessee provides services to the lessor in exchange for use of the land parcel). Lease payments are not limited to the above forms, and any other form of payment the parties agree on may be included in the lease agreement. However, lease payments for land parcels under state or communal ownership may only be effectuated in cash (via bank transfers). A lease agreement may also take into account inflation in the calculation of lease payments.

The parties to the lease agreement are free to change the amount of lease payments pursuant to mutual agreement. Interestingly, the lessee has the right to demand a decrease in the lease payments when the condition of the leased land parcel worsens without such lessee's fault (i.e. negligent acts or omissions to act). As mentioned above, lease payments may also be increased in correspondence with increases in land taxes. Annual lease payments for state or communally owned land parcels are applied to a corresponding budget and are allocated and used pursuant to the law, but they may not exceed 10 percent of their normative cash value unless leased as a result of an auction or tender.

If a court of law deems a lease agreement invalid, then the lease payments for the factual term of lease will not be returned to the lessee. Finally, payments for the sublease of a land parcel under state or communal ownership may not exceed the amount of lease payments under the original lease agreement.

E. Termination

Lease agreements can be terminated by mutual agreement of the parties. The lease agreement can also be prematurely terminated at a party's request by court decision if the other party fails to fulfill its obligations under the lease agreement and/or Ukrainian law. A party may unilaterally terminate a lease agreement only if the agreement provides for unilateral termination or legislation provides for such termination. The Land Code and other Ukrainian laws provide additional grounds for unilateral termination.

Please note that the lease agreement for a land parcel also expires in the following cases:

- 1) expiration of the term for which the agreement was concluded;
- 2) the receipt of the land parcel into ownership by the lessee according to the procedure provided by the Land Code;

- 3) forced buyout (eminent domain) and alienation of the land parcel for “social needs” in accordance with the relevant procedure provided by the law;
- 4) the lessee’s death or conviction (resulting in a jail sentence) or a party’s refusal of the lease agreement; and
- 5) liquidation of a legal entity-lessee.

A discussion concerning the various consequences of expiration or termination of the lease agreement, the procedure for returning the land parcel to the lessor, compensation to the lessor for any damage inflicted upon the land parcel by the lessee, and the settlement of disputes, is beyond the scope of this brief overview. As a general observation, however, these provisions imitate standard provisions found in other Western property laws.

F. Inherent Defects to Land

As in the West, the lessor is liable for any defects of which he knows about and fails to inform an unknowing lessee e.g., environmental contamination, infertility, etc. Such defects must be clearly disclosed in the lease agreement, and if so, the lessor will not be subject to liability for any damage caused thereby. If defects that materially impede the use of the land are subsequently revealed, and such defects were not described in the lease agreement, the lessee has the right to:

- 1) demand a decrease in the lease payment or the compensation of expenses for removing the defects;
- 2) retain the appropriate amount of lease payments for expenses incurred by removing the defects upon prior notice to the lessor regarding such defects; and
- 3) demand premature termination of the lease agreement.

IV. Conclusion

The Law “On Lease of Land” does not grant anything to foreign investors that was not already promised by Decree No. 608 “On the Privatization and Leasing of Non-Agricultural Land for Business Purposes.” Unlike Decree No. 608, however, the Lease Law did not even attempt to give foreign investors the right to purchase leased land by merely deferring to the ultra-conservative, former Land Code. However, this deficiency has been overcome with the passing of the new Land Code on October 25, 2001.

L APPRAISAL OF LAND

I. Introduction

According to the Closing Provisions of the Land Code of Ukraine of October 25, 2001, the Cabinet of Ministers of Ukraine was put to the task of developing certain rules and regulations, which will govern relations on the Ukrainian land market. The land market was supposed to become fully functional in less than a year, i.e., as of January of 2005. Consequently, some of these rules and regulations have actually already been enacted as legislative acts.

The Law of Ukraine No. 1378-IV “On Appraisal of Land,” dated December 11, 2003 (hereinafter referred to as the “Act”), entered into force and effect as of January 13, 2004. The Act states its principal objective as the protection of the lawful interests of the state and other entities in connection with land appraisal matters, as well as the provision of information with respect to taxation and the land market.

The Act has defined several types of land appraisal, including the comparative appraisal of natural soil qualities, economic appraisal (i.e., appraisal of land as a natural resource, means of production in agriculture and forestry and as a spatial basis of public production according to indicators characterizing productivity of land, efficacy of their use and returns (profitability) per area unit) and monetary (pecuniary) appraisal.

Monetary appraisal is further divided into (i) expert monetary appraisal (i.e., the result of a defined value of a land plot and the rights associated therewith) and (ii) normative monetary appraisal (i.e., capitalized rental (income) generated from a land plot). The method of land appraisal is defined as the method of defining the value of an object of appraisal, the sequence of appraisal procedures of which allows the realization of a certain methodological approach.

The Act defines the following “subjects of appraisal activity,” which may officially carry out appraisal activity in Ukraine:

1. state executive bodies and bodies of local self-governance, which carry out administrative management in the sphere of appraisal;
2. legal entities and natural persons interested in practicing land appraisal, provided they obtain the relevant certificate of an expert appraisal;

3. legal entities, which employ certified expert appraisers and possess a license to carry out appraisal activity;
4. the legal entities and natural persons, which are registered business entities or entrepreneurs and which have obtained proper licenses according to the procedure established by law.

Article 13 of the Act provides the list of instances when monetary land appraisal is mandatory by law. Normative monetary land appraisal must be carried out in the following cases:

- a) when determining the size of land tax;
- b) when determining the size of lease payments for state-owned and communally-owned land plots;
- c) when determining the amount of state duties in connection with the exchange, inheritance or gift of land parcels pursuant to law;
- d) when determining losses in agricultural and forestry production;
- e) when developing the indicators and mechanisms of economic stimulation for the rational use and preservation of lands.

In addition, expert monetary land appraisal must be carried out in the following cases:

- a) upon the alienation and insurance of state-owned or community-owned land plots;
- b) upon the pledge of land plots according to the law;
- c) when determining investment contributions in the realization of investment projects for land improvement;
- d) when determining the value of state-owned and/or communally-owned land plots upon the contribution of such land plots into the authorized capital of a company;
- e) when determining the value of a land plot for purposes of the reorganization, bankruptcy or liquidation of a company, which is the owner of such land plot and in which the state or a community holds a share;
- f) when identifying or determining the share of the state or a territorial community in the common ownership land plots;

- g) when reflecting the value of land plots and the right to use land plots in accounting according to Ukrainian legislation;
- h) when determining losses for owners or users of land in cases provided by law or agreement; and
- i) pursuant to a court decision.

In all other cases, the appraisal of land may be carried out pursuant to the agreement of the parties to an agreement and in cases determined by the Act and other laws of Ukraine.

At the same time, Article 14 of the Act provides that a certified appraiser may not carry out an expert monetary land appraisal in the following cases:

- a) when the land plot subject to such appraisal belongs to a certified appraiser or to appraiser(s) employed by a expert appraiser;
- b) when an expert monetary appraiser has familial relations with the client (i.e., the person ordering the expert monetary land appraisal) or a business entity has management with familial relations with the client; and
- c) when the land plot subject to appraisal belongs to the founders of, or participants in, a subject of appraisal activity.

The provisions of Article 14 further state that an expert monetary land appraisal will be deemed null and void if carried out in violation of its requirements or by entities, which are not subjects of appraisal activity.

Moreover, the Act states that any land appraisal should be carried out pursuant to a decision of the relevant state executive body or body of local self-governance. A normative monetary appraisal may be carried out on the basis of an agreement concluded by the interested parties as provided by law. In this case, the grounds for carrying out the normative monetary appraisal will be either the agreement or a court decision.

The Act requires that a comparative appraisal of *agricultural* land be carried out at least once every seven (7) years. Further, the Act requires that an economic appraisal of the same category of land be carried out at least once in every five (5) to seven (7) years. A normative monetary appraisal of agricultural land should be carried out at least once in every five (5) to seven (7) years, whereas the same type of appraisal of non-agricultural land should be carried out at least once in every seven (7) to ten (10) years. Of course, all of these appraisals may be performed exclusively by those *legal entities*, which have obtained proper licenses for land use organization.

The expert monetary appraisal of land should be carried out by appraisers in compliance with the requirements of the Act, as well as the Law of Ukraine “On Appraisal of Property, Property Rights and Professional Appraising Activity in Ukraine,” and other relevant rules, regulations and state standards. Appraisal work may either be financed at the expense of the State Budget of Ukraine, local budgets, the funds of landowners and land-users or any other sources not expressly prohibited by law.

II. Certain Observations

Matters related to the appraisal of land were already regulated in detail prior to the adoption of the Act. Moreover, most of the principal issues related to land appraisal have been set forth in the Land Code of Ukraine (the “Land Code”) and even more detailed rules have been provided in several rules and regulations issued by the Cabinet of Ministers of Ukraine (the “CMU”) and the State Committee of Ukraine for Land Resources (the “SCULR”). On the other hand, the closing provisions of the Land Code required the development of the Act, while the land appraisal rules and regulations need constant updating. For instance, the Methods of the Monetary Appraisal of Agricultural and Urban Land, approved by Resolution No. 213 of the CMU of March 23, 1995, are still entitled as “Temporary.” This notwithstanding, it would have been quite difficult to attempt to update the rules and regulations without the adoption of a concrete law on appraisal of land in Ukraine.

Taking the above into account, below we present what seem to us the most interesting and important “innovations” of the Act. It is important to note, however, the difference between the value, the appraisal and the price of a land plot.

As it was practiced prior to the enactment of the Act, it is likely that the owners and users of land will tend to use the normative monetary appraisal of land, which is applied in most cases for the calculation of land taxes. Moreover, Article 13 of the Act stipulates that the normative monetary appraisal of land should also be used for determining the size of the state duty in case of the exchange, inheritance and gift of land plots. This requirement may be explained as the legislators’ aspiration to standardize the procedure for charging state duties on the alienation of land plots.

For instance, Decree No. 7-93 of the CMU “On the State Duty,” dated January 21, 1993 (the “Decree”), sets the state duty for the alienation of land plots at one (1) percent of the amount of the corresponding agreement and, in any case, not less than one (1) non-taxable minimum income, which is currently 17 Hryvnia (see sub-point “b” of point 3 of

Article 3 of the Decree). At the same time, point 49 of the Instruction on the Procedure for the Calculation and Collection of State Duty, approved by Order No. 15 of the General State Tax Inspection of Ukraine (the “Instruction”) suggests that the amount of the state duty be calculated based on “the amount of the agreement, but not less than the normative price of the land plot as set forth by the Law ‘On Payment for Land’”.

Please note that this provision only concerns land plots turned over to Ukrainian citizens on a gratuitous basis for so-called ancillary individual farming, construction and maintenance of individual residential houses and commercial buildings, gardening, country cottage and garage construction, etc. Notably, at the time of the adoption of the Instruction, no other form of private land ownership was allowed. Therefore, the practitioners “expanded” the interpretation of the rule and applied it to other forms of private land ownership. Upon enactment of the Land Code, however, notaries tend to relate the amount of the agreement to the expert appraisal rather than to the normative one, making references to Article 201 of the Land Code.

Given the above-mentioned, it is most likely that the enactment of the Act will alter the size of the state duty charged for the exchange, gift and inheritance of land plots, which size will become at least one (1) percent of the amount stated by the normative monetary appraisal of the land plot in question. Support of this assumption can be found in Article 5 of the Act, which requires the application of the normative monetary appraisal of land plots for purposes of determining the size of the state duty in cases of exchange, inheritance and gift of the land plots in question.

The Act has also introduced certain changes to the rules governing expert monetary appraisals. Point 4 of Article 201 of the Land Code stipulated that an expert monetary appraisal is applied in effectuating civil law transactions with respect to land plots. Article 5 of the Act adds a slight clarification by adding that such appraisals are also applied with respect to the rights to land plots as well. In other words, any transaction, including those not involving alienation, will require that an expert appraisal be carried out. Therefore, it is likely that a land lease agreement would not be registered until the interested party carried out (i.e., paid for) an expert appraisal.

In general, one effect of the Act is that the appraisal of land (either normative or expert) would be carried out more often, considering the following:

- a) Article 4 of the Act names the uninterrupted continuity of the process of land appraisal as one of the basic principles of its application;
- b) the legislator expanded the list of cases when a normative appraisal of land is required (i.e., determination of the amount of lease payments

for state-owned and communally-owned land plots and the size of state duties);

- c) the legislator expanded the list of cases when an expert monetary appraisal of land is required (including such instances as insurance of state-owned and communally-owned land plots; reorganization, bankruptcy or liquidation of land owning companies in which the state or the community hold shares; and reflecting the value of land plots and/or the right to use land plots in accounting reports); and
- d) the legislator determined the concrete frequency of carrying out land appraisals (see discussion above).

One question arises: who is supposed to finance land appraisal? As mentioned above and according to Article 24 of the Act, “the appraisal of land and land plots may be carried out at the expense of the State Budget of Ukraine, local budgets, landowners and land-users, as well as at the expense of other sources not prohibited by law.” It is most likely that the users and owners of land plots will bear the burden of monetary appraisals of their land plots, while the economic and comparative appraisal of administrative units, territories, districts, zones, etc., will most likely be carried out at the expense of the taxpayer (i.e., the budget at the national or local levels). One last point to remember, however, is that land appraisal is not and presumably will not become an inexpensive procedure.

III. Conclusion

In general, the Act appears to represent a rather positive development. The structured types of land appraisal, the defined requirements regarding the documentation related to land appraisal, a rigidly regulated appraisal business and other finalized statutory requirements will facilitate transparency of the land appraisal procedures. This will undoubtedly influence the development of the land market. As with many sectors of the economy involving land, this sphere is expecting more detailed changes to the existing regulations as land appraisal practice broadens, and the Cabinet of Ministers has been granted only six (6) month to introduce them.

M BASIC STEPS TOWARD THE OWNERSHIP OF LAND

On October 25, 2001, the new Land Code of Ukraine (the “Land Code”) was adopted and came into effect on January 1, 2002. In general, the Land Code is intended to facilitate the development of the real estate and land markets in Ukraine. And, surprisingly, it actually has led to some long-awaited changes and sighs of relief.

The first and probably the most important change is that land in Ukraine may be privately-owned. Of course, the Land Code has retained the archaic, socialistic notions of communal and state ownership. Another provision of the Land Code stipulates that ownership rights to land are now acquired and realized on the basis of the Constitution of Ukraine and the Land Code. This is another step confirming that it is not a crime to be a proud owner of land.

Article 657 of the newly enacted Civil Code of Ukraine (the “Civil Code”) clearly states that agreements involving the sale of land must be notarized and are subject to state registration. Accordingly, the failure to comply with the requirement to notarize and register a land sale-purchase agreement may render such agreement null and void. Agreements involving the sale, exchange and gift of land in all cases are subject to notarization at the location of the land plot in question and such agreements are of equal legally binding force and effect regardless of whether a state or a private notary certifies the agreement.

With respect to the sale of land, prior to visiting a notary, the seller must prepare a number of documents, which are required for the proper processing and execution of the sale-purchase agreement. Notably, the right to dispose of land plots, and specifically, to enter into sale, exchange and/or gift agreements belongs exclusively to the owners of such land plots. Pursuant to this presumption, the notary will require the seller to present the relevant state act confirming his or her ownership rights to the land plot according to Article 126 of the Land Code of Ukraine (the “Land Code”). Any other documents evidencing ownership rights, such as a decision of a local council on the allocation of a land plot, will not be accepted by a notary.

Further, the notary will be required to verify that there are no liens and other encumbrances on the land plot offered for sale. A notary receives this information from the Unified Register of Liens to Immovable Property, which accumulates such data from all over the nation. Should

the notary reveal that a lien is imposed upon a land plot in question, it will refuse to certify the sale-purchase (gift, exchange) agreement.

In case a spouse has acquired a land plot during marriage, written consent from the other spouse will be required in order to alienate the land plot. As an exception, however, such consent will not be requested if the land plot was acquired by way of privatization.

In order to process and execute certain land-related transactions, the land plot may be required to be appraised by a licensed appraiser and the results of such appraisal must be compiled in an appraisal report. The general legal issues related to the value of the land are regulated by the rules provided in the Civil Code, the Land Code and the Law "On Appraisal of Land." In general, both Codes state that the sale of a land plot is executed at the price agreed upon by the parties. Please note, however, that the specific requirements are provided for in the recently enacted Law "On Appraisal of Land" and related regulations approved by the Cabinet of Ministers of Ukraine.

Notarization of an agreement to alienate land is subject to state duty, which in most cases will amount to one (1) percent of the value of the agreement. In cases when the value of the agreement has been intentionally decreased by a party and is lower than the value stipulated in an appraisal report issued by the state land management bodies, the state duty will be calculated on the basis of the larger value.

Interestingly, upon the certification of land-related agreements by a state notary, rather than a private notary, any provision of legal services by the state notary, such as the drafting of a proper agreement, will be provided free of charge. The parties to the agreement simply reimburse to the notary the value of the special blank form (seven (7) Ukrainian Hryvnias) on which the agreement is set forth in writing, as well as the value of the verification service with the relevant register with respect to liens and encumbrances (thirty-four (34) Ukrainian Hryvnias). On the other hand, private notaries will not charge the state duty. The amount payable to a private notary is set according to an agreement reached between the parties to the land-related agreement and the corresponding private notary.

In purchasing land, one should clarify the designated usage "assigned" to the land plot as land may only be used in compliance with its purpose (e.g., farming, industrial, residential, etc.). It is acceptable and, in fact, possible to apply for a change of the land's designated use (purpose). This change, however, usually tends to be rather expensive and extremely time consuming, especially with respect to a change from non-commercial to commercial designation.

Notably, the Land Code sets forth several direct prohibitions with respect to the sale or purchase of land. For the most part, foreign citizens, as well as foreign legal entities, are somewhat discriminated under the Land Code. Specifically, agricultural land may not be transferred for direct ownership to foreigners, persons without citizenship, foreign legal entities, etc. The said persons may use farming land and other agricultural lands only under lease agreements.

Further, foreign citizens and persons without citizenship may own non-agricultural land only within urban (city, town, village, etc.) limits. Outside such urban limits, foreign citizens and persons without citizenship may only own non-agricultural land if they privately own the immovable property objects thereon. As far as foreign legal entities are concerned, they are allowed to own non-agricultural land, provided that they have acquired the immovable property located on such land. Encouragingly, many foreign business organizations have been lobbying for changes to the Land Code to remove all discrimination against foreign citizens and companies. These efforts have proved effective and amendments to the Land Code are widely expected.

If a legal entity wishes to acquire ownership rights to land that belongs to the state or a community, the procedure is different from the one set for purchasing land on the secondary market. In general, state-owned or communally-owned land may be offered for sale to legal entities on a competitive basis, with the exception of cases when land is being sold to legal entities which already own real property located thereon.

Moreover, a legal entity is required to file a petition and other required documents with the relevant national or local body requesting the acquisition of the ownership rights to a certain land plot. Such body will consider the petition and within one (1) month will return its consent to the sale or decline the petition. In cases when the legal entity in question receives consent to purchase, such legal entity will be able to acquire the ownership rights to the land plot in question upon preparation of the technical documents describing such land plot.

The sale of the land plot will be effectuated on the basis of a sale-purchase agreement, which is executed pursuant to the decision of the proper national or local body. Please note that in most cases, foreign legal entities should seek prior consent of the Cabinet of Ministers of Ukraine in order to purchase state-owned or communally-owned land. Alternatively, there is always the option of a long-term lease arrangement of up to 50 years.

In conclusion, a foreign buyer of Ukrainian land should remember that the land market in Ukraine is still under formation and malpractice is still quite common. Land prices continue to grow and, therefore, before taking any practical steps towards the acquisition of land and getting a fair deal, any potential buyer should seek professional legal guidance. All too many foreign companies are offered a cheap and quick deal to purchase land only to find out later that violations in the purchase procedure have endangered their ownership rights. Careful due diligence and verification of all steps in a land-purchase transaction can often reveal that a seller's offer was really too good to be true.

N NEW MORTGAGE LAW AND (HOPEFULLY) MORTGAGE MARKET FOR UKRAINE IN 2004

I. Introduction

After years of attempts, the Ukrainian Parliament has finally succeeded in passing a mortgage law, which could spell the beginning of a successful mortgage market in Ukraine. The new law "On Mortgages" (June 5, 2003, No. 898-IV), which came into force on January 1, 2004, was drafted with the aim of minimizing the credit risks of financial institutions and allowing citizens and companies alike to attract additional financial resources for personal or business needs.

Under the new mortgage law, citizens and businesses have the right to receive credit by pledging their land or real estate under a mortgage agreement as security for a loan (credit). The list of objects, which may be pledged under a mortgage agreement, includes land parcels (of non-agricultural designation until January 1, 2005), real estate objects, including unfinished construction objects, and air and sea vessels, rendering the possibilities for securing a transaction in Ukraine even more attractive to foreign investors than previous possibilities under the Law "On Pledges."

II. General Rules

Mortgages may arise on the basis of a mortgage agreement, legislation or a court decision. This being said, the rules regarding mortgage agreements will apply in all cases unless specifically otherwise stated in the legislation or a court decision. In general, the mutual rights and obligations of the parties to a mortgage agreement arise at the moment of its notarization. However, in the case of mortgages arising on the basis of the law or a court decision, the mutual rights and obligations of the mortgagor and mortgagee arise on the date of the conclusion of the corresponding transaction or the date when the court decision comes into legal force respectively.

In general, mortgages under the new mortgage law are derived directly from a principal obligation and remain valid until the principal obligation is satisfied. Of course, if the principal obligation is violated, the mortgagee has the right to satisfy its claims at the expense of the mortgaged immovable property before any other entities/persons with unregistered or later registered rights and obligations related to the mortgaged immovable property. In other words, the new mortgage law sets forth a priority system whereby property may be subjected to a mortgage more than once and whereby the order of the state registration of a mortgage determines the priority of claims against mortgaged property.

Given the above general points, the encumbrance of immovable property by a mortgage should be evidenced by the state registration of such mortgage. If a mortgage is not properly registered, the mortgage agreement will remain valid, however the claims of the mortgagee will not be given priority in relation to other registered rights and claims to the immovable property, even if such mortgage agreement was concluded before such other claims were duly registered. Importantly, the mortgagee is responsible for registering its mortgage over immovable property on the basis of a simple notice containing information about the parties, a description of the mortgaged property (sufficient for its identification) and/or its registration information, the amount of the principal obligation, the term for performance of the principal obligation and a reference as to whether a mortgage deed was issued or not.

A mortgage agreement must be in writing and contain information about the mortgagor and mortgagee, the obligations of the parties, a detailed description of the mortgaged property, the value of the mortgaged property, an indication of the legal basis allowing the mortgagor to pledge the property, among others. The new law allows the mortgagor to build, destroy or introduce capital repairs to buildings located on pledged land parcels and/or to transfer mortgaged property into joint activity, leasing, rent or use. Of course, such rights must be specifically agreed upon with the mortgagee in the mortgage agreement.

All amendments and additions to mortgage agreements are subject to notarization and state registration. Increases of the principal obligation or interest on the principal obligation may be carried out only after the state registration of amendments to the terms and conditions of the mortgage agreement. However, the parties may directly provide for such increases in the mortgage agreement, thus avoiding the need to register amendments for each increase of the principal obligation or the interest thereon.

One or several objects of immovable property may be mortgaged under a mortgage agreement provided that (i) the ownership rights (or usage rights) thereto are valid; (ii) the property may be legally alienated by the mortgagor (and collection of the immovable property may be exacted in case of a violation of the mortgage terms by the mortgagor); and (iii) the property is duly registered as a separate, distinct object of ownership rights, unless otherwise provided by the new mortgage law. The mortgage law also permits the mortgaging of unfinished construction or other immovable property, which will become the property of the mortgagor *after* the conclusion of the mortgage agreement, provided that the mortgagor can documentarily prove its right to acquire the property in the future.

In most cases, a specific part of an immovable property object may be mortgaged *only* after it is apportioned (separated) in-kind and the owner-

ship rights to such part are registered as a separate piece of real estate. However, if a specific part of an immovable property object is connected to or built on to mortgaged immovable property after the conclusion of a mortgage agreement, and such part cannot be separated from the immovable property and the ownership rights thereto were not duly registered, then the mortgage agreement will apply to such part as a separate object of real estate.

Once a mortgage agreement is concluded, the immovable property together with all of its appurtenances will become the subject of such mortgage agreement. The value of the immovable property may be determined by the mortgagor or mortgagee in the mortgage agreement or by a licensed appraiser if so required by the agreement or by law. Importantly, the risk of accidental destruction or damage to the immovable property under a mortgage agreement is borne by the mortgagor, unless the parties agree otherwise in the mortgage agreement.

Obviously, if immovable property may not be disposed of without the consent of its owner or a specific governmental body, then such consent will also be required for transferring such property into a mortgage. Likewise, jointly or commonly owned property may only mortgaged with the notarized consent of all of its owners. As mentioned above, however, a joint (common) owner may mortgage its share interest in joint property without the consent of the other owners provided the share interest is apportioned in-kind and the ownership rights thereto are registered as a separate object of real estate.

Before the conclusion of a mortgage agreement, the mortgagor must make known to the mortgagee all rights and claims of third parties to the property to be mortgaged, including all known unregistered rights and claims. If the mortgagor fails to do so, the mortgagee may demand the premature performance of the principal obligation and claim any damages it incurs.

In cases when buildings (structures) are mortgaged, the mortgage shall also apply to the mortgagor's land parcel or the relevant part thereof on which such buildings are located and which are necessary for the use of such buildings. If the land parcel belongs to a third party and was leased to the mortgagor, then in case of the mortgagor's default, the mortgagee (or other new owner of the buildings) acquires the rights and obligations of the mortgagor under its original lease transaction with the third-party owner of the land parcel. Conversely, if a land parcel is mortgaged, the mortgage will apply to the buildings (structures) and any unfinished construction objects, which are owned by the mortgagor and are located on the said land parcel.

Logically, the next question is: what happens if the land parcel is owned by the mortgagor, but the buildings and unfinished construction objects belong to a third party? In this case, the mortgagee (or other new owner) of the land parcel must provide the third-party real estate owner with the same terms and conditions of lease (use) of the land parcel as were provided by the mortgagor.

Analogous with other mortgage laws, the new Ukrainian mortgage law allows the mortgagor to possess and use the mortgaged property during the term of a mortgage agreement. During this time, the mortgagor must use the property in accordance with its purposeful designation (i.e., commercial, residential, etc.) and may not permit a worsening of the mortgaged property's condition or a decrease in its value (with the exception, of course, of normal wear and tear). However, the following acts with respect to mortgaged property require specification in the mortgage agreement:

- 1) the erection, destruction or capital repair of buildings (structures) located on the land parcel, which is subject to the mortgage, or significant improvements to such land parcel;
- 2) the transfer of the mortgaged property into a subsequent mortgage;
- 3) the alienation of the mortgaged property; and
- 4) the transfer of the mortgaged property into joint activity, leasing, lease or use.

Obviously, the mortgagor must take all necessary measures to preserve the mortgaged property during the term of the mortgage agreement, including timely repairs, minor restoration jobs and protection from unlawful claims or encroachment. The mortgagor is under a constant obligation to inform the mortgagee regarding any threat of destruction, damage or deterioration, which may materially affect the rights of the mortgagee. Conversely, the mortgagee has the right to inspect the mortgaged property upon proper written notice to the mortgagor without interrupting the mortgagor's (or tenant's) activities.

The new mortgage law also permits a third party to mortgage its immovable property in order to secure the performance of a principal obligation by a mortgagor. Such third party is known as a property surety under the new mortgage law. In such cases, the property surety actually becomes the "mortgagor" under the mortgage agreement and bears liability before the mortgagee for the performance of the principal obligation by the "debtor" (i.e., the original mortgagor).

If the ownership rights to mortgaged property are transferred to a third party, including cases of inheritance and succession, then the mortgage remains valid for the acquirer of the corresponding immovable property even if information regarding the encumbrance by mortgage has not been conveyed. The entity or person to which ownership rights of mortgaged property have been transferred acquires the status of mortgagor, possess all of the rights of the original mortgagor and bears all of the obligations under the mortgage agreement in the same volume and on the same terms and conditions which existed before the acquisition by such entity or person of the ownership rights to the mortgaged property.

Finally, the rights under a mortgage agreement may be assigned without the necessity to receive the consent of the mortgagor, unless otherwise specifically provided by the mortgage agreement, and on the condition that the assignment of the right to submit all claims for the principal obligation is carried out simultaneously. In this case, the mortgagee must notify the debtor in writing within a five-day period regarding the assignment of rights under the mortgage agreement and the right of claim to the principal obligation. Such transactions and all information regarding such transactions are subject to notarization and state registration respectively. Conversely, any transactions for the alienation of mortgaged property or its transfer into a subsequent mortgage, joint activity, leasing, rent or use without the consent of the mortgagee are invalid.

In case of the violation by a mortgagor of the obligations provided by a mortgage agreement, the mortgagee has the right to demand the premature performance of the related principal obligation. If the principal obligation is not performed upon demand, the mortgagee has the right to levy execution (foreclose) on the mortgaged property. The levying of execution on mortgaged property may be carried out on the basis of a court decision, the endorsement of a notary or pursuant to an agreement on the satisfaction of the mortgagee's claims.

Likewise, if the mortgagor violates its obligation to preserve and insure the mortgaged property, the mortgagee may either demand premature performance of the principal obligation or take measures for preserving or insuring the mortgaged property in its own interests and at its own expense. In this case, the mortgagor must compensate the mortgagee for all expenses incurred in connection with the specific measures taken by the mortgagee.

As an alternative to levying immediate execution (foreclosure), the mortgagee may choose to transfer the mortgaged property into its own management or the management of a third party in order to secure the receipt of all revenues, products and proper economic use for the period

before its sale on the basis of an agreement between the mortgagor and mortgagee or a court decision. All revenues, products and results received as a result of such management will be designated to cover the mortgagee's claim, unless otherwise agreed upon by the parties.

III. Insurance

The new mortgage law also provides for a number of general novelties. For instance, the mortgagor must purchase mandatory insurance on its pledged property for the entire value of the property from the risk of accidental destruction, damage or loss, unless otherwise agreed upon in the mortgage agreement. As a result, the insurance market could considerably grow for such type of mandatory insurance. Moreover, as the mortgage market grows, the number of banks and financial institutions may also increase with a corresponding decrease in the interest rates on loans.

Many specialists also believe that the life insurance market will be significantly affected, as loan providers will be increasingly concerned about the life of the mortgagor (i.e., the mortgagee will want to avoid dealing with social and familial issues involved in the death of a mortgagor). In addition, the new mortgage law does not limit the types of insurance that may be required under a mortgage agreement, therefore the parties may agree to execute any type of permissible insurance agreements under Ukrainian legislation.

An insurance agreement in favor of a mortgagee must be included whereby the mortgagee will acquire the right of claim toward the insurer upon the occurrence of an insured event. If a third party acquires the rights of a mortgagee under a mortgage agreement, such new mortgagee will also acquire the right of claim toward the insurer. Significantly, the mandatory insurance requirement does not apply in case of subsequent mortgages on the same immovable property, however, the mortgagor and the subsequent mortgagee may provide for the acquisition of insurance under their mortgage agreement. In the event of an insured event, all insured mortgagees have the right to satisfaction of their claims from the amount of insurance compensation on the principal obligation in their order of registered priority.

IV. Subsequent Mortgages

Unless specifically provided in a mortgage agreement, mortgaged property may be transferred into a subsequent mortgage with the consent of the preceding mortgagee. A subsequent mortgage has a lower priority than any preceding mortgages. This provision of the law can lead to several scenarios. For example, if a subsequent mortgage involves property, which be-

longs to several entities/persons and is subject to a preceding mortgage, then the mortgagor must obtain the consent of the owners of all immovable property objects originally transferred into such joint mortgage.

If immovable property is mortgaged under several mortgage agreements and one mortgagee wishes to execute collection on the mortgaged property due to the mortgagor's default of its obligation before such mortgagee, then this mortgagee must inform all other mortgagees in the chain in writing regarding its intention to foreclose on the mortgaged property ten days before it exacts foreclosure.

Overall, if a subsequent mortgagee in a chain of mortgagees executes collection on mortgaged property, then the preceding mortgagees also have the right to submit their claims against the mortgagor even if the terms for performance of the principal obligations under their subsequent mortgage agreements have not yet matured. If a preceding mortgagee decides not to exercise this right, its preceding mortgage agreement will remain valid until satisfaction of its principal obligation by the mortgagor. In this case, the mortgaged property will transfer to a new owner (on the basis of a public auction of such property) along with the preceding mortgagee's encumbrance on the property.

Moreover, a preceding mortgagee, on the basis of written notice, can prevent a subsequent mortgagee from foreclosing on mortgaged property if such foreclosure will impede the complete satisfaction of the claim of the preceding mortgagee. In this case, the claims of the subsequent mortgagee will only be satisfied after the preceding mortgagee initiates foreclosure and achieves complete satisfaction of its claims secured by the mortgage.

On the other extreme, if a preceding mortgagee initiates collection and foreclosure on immovable property under its mortgage agreement, a subsequent mortgagee (if one or several exist) also has the right to immediately submit its claims on the immovable property even if the term for performance of the principal obligation before it has not matured. As stated above, in the case of several mortgagees, the claims of each preceding mortgagee must be satisfied in their order of priority (state registration).

V. The Mortgage of Unfinished Construction Objects

In case of the mortgage of unfinished construction objects, the mortgagor may be an entity which will only come into ownership of the unfinished construction object (i.e., building, apartment, residential home, etc.) after the completion of the construction and the state registration of the ownership rights to the said objects. In the case of the financing of residential or non-residential construction projects with the aim of their sale to other

entities (individuals), the mortgagor may also be the builder or developer of the project under the mortgage agreement.

There are two methods to choose in order to mortgage unfinished construction: (i) the land parcel on which the construction is taking place may be mortgaged; or (ii) the immovable property to which the ownership rights of the mortgagor will arise in the future may be mortgaged. The encumbrance of unfinished construction objects is also subject to state registration pursuant to the procedure established by Ukrainian law.

VI. Termination of a Mortgage

A mortgage will terminate on six main grounds, which are as follows:

- 1) the termination of the principal obligation of the mortgagor/debtor;
- 2) the sale of the mortgaged property in accordance with the new mortgage law;
- 3) the acquisition by the mortgagee of ownership rights to the mortgaged property;
- 4) the recognition of the mortgage agreement as invalid;
- 5) the destruction (loss) of the mortgaged building (structure) if the mortgagor has not restored it. If the subject of a mortgage agreement is a land parcel and a building (structure) is located thereon, then in case of the destruction (loss) of the building (structure), the mortgage on the land parcel shall *not* terminate;
- 6) on other grounds provided by the mortgage law.

In effect, subsequent mortgages terminate as a result of foreclosure actions by preceding mortgagees. In all cases, all information related to the termination of a mortgage is subject to state registration.

VII. Additional Protection for the Mortgagee: Mortgage Deeds, Out-of-Court Settlements, Public Sales

While the new law is quite advantageous for both citizens and business looking for financial credit, the new law also maximally protects the mortgagee in two ways. Firstly, the procedure for collecting the mortgaged property from the mortgagor in case of non-fulfillment of the mortgage agreement has been simplified and an “out-of-court” collection procedure may be provided for directly in the mortgage agreement.

Secondly, the new law introduces so-called “mortgage deeds” — a transferable type of security which certifies the exclusive right of the owner to receive from the mortgagor the fulfillment of the principal obligations under a mortgage agreement (or in case of non-fulfillment to file for collection of the mortgaged property). However, such “mortgage deeds” may only be issued in cases of cash debts. Finally, the new law contains the rules for the public sale of mortgaged property on a competition basis by specialized organizations upon the decision of a court.

A. Mortgage Deeds

As briefly described above, a mortgage deed is a debt security certifying the unconditional right of its bearer to obtain performance by a debtor under a principal obligation on the condition that it is subject to performance in cash. If the debtor fails to perform upon demand of the bearer, the bearer has the right to foreclose on the mortgaged property. Mortgage deeds are executed if their issuance is provided for by a mortgage agreement.

Mortgage deeds are subject to state registration together with the state registration of the encumbrance by mortgage of the relevant immovable property. Upon registration of the issuance of a mortgage deed, the original deed must be transferred to the mortgagee.

Mortgage deeds are transferable to third parties upon the execution of an endorsement in accordance with the new mortgage law. A subsequent bearer of a mortgage deed is entitled to the same rights possessed by the original mortgagee pursuant to the agreement reflecting the principal obligation and the mortgage agreement on the basis of which it was executed. After a mortgage deed is executed, the performance of the principal obligation and any foreclosure action may be carried out only upon the demand of the mortgage deed's bearer.

Mortgage deeds may be annulled and new mortgage deeds may be issued only upon the consent of the mortgagor and the debtor (if it differs from the mortgagor) and the bearer of the mortgage deed. All information regarding the annulment of a mortgage deed and the issuance of a new mortgage deed is subject to state registration.

A mortgage deed is drawn up in written form in one copy on a blank standard form established by the State Commission for Securities and the Stock Market. All original copies of the mortgage agreement must clearly indicate the issuance of a mortgage deed in connection with the mortgage agreement. Mortgage deeds must contain at a minimum very specific requisites, including among others (i) the word “Deed” as an integral part of the name of the document; (ii) a determination of the obligation of the

debtor to perform the principal obligation within an established term; (iii) the names, addresses and identification codes of the parties; (iv) a reference to the mortgage agreement and the agreement containing the principal obligation; (v) a description of the mortgaged property sufficient for its identification; (vi) the contents and amount of the principal obligation and its performance term and procedure; (vii) a note on the registration number, date and place of state registration of the encumbrance by mortgage of the relevant immovable property; etc. A mortgage deed must be signed by a mortgagor and debtor (if it differs from the mortgagor) and, in case of legal entities, the signatures must be certified with a corporate seal.

In order to exercise the rights under a mortgage deed, its bearer must notify the debtor in writing with a demand to perform the principal obligation. The bearer must also indicate its bank account information for execution of a transfer of the principal obligation's amount by the debtor. If the debtor wishes, it may demand the presentation of the original mortgage deed before making the relevant transfer of funds.

A mortgage deed becomes subject to transfer to the debtor only in case of the full and proper performance by such debtor of the principal obligation. Thereafter, the mortgage deed is subject to annulment. However, for principal obligations, which are subject to performance in parts, the bearer of a mortgage deed must issue to the debtor written receipts of payment and record a register of payments pursuant to the mortgage deed. In case of any discrepancies between the receipts of payment and the register of payments, the receipts of payments will have priority.

Upon execution of a mortgage deed, the transfer of the ownership rights to mortgaged property is prohibited until the full satisfaction of the claim pursuant to the mortgage deed. Exceptions exist to this rule in cases of the transfer of ownership rights to mortgaged property under the procedures of inheritance or succession.

The transfer of a mortgage deed is carried out by way of execution on such mortgage deed by its owner (endorser) of a transfer inscription (endorsement) in favor of another entity/person and the physical transfer of the original mortgage deed. Importantly, the transfer of a mortgage deed does not require the consent of the mortgagor or debtor (if the debtor differs from the mortgagor).

The transfer inscription (endorsement) must indicate the full name and address of the party to which the mortgage deed is being transferred. The transfer inscription (endorsement) must also be signed by the mortgagee indicated on the mortgage deed or, in case the original mortgagee has previously transferred the mortgage deed, by the bearer of the mortgage deed.

The transfer inscription may also set forth the terms and conditions for the transfer of the mortgage deed. Importantly, however, any endorsements on a mortgage deed which restrict its subsequent transfer will be deemed invalid.

Upon transfer of a mortgage deed, the endorsing party must inform the debtor in writing regarding such transfer and apply all possible means to prevent the debtor from performing the principal obligation in its favor. Of course, if the principal obligation is subject to performance in installments, then the endorsing party must provide the transferee with all copies of payment receipts and the payment register maintained for the relevant mortgage deed.

1. Legal Consequences of a Transfer of a Mortgage Deed

The transfer of a mortgage deed by way of completing an above-described endorsement provides the transferee with all of the rights of the mortgagee under the mortgage agreement and the agreement reflecting the principal obligation. Such transfers do not require state registration, however, the transfer of the mortgage deed may be registered at the transferee's discretion.

The endorsing party (transferor) bears liability before the transferee for the authenticity of the information contained in the mortgage deed and for the validity of the mortgage deed. This does not mean, however, that the transferor is responsible for performance under the mortgage deed by the mortgagor or debtor.

Practically, upon the transfer of a mortgage deed, the endorser (transferor) certifies to the transferee that at the moment of transfer the debtor continues to duly perform the principal obligation and has made all payments due thereon until the date of transfer, unless the transferee was informed otherwise in writing. The endorser bears liability for any damages incurred by the endorsee in case of the failure to fulfill this condition.

On the other side of the coin, the debtor may refuse to make payments under a mortgage deed in favor of an endorsee, which was not aware of any unauthentic information in the mortgage deed, the invalidity of the mortgage deed or any objections by the debtor, *only* if the debtor continues to properly perform under the mortgage deed conditions or if the mortgage deed was issued under the influence of fraud, force, threat or bad faith. The law strictly states that there may be no other grounds for the refusal to effectuate payments on a mortgage deed by the debtor.

Finally, the new mortgage law is not completely void of human compassion when it permits the restoration of rights under a mortgage deed that has been lost. In case of such loss, the mortgagor and debtor (if he differs from the mortgagor) must issue a duplicate mortgage deed on the condition that the party demanding the issuance of a duplicate proves its ownership right to the lost mortgage deed by way of restoration of all preceding endorsements. All disputes surrounding the refusal to issue a duplicate mortgage deed should be disputed in a court of law. Notice regarding the issuance of a duplicate mortgage deed must be indicated on each page of the duplicate and is subject to state registration.

2. The Use of Mortgage Deeds for Refinancing

Another distinct advantage of mortgage deeds is the ability to use them as an instrument for refinancing. Specifically, a mortgagee (or bearer of a mortgage deed) may use a mortgage deed for refinancing its personal activity by way of procuring monetary funds on the basis of such mortgage deed before the term arises for the performance by the debtor of the obligations under the mortgage deed. The generously law provides for five methods of refinancing: (i) sale of the mortgage deed via an endorsement for an amount established by the parties to the transaction; (ii) sale of the mortgage deed with the obligation of a return buyout for a specific price before the term of the principal obligation arises; (iii) transfer of the mortgage deed into pledge; (iv) the issuance of mortgage securities (mortgage obligations and mortgage certificates, which may only be issued by banks and financial institutions with the proper license); and, of course, (v) any other method which does not contradict Ukrainian legislation.

B. Out of Court Settlements

The parties to a mortgage agreement may resolve the issue of foreclosure on the mortgaged property by settling their disputes out of court. Such settlement may be contained in a separate provision of the mortgage agreement or set forth in a separate agreement, which will be subject to notarization and may be concluded at any time before the court decision on foreclosure comes into legal force. An out of court settlement must completely comply with the provisions of the new mortgage law with respect to the methods of foreclosing on the mortgaged property. Importantly, however, such out of court settlement may not hinder the mortgagee from applying other methods of foreclosure permitted by the new mortgage law even if they are not specified in the out of court settlement agreement.

Out of court settlement agreements usually come in two forms: (i) the ownership rights to the mortgaged property are transferred to the mort-

gagee; or (ii) the mortgagee is given the right to sell the mortgaged property. In the first case, the agreement providing for the transfer of the mortgaged property to the mortgagee in lieu of the performance of the principal obligation by the mortgagor will be the legal basis for the registration of the ownership rights to the said property in the name of the mortgagee. However, the rights and claims of any other persons/entities to the transferred property will remain valid and the mortgagee will be responsible for the satisfaction of any claims with higher priority in excess of the size of its mortgaged claim.

In the second case, the mortgagee's right to sell the mortgaged property must be reflected in either an agreement or a court decision. In both cases, the mortgagee must notify in writing the mortgagor and all others with registered claims to the mortgaged property of its intention 30 days before the conclusion of the corresponding sale-purchase agreement. Within the 30-day period, any entity/person with registered rights to the mortgaged property has the right to notify the mortgagee in writing regarding its intention to purchase the said property. If several notices are received by the mortgagee from such entities/persons, the entity/person with the highest registered right or claim to the mortgaged property will acquire the priority right to purchase the property.

The entity/person with the highest priority has 5 days to complete a sale-purchase agreement with the mortgagee after the expiration of the above-mentioned 30-day notice period. If it fails to do so, the priority right will transfer to the next person in the priority chain. Conversely, if no intention is expressed by any entity/person with registered rights or claims, then the mortgagee is free to sell the mortgaged property to any third party at its own discretion. Notably, however, the mortgagor or debtor (if it differs from the mortgagor) will have the right to perform the principal obligation within the 30-day notice period, thereby avoiding the sale of the mortgaged property by the mortgagee.

C. Public Sales

Upon the decision of a court or a notary's endorsement, the sale of mortgaged property with the aim of covering the mortgagor's principal obligation (debt) toward the mortgagee will take place at public sales (auctions), unless otherwise specified by the court decision. For this purpose, the new mortgage law calls for the creation of "specialized organizations" to organize and conduct the public sale of mortgaged property. The mortgagee retains the right to choose the specialized organization to his liking and may agree upon the place of the public sale in an agreement with the specialized organization.

As with the case of the sale of mortgaged property by the mortgagee, in the case of public sales, mortgagors retain the right to fulfill their principal obligations or the overdue parts thereof before the day of the auction. The mortgagor must also pay the compensation of any expenses and damages incurred by the mortgagee, including court costs, expenses for hired experts (appraisers, lawyers' fees, etc.), expenses for any preparations made for the public sale, etc. On the bright side for the mortgagor, however, this right may not be limited and its performance of the principal obligation (plus all other expenses and damages) will terminate the public sale. This right is not exactly absolute: in the case of "installment plans" for the performance of the principal obligation, the mortgagor only has the right to use this saving grace once per year or twice within the validity term of the principal obligation.

In addition, a subsequent mortgagee or property surety may step in to "save the day" by performing the principal obligation on behalf of the mortgagor. As a result, the subsequent mortgagee will be deemed to have been assigned the rights of the preceding mortgagee under the mortgage agreement. Similarly, the property surety will obtain the right to demand from the debtor compensation of the amount for the mortgaged property.

1. Procedure

Public sales (or auctions) are carried out in a two-month period commencing from the date the chosen specialized organization receives an application from a state enforcement agent to conduct a public sale. The initial sale price of the mortgaged property to be sold will either be established by a court or the mortgagor and mortgagee. In the later case, if the parties fail to reach an agreement, the specialized organization will set the initial sale price on the basis of an expert appraisal of the mortgaged property to be sold. In this case, the initial price of the property may not be lower than 90 percent of its value established by way of its appraisal.

Procedurally, the specialized organization must publish a notice regarding the public sale no later than 15 days before the day of the sale at the place of location of the mortgaged property and in at least two official local mass media publications. The notice must contain information regarding the date, time and place of the public sale, a description of the property to be sold, information about where to obtain additional information regarding the terms and conditions of the public sale and any other necessary information. The specialized organization must allow access to the terms and conditions of the sale and information about the property subject to sale to any interested buyers. Additionally, the specialized organization must inform the state enforcement authority, the mortgagor, the mortgagee and all persons/entities with registered rights

and claims to the property to be sold about the date, time and place of the public sale (auction) and the initial price of the property no later than the day of publication of the notice on the public sale in the press.

All natural persons and legal entities, which have paid a guarantee contribution and may legally be purchasers of the property to be sold, have the right to participate in a public sale (auction). The specialized organization sets the amount of the guarantee contribution, which may not exceed 5 percent of the initial sale price of the property to be sold. However, the mortgagor and mortgagee may participate in the public sale without paying the guarantee contribution.

The specialized organization is responsible for registering all participants in a public sale (auction). The registration period terminates one hour before the commencement of the actual sale (auction). For purposes of registration, all participants must provide a document, which certifies its identification, a completed application and the document confirming its payment of the guarantee contribution. Upon official registration, each participant will receive a card indicating its special registration number for participation.

Surprisingly and openly, the new mortgage law specifically states that all public sales (auctions) must be conducted with utmost transparency. Therefore, all participants are provided with the rules of the sale before its commencement. The participant offering the highest purchase price will be deemed the purchaser of the property subject to public sale. If the purchaser turns out to be the mortgagee, it will only be obliged to pay the difference between its offered price and the amount of the unperformed principal obligation to which it is due.

Public sales (auctions) may only be conducted if at least one person/entity registers to participate. Obviously, if only one participant is present, it has the right to purchase the property at the set initial sale price. If no participants register or the property cannot be sold at the initial sale price, the public sale (auction) will be deemed to have not taken place.

Once a purchaser is identified, a protocol must be signed by the authorized representative of the specialized organization and the purchaser according to the results of the public sale. This protocol must indicate a description of the sold property, the initial sale price, the actual sale price, information about the purchaser, the due date for full payment for the property and the bank account of the specialized organization for transfer of the sale price. A copy of this protocol must be sent to the mortgagor, all mortgagees and the state enforcement authority within 5 days of its signing. If the purchaser refuses to sign such a protocol, the next highest bid-

der will subsequently be deemed the purchaser or, if no other potential purchaser exists, the public sale will be deemed to have not taken place.

The lucky winner of the public sale (auction) must transfer the full payment for the property within 10 working days from the date of signing the above-mentioned protocol. The sale price must include the amount paid in as a guarantee contribution to participate in the public sale. If the victor fails to duly transfer the purchase price or refuses to sign the protocol, its guarantee contribution will not be returned and the next highest bidder will be deemed the victor. The guarantee contributions of all other participants must be refunded within three working days from the conclusion of the sale. If a public sale is deemed to have not taken place, all guarantee contributions are returned to the participants.

Upon payment of the full purchase price, the specialized organization must notify the relevant state enforcement authority of such payment within 5 working days of the receipt of payment. Thereafter, the state enforcement authority must send to the specialized organization a so-called "certificate on the acquisition of property at a public sale" within 5 working days of receipt of notice of full payment. Unless the public auction took place in violation of the new mortgage law, the state enforcement authority may not refuse to issue the said certificate. If a refusal is issued by the state enforcement authority, the grounds must be indicated for such refusal, which grounds may be appealed in a court of law.

A certificate on the acquisition of immovable property at a public sale will serve as the legal grounds for registration of the ownership rights of the purchaser. Within 5 days of its receipt of such certificate, the specialized organization must send the certificate to the purchaser of the property and distribute the funds received by the public sale as follows: (i) for expenses for conducting the sale; (ii) for its commission (which may not exceed 3 percent of the actual sale price); (iii) for satisfaction of the claims of mortgagees and creditors in the appropriate priority; and (iv) the remaining amount is returned to the mortgagor. If the amount received by the public sale is not sufficient to cover the mortgagee's (or mortgagees') claim(s), it (they) will have the right to receive the remaining amount due from other property of the mortgagor (debtor). Any of the interested parties have the right to appeal the results of the public sale in a court of law at the location of immovable property within 3 months from the date of the public sale.

VIII. Conclusion

As with most laws in Ukraine, the new mortgage law is in need of amendments to certain existing laws and additional supporting legislation in order

to be completely effective. For example, it is essential to establish a permanent unified mortgage register for real estate so that creditors may verify other existing mortgages and ensure their priority rights to mortgaged property. In addition, the moratorium placed on the sale of agricultural land until 2005 by the Land Code will leave quite a large void on the mortgage market until lifted. This being said, the Ukrainian Parliament has already passed the Laws "On Mortgage Crediting of Operations with a Consolidated Mortgage Pledge and Mortgage Certificates" and "On Financial-Credit Mechanisms and the Management of Property During the Construction of Residences and Operations with Real Estate." However, a detailed analysis of these laws is beyond the scope of this article.

Regardless of the criticisms, the new mortgage law has been a long time coming and is overall positively looked upon by most experts and analysts. Noteworthy in closing is the fact that the new mortgage law came into effect on the same day as the new Commercial Code, the new Civil Code, new taxation legislation, etc. Needless to say, the Ukrainian legislation makers have been extremely busy trying to put the necessary supporting legislation in place since January 1, 2004. The results of implementing a new body of general legislation without supporting legislation and normative acts could be quite confusing and disastrous.

O TEMPORARY PROCEDURE FOR THE STATE REGISTRATION OF MORTGAGES

I. Introduction

Since the coming into force of the Law of Ukraine No. 898-IV "On Mortgages," dated June 5, 2003, on January 1, 2004, the Cabinet of Ministers was charged with approving a temporary procedure for the state registration of mortgages within two months. Although the Cabinet of Ministers was unable to pass the temporary procedure within the prescribed two-month term, they were able to approve the temporary procedure by the end of March. This slight thirty day delay is quite commendable in light of the amount of other legislation which came into force on January 1, 2004 and the necessity to pass numerous legislative acts to complement the new legislation.

Decree No. 410 of the Cabinet of Ministers "On Approval of the Temporary Procedure for the State Registration of Mortgages," dated March 31, 2004, sets forth the temporary state registration procedure required by the Law "On Mortgages" and appoints the Ministry of Justice as the keeper of the State Mortgage Register. The state-owned enterprise "Informatsiyniy Tsentr" (Information Center) of the Ministry of Justice was handed the responsibility to administer the State Mortgage Register.

One of the noble goals of the state registration of mortgages are to support the priority right of a mortgagee in the satisfaction of its claim at the expense of mortgaged property before other non-registered mortgagees or registered mortgagees with later priority. The other goal is to provide natural persons and legal entities with information on the encumbrance of immoveable property by a mortgage or the absence of such encumbrance.

The State Mortgage Register is a unified computer database, which contains information regarding the existence of mortgages or changes in their terms and conditions with respect to immoveable property, the cessation of rights under a mortgage agreement, the transfer, annulment or issuance of a duplicate or new mortgage deed. State and private notaries (hereinafter "Registrars") may carry out registration activities with respect to mortgages only upon concluding an agreement with the Information Center of the Ministry of Justice. The state registration of information with respect to mortgages is carried out by way of making the relevant entries into the State Mortgage Register.

II. The Procedure

Entries into the State Mortgage Register with respect to existing information on mortgages placed on immoveable property and amendments there-

to be made on the basis of a so-called "notice" (hereinafter "Notice") from a mortgagee (i.e., in whose favor a mortgage is registered), a mortgagee's authorized individual or a court of law. In case of the existence of more than one mortgagee under a mortgage agreement, one mortgagee may submit a Notice upon the mutual consent of the other mortgagees.

Upon submitting a Notice, the mortgagee or its authorized representative must present identification documents and, in case of a representative, a power of attorney. A certified copy of the mortgage agreement or court decision, a copy of the mortgage deed (in case of its state registration) and the document evidencing payment for the state registration of the mortgage (and payment for the registration of the mortgage deed if submitted for state registration) must be submitted along with the Notice.

A Notice must contain the following:

- 1) Information on the mortgagor and the mortgagee, as well as information on the debtor under the principle obligations if it is not the mortgagor, including the following:
 - a) for mortgagors, mortgagees and debtors, which are legal entities, the following information must be provided:
 - i) with respect to residents — name, location and identification code pursuant to the Unified State Register of Enterprises and Organizations of Ukraine;
 - ii) with respect to non-residents — name, location and country of registration;
 - b) for mortgagors, mortgagees and debtors, who are natural persons, the following information must be provided:
 - i) with respect to Ukrainian citizens — surname, name and patronymic, permanent place of residence and identification number pursuant to the State Register of Physical Entities-Taxpayers and Payers of Other Mandatory Payments;
 - ii) with respect to foreigners and persons without citizenship — surname, name and patronymic (if available) and permanent place of residence outside of Ukraine;
- 2) A description of the mortgage subject (immoveable property), which is sufficient for its identification and/or its registration data;

- 3) The amount of the principle obligation;
- 4) The term for the full performance of the principle obligation;
- 5) Reference to the issuance of a mortgage deed or its absence.

A Registrar is prohibited from demanding additional information upon the receipt of a Notice to enter or amend information in the State Mortgage Register.

In case of the registration of a mortgage on immoveable property, the following information must be introduced into the State Mortgage Register:

- 1) Information on the mortgagor and the mortgagee, as well as information on the debtor under the principle obligations if it is not the mortgagor, including the following:
 - a) for mortgagors, mortgagees and debtors, which are legal entities, the following information:
 - i) with respect to residents — name, location and identification code pursuant to the Unified State Register of Enterprises and Organizations of Ukraine;
 - ii) with respect to non-residents — name, location and country of registration;
 - b) for mortgagors, mortgagees and debtors, which are natural persons, the following information:
 - i) with respect to Ukrainian citizens — surname, name and patronymic, permanent place of residence and identification number pursuant the State Register of Physical Entities-Taxpayers and Payers of Other Mandatory Payments;
 - ii) with respect to foreigners and persons without citizenship — surname, name and patronymic (if available), and permanent place of residence outside of Ukraine;
- 2) A description of the mortgage subject (immoveable property) which is sufficient for its identification and/or its registration data;
- 3) The amount of the principle obligation;
- 4) The term for the full performance of the principle obligation;

- 5) Reference to the issuance of a mortgage deed or its absence;
- 6) The grounds for the introduction of information into the Register (mortgage agreement or court decision);
- 7) Information on the Registrar;
- 8) The date of the state registration of the information.

In case a mortgagee submits a mortgage deed for registration together with the state registration of a mortgage or amendments to the terms and conditions of a mortgage, the Registrar will place the number of the entry and the date and place of state registration of the mortgage of the immoveable property directly on the mortgage deed.

The Registrar will refuse to introduce an entry into the State Mortgage Register if (i) the information submitted is incomplete; (ii) the proper identification documents were not presented by the mortgagee or its representative; (iii) a duly executed copy of the mortgage agreement or court decision was not submitted; (iv) the document on payment of the fee for introducing the entry into the Register was not submitted; or (v) payment of the fee for introducing the entry was not carried out in full. A refusal to introduce an entry into the Register will be executed in writing within two (2) working days with an indication of the reason for refusal.

If all information and documents have been presented and/or submitted correctly, the Registrar will place the relevant entry into the State Mortgage Register. The date of state registration of a mortgage on immoveable property is the date and hour of the introduction of the relevant entry into the State Mortgage Register. A copy of an extract from the State Mortgage Register will be issued to the mortgagee or its authorized representative upon the introduction of an entry on the registration of a mortgage on immoveable property and/or on the registration of a mortgage deed. A second copy of the extract will be sent to the mortgagor within five (5) days.

An extract from the State Mortgage Register contains basically the same information contained in the Register itself, including information on the Registrar, the grounds for entrance into the Register (mortgage agreement or court decision), notice on whether the mortgage is a subsequent mortgage, information about the parties and the principle obligation, etc.

In case of the amendment and addition of information to an entry in the State Mortgage Register, the mortgagee or its authorized representative must notify the Registrar. Such notice ("Notice") must indicate the date of state registration of information, the number of the entry, the grounds

for introducing information (notice of a mortgagee or court decision) and information on the Registrar. Moreover, the mortgagee must submit information on any amendments to the terms and conditions of the mortgage on immoveable property and on the cessation of rights under the mortgage agreement (in favor of whom such cessation was carried out and information on the agreement confirming such cessation). Additionally, the mortgagee must submit information on the transfer, annulment or issuance of a duplicate mortgage deed and the issuance of a new mortgage deed, including information on the parties and the person to whom a mortgage deed is transferred, the date of transfer of the mortgage deed, the date of annulment of the mortgage deed, the date of issuance of a duplicate mortgage deed or the date of issuance of a new mortgage deed.

The text of the amendments and additional information introduced into the mortgage agreement (i.e., agreement confirming the cessation of rights under the mortgage agreement or the transfer, annulment, issuance of a duplicate mortgage deed and the issuance of a new mortgage deed) must be affixed to the Notice along with the document confirming payment for the introduction of the amendments and additional information into the State Mortgage Register.

The Registrar will refuse to introduce amendments or additions to the Register if (i) incomplete or inconsistent information is submitted; (ii) the mortgagee or its representative failed to present their proper identification documents; (iii) the text of the amendments and/or additions was not affixed to the Notice; (iv) the document confirming payment for the entry into the Register was not submitted; or (v) payment for the entry was not made in full. A refusal will be executed in writing within two working days with an indication of the reason for refusal.

After the performance of an obligation secured by a mortgage, the mortgagee must send to the Registrar within ten (10) days written notice on the exclusion of the relevant entry from the State Mortgage Register with mandatory indication of the number of the entry. An entry may also be excluded from the Register on the basis of a court decision with mandatory indication of the entry number. Upon receipt of the notice or court decision, the Registrar will exclude the relevant entry from the Register and introduce the following information: (i) the date and number of the notice or court decision on exclusion; (ii) the date of exclusion; and (iii) information on the Registrar.

The Registrar has the right to refuse to exclude an entry from the State Mortgage Register if the information indicated in the application notice on its exclusion does not correspond to the information located in the Register. In this case, the Registrar will inform the mortgagee in writing within two (2) working days.

Once an entry has been excluded from the State Mortgage Register, the Registrar will issue to the mortgagee or its authorized representative a copy of an extract from the Registrar. A second copy of the extract will be sent to the mortgagor within five (5) days. Interestingly, the exclusion of an entry from the Register is done on a free-of-charge basis.

As a show of progress in Ukraine, the Cabinet of Ministers has permitted any natural person or legal entity to receive extracts from the State Mortgage Register. In order to receive an extract, a request must be submitted on the presence or absence of an entry in the Register on a mortgage, the cessation of rights under a mortgage agreement, the transfer, issuance of a duplicate mortgage deed and the issuance of a new mortgage deed, or the issuance of an extract on the state registration of a mortgage on immoveable property. The request must indicate the following:

- 1) A description of the mortgage subject sufficient for its identification and/or its registration data;
- 2) For legal entities — the name, location and identification code in the Unified State Register of Enterprises and Organizations of Ukraine;
- 3) For natural persons — surname, name and patronymic, permanent place of residence and identification number pursuant to the State Register of Physical Entities-Taxpayers and Payers of Other Mandatory Payments.

If the requesting person or legal entity wishes to receive an extract from the State Mortgage Register by mail, the address to which the extract should be sent must be indicated in the request. Of course, the request must be submitted along with the document evidencing payment for the issuance of an extract, otherwise the Registrar will refuse to issue the extract. The Registrar will also refuse to issue the extract if any of the required information is absent from the text of the request. Interestingly, courts, bodies of internal affairs, prosecutors' offices, the state tax service, security services and other bodies of state power have the right to receive so-called "informational certificates" at no charge if their requests are made within their authorities pursuant to law.

An extract or information certificate is issued on the basis of the information contained in the State Mortgage Register after the receipt of a request. The Registrar has two (2) working days from the day of registration of a request to issue an extract or informational certificate or to refuse to grant such request with an indication of the reason for refusal.

An extract from the State Mortgage Register will be affixed with the official seal of the issuing Registrar and contains the following information:

- 1) The date of registration of a mortgage on immovable property;
- 2) The registration number of the entry in the Register;
- 3) Information on the mortgagor, mortgagee and/or debtor under the principle obligation (if it differs from the mortgagor);
- 4) Information on the cessation of rights under the mortgage agreement;
- 5) A description of the mortgage subject sufficient for its identification and/or its registration data;
- 6) The amount of the principle obligation;
- 7) The term for the full performance of the principle obligation;
- 8) Reference to the issuance of a mortgage deed or its absence, and in case of the registration of a mortgage deed — the requisites of such deed;
- 9) Reference as to whether the mortgage is a subsequent mortgage;
- 10) The grounds for the introduction of an entry into the Register (mortgage agreement or court decision); and
- 11) Information on the Registrar.

The official fee for the introduction of entries into the State Mortgage Register (including the introduction of amendments) currently amounts to 34 Ukrainian Hryvnia (including VAT). Likewise, an extract from the Register costs 34 Ukrainian Hryvnia (including VAT). Natural persons and legal entities may use information from the Register via the unified computer database on the basis of an agreement with the state-owned company Information Center of the Ministry of Justice. Accordingly, such natural persons and legal entities independently establish the payment amounts for the use of information from their access to the Register, while they must send the official fees and payment amounts provided by their Agreement with Information Center to the Center for maintenance of the Register.

III. Conclusion

As is obvious by the name of the Cabinet of Ministers' Resolution No. 410, this is only a temporary procedure for the registration of mortgages on immovable property. As experience is gained by the practical implementation of the Law "On Mortgages" and the growth of the mortgage market, this simple procedure will most likely begin to reveal many flaws. On

April 20, 2004, the first mortgage registered in the State Mortgage Register was finally announced. The unique aspects of the infant Ukrainian mortgage market and the experience of other emerging markets with their new mortgage laws (especially Russia) will play a role in dictating when a permanent and workable registration procedure will be passed in the future.

V Securities

A SECURITIES REGULATIONS

I. Introduction

The Ukrainian securities market is still considered to be in its infancy, but not for much longer. On-going privatization efforts are witnessing the creation of thousands of publicly traded stock companies. This phenomenon has forced the normally complacent Ukrainian legislators to implement a comprehensive system of securities regulations. Alternatively, Ukraine will continue suffer the fate of the U.S. during the early 1930's, much as it has during the past decade, until such time as the necessary legal and economic system functions.

Previously, the lack of stock available for trading on the stock exchange, coupled with a non-functioning enforcement mechanism for securities trading legislation, were only two of the many elements contributing to Ukraine's inability to absorb significant foreign investment. In the early days, only three companies officially traded their shares of stock on the Ukrainian Stock Exchange (the "USE"): (1) UkrRechFlot, a privatized river boat company; (2) Ukraina joint stock bank (which is currently undergoing liquidation proceedings); and (3) Olbi Ukraina. Presently, there are several stock exchanges and professional associations in Ukraine. The most important of all the exchanges and associations is the "Association of Over the Counter Trading System" (the "PFTS"), which accounts for an overwhelming majority of the total volume on the Ukrainian securities market.

The volume of trading increased dramatically in 1995, following the Presidential Decree No. 146, issued on February 27, 1995, "On Participation of the Ukrainian Stock Exchange in the Privatization Process," which finally allowed the stock exchange to trade in shares of open stock companies in exchange for cash. This Decree served as the basis for the eventual release of hundreds of thousands of shares into the fledgling securities market. Most of them belonged to recently privatized enterprises, and therefore rules applicable to the privatization process in general (and certificate vouchers in particular) complemented the already cumbersome Ukrainian legislation governing securities issuance and regulations.

The development of a securities market was not without its "rogue elements," as the initial "pyramid" schemes flourished and fly-by-night "trust companies" disappeared after receiving deposits of many trusting souls (mostly the elderly, who lost their entire life savings). While the legislation governing activities of trust companies, investment funds and investment companies existed, it went virtually unenforced. The fleecing

of citizens came to an abrupt end on June 26, 1995, when the Cabinet of Ministers ordered the SPF, the Ministry of Internal Affairs, the SBU (formerly known as the KGB) and local enforcement organs to terminate the activities of trust companies, which failed to comply with applicable legislation. Since September 1, 1995, statistical accounting from all trust companies has been required with the aim of preventing a repeat of their previously unregulated activities.

Below we discuss the legislative acts shaping the Ukrainian securities market, and their practical consequences, in greater detail.

II. The Law “On Securities and the Stock Exchange”

The cornerstone of the regulatory framework, governing Ukraine’s nascent stock market, is the Law No. 1201-XII “On Securities and the Stock Exchange,” dated June 18, 1991 (the “Securities Law”). Passed by the Parliament even before Ukraine’s independence in August of 1991, the purpose of this law, as set forth in its preamble, was to establish the conditions and procedures, governing the issuance of securities, and to regulate intermediary activities in the organization of the circulation of securities on the territory of Ukraine.

As with many Ukrainian laws that purport to regulate highly complex areas of commercial activity, such as banking and taxation, the actual text of this law is very short, leaving much room for interpretations in subsequent instructions. Comprised of only forty-one articles, the Securities Law effectively serves as the springboard for a myriad of supporting resolutions, instructions, and procedures governing the vast area of securities regulation that has emerged over the past ten years. Therefore, only a brief review of this fundamental legislative act is necessary.

Beginning with the basics, the Securities Law defines “securities” as monetary documents, which evidence ownership rights or relations, and set forth the mutual relations between the issuer of the security and its owner. As a rule, securities provide for the payment of income in the form of dividends or interest, and also allow the owner to transfer its monetary and other rights, which arise from these documents, to other persons. These monetary documents generally possess the following characteristics:

- (a) Securities may be issued in either registered (named) or bearer form;
- (b) Registered securities may only be transferred by a full endorsement (a signature of conveyance that evidences the transfer of rights under the security to another person), unless the Securities Law or the security itself otherwise specifically provides that the security is not subject to transfer;

- (c) Bearer securities may be transferred freely, without restriction;
- (d) Securities may be used for settlement of accounts and may also be pledged as collateral for securing payments and credits; and
- (e) Securities may be inherited in accordance with the provisions of the Civil Code.

Under the Securities Law, only the following types of monetary documents are considered securities, and as such, are subject to regulation under Ukrainian law: shares of stock; republic and municipal loan bonds (T-bills), enterprise bonds, treasury obligations, savings certificates, investment certificates, bills of exchange, mortgage securities, pledge securities and privatization certificates. Please note that mortgage securities, pledge securities and privatization certificates are regulated by specialized legislation.

Following this basic outline of Ukrainian securities, in the next section we describe their legal attributes. Thereafter, we review the general framework, applicable to investment funds and investment companies, and describe the rules applicable to securities traders, brokers and dealers. We conclude our review of this section with a description of Ukrainian Stock Exchanges, Professional Associations, and the Securities Commission.

III. General Characteristics of Securities

The Securities Law delineates the legal characteristics of the various securities listed above. Other types of securities not mentioned in the Securities Law are discussed in separate legislative acts.

For example, in the Decree of the Cabinet of Ministers “On the System of Currency Regulation and Currency Control,” the term “currency value,” in encompassing Ukrainian currency, not only includes bank notes, treasury notes, coins or other forms of money that circulate and are the legal means of payment on the territory of Ukraine, but also payment documents and certain securities not mentioned in the antiquated Securities Law: letters of credit, debentures, checks, bank orders, certificates of deposit, savings books, and other financial and bank documents.

Below we discuss the general characteristic of the securities regulated by the Securities Law.

A. Shares of Stock

Under the Securities Law, shares of stock are defined as securities with an indefinite period of circulation, evidencing a proportional ownership share

in the authorized capital of a joint stock company, membership in such company, and the corresponding right to participate in the company's management. A share of stock entitles its owner to receive a portion of a company's profits, in the form of dividends, as well as the right to participate in the division of property upon such company's liquidation.

Although a number of stock companies exist in Ukraine, an overwhelming majority of these companies are closed joint stock companies, whose shares of stock are distributed solely amongst their members and are not freely circulated on the securities market. For the most part, these companies tend to be private companies created by local businessmen and foreign entities (e.g., joint ventures). The discussion below provides an overview of the current regulatory regime. We encourage you to seek an update anytime hereafter.

(i) Types of Shares

Shares of stock may be either registered or bearer shares and common or privileged. The distribution and circulation of registered shares is recorded in the share registry maintained by a company (or by an independent registrar), which contains information regarding each registered share issued by the company, such as the owner's name and address, the date on which the owner purchased the share, the total number of shares held by the owner, etc. As for bearer shares issued by a company, only the total number of these shares is recorded in the company's share registry.

Preferred shares entitle the owner to a priority right to receive dividends, as well as a priority right to participate in the division of the company's property upon its liquidation. Holders of preferred shares are not entitled to participate in the management of the company, however, unless the company's charter expressly provides otherwise. Note one limitation, however: a stock company may only issue preferred shares in an amount that does not exceed 10 percent of its authorized capital.

With respect to the holders of preferred shares, stock companies can provide that the holders of such shares will be entitled to receive dividends annually in an amount equal to a fixed percentage of the nominal value of the share, regardless of whether the company earned a profit. In any given year, if the amount of profit earned by the stock company is insufficient to pay such dividends, then dividends are paid from the reserve fund of the company. Moreover, if the amount of dividends paid to the holders of common shares exceeds the amount paid to preferred shareholders, the latter are entitled, upon request, to receive an additional payment in an amount equal to the difference.

In general, dividends are paid by a stock company, in accordance with the procedures set forth in the company charter, out of the remaining profits after the payment by the company of all taxes, other mandatory payments to the state budget and interest on any bank loans.

(ii) General Characteristics

Shares of stock are issued in an amount corresponding to the entire authorized capital of a stock company or, in the event of corporatization (i.e., conversion of a state-owned enterprise into a stock company), an amount equal to the full value of the property of a state-owned enterprise. A stock company may not issue additional stock to cover any debts incurred by the company as a result of its disastrous business activities. An additional issuance of shares is only permitted after the stock company has received payment in full for all earlier issued shares at not less than the nominal value of those shares.

Interestingly, stock companies may not issue fractional shares. The Securities Law expressly states that shares of stock are not divisible. If one share is issued to more than one person, the individual owners do not each own a fractional share; instead, each of those individuals together owns one share and can exercise their rights as a shareholder in the company through one of them or through a joint representative.

With respect to purchases of securities by legal entities, the Securities Law contains a peculiar limitation: enterprises, organizations and institutions can only purchase shares of stock using funds remaining at their disposal after the payment of all taxes and interest on any outstanding bank loans.

Stock certificates must contain certain information, including among others:

- the name of the stock company and its address (actual location);
- the name of the security (share of stock);
- the consecutive number of the share and its date of issuance;
- the type of share (i.e., common or preferred);
- the nominal value of the share;
- the name of the owner of the share (for registered shares only);
- the amount of the authorized capital of the stock company on the date

- the share of stock is issued;
- the total number of shares issued; and
- the period for payment of dividends.

Instead of issuing stock certificates for each individual share issued to a shareholder, a stock company can issue a single document representing the aggregate number of shares owned by the individual shareholder. Shares of stock may also include coupons (or vouchers) for the payment of dividends. To be valid, these annual payment vouchers, which, upon presentation entitle the owner to his proportionate share of stock company's dividend distribution, must also indicate the voucher's consecutive number, the consecutive number of the share of stock on which the dividend payment is based, the name of the stock company, etc.

The Ukrainian securities market is a quasi-dematerialized market where the legal proof of ownership is limited solely to entry in the registrar's records. Securities transactions in Ukraine involve significantly more paper work than what ordinarily exists in a security transfer which is represented by a registered stock certificate. To update the registration of ownership in this environment, one needs the following:

- a copy of the sale-purchase agreement;
- the transfer order;
- a power of attorney;
- a copy of the extract reflecting the prior entry in the registrar; and
- proof of payment of the re-registration fee, delivered to the registrar.

Please note that shares of stock may only be issued to a purchaser after payment by the purchaser for the full value of shares.

As a side-comment, a stock company is permitted to repurchase issued shares of stock from its shareholders for further resale, distribution among its employees or annulment. Note, however, that any shares repurchased by the company for these enumerated purposes must be sold, distributed or annulled within one year of repurchase. During the period between repurchase and resale, distribution or annulment, the repurchased shares are not considered for purposes of calculating the amount of dividends distributed by the company or for voting and quorum requirements.

(iii) Issuance of Shares of Stock and Registration Requirements

Prior to issuing shares of stock, the founders of a stock company or its general assembly of shareholders must document their decision to issue additional shares in a protocol (i.e., minutes of the founders' meeting or general assembly). This protocol must contain certain information, including but not limited to:

- the name of the issuer and its address (actual location);
- the amount of the authorized capital or the value of fixed and current assets of the issuer;
- the goals and scope of the issuer's activities;
- an indication of the issuer's officers;
- the name of the issuer's controlling body (auditing firm);
- information regarding the issuer's securities, which were previously placed into circulation;
- the goal of the issuance of shares;
- an indication of the category of shares;
- the quantity of bearer and registered shares being issued;
- the quantity of preferred shares being issued;
- the total value of the issuance and the number of shares;
- the nominal value of the shares being issued;
- the number of participants in the voting and the voting procedure;
- the procedure for payment of dividends;
- the term and procedure for pre-payment and payment for shares being issued;
- the term for returning funds in case the share issuance is refused;
- the schedule for the issuance of shares if they are issued in installments;

- the procedure for the notification of the share issuance and the procedure for the allocation of shares;
- the rights of the holders of preferred shares; and
- the preferential right for acquiring shares of the new issuance.

According to the provisions of the Securities Law, an issuer has the right to issue shares and enterprise bonds (discussed further below) from the moment the issuer registers its issuance with the State Commission for Securities and the Stock Market (the “SCSSM”) or its regional departments.

In addition, if shares or bonds are to be issued via an open subscription, that is, for sale and distribution among individuals and legal entities whose identities cannot be determined in advance, the issuer must provide the SCSSM with certain information regarding the issuance. The registration of the share issuance and the release of information regarding the share issuance must take place no later than thirty (30) days after submission of an application and the necessary additional documents to the SCSSM. Registration of a stock or enterprise bond issuance is mandatory under the law, regardless of the overall amount of the proposed issuance.

The SCSSM is responsible for maintaining a general register of all security emissions. The relevant department of the SCSSM, which is responsible for registering a share issuance, reviews the issuer’s documents for compliance with Ukrainian law. Registration by the SCSSM of an issuance, information connected with an issuance or the report on the results of the subscription for shares, however, should not be relied upon as a guarantee of the value of the shares or bonds.

Theoretically, the SCSSM can refuse registration only in the event that the procedures for registration have been violated or the documents submitted for registration do not comply with the requirements of law. If the issuance is not registered by the SCSSM within the requisite thirty-day period, or if the SCSSM refuses to register the issuance for reasons deemed groundless by the issuer, the issuer may seek legal redress in a court of law.

To register a security issuance by a closed joint stock company, the issuer must provide the SCSSM with certain documents, including an application for the registration of securities; a notarized copy of the minutes reflecting the decision to issue securities; a notarized copy of the charter of the issuer; a copy of the certificate on the issuer’s state registration; a sample of the share blank form executed in accordance with the requirements of Ukrainian law (if the shares of stock are issued in a

documentary form); a balance sheet certified by the signatures and corporate seals of both the issuer and the auditing firm; a certificate on the issuer’s financial condition certified by the signatures and corporate seal of its auditing firm; an auditing firm’s findings as of the first day of the current quarter in which the documents are submitted for the registration of the share issuance; and copies of certificates confirming the registration of shares previously issued by the issuer. Upon registration, the issuer receives a certificate, which entitles it to acquire blank security forms or order the printing of such forms if the shares are issued in a documentary form or to execute a global certificate with the relevant depositary if the shares are issued in an electronic form.

If the issuance is to take place via an open subscription by an open joint stock company, the issuer must submit detailed information regarding the issuance and the issuer, namely:

- the company name and address;
- the date when the company was founded;
- the scope of its activities and certified financial statements (a balance sheet and profit/loss statement) for the previously completed financial year of the company;
- a quarterly balance sheet disclosing the company’s status as of the quarter preceding the company’s decision to issue securities;
- a financial report on the company’s authorized capital;
- the number of employees; and
- professional information regarding the company’s management, including education, qualifications and number of years in employment.

Additional information may be necessary, including but not limited to:

- a listing of the activities of the issuer, certified by an auditor, including information regarding manufacturing, sales, scientific research and investments;
- information regarding the issuance of securities;
- the date and protocol number of the decision to issue securities;
- the purpose for which the funds collected from the issuance will be used;

- the proposed volume of the emission;
- the type and category of the securities, indicating the rights connected to them.

With respect to the shares of stock, the following information must be included:

- the founders and the rights given to the owners of preferred shares;
- the quantity, nominal value and sum of the security issuance;
- the number of the series and the consecutive numbers of the securities;
- the place and date of the beginning and end of the subscription;
- information about possible privileges/benefits for the owners of securities;
- the name of the securities trader (if the issuer will be using a trader's services); and
- the addresses and places where dividends will be paid out, etc.

In case of creating a new open joint stock company (i.e. one that has no legal predecessor), the information regarding the issuance of securities must include the following:

- the name of the future stock company;
- the subject of its activities;
- the date of the constituent founders' meeting;
- the amount of the authorized capital;
- a list of property to be contributed to the company by the founders as in-kind contributions;
- the name of the new company's bank and the number of the settlement account to which the initial contributions should be paid; and
- the above-described information required for the issuance of securities.

The information provided by the issuer regarding the securities issuance may not be more than six (6) months old and must accurately reflect the

nature of the issuer's state of affairs, fully allowing any interested parties to evaluate the financial and economic condition of the issuer. For example, if the issuer, or its legal predecessor, filed for reorganization, bankruptcy or liquidation within three years preceding the securities issuance, this fact, as well as all information regarding the same, must be contained in the submitted information.

In addition, if any legal entity will act as a guarantor for the fulfillment of the obligations contained in the securities, the information submitted must disclose this fact, along with any other information regarding possible risks in the issuer's business activities. Finally, the submitted information must be signed by the issuer (and by the trader, if a trader's services are to be used in issuing the securities).

If, within ten (10) business days after submission of the above information, the SCSSM does not refuse to register an issuer's application, the issuance is deemed registered. The SCSSM may refuse to register an application on certain grounds, including the existence of information indicating that the conditions of the issuance are not in accordance with the requirements of applicable law or the submitted information is insufficient in accordance with the applicable legal requirements, among others.

In addition to registering an application with the SCSSM, the issuer must publish in full the registered information on the security issuance in the official publications of the Parliament or the Cabinet of Ministers, or in the official publication of the SCSSM at least ten (10) days prior to commencing the open subscription period. Shares and enterprise bonds subject to open subscription may not be distributed earlier than thirty days after publication of the informational notice on the issuance.

In the event that any information contained in the submission or publication should change during the thirty-day period following the initial submission of information to the SCSSM regarding the issuance of the securities, the issuer must provide the SCSSM with updated information before the end of this period. In the event that the published notice contains any incorrect information, the SCSSM may suspend the open subscription period until such time as the issuer corrects the information.

No later than fifteen (15) calendar days after the termination of the open subscription period, the issuer must provide the SCSSM with a report on the results of the issuance. This report must be signed by the issuer (and a trader, if the issuer used a trader's services), and certified by an auditing firm. If the shares are issued in an electronic form, the above report must be also certified by the depositary with which the issuer entered into share issuance service agreement and executed and deposited a temporary

global certificate of the security issuance. This report must contain information including, but not limited to:

- the dates on which the open subscription period began and ended;
- the actual price and quantity of securities sold;
- the overall value of the securities sold, including the method of payment for the shares, such as:
- cash amounts in Hryvnias;
- valuation of material assets; and
- a valuation in Hryvnias of the foreign currency.

(iv) Reporting Requirements

Issuers of shares and bonds are required to inform the public about their financial and economic condition and the results of their activities at least once a year by publishing an annual report. The annual report must be published no later than on the ninth month of the previously completed financial year, and must be sent to all holders of registered shares, as well as to the SCSSM. The annual report must contain certain information about the issuer, including:

- information on the results of the issuer's economic activity for the previous year;
- the issuer's annual balance sheet and certificate on the issuer's financial condition, confirmed by an auditor (auditing firm),
- general information regarding additionally issued securities; and
- substantiated reasons for changes in the executive personnel of the issuer, if any.

In addition to the annual reporting requirements, issuers are subject to continuing reporting obligations. Specifically, within two (2) days after information surfaces regarding any changes in the issuer's economic activities which would negatively affect the value of the securities or the amount of income received from the securities, the issuer must disclose this information to the relevant bodies of the SCSSM. Such changes can include:

- changes in the rights guaranteed to the holders of securities;
- changes in the issuer's executive personnel;

- an arrest (seizure) of the issuer's bank accounts;
- the initiation of measures to prevent the bankruptcy of the issuer, such as reorganization proceedings, etc.;
- reorganization, cessation or termination of the activities of the issuer;
- the destruction of not less than 10 percent of the issuer's property due to force majeure events;
- initiation of a claim or action against the issuer in an amount that exceeds 10 percent of either the issuer's authorized capital or the sum of its fixed and current assets; and
- the receipt of a loan or the issuance of securities in an amount that exceeds 50 percent of either the authorized capital or the fixed and current assets of the issuer.

Moreover, if incorrect or misleading information is published regarding the issuer, which information may affect the value of the issuer's securities or the income received from such securities, the issuer must take steps to correct such information within two (2) business days of publication.

The Securities Law provides that if a party has subscribed to or purchased securities prior to the publication by the issuer of information regarding changes in its economic activity that negatively affect the value of the securities or the income received therefrom, such person may unilaterally terminate the purchase agreement within fifteen (15) days after the publication of such information.

In the event that the purchaser exercises this right, and actually terminates the agreement, the issuer is required to reimburse the purchaser at the purchaser's prior written request for all expenses and any possible losses resulting from the subscription or purchase of the securities. Moreover, an issuer is required to indemnify a party for any losses occurring as a result of inadequate information regarding the securities. Finally, an issuer that does not fulfill the terms of a subscription for securities is required to return to the subscribers, upon prior written request, all money received from them, along with interest for the period during which the issuer held these funds.

IV. Bonds

Bonds are defined as a security, certifying that the owner thereof has contributed money and confirming the issuer's obligation to return the nomi-

nal value of the bond within the time period specified therein, along with payment of a fixed interest rate (unless otherwise stipulated in the bond issuance). Since owners of bonds are effectively creditors of the issuer, they are not entitled to participate in the management of the enterprise that issued the bond. As the creditors of the issuer, however, bondholders have a priority right before the shareholders of the issuer to satisfy their claims against the issuer's property.

Moreover, as compared to stockholders, whose income theoretically depends upon the annual results of the issuer's economic activities, the income of bondholders, including the nominal value of the bond and the interest thereon, does not depend on the issuer's annual financial condition and may not be unilaterally reconsidered or revised by the issuer (except to pay out a higher sum).

A. Types of Bonds

The Securities Law provides for two types of bonds: (1) bonds for republic and regional loans (also referred to as T-bills); and (2) enterprise bonds. The former type of bonds are issued by the state, local and regional governments, while the latter may be issued by all enterprises, regardless of their form of organization and ownership, including stock companies and unions of enterprises. One should be aware that unions of enterprises include among their ranks consortiums and temporary unions of industrial and banking capital.

Nothing in the Securities Law, or any other law, prevents consortiums from issuing bonds in which the repayment period exceeds the period for which the consortium was created. Given that the members of a consortium are not individually liable for the obligations of the consortium, however, bonds issued by consortiums are considerably more risky than bonds issued by other types of enterprises.

Certain limitations exist regarding the issuance of bonds. As discussed earlier, a stock company may only issue bonds in an amount that does not exceed twenty five percent (25%) of its authorized capital, and then only after receipt of full payment for all issued shares of stock. In general, bonds may not be issued by any enterprise to form its authorized capital or to cover losses connected with an enterprise's economic activities. Moreover, payments on bonds are made from funds remaining at the disposal of the enterprise after payments to the state budget for taxes and other obligatory payments, such as dividends on preferred shares of a stock company.

B. General Characteristics

Bonds may be issued in either registered or bearer form, and may be either interest bearing or non-interest bearing (also known as a "purpose bond").

Republic and regional bonds, however, may only be issued in bearer form. Bonds (T-Bills) may also be issued for open circulation or for limited circulation (i.e., open or closed subscription).

Bonds must be purchased with Hryvnias, unless otherwise specifically provided in the issuance terms. Regardless of the payment means, bonds may only be denominated in Hryvnia. Individuals are permitted to purchase bonds with their own personal funds, while enterprises may only purchase bonds with funds remaining at their disposal after the payment of all taxes and interest on bank loans. All non-residents may conduct T-Bill transactions only through Ukrainian banks, and the corresponding contracts must be registered with the National Bank. Upon such registration, non-residents are assigned an individual code to buy, hold, and sell T-Bills.

A bond must contain the following requisites:

- the name of the security (i.e., "bond");
- the name of the purchaser, (for registered (named) bonds only);
- the nominal value;
- the repayment period;
- the amount and period for interest payments;
- the place and date of issuance, as well as the series and consecutive number of the bond;
- the signature of the issuer's executive officer or other authorized signatory; and
- the issuer's corporate seal.

In addition to the above information, so-called "purpose bonds" must state the chattel or service to be received by the bondholder at the end of the term. The Securities Law provides that non-interest (purpose) bonds provide the holder with the right to acquire the chattel or services for which the bond was issued. If, at the time of acquisition of the chattel or service, the value of the chattel or service exceeds that stated in the bond, the bondholder acquires the chattel or service for the value stated in the bond. If, on the other hand, the value of the chattel or service is less than stated in the bond, the bondholder receives the difference between the two.

The Securities Law, however, is not clear as to whether all non-interest bearing bonds can only be purpose bonds, or whether non-interest bearing

bonds may be sold at below nominal value (i.e., at a discount) and repurchased by the issuer at the end of the term for the full nominal value of the bond.

Much like shares of stock, interest bearing bonds can contain coupons for the payment of interest. These coupons must contain information concerning the consecutive number of the coupon, the consecutive number of the bond, the name of the issuer, and the year in which the interest is to be paid. Moreover, bonds issued under an open subscription for open circulation must contain a coupon book.

C. Issuance of Bonds and Registration Requirements

The decision to issue national and regional loan bonds (T-Bills) is taken by the Cabinet of Ministers and by the regional councils of people's deputies, respectively. The decision must determine and appoint the issuer and set forth the conditions of the issuance, as well as the procedure for distribution of the bonds.

The first such bond issuance after Ukraine declared independence took place early in 1995, when the National Bank conducted an auction for 1995 government bonds. Approximately 10,000 bonds were emitted with a face value of 100 million karbovantsi per bond, for an overall issuance of 1 trillion karbovantsi. The guaranteed nominal income for each bond was set at 140% annually, which, at the then current discount rate, amounted to approximately 164.60% per annum. Dividends on these bonds were paid quarterly in the amount of 35 million karbovantsi. Since then, auctions for government bonds (T-Bills) have been held regularly on a daily basis.

By the prosperous mid-1997, the bond market was attracting a great deal of foreign interest. The dramatic fall of the South East Asian economies, combined with investor concerns about the pace of Ukrainian reforms and increasingly less than attractive interest rates, caused an outflow of foreign money from the Ukrainian bond market. In the beginning of 1998, the Ukrainian government took measures to quell foreign concerns and increased annual rates to a more reasonable fifty (50) percent.

In contrast, the issuance of enterprise bonds occurs by decision of the enterprise as documented in the relevant official minutes. The minutes must contain certain information, including, but not limited, to:

- the name and address (location) of the issuer of the bond;
- information regarding the authorized capital of the issuer, its economic activities, and the names of its executive personnel;

- the name of the issuer's controlling body (auditing firm);
- data regarding the distribution of previously issued securities;
- the objective of the bond issue and a specification of the types of bonds to be issued (registered or bearer);
- the total value of the issue and the quantity and nominal value of the bonds;
- the number of persons who participated in the voting;
- the procedure for issuing bonds and payment of interest thereon;
- the period of time for returning funds if the issuer refuses to issue bonds;
- the period of time for selling the relevant goods and services under the purpose bonds;
- the procedure for notifying of the issuance and allocation of bonds; and
- the procedure for payment of bonds.

The procedures for registering a bond issuance by an enterprise, as well as the reporting requirements for bond issuers, are the same as for issuers of shares of stock (see discussion above).

V. Treasury Obligations

Treasury Obligations are defined by the Securities Law as a security, issued in bearer form and distributed exclusively on a voluntary basis among the general public, which certifies a monetary contribution by the owner to the State budget, and which entitles the owner to receive financial income. As is evident from this definition, treasury obligations are floated only among the population, that is, individual physical persons (*not legal entities*). The proceeds from the sale of treasury obligations are used to cover current expenditures of the State budget.

According to the provisions of the Securities Law, three types of treasury obligations exist:

- (a) long-term obligations with a term of 5 to 10 years;
- (b) medium-term obligations with a term of 1 to 5 years; and
- (c) short-term obligations with a term of up to 1 year.

Decisions to issue long-term and medium-term treasury obligations are entrusted to the Cabinet of Ministers, while decisions to issue short-term obligations are entrusted to the Ministry of Finance. Both the Cabinet of Ministers and the Ministry of Finance establish the procedures for issuing treasury obligations and paying income thereon. The selling price for treasury obligations, however, is determined according to the procedures established by the Ministry of Finance, and is based on the time of purchase.

As an observation, the Securities Law merely sets out the general characteristics for treasury obligations. Specific regulations applicable to each issuance are determined by the respective issuing authority, and may vary from issuance to issuance. Currently, there is no widespread distribution of these securities in the territory of Ukraine, which can be explained by the fact that the population, as the only potential investor in these types of securities, not only lacks sufficient disposable income to invest in these securities, but also harbors its own doubts regarding the trustworthiness of the government as a debtor.

VI. Savings Certificates

According to the Securities Law, savings certificates are defined as written certificates issued by banks, indicating that a certain sum of money has been deposited, and entitling the owner to receive his deposit and the interest accrued thereon at the end of a fixed period. An investor in savings certificates should be aware of two important characteristics of these securities.

First, in Ukraine, only banks are permitted to accept money in deposit accounts and, in return, issue savings certificates. Secondly, although the definition of savings certificates implies that these securities may, under common Western understanding, be more aptly titled certificates of deposit, the latter are not defined as securities under Ukrainian law. Therefore, an investor who invests in a certificate of deposit issued by a bank, as opposed to a savings certificate, will not be guaranteed the same protection as is provided to purchasers of savings certificates. The rights and obligations of the issuer and owner of a savings certificate are regulated by the Securities Law, whereas the rights and obligations of the issuer and owner of a certificate of deposit are subject to the terms and conditions established by the issuer itself.

Savings certificates may be issued in either registered or bearer form, for a fixed period with a fixed interest rate (i.e., fixed-term savings certificates), or as call certificates, with redemption upon presentation. Registered certificates may not circulate freely and any sale of these certificates is deemed invalid. Every savings certificate must contain the following information:

- the name of the security (i.e., “savings certificate”);
- the name and address (location) of the bank that issued the certificate;
- the serial number of the certificate, date of issuance, sum of the deposit, term for withdrawal, title or full name of the holder (for registered certificates); and
- the signature of the bank’s senior manager or other authorized officer, and the bank’s official seal.

Individuals are permitted to acquire savings certificates with their own personal funds, whereas enterprises can only invest in these certificates with funds remaining at their disposition after the payment of all taxes and interest on bank loans. Holders may redeem savings certificate by presenting such savings certificates to the issuing bank. If the holder of a fixed-term savings certificate withdraws the deposited funds prior to the prescribed term, the bank will pay out a lower amount of interest in accordance with the terms agreed to by the bank and the holder at the time of deposit.

VII. Bills of Exchange

Currently, the Ukrainian legislation on the circulation of bills of exchange consists of (i) the 1930 Geneva Convention, which implemented the Unified Law on Bills of Exchange and Promissory Notes with due regard to reservations stipulated in Annex II to this Convention; (ii) the 1930 Geneva Convention “On the Regulation of Certain Conflicts of Laws on Bills of Exchange and Promissory Notes;” (iii) the 1930 Geneva Convention “On Stamp Duty Regarding Bills of Exchange and Promissory Notes;” (iv) The Law of Ukraine “On Securities and Stock Exchange;” (v) the Law of Ukraine “On Ukraine’s Joining the 1930 Geneva Convention Which Implemented the Unified Law on Bills of Exchange and Promissory Notes;” (vi) the Law of Ukraine “On Ukraine’s Joining the 1930 Convention On the Regulation of Certain Conflicts of Laws on Bills of Exchange and Promissory Notes;” (vii) the Law of Ukraine “On Ukraine’s Joining the 1930 Geneva Convention On Stamp Duty Regarding Bills of Exchange and Promissory Notes;” and (viii) the Law of Ukraine “On Circulation of Bills of Exchange in Ukraine.”

Bills of exchange are defined by the Securities Law as a security, which evidences the unconditional obligation of the drawer to pay a specified sum of money to the owner (holder) of the bill within a certain time frame. Two types of bills of exchange are recognized in Ukraine: (i) promissory notes and (ii) transfer bills.

Both promissory notes and transfer bills must contain the following requisites:

- the name of the security (i.e., “promissory note” or “transfer bill”);
- an unconditional obligation (order for bills of exchange) to pay a determined sum of money;
- the term for payment;
- the place for payment;
- the name of the party who receives payment or who instructs the maker to pay;
- the place and date of formation of the note; and
- the signature of the drawer.

In addition, a transfer bill must also contain the name of the payer.

If a document does not contain one of the requisites outlined above, the document will not be recognized as a promissory note or transfer bill, except in the following cases:

1. a document, in which the payment term is not stated, will be regarded as payable upon presentation;
2. if not stated otherwise in the document, the place stated next to the payer’s name (i.e., the place of execution for promissory notes) will be regarded as the place of payment and, at the same time, as the payer’s place of residence (drawer’s place of residence in case of promissory notes); and
3. a note that does not contain the place where the note was executed is considered to be signed at the place indicated beside the name of the drawer.

Importantly, those norms contained in the Ukrainian normative acts regarding the circulation of bills of exchange, which still exist but contradict the above-listed Conventions and Laws, are not applicable.

VIII. Privatization Certificates

The addition of privatization certificates to the list of securities contained in the Securities Law was due to the Parliament’s passage of a separate law

in 1992, governing the use and issuance of privatization certificates (the “Privatization Certificates Law”). Under the Privatization Certificates Law, privatization certificates are defined as the only type of government securities which confirm the right of the owner to receive, free of charge, a portion of property of state enterprises, the state residential housing fund and the land fund during the process of privatization.

According to the Privatization Certificates Law, privatization certificates may take the form of either paper certificates, approved by the National Bank, or non-cash deposits. Initially, in accordance with the privatization laws, the Cabinet of Ministers’ Resolution, dated November 25, 1992, set forth the procedure for the issuance of privatization certificates.

According to this early resolution, privatization property certificates were valued at 30,000 karbovantsi (equivalent to 0.3 hryvnias) and were to be issued in the form of privatization deposit accounts, which were to be opened in the name of every eligible citizen in Ukraine at Sberbank, the State’s savings bank.

In an extraordinarily cumbersome and inefficient manner, these accounts were to be used as follows: a Ukrainian citizen, who chose to invest in a state enterprise undergoing privatization, had to visit a branch of Sberbank to fill out an order to transfer the funds in his or her privatization account to the account of the state enterprise (or to a designated intermediary). After the eventual completion of the privatization process, the citizen would receive his or her share(s) of stock in the newly privatized company, inversely proportional to the private enterprise’s authorized capital. The complexity of these transactions, coupled with widespread ignorance of the process, barred effective conversion of privatization “deposit account” certificates into shares of stock on a mass basis. Consequently, this complex procedure had to be supplemented by a more practical method: the issuance of paper certificates.

In an effort to keep up with galloping inflation, a presidential decree, issued on November 2, 1993, indexed the nominal value of privatization certificates at 1,050,000 karbovantsi (i.e. 10.5 Hryvnias), and another decree required re-indexation up to 50,000,000 karbovantsi (500 Hryvnias) after January 1, 1995. Additionally, in accordance with other presidential decrees, actual paper privatization certificates were issued to Ukrainian citizens in named form (i.e., each certificate contained the name of the citizen to which it was issued). These privatization certificates, in the form of both named (registered) certificates and deposit accounts, were supposed to be in use until July 1, 1995; after that period, only the paper certificates would have been in use. However, because the majority of the population had not received these certificates, this period was extended several times.

For purposes of granting only Ukrainian citizens an opportunity to obtain shares of stock in privatized enterprises (to the exclusion of all other potential investors), privatization certificates could only be issued in named (registered) form, and had to contain certain requisites, including among others:

- a notation that the paper belongs to the government of Ukraine;
- the type of privatization paper, the series and its consecutive number;
- the date of issuance and period of use;
- the nominal value of the privatization paper;
- the last name, first name, patronymic and address of the owner; and
- a signature of the senior manager of the issuer or an authorized signatory, as well as the seal of the issuing institution.

The use of named privatization certificates as securities hampered the privatization process in a number of ways. According to the Privatization Certificates Law, privatization certificates may only be used in the process of privatization, that is, these securities may only be exchanged for other securities (e.g., shares of stock) which establish the owner's rights in a privatized object.

Objects of privatization include state-owned enterprises, state residential property and the land fund, as well as other state-owned property defined in accordance with Ukrainian privatization laws and the annual State Privatization Program. The exchange of privatization certificates for shares of stock or other documents, confirming ownership rights to state property, automatically invalidates the certificate.

Moreover, as privatization certificates may not be freely circulated, the sale or alienation of such certificates by any means is invalid. Further, no dividends or interest are paid on privatization certificates. Finally, privatization certificates may not be used for the settlement of accounts, as collateral for securing payments or for the receipt of loans. In fact, any agreements for the use of privatization certificates for purposes other than to facilitate the privatization of state property are invalid.

As stated briefly above, issues with respect to mortgage securities and pledge securities in connection with the passing of the Law No. 898-IV "On Mortgages," dated June 5, 2003, are regulated by separate laws. These laws are beyond the scope of this general overview.

B FINANCIAL INTERMEDIARIES

Average Ukrainian citizens never quite believed in the promised benefits that the privatization process will allegedly bring them in the form of privatization certificates. Many reasons exist for such deep-rooted distrust, starting with ruble confiscation and continuing with the behavior of some financial intermediaries, exemplified by the infamous early trust companies.

Below we review the Ukrainian legislation governing trust funds as it pertains to their activities with privatization certificates, followed by a discussion concerning investment funds and investment companies.

I. Trust Companies

A. Introduction

The irony in the legal definition of trust companies was not lost on Ukrainian citizens, becoming the butt of many jokes. In retrospect, "trust companies" proved to be probably the single most untrustworthy entities when dealing with privatization certificates. According to the State Property Fund's (the "SPF's") estimates, during the height of their activities in 1994, swindler-trust companies emptied the purses of some Ukrainians by a total of \$18,000,000 US Dollars. The General Prosecutor's office conservatively estimated that more than \$20 million US Dollars and 100 billion karbovantsi were irretrievably lost. After the so-called trust companies collected money or privatization certificates from uninformed people, they simply disappeared with the funds.

Decree No. 23-93 "On Trust Companies," dated March 17, 1993 (the "Decree"), as originally enacted, was either an incredibly short-sighted or brilliant move, depending on the interests of the active players at the time. This Decree allowed everyone (legal entities as well as individuals) to register trust companies with a 1 million karbovantsi (approximately \$5 US) capitalization and, most importantly, without a license from the National Bank. Whether the complete lack of control over various trust companies' currency operations was negligent or intentional is a historical curiosity today; nevertheless, until August 1994, no tax authorities found fault with the operations of any trust company.

Conclusive statistics about the impact of trust companies are still difficult to obtain. Apparently, Ukraine had about 600 registered trust companies, but only 380 of them had a license to operate with privatization certificates (others worked with cash and real property). By October 1,

1997, 188 licenses had been revoked due to either expiration or legislative violations. In the third quarter of 1997, trust companies collected about 46,903 certificates (approximately 14 times less than the previous year), and about 132,000 were redeemed for stock of privatized companies (7 times less than in the same quarter of 1996). By December 1997, trust companies had accumulated about 8.1 million privatization certificates, which is about 30% of the total amount of certificates accumulated by all Ukrainian financial intermediaries, and about 7.34 million of them were redeemed (82% of the total amount accumulated by trust companies). Such efficiency was indeed impressive.

While in 1995 everyone agreed that trust companies gathered more certificates than other financial intermediaries (including investment funds and companies), with the subsequent phasing out of privatization certificates and the Ukrainian government's newly-applied strict control over the activities of trust companies, the risk of the population being fleeced again by the notorious trust companies has been greatly minimized.

B. Discussion

Before being hijacked by practice, the theory was quite straightforward: in order to assist the Ukrainian population with the investment of privatization certificates, the SPF began licensing trust companies to engage in representative activity with privatization certificates. To achieve this noble vision, the creation of "trust companies" was provided for in the Decree.

This Decree defines trust companies as companies with additional liability that engage in representative activity with respect to the property of a trustor on the basis of an agreement entered into between the company and the trustor of the property. The property that may be entrusted to a trust company is limited to cash sources, securities, and documents, which confirm the ownership rights of the trustor to certain property. Trustors of property may be Ukrainian citizens or legal entities, who transfer to a trust company the authority to exercise ownership rights to their property in accordance with the terms of an agreement.

Procedurally, trust companies are organized in accordance with the requirements of the Law "On Economic Associations." With respect to the authorized capital of a trust company, the Decree requires that the authorized capital be formed exclusively from contributions in cash and in securities owned by the participants.

Prior to submitting documents for registration of a trust company, each of the founders must effectuate not less than 50% of its respective contribution to the authorized capital as set forth in the founding documents, which

must be evidenced by documents issued by a commercial bank. Further, each founder must effectuate the remainder its contribution within three (3) months after the registration of the trust company. The participants in a trust company are liable for the obligations of the company within the limits of their contributions to the authorized capital of the company and, if these amounts are insufficient to cover the company's liabilities, with their individual property in an additional amount equal to five times the contribution of each participant.

The services provided by trust companies to the trustors of property (i.e., trust operations) are carried out by the participants of the company (the trustees), which are subject to certain rather minimal fiduciary responsibilities. For example, the Decree provides that the activities of trustees are to be carried out exclusively on the behalf of and in the interests of the trustors on the conditions set forth in the applicable trust agreement.

Moreover, the value of property accepted by a trustee may not exceed the sum of the portion of that trustee's contribution to the authorized capital of the trust company and such trustee's additional liability. Finally, trust companies are required to enter into an agreement with commercial banks to serve the trust operations of the company by acting as a depository for the funds of the trust company and for the property of the trustors.

Although trustees are themselves exclusively required to fulfill the obligations of the trust agreement before trustors of property, the founding documents of a trust company can delegate the authority of certain trustees to other participants of the company or to third parties by means of a power of attorney with a duration of no more than 1 year. If the participant of a trust company is a legal entity, then the activities of such trustee are carried out on its behalf by an authorized representative.

Under the Decree, trust companies are permitted to carry out the following trust operations:

- (1) for citizens: safekeeping and representative (agency) services with respect to a trustor's property; and
- (2) for legal entities: disposal of property, agency services, maintenance of accounts for securities owned by a trustor, and the management of voting shares of stock assigned to the trust company by participating in the General Assembly of a joint stock company.

Upon receipt of a license from the SPF, trust companies are permitted to commence the placement (investment) of privatization certificates held by Ukrainian citizens in privatization objects. This license entitles the trust

company to engage in the exchange of privatization certificates for shares of stock in the name of, on behalf of, and at the account of the owner of such privatization certificates.

To obtain such a license, the trust company must submit to the SPF the following documents:

- an application for the issuance of a license;
- notarized copies of the founding documents of the trust company;
- information regarding the composition of the trustees, which must contain: the name of each trustee; its full corporate name and legal address (for a legal entity), and the full name of the representative authorized by the legal entity to carry out representative activities with privatization certificates; and the contribution of each founder to the authorized capital;
- copies of a qualification certificate or notarized documents, which confirm the existence of a higher economic or legal education of the trustee or the representative of a legal entity;
- a notarized copy of the agreement between the trust company and a commercial bank for servicing trust operations;
- a bank letter confirming full contribution of the trust company's authorized capital;
- a report certified by an auditor regarding the composition of the authorized capital (money or securities) and an auditor's evaluation of the participants' property in the amount of the additional liability of each participant; and
- if the authorized capital is formed with securities, the following additional information must be provided: the issuer and name of each security, its nominal value or a quotation of the results of the securities' trading on the stock exchange, the number of securities, and the overall value of such securities.

The SPF must issue a license, or an official refusal to issue a license, within 30 days after receipt of the documents listed above. Refusals to issue a license may be based on one or more of the following grounds:

1. the authorized capital of the trust company was not formed by the participants' cash or securities;

2. the trustees or representatives of legal entities do not have the qualification certificate or documents confirming a higher legal or economic education;
3. the submitted documents do not comply with the requirements of law, do not contain accurate information, or are incomplete in regard to required information; or
4. a commercial bank joined as a participant of the trust company and its share in the authorized capital is greater than 15%.

Once issued to a particular trust company, the coveted license to carry out representative activity with privatization certificates may not be transferred to a third party. Upon liquidation or reorganization of the trust company, the license must be returned to the SPF.

At all times, the SPF retains the right to suspend the license for one or more of the following reasons:

1. violations by trustees connected with the use of a trustor's money;
2. systematic failure by a trustee to fulfill its obligations before a trustor;
3. refusal of the trustee to provide the SPF with documents requested by it under law;
4. the emergence of facts regarding the inaccuracy of documents or the deliberate falsification of information on the basis of which the license was issued; or
5. failure to inform the SPF of registered changes to the charter of the trust company in a timely manner.

Systematic violations by a trust company can result in annulment of its license.

II. Joint Investment Institutions

In comparison with the outrageous earlier behavior exhibited by Ukrainian trust companies, investment funds and investment companies have conducted themselves with more discipline. Perhaps it is because of the more strict control that was initially exerted over such companies' activities as the SPF, bank depository and an auditing company always exercised supervisory reviews.

This is truly a constantly emerging area of law. For instance, in March of 1995, the President amended the regulations of investment funds and investment companies in his Decree No. 55/94 "On Investment Funds and Investment Companies," dated February 19, 1994 (the "Investment Fund Regulation"), significantly expanding the scope of authority of these financial intermediaries and their ability to "positively influence the economy." Six years later, the Ukrainian Parliament adopted the Law of Ukraine No. 2299-III "On Joint Investment Institutions (Share and Corporate Investment Funds)," dated March 15, 2001 (hereinafter the "Investment Fund Law").

Today, the situation surrounding joint investment institutions is ambiguous. This ambiguousness is due to the co-existence of both investment funds and companies established and still operating pursuant to the original Investment Fund Regulation, on the one hand, and joint investment institutions formed and existing under the new Investment Fund Law, on the other hand.

The Investment Fund Law permits closed investment funds and mutual investment funds of investment companies, created before the effective date of the Investment Fund Law, to continue their activities during the term for which they were created. However, open investment funds and open mutual funds of investment companies formed before the adoption of the Investment Fund Law may continue their activities for two (2) years following the effective date of the said Law. Immediately below we describe all types of joint investment institutions which currently exist in Ukraine.

A. Investment Funds Created Under the Investment Fund Regulation

By definition, investment funds are legal entities in the form of stock companies, founded in accordance with the requirements of the Investment Fund Regulation, which engage exclusively in joint investment activity. "Joint investment activity" is defined by the Investment Fund Regulation as an activity carried out by an investment fund in the interests of and for the account of the founders or by issuing investment certificates and engaging in commercial activity with securities.

Investment funds may be either open or closed. Open investment funds are created for an indefinite period of duration and issue investment certificates to their participants with an obligation to repurchase the certificates within the time periods specified in the investment declaration of the fund. Closed investment funds, on the other hand, are created for a definite period of duration and issue investment certificates without a concomitant obligation to redeem the certificates.

Both individuals and legal entities may be founders of an investment fund; however, legal entities with at least twenty five percent (25%) of state ownership may not act as a founder. The liability of the founders before the participants in an investment fund is limited to the value of their shares in the authorized capital. Shares of the founders must be kept by a depository and may not be offered for sale.

An investment fund is formed on the basis of a charter and founders' agreement and must be registered with the applicable Ukrainian authorities. The minimum amount of the authorized capital of an investment fund is 2,000 minimum wages, which may consist of cash, securities and real estate; provided, however, that the real estate contributed to the authorized capital may not exceed twenty-five percent (25%) of the entire authorized capital.

As with any stock company, the highest governing body of an investment fund is its general assembly of founders (the "General Assembly"), which is responsible for the general functioning of the fund. The General Assembly is charged with, among others things, the following functions:

1. amending the charter and founding agreement of the investment fund;
2. approving the investment declaration and the conditions of the depository agreement, as well as the agreements with the investment manager and the auditor or auditing firm;
3. deciding on and approving the information regarding the issuance of investment certificates;
4. approving the procedure for the distribution of dividends;
5. creating, reorganizing or liquidating affiliates or regional branches;
6. deciding to liquidate the fund, appointing the liquidation commission and approving the liquidation balance; and
7. selecting the supervisory council (board of directors).

The board of directors of an investment fund is responsible for controlling the activity of the investment manager and protecting the interests of the participants. At least sixty percent (60%) of the directors must be non-affiliated persons. "Affiliated persons" include the investment manager, the founders and participants who own at least twenty-five percent (25%) of the investment certificates.

Members of the board of directors have the right to be present at meetings of the General Assembly, to receive reports regarding the investment activities of the fund and the activities of the depository, and to be consulted on and approve changes and amendments to the investment declaration and the agreement with the investment manager. Naturally, a director of an investment fund may not concurrently serve as a director of another investment fund.

An investment manager of an investment fund is a securities trader, who manages the investment fund pursuant to a contract with such investment fund. The investment manager is authorized to manage the assets of an investment fund in its name without a power of attorney, and is required to prepare drafts of the informational notice for the issuance of investment certificates. Sales of investment certificates are organized by the investment manager and conducted either by the investment manager or through agents. The investment manager may not offer investment certificates for sale at less than nominal value.

In addition to its other obligations, the investment manager, together with the depository, calculates the value of the net assets of the fund, taking into account the value of one issued investment certificate, and publishes this information once every six months. In open investment funds, the investment manager is required to use all efforts to repurchase the investment certificates, upon the request of their owners, in the name of and at the expense of the investment fund. In case the investment fund lacks sufficient funds for such requests, the investment manager is required to purchase the investment certificates at his own expense. Importantly, an investment manager of an investment fund may not simultaneously act as the depository of the fund.

An investment manager is entitled to receive remuneration for carrying out its obligations in an amount not exceeding five percent (5%) of the average annual value of the net assets of the investment fund, or ten percent (10%) if more than fifty percent (50%) of the assets of the investment fund were formed with privatization certificates. In fulfilling its obligations, the investment manager is required to act exclusively in the interests of the founders and participants in the investment fund. If the investment manager of one investment fund enters into a management contract with another investment fund, the investment manager must inform the Antimonopoly Committee within ten (10) days from the date it enters into such a contract.

The depository of an investment fund is a legal entity, which is entrusted with the safekeeping of the investment fund's assets, servicing operations with those assets, and maintaining a record of the assets' cir-

ulation pursuant to a depository agreement. To act as a depository for an investment fund or company, the depository must first obtain approval from the Ministry of Finance.

Note that the founders of an investment fund, the investment manager and creditors of the fund may not act as depositories of the fund. Naturally, the assets deposited with the depository may not be used by the depository as its own personal source of credit. Depositories are required to present the board of directors with a report on operations involving the investment's fund assets according to the procedures set forth in the depository agreement.

An investment fund is not permitted to engage in certain activities, including but not limited to:

- issuing bonds and bills of exchange;
- holding more than ten percent (10%) of its assets in securities of any one issuer, with the exception of up to twenty-five percent (25%) of securities acquired for privatization certificates, or investing over five percent (5%) of its assets in the securities of any one issuer, with the exception of investment in internal state loan bonds, state treasury obligations or other state-guaranteed securities;
- holding less than seventy percent (70%) of the assets of the investment fund in securities;
- purchasing investment certificates of other investment funds or companies;
- obtaining bank credits (loans), except in cases when such credits (loans) will be used for the repurchase of its investment certificates by an open fund;
- effectuating investments in securities which were issued by an affiliated company of the investment fund; and
- providing property guarantees to third persons (parties) and entering into pledge agreements.

B. Investment Companies Created Under the Investment Fund Regulation

An investment company is primarily a trader of securities which, aside from engaging in other activities, may also accept funds for the purpose of joint

investment activity by issuing and distributing its own securities (i.e., investment certificates). An investment company may be created in the form of a joint stock company or a limited liability company. The authorized capital of the company is formed in accordance with the requirements of the Law "On Economic Associations," which governs the formation and structure of stock companies and limited liability companies. Accordingly, the authorized capital cannot be less than 50,000 minimum wages.

As with investment funds, individuals and legal entities alike may be founders in an investment company. Legal entities, in which twenty-five percent (25%) of the authorized capital consists of state-owned property, however, may not act as a founder. To engage in an investment activity, an investment company must create a mutual fund, register the issuance of investment certificates, and publish an investment declaration and notice regarding the issuance of its investment certificates.

A mutual fund is created by decision of the highest body in the investment company (either the general assembly of shareholders in a stock company or the general assembly of participants in a limited liability company) to engage in joint investment activity in the name of the company. The mutual fund has an independent balance and bank accounts and, therefore, must be legally registered as an affiliate of the investment company. The balance of the mutual fund may consist of property in the form of securities and real estate transferred to it by the investment company, which created such mutual fund.

An investment company receives investment certificates in an amount that corresponds to the value of property transferred by it to a mutual fund. Investment certificates of the founders must be kept by a depository and may not be offered for sale. An investment company receives profit from activities connected with the mutual fund's investment activity in proportion to the value of property transferred to it by the investment company, unless otherwise provided in its investment declaration. Funds in a mutual fund may not be used to cover the losses of an investment company. Moreover, the property of an investment company may not be seized in satisfaction of claims against the investment company not connected with the investment activities of the mutual fund.

As with investment funds, mutual funds of an investment company may either be closed or open. Open mutual funds are created for an indefinite period of duration, and issue investment certificates to their participants with the obligation to repurchase the certificates within the time periods specified in the investment declaration of the fund. Closed mutual funds, on the other hand, are created for a definite period of duration and issue investment certificates without a concomitant obligation to redeem the certificates.

With respect to its investment activities (i.e., the issuance of investment certificates), an investment company is required to adhere to the same limitations set out for investment funds; as such, investment companies may not:

- issue bonds or bills of exchange;
- hold more than ten percent (10%) of its assets in securities of any one issuer, with the exception of up to twenty-five percent (25%) of the securities of an issuer acquired for privatization certificates;
- invest over five percent (5%) of its assets in the securities of any one issuer, with the exception of investment in internal state loan bonds, state treasury obligations or other state-guaranteed securities; or
- hold less than seventy percent (70%) of the assets of the investment company in securities.

Moreover, the mutual fund must report on its activities at least once per year to the general assembly of shareholders (or participants, as the case may be) of the investment company.

Investment funds and investment companies, which have established mutual funds, are subject to reporting requirements regarding their investment activities in accordance with the applicable law. For example, funds operating with privatization certificates are subject to control and reporting in accordance with the procedures established by the SPF and the Ministry of Finance.

At least once every half-year, open funds are required to inform their participants of the fund's financial condition and publish a financial report in the mass media, which must be certified by an auditor. This document includes certain information, such as:

- a balance sheet with a list of the quantity, types and market values of the securities owned by the fund;
- a profit and loss report, along with a report on the dividends paid by the fund during the reporting period;
- a report on the value of the net assets of the fund; and
- a report on the quantity of investment certificates issued by the fund, the nominal value of an investment certificate and the value of the net assets corresponding to each investment certificate on the date of the financial report, etc.

Closed funds must publish the following information once every six months:

- the value of the net assets of the fund (including the value and quantity of privatization certificates that have not been used by the fund, as certified by an auditor);
- a list of securities and the quantity for each issuance (in an amount greater than one percent (1%) of the assets of the fund) owned by the fund;
- the value of other assets owned by the fund;
- a report on the debts of the fund; and
- information regarding the overall quantity of the fund's investment certificates in circulation as of the end of the mid-year period.

In addition to the above information, investment companies are subject to separate reporting requirements for each of their mutual funds. Funds engaged in operations with privatization certificates are required to maintain documents for every agreement involving the use of such privatization certificates for a period of five years.

Investment funds and investment companies are required, either directly or through their investment managers, to inform the Antimonopoly Committee within 5 days of entering into securities purchase agreements for the acquisition of ten percent (10%) or more of the securities of one issuer or, in the event of an acquisition with privatization certificates, of twenty-five percent (25%) or more of the securities of any one issuer.

C. Investment Institutions Formed Under the Investment Fund Law

1. Introduction

Forever in search of viable investment vehicles, on March 15, 2001, the Ukrainian Parliament passed the Law "On Joint Investment Institutions (Share and Corporate Investment Funds)," No. 2299-III (the "Investment Fund Law"). The Investment Fund Law sets forth the legal and organizational foundations for the creation, activity and liability of joint investment subjects, as well as the peculiarities involved in managing their assets.

With the passing of the Law, and its signing by the President on April 17, 2001, investment funds may be formed to work with the cash of legal entities and individuals by investing in securities with the aim of making a

profit for its investors. Importantly, foreign investors now have an avenue for joining their investment capital with other investors, rather than taking on the risks of the Ukrainian market alone.

Moreover, this method of joining investment resources gives interested foreign investors the ability to join a strong group of investors striving for profits from larger projects and/or security purchases without using the services of banks and other financial institutions. Admittedly, however, the Investment Fund Law is aimed more toward getting the Ukrainian population to invest within the country instead of sending all extra cash offshore.

The discussion below analyzes the effects and novelties of the Investment Fund Law.

2. Structural Peculiarities of Joint Investment Institutions

Joint investment institutions carry out their activities by attracting cash from investors for purposes of receiving a profit via investing in the securities of other issuers, corporate rights and property. In other words, joint investment institutions are instruments for unifying individual financial resources. The Investment Fund Law classifies joint investment institutions as either open, interval or closed, and either definite or indefinite, and either diversified or non-diversified.

An open joint investment institution takes upon itself the obligation, at any time upon the demand of investors, to buyout the securities issued by such investment institution. The dividends from securities of open joint investment institutions are not calculated and paid out. An interval joint investment institution takes upon itself the obligation to purchase securities issued by such investment fund upon the demand of investors within the term stipulated in the issuance prospectus, but no less than once per year. Similar to open institutions, interval joint investment institutions do not calculate and pay out dividends. A joint investment institution will be considered a closed investment institution if it does not assume the obligation to purchase securities issued thereby before the moment of its reorganization or liquidation.

Further, joint investment institutions may be created for an indefinite term or for a specific term, which must be set forth in the relevant institution's prospectus. Upon the expiration of a definite term, the joint investment institution must be either liquidated or reorganized. Notably, closed joint investment institutions may only be created for a definite term.

Finally, joint investment institutions are considered diversified if they simultaneously meet the following three requirements: (i) each issuer has a qua-

ntity of securities within the institution's assets not exceeding 10 percent of the total volume of such issuer's issuance; (ii) the sum value of securities, which make up the assets of the joint investment institution in a quantity equaling more than 5 percent of the total volume of their issuance, does not exceed 40 percent of the value of net assets of the institution at the moment of their acquisition; and (iii) monetary funds (cash), savings certificates, bonds of enterprises and local bond issues, state securities and securities, permitted for trade on the stock market or on the trade-informational system, make up no less than 80 percent of the total value of assets of the institution.

Diversified joint investment institutions are subject to a number of limitations regarding their investment activities and the composition of their assets. Specifically, diversified joint investment institutions are prohibited from:

- a) holding more than 30 percent of the total value of their assets in cash, in bank deposit accounts and in savings certificates and bonds issued by commercial banks;
- b) acquiring or additionally investing more than 5 percent of the total value of their assets in the securities of one issuer;
- c) acquiring or additionally investing more than 25 percent of the total value of their assets in state-issued securities, the income from which is guaranteed by the Cabinet of Ministers. In this case, the institution's funds may not be invested in less than 3 types of state-issued securities;
- d) acquiring or additionally investing more than 10 percent of the total value of their assets in securities of local bodies of self-governance;
- e) acquiring or additionally investing more than 20 percent of the total value of their assets in bonds of enterprises, the issuers of which are Ukrainian residents (with the exception of commercial banks);
- f) acquiring or additionally investing more than 40 percent of the total value of their assets in shares of stock of Ukrainian issuers;
- g) acquiring or additionally investing more than 20 percent of the total value of their assets in securities, the income from which is guaranteed by representatives of foreign governments;
- h) acquiring or additionally investing more than 20 percent of the total value of their assets in the shares of stock and bonds of foreign issuers, permitted to trade on organized foreign stock markets;

- i) acquiring or additionally investing more than 5 percent of their assets in other assets permitted by Ukrainian legislation;
- j) acquiring or additionally investing more than 10 percent of the total value of their assets in securities, the income from which is guaranteed by the representative of one foreign government; and
- k) acquiring or exchanging securities issued by affiliated entities of the institution, its asset management company or its custodian.

If a joint investment institution does not have all of the characteristics of a diversified institution, it will automatically be considered a non-diversified institution. Open and interval joint investment institutions may only be non-diversified joint investment institutions. In other words, only closed joint investment institutions may be diversified.

Non-diversified joint investment institutions are not subject to the above prohibitions and, in certain cases, may be considered venture funds (venture capital funds). Specifically, if a closed, non-diversified joint investment institution exclusively and privately disposes of its own securities, and such institution's assets consist of more than 50 percent of corporate rights and securities not permitted for trade on the stock market or the trade-information system, then such institution is a venture fund. Interestingly, only legal entities may be participants in venture funds.

Last, but not least, joint investment institutions must employ an auditor (audit firm), which may not be affiliated with their asset management company, for purposes of confirming annual financial reports. A joint investment institution's auditor must make sure that the results of the said institution's activities correspond with the assets of the institution. For this purpose, the auditor must comply with the requirements of the Law of Ukraine "On Audit Activity," which complicates the job of foreign auditors (audit firms) not familiar with the peculiarities of Ukraine's audit rules. A joint investment institution's auditor is compensated out of the institution's assets in accordance with the procedure established by the State Commission on Securities and the Stock Market (the "SCSSM").

3. Types of Joint Investment Institutions

The Law further categorizes joint investment institutions into two types: (a) corporate investment funds; or (b) share investment funds. Corporate investment funds are created in the form of open joint stock companies and carry out exclusively joint investment activities. In contrast, share investment funds are not legal entities and are composed of assets owned jointly by individual investors and managed by an asset management company. Both types of joint investment institutions are discussed immediately below.

a. Corporate Investment Funds

Corporate Investment Funds (CIFs) are created and governed in accordance with the laws on joint stock companies and the Investment Fund Law. Today, the Law “On Economic Associations” governs, but a new law on “Joint Stock Companies” is widely expected, which hopefully, but not necessarily, will correspond to the Joint Investment Law.

As other companies, CIFs are established on the basis of a charter (statute) and its regulations. The Investment Fund Law sets forth the mandatory provisions, which must be contained in both a CIF’s charter and regulations. Namely, a CIF’s charter must contain information regarding the following:

- a) the structure of the CIF (open, interval or closed);
- b) the form of the CIF (diversified or non-diversified);
- c) joint investment as the CIF’s exclusive activity;
- d) the limitations regarding the CIF’s activity in accordance with the Investment Fund Law;
- e) the CIF’s shares of stock, which may only be simple named shares (registered shares); and
- f) the size of the initial authorized capital and the quantity of shares of stock, which compose the initial authorized capital of the CIF.

Any amendments to a CIF’s charter must be introduced according to the law governing joint stock companies with mandatory notification to the SCSSM. Further, a CIF’s regulations must contain information regarding the following:

- a) the terms and conditions under which the change of the asset management company or custodian may take place, and the procedure for such change with an indication of the activity aimed at the protection of shareholder rights;
- b) the procedure for determining the value of net assets and the prices for disposing of or purchasing shares of stock;
- c) the amount of compensation and/or coverage of expenses related to the CIF’s activity, which amount can be paid to the CIF’s asset management company;

- d) the procedure for distributing the CIF’s profits;
- e) the procedure and terms for the purchase by the CIF of its shares of stock upon the demand of investors;
- f) the purposes of investment (investment declaration); and
- g) the minimum value of contracts (agreements) for the CIF’s assets concluded by the asset management company and subject to approval by the CIF’s supervisory council.

The founders of a CIF must approve its regulations, while any subsequent amendments thereto must be approved by its general assembly of shareholders. Likewise, the regulations and all amendments thereto must be registered with the SCSSM. Importantly, a CIF’s documents and its name must specifically reflect the words “corporate investment fund,” as well as the structure type (open, closed or interval) and form (diversified or non-diversified) of the fund.

The initial authorized capital of a CIF may consist of cash, state-issued securities, publicly traded securities and real estate objects necessary for carrying out the fund’s activities. The initial authorized capital of a CIF may not be less than the sum equivalent to 1,250 minimum salaries, based on the rate of minimum salaries effective at the time of the CIF’s creation. As of the date of this publication, one minimum salary is currently equivalent to 205 Ukrainian Hryvnias (approximately 39 US Dollars), and as of November 2004, the Parliament plans to increase the minimum salary to 237 Ukrainian Hryvnias. The initial authorized capital may be thereafter increased exclusively at the expense of the shareholders’ cash, which is contributed via the acquisition of shares of stock.

CIFs may only carry out their activities if 70 or more percent of the average annual value of assets under their ownership are invested in securities. This requirement is based on the Western requirements for investment institutions and could prove difficult for CIFs on the Ukrainian market. The Investment Fund Law provides six months for a CIF to bring the composition of its assets into compliance with its requirements and the requirements of the SCSSM. For purposes of managing a CIF’s assets, the CIF must conclude an agreement with an asset management company for a minimum term of three years.

Importantly, Article 12 of the Investment Fund Law sets forth the restrictions on the activities of CIFs. Specifically, CIFs are prohibited from:

- a) issuing and circulating securities other than shares of stock;

- b) taking upon loans or credit in an amount exceeding 10 percent of their assets;
- c) placing assets under pledge in the interests of third parties;
- d) circulating shares of stock at a price lower than nominal value;
- e) circulating shares of stock at a price lower than the value of their net assets based on the calculation of one share of stock;
- f) circulating shares of stock above their declared amount;
- g) refusing to purchase its own shares of stock for reasons not provided in the Investment Fund Law or in the normative-legal acts of the SCSSM; and
- h) creating any special or reserve funds.

As briefly mentioned, CIFs may only issue simple, registered shares of stock. Upon registration of a CIF, it must hold an open subscription for its shares of stock. Importantly, each share of stock must offer equal rights to each owner and may only be purchased with cash for the full value (i.e., less than full payment is prohibited). If the shareholders of a CIF decide to convene a general assembly, the purchase and allocation of shares will terminate for 30 days before the announced date of the assembly and resume on the next day following the assembly.

The general assembly of shareholders and the supervisory council are the governing bodies of a CIF, and the Investment Fund Law strictly prohibits the creation of any other bodies. As with other corporate structures, the highest body in a CIF is the general assembly of shareholders. In addition to the authorities listed in the law governing joint stock companies (Law No. 1576-XII "On Economic Associations," dated September 19, 1991), the Investment Fund Law provides that the following issues are within the competence of the general assembly of shareholders:

- a) approval of the agreements concluded with the CIF's asset management company and custodian;
- b) approval of decisions regarding the termination of the above agreements; and
- c) approval of amendments to the CIF's regulations.

The general assembly of shareholders in a CIF also elects the members of the supervisory council. Importantly, the above authorities, as well as the

exclusive authorities listed in the law governing joint stock companies, may not be delegated to a CIF's supervisory council. A CIF may include a provision in its charter, however, that certain decisions related to the competence of the general assembly may be accepted via voting. Finally, representatives of a CIF's asset management company, register, custodian and independent property appraisers may participate in the general assembly with a right to an advisory vote and for purposes of informing the general assembly regarding their activities.

The procedure for calling the general assembly of shareholders of a CIF mirrors that of the procedure in all joint stock companies as provided by the Law "On Economic Associations." The asset management company, custodian or supervisory council of a CIF may convene an extraordinary assembly of shareholders in the following cases:

- a) insolvency of the CIF;
- b) a decrease in the value of net assets of more than 25 percent in comparison with the last appraisal (for closed or interval types);
- c) a decrease in the value of net assets of more than 15 percent for a seven day period (for open types);
- d) a decrease in the value of net assets to lower than their nominal value;
- e) the necessity to approve a decision on concluding or terminating an agreement with the asset management company or custodian;
- f) the necessity to elect new members of the supervisory council; and
- g) the presence of other circumstances determined in the CIF's charter.

The supervisory council of a CIF, among other activities, carries out supervision of the CIF's asset management company on the basis of its charter, and must meet at least once per quarter. Decisions of the supervisory council are accepted by a simple majority of votes and are binding if at least two-thirds of the council's members participate in the voting. The supervisory council is also responsible for ensuring the proper fulfillment of the terms and conditions of agreements with the asset management company, the custodian, the registrar, the auditor and the independent appraiser of the CIF.

The supervisory council's composition must be determined in a CIF's charter and is elected by the general assembly of shareholders. Representatives of a CIF's asset management company, securities traders, custodian, reg-

istrar, auditor, independent appraiser and their affiliated entities may not be members of the supervisory council.

In addition to the abovementioned activities, a CIF's supervisory council is charged with the following:

- a) calling the general assembly of shareholders;
- b) preparing the agenda of the general assembly of shareholders;
- c) determining the dates for holding the general assembly, the dates for compiling the list of persons with the right to participate in the general assembly and other issues connected with the arrangements for holding the general assembly;
- d) electing the chairman of the supervisory council (president of the corporate investment fund) and his/her deputy;
- e) preparing the draft decisions of the general assembly of shareholders regarding the amount of dividends and their payout procedure for approval by the general assembly (for closed corporate investment funds);
- f) concluding and terminating agreements with the asset management company, the custodian (as approved by the general assembly of shareholders) and approving agreements with the registrar, auditor (audit firm) and an independent appraiser of property;
- g) accepting amendments to the prospectus for issuing the CIF's shares of stock; and
- h) approving agreements regarding the assets of the CIF, which agreements are concluded by the asset management company for an amount exceeding the minimum amount established by the CIF's regulations.

Termination of a CIF's activity may take place either via reorganization or liquidation in observance of the requirements of antimonopoly legislation and the Law "On Economic Associations." A CIF must liquidate if:

- a) the value of its assets becomes less than the initial amount of its authorized capital as a consequence of the buyout of shares of stock by such CIF; or
- b) within a three-month period from the day of its registration in the register of joint investment institutions, agreements were not concluded by its supervisory council with an asset management company or a custodian.

Moreover, the SCSSM may initiate a CIF's liquidation in a court proceeding in the following cases:

- a) a CIF carries out its activity without registration in the register of joint investment institutions; or
- b) a CIF carries out an activity which is prohibited by law.

As with all joint stock companies, a liquidation commission must be formed upon liquidation to draw up the liquidation balance and other necessary documentation for winding up the company's affairs. Representatives of the SCSSM must be included into the liquidation commission (representatives of the CIF's asset management company and custodian may be included as well). Once a decision to liquidate has been handed down by the general assembly of shareholders, the CIF must cease circulating and buying out its shares of stock.

Upon approval of the liquidation balance, the assets of the CIF will be subject to sale for cash in the term established by the SCSSM, which term may not be longer than six months. All funds received from the sale of the CIF's assets must firstly be distributed between the shareholders in proportion to the quantity of shares owned by each shareholder.

If the CIF has insufficient funds to buyout shares of stock from non-founding shareholders at the expense of its net assets, then the difference must be refunded at the expense of the portion of funds belonging to the founding shareholders. In this case, founders only risk to lose their contributions if the need to settle with all shareholders/non-founders cleans the fund out. The shareholders, however, take a bigger risk because the Investment Fund Law does not obligate founders to remain with the fund until its liquidation. Therefore, theoretically, a founder may move its status up in the priority scale by selling their original shares and buying new ones.

Once all calculations and distributions have been completed, the liquidation commission must provide the SCSSM with a report on the results of liquidation, which report will be the basis for removing the CIF from the register of joint investment institutions. A CIF will be deemed liquidated only after it is finally removed from the said register.

b. Share Investment Funds

As briefly described above, share investment funds (SIFs) are basically assets, which belong to investors under the right of general, joint ownership, and are located under the management of an asset management company, which accounts for the assets separately from the results of its busi-

ness activity. The minimum volume of assets in an SIF may not be less than the size of the initial authorized capital of a CIF (i.e., 1,250 minimum salaries), which volume must be in place within six months from the day of registration of an SIF. In contrast to CIFs, SIFs are not legal entities.

SIFs are created at the initiative of asset management companies via the acquisition by investors of investment certificates issued by an asset management company. For purposes of creating an SIF, an asset management company must take certain preliminary steps. Firstly, the asset management company must draw up regulations for an SIF and register them with the SCSSM. Secondly, the asset management company must conclude agreements with an auditor (audit firm), custodian, registrar and property appraiser. Thirdly, the asset management company must register the SIF in the register of joint investment institutions. And, finally, the asset management company must organize an open subscription for the SIF's investment certificates or privately allocate such certificates. Open subscriptions are held pursuant to the SCSSM's procedure for all open subscriptions for securities.

The asset management company is responsible for the SIF's accounting, which must be separately maintained from the accounting of such asset management company's general accounting and the accounting of other joint investment institutions managed thereby. The agreements with the auditor, custodian, registrar and appraiser are concluded at the expense of the SIF's assets, however the asset management company acts on its own behalf and must represent so to third parties.

Although SIFs are not required to have a charter, all SIFs must have regulations much like in CIFs. The regulations of an SIF must contain information regarding:

- a) the procedure for the formation, composition, competence and activity of the SIF's supervisory council;
- b) the procedure for determining the value of net assets and the price for the allocation (buyout) of investment certificates;
- c) the procedure for determining the amount of remuneration and coverage of expenses connected with the SIF's activity, which amounts may be paid to the asset management company;
- d) the procedure for distributing the SIF's profits;
- e) the procedure and terms for the buyout of investment certificates by the SIF's asset management company at the demand of investors; and

f) the aims of the SIF's investment (investment declaration).

Investors participate in an SIF by way of acquiring investment certificates issued by such SIF. In non-diversified SIFs, however, investors may not be physical entities (natural persons). Each SIF must have a prospectus, which is a public or private offering of its investment certificates containing the terms and conditions of an agreement on joining the SIF. An investor's acceptance of such offer is immortalized in an agreement on joining the SIF, which must be concluded with its asset management company, and upon the acquisition of investment certificates (shares) for cash.

Investors in an SIF do not have the right to interfere with the activity of its asset management company. However, in cases when investors' funds are attracted via private allocation of investment certificates, the investors may create a so-called "supervisory council." The supervisory council's function is to supervise the fulfillment of the SIF's investment declaration, the safe-keeping of the SIF's assets, the maintenance of the register of owners of investment certificates, the carrying out of audits and the valuation of the SIF's property.

The supervisory council is formed out of the investors themselves. Each investor has the right to be elected into the supervisory council or appoint a representative, provided that such investor acquires the minimum amount of investment certificates established in the SIF's regulations. The supervisory council's decisions are taken by a simple majority of votes, and are considered valid if at least two-thirds of the supervisory council's composition participates in the voting. The supervisory council is responsible for electing the council's chairperson, approving decisions on the termination of agreements with the SIF's custodian, registrar, auditor and independent property appraiser, and approving amendments to the SIF's regulations.

The asset management company of an SIF acts as the issuer of its investment certificates, which certificates give equal rights to all owners. As briefly mentioned, SIF investment certificates may be circulated by way of open or private placement. As a protective measure for investors, an SIF's asset management company is strictly prohibited from offering derivative securities on the basis of such SIF's investment certificates.

As a final note on investment certificates, dividends on investment certificates of open and interval SIFs are not calculated and paid out. In all SIFs, the quantity of declared investment certificates must be indicated in each SIF's issuance prospectus. The procedures for allocating and circulating SIF investment certificates are established by the Investment Fund Law and the SCSSM.

An SIF may replace its asset management company according to the procedure established by the SCSSM in the following cases:

- a) if, within one year, the value of the SIF's net assets, based on the calculation of one investment certificate, decreased by more than 30 percent;
- b) if, within one year, the value of the SIF's net assets, based on the calculation of one investment certificate, decreased by more than 20 percent from its nominal value;
- c) if the SIF's asset management company officially decides to refuse to act as asset manager of the SIF it has created;
- d) the annulment by the SCSSM of the license issued to the asset management company to carry out asset management activity; and
- e) liquidation of the asset management company.

The SCSSM may issue a decision to liquidate an SIF in the following cases:

- a) the SCSSM deems it impossible to replace the asset management company;
- b) the annulment of the license issued to the SIF's custodian to carry out depository activity, and the failure of the asset management company to conclude an agreement with another custodian within 30 calendar days; and
- c) the expiration of the term for which a closed SIF was created.

If an SIF is liquidated by decision of the SCSSM, the allocation and buy-out of its investment certificates must cease and desist. Thereafter, the SIF's asset management company must draw up the liquidation balance and commence the sale of the SIF's assets for cash. All funds received from the sale of the SIF's assets will be distributed as follows:

- a) in the first priority — payouts to the participants, which submitted an application to buyout investment certificates before the moment of the decision on the SIF's liquidation;
- b) in the second priority — mandatory payments must be paid to the state budget of Ukraine;

- c) in the third priority — payouts to the creditors of the SIF's asset management company for the repayment of debts arising in connection with the activity of the liquidated SIF; and
- d) in the fourth priority — payouts to the SIF's other participants.

After all settlements have been made by the SIF's asset management company under the above scheme, the asset management company must provide the SCSSM with a report containing the results of liquidation. The SCSSM will use the liquidation report as the basis for excluding the SIF from the register of joint investment institutions. Upon the said exclusion, the SIF will be considered completely liquidated.

4. The Asset Management Company

The asset management company of a joint investment institution may be any form of legal entity created in accordance with Ukrainian legislation. However, certain restrictions apply. For instance, the State may not own more than a 10 percent share in the authorized capital of an asset management company. Moreover, asset management companies may only carry out asset management activities (i.e., they may not combine their asset management activity with another type of professional activity).

In terms of their asset management activities, asset management companies are also subject to numerous restrictions. Specifically, asset management companies may not:

- a) acquire, at the expense of the assets of a joint investment institution, property and securities of such types which are not provided for in such institution's issuance prospectus of securities;
- b) conclude agreements, which violate or have consequences that violate the norms of legislation and the requirements of the SCSSM;
- c) carry out operations with securities, which are the assets of a joint investment institution, at its own expense;
- d) gratuitously alienate the assets of a joint investment institution;
- e) take a loan or credit, which is subject to return at the expense of the assets of a joint investment institution, in a volume of more than 10 percent of the value of net assets of a joint investment institution, for a term of more than three months, and for a purpose other than the use of such funds for the buyout of an institution's securities;

- f) provide a loan or credit at the expense of a joint investment institution's assets;
- g) use the assets of a joint investment institution for securing the fulfillment of obligations, the origin of which is not connected with the functioning of the corresponding joint investment institution;
- h) acquire promissory notes, derivative securities and securities of an joint investment institution of an open type, unless otherwise provided for in the normative-legal acts of the SCSSM;
- i) allocate securities of issuers other than the securities of a joint investment institution with assets under its management;
- j) conclude sale-purchase agreements and loan or credit agreements with affiliated entities with the exception of agreements with securities traders for the allocation and buyout of securities of a joint investment institution;
- k) conclude sale-purchase agreements for securities, which on the date of the conclusion of such agreement do not comprise the assets of a joint investment institution;
- l) carry out the function of a nominal holder in relation to securities of a joint investment institution with assets under its management;
- m) sell securities of a joint investment institution to the custodian, registrar, independent appraiser of property and auditor (audit firm) of such institution, as well as to state bodies;
- n) acquire into ownership real estate, comprising the assets of a corresponding joint investment institution;
- o) conclude, on behalf of a joint investment institution, agreements, which by character may be concluded only by it personally;
- p) alienate property belonging to the company into the assets of a joint investment institution; and
- q) alienate property, comprising the assets of a joint investment fund, in the favor of another joint investment institution managed thereby.

Notably, the limitations listed in points d), g), j) and k) above do not apply to the asset management companies of venture funds.

Asset management companies are compensated in correlation to the value of the net assets of a specific joint investment institution under its management. Such compensation must be paid out in cash. All provisions related to the size and composition of an asset management company's expenses in relation to a joint investment fund, which expenses are subject to compensation at the account of such institution's assets, must be approved by the SCSSM.

All asset management companies are unified on the securities market by one self-regulating organization. Keeping in line with Ukraine's notorious licensing requirements, asset management companies must receive a license from the SCSSM to carry out their activities and represent the said self-regulating organization on the securities market. The self-regulating organization has the right to receive the bookkeeping of any asset management company for purposes of control, generalization of bookkeeping standards, analysis and transfer to the SCSSM.

The SCSSM has the right to annul the license of an asset management company on legislative grounds, as well as in the following cases:

- a) if the asset management company carries out another type of professional activity other than asset management during the validity of an agreement with a joint investment institution on asset management;
- b) if the asset management company commits repeated or gross violation of the Investment Fund Law or securities legislation and causes significant damage to investors; and
- c) if the asset management company does not carry out asset management activity for a period of two years.

The annulment of an asset management company's license is the basis for liquidation of an SIF or the transfer of an SIF's assets and obligations to another asset management company. An asset management company may appeal the SCSSM's decision to annul its license in a court of law.

Finally, asset management companies are subject to liability for damages caused to joint investment institutions due to their activity or omission to act in accordance with the general principles of Ukrainian legislation and the terms and conditions of their agreements with joint investment institutions. Moreover, an asset management company must compensate any losses incurred by a joint investment institution, which is carrying out open subscriptions for their securities, if, within one year, the value of the joint investment institution's net assets decreases to lower than 20 percent of its nominal value as a consequence of the asset management company's violation of the Investment Fund Law.

In order to cover the compensation of losses to joint investment institutions, asset management companies must form a reserve fund at the expense of its profits. If the reserve fund holds insufficient funds to compensate a joint investment institution for losses caused by the asset management company, then compensation must be carried out at the expense of the additional contributions of the company's founders. The reserve fund must be maintained in a separate bank account or allocated in state-owned securities specified by the SCSSM.

If an asset management company exceeds its authorities or concludes an agreement, which is not on behalf of a joint investment institution (a corporate investment fund), then it is liable for the obligations arising as a consequence of fulfilling such agreements exclusively with the property owned directly by the company, unless otherwise established by law. In case of bankruptcy of an asset management company, the assets of joint investment institutions managed thereby will not be included into the liquidation mass of such company.

5. The Custodian

In addition to the asset management company, joint investment institutions must conclude an agreement with a custodian, who will be charged with holding the joint investment institution's assets in the form of securities. The custodian also maintains the register of ownership rights to a joint investment institution's securities (unless the joint investment institution has less than 500 shareholders/participants) and services their operations. The custodian of a joint investment institution may be any legal entity with the corresponding license to provide custodial services. Each investment fund may only hire one custodian, which consequently may not be its asset management company, independent appraiser or their affiliated entities.

A custodian carries out its activities on the basis of a charter and agreement on servicing a joint investment company concluded with a CIF directly or with the asset management company of an SIF. Custodians are prohibited from using the assets of a joint investment institution for carrying out its own operations. Custodians service joint investment institutions by effectuating control over the compliance of operations involving the issuance, sale, buyout and annulment of securities with the institutions' regulations, prospectus and effective legislation.

Moreover, custodians effectuate control over the activity of asset management companies with respect to the procedure for calculating the value of a joint investment institution's net assets, the allocation and buyout of its securities and the directions for using profits received on the institution's

assets. Custodians also act as a policing force for the SCSSM in relation to the compliance of asset management companies with a joint investment institution's prospectus and regulations, as well as with the SCSSM's legislative acts. If a custodian fails to inform the SCSSM of any violations by an asset management company within one day, such custodian will be held liable for any losses incurred by shareholders or participants of a joint investment institution.

6. Miscellaneous Issues In The Investment Fund Law

The Investment Fund Law governs many issues regarding joint investment institutions, the discussion of which is beyond the scope of this general overview. However, these issues are of importance to the functioning of joint investment institutions and deserve a brief description.

For example, the Investment Fund Law provides a detailed description of the composition and structure of joint investment institutions' assets, as well as the thresholds amounts for assets in cash, real estate, corporate rights and securities. In order to form personal assets, joint investment institutions may acquire foreign currency via banking institutions with a corresponding license. However, the value of securities of foreign issuers may not be more than 20 percent of the total value of a joint investment institution's assets.

In addition, the assets of a joint investment institution may not include:

- a) securities issued by the asset management company, custodian, registrar and auditor (audit firm) of such institution and by its affiliated entities;
- b) securities of foreign governments and foreign legal entities, which are permitted for trade on less than two well-known foreign exchanges or in trade-information systems, the list of which is determined by the SCSSM;
- c) securities of other joint investment institutions;
- d) promissory notes and savings certificates for an amount of more than 10 percent of the value of its assets, unless otherwise provided by the SCSSM; and
- e) derivative securities, unless otherwise provided by the SCSSM.

The Investment Fund Law also contains provisions regarding determination of the value of a joint investment institution's net assets and securities.

Each joint investment institution must hire an independent appraiser to determine the value of its real property upon acquisition or alienation. The independent appraiser is paid out of the joint investment institution's assets and works on the basis of an agreement with such institution's asset management company. The agreement with the independent appraiser must be approved by the SCSSM. Importantly, the independent appraiser may not be affiliated entities of the joint investment institution, nor may it be its asset management company, custodian, auditor or their affiliated entities.

Finally, with respect to a joint investment institution's prospectus for the issuance of securities, the issuance and circulation of securities of a joint investment institution must be executed in accordance with Ukrainian securities legislation and the peculiarities of the Investment Fund Law. A joint investment institution's prospectus must be presented by such institution's asset management company to the SCSSM for mandatory registration and publication (however, a private allocation of securities is not subject to publication).

While the Investment Fund Law briefly describes the contents, registration and publication of joint investment institution prospectuses (and in some cases amendments thereto), a review of the Ukrainian securities legislation is also essential in order to receive a comprehensive overview of the nature of a joint investment institution's prospectus, as well as the information contained therein and the documentation required to register a prospectus. The Investment Fund Law also describes the allocation and buyout of a joint investment institution's allocated securities, the conversion of its securities and the procedure and volume for the disclosure of a joint investment institution's information.

The SCSSM may refuse to register a joint investment institution's prospectus if such institution or its asset management company violate Ukrainian securities legislation, the documents or information contained in the prospectus and the registration documentation do not comply with securities legislation or the prospectus contains unauthentic information. The SCSSM will send the joint investment institution a notice regarding its refusal to register the prospectus, along with an indication of the reason for refusal, within three days after its decision has been taken. The SCSSM's decision may be appealed in a court of law. However, missing from the Investment Fund Law are sanctions if unauthentic information is added and the SCSSM doesn't catch such addition until after registration.

A duly registered prospectus will contain information about the terms for allocating a joint investment institution's securities, the nominal value of securities, the procedure for buying out and/or acquiring securities, etc. The securities of closed and interval joint investment institutions are sub-

ject to free circulation on the securities market, while the securities of open joint investment institutions are subject to certain limitations. For example, investors in an open joint investment institution may only alienate their securities by way of their buyout by the institution's asset management company. In other words, securities of an open joint investment institution may not be sold to third parties, except in cases of legal succession, inheritance and gift.

III. Conclusion

Partially due to the trust companies' early fiascoes, investment funds and companies became more active on the Ukrainian securities market (especially privatization certificate market). In fact, while privatization certificates were still in wide circulation, these financial institutions gathered more certificates than those accumulated by trust companies. Clearly, investment companies are more active than investment funds. After the adoption of the Investment Fund Law, the activities of the joint investment institutions must become more effective. However, as always, only time will demonstrate the efficiency of newly-created joint investment institutions.

C SECURITIES TRADERS, BROKERS AND DEALERS

Under the Securities Law, activities connected with the issuance and circulation of securities are considered to be intermediary activities. This type of securities trading activity may only be carried out by banks, stock companies (the authorized capital of which is formed exclusively of registered shares of stock) and other companies whose sole activity is dealing in securities. According to this definition, individuals may not act as securities traders. Moreover, only “companies,” as opposed to enterprises, may engage in trading activities, which legal definition is limited to stock companies, limited liability companies, partnerships, general partnerships and limited partnerships.

The Securities Law also envisages that securities traders only engage in activities, which are solely connected to the issuance and circulation of securities. Thus, pursuant to the Securities Law, securities traders have the right to engage in the following:

1. activities connected with the issuance of securities;
2. commission activities with securities; and
3. commercial activities with securities.

In addition to the aforementioned, a securities trader is entitled to engage in ancillary activities, such as consulting services for owners of securities.

A trader who engages in “activity connected with the issuance of securities” is required to organize a subscription for securities (or the sale of securities by any other means), provided the trader does so pursuant to an issuer’s authorization, and on behalf of and at the expense of such issuer. If a trader engages in this type of activity, it undertakes to perform all duties necessary to issue and sell the securities on behalf of the issuer, including all preparatory work connected with the valuation of the issuer’s securities, registration of the securities with the SCSSM, and the actual sale of the securities. In the event a trader carries out an unfulfilled subscription, the trader may, pursuant to an agreement with the issuer, be required to purchase any remaining shares which were not subscribed for.

“Commission activity with securities” is defined as the sale and purchase of securities by a trader in his own name, but as authorized by and at the expense of another party. Commission activity assumes that the

trader has entered into a commission agreement, pursuant to which the trader agrees to carry out the purchase of securities with funds of the client or the sale of securities owned by the client for a commission (more commonly referred to as broker activity). Finally, “commercial activity with securities” by a trader is defined as the purchase and sale of securities by a trader on his own behalf and at his own expense. In this manner, the trader purchases securities with its own funds and sells those securities when the value of the securities has increased (more commonly referred to as dealer activity).

Securities traders may only engage in the aforementioned activities upon receipt of permission from the SCSSM. Licenses may be granted to securities traders to engage in any or all of the aforementioned activities (except commission activities) if the trader has a fully contributed authorized capital of not less than 1,000 non-taxable minimum incomes (i.e. 17,000 Hryvnias). In order to qualify for a license to engage exclusively in commission activities, the authorized capital of the trader may not be less than 200 non-taxable minimum incomes (i.e. 3,400 Hryvnias). A trader obtains the right to engage in trading activities on the entire territory of Ukraine from the moment it receives the relevant license to do so.

A license to engage in any type of activity connected with the issuance and circulation of securities will not be granted to a securities trader if such a trader either directly or indirectly owns ten percent (10%) or more of another securities trader’s authorized capital, provided that at least five percent (5%) is directly owned by that trader. Similarly, of course, once a securities trader has received its license, it is prohibited from thereafter owning property of another securities trader valued over an amount equal to ten percent (10%) of the authorized capital of that securities trader, subject also to the same five percent (5%) direct ownership restriction.

If the share of an individual or a legal entity, which does not have a license to engage in securities trading, exceeds five percent (5%) of each trader in the authorized capital of several securities trades, then those traders may not engage in the trading of securities amongst themselves. The Securities Law further prohibits a trader of securities from trading in its own securities (i.e., those securities issued by the trader) or in shares of stock of an issuer if the trader directly or indirectly owns property of that issuer valued over an amount equal to five percent (5%) of such issuer’s authorized capital. Incidentally, direct ownership is defined simply as the ownership of a portion of the authorized capital of any company, and indirect ownership is defined as the ownership of a portion of the authorized capital of a company that is a participant of another company.

To obtain a license, any company that intends to engage in trading activities with securities must submit various documents, including but not limited to:

- an application stating the residential and legal address of the company and describing the proposed trading activities of the company;
- a notarized or certified copy of the company's registration certificate;
- a notarized copy of the company's charter;
- a notarized copy of the company's founding agreement;
- a list of all of the founders (shareholders, participants) of the company, specifically indicating each founder (shareholder, participant) that holds more than five percent (5%) of the company's authorized capital;
- a list of the members of the company's executive body;
- a list of the company's qualified employees who will be directly engaged in activities connected with the issuance and circulation of securities;
- a list of all of the company's departments, branches and representative offices, which are authorized to carry out securities transactions;
- an audit firm's confirmation that the company's authorized capital is contributed in full;
- a copy of the certificate, evidencing the registration of the company's issuance of shares of stock (for joint stock companies only); and
- a copy of the payment order to effectuate payment in the amount of 50 non-taxable minimum incomes for the issuance of a license.

If the shareholders of the company include entities other than the original founders of the company, then the company must submit a list of those shareholders who, at the last general assembly of shareholders, held more than five percent (5%) of the total number of votes. All of the above documents, with the exception of founding documents, must be signed by the director of the applicant, affixed with the applicant's official seal and may not be issued more than two months from the date of the submission of the application for the license. Additional requirements exist that are beyond the scope of this general overview.

A license is issued no later than thirty days after submission of the application and the above information. The SCSSM may refuse to issue a

license in case the information contained in the license application and the documents are not authentic or the applicant does not correspond to the information submitted for obtaining a license, and upon the following conditions:

1. if the company's charter permits the company to engage in activities unrelated to the issuance and circulation of securities;
2. if the company's authorized capital is formed by means other than registered shares of stock (for joint stock companies only);
3. if the issuance of shares of stock is not registered (for joint stock companies only);
4. if the company's authorized capital is less than 1,000 non-taxable minimum incomes or, for companies engaging in commission activities, less than 200 non-taxable minimum incomes;
5. if the company's authorized capital has not been fully contributed;
6. if a securities trader holds more than five percent (5%) of the authorized capital of the company or if a company, in which a securities trader is a shareholder (participant), owns more than ten percent (10%) of the company;
7. if the specialists of the company do not meet the qualifications set forth by the Ministry of Finance;
8. if the company has been sanctioned for legal violations;
9. if the employees of the company have been sentenced for "economic crimes" (i.e., crimes of ill gain) or forgery;
10. if the documents submitted together with the application do not comply with the requirements of the law or are incomplete; or
11. if the company does not possess adequate means of communication and data processing equipment.

If the SCSSM refuses to issue a license for reasons, which the applicant deems unfounded, the applicant may seek redress in a court of law.

The Securities Law sets forth certain requirements with respect to contracts concluded by a securities trader for its services. For example, upon accepting an order to purchase or sell securities, the trader is required to

provide its client with information on the rates of such securities. In addition, the trader is required to provide the SCSSM with information regarding all securities contracts it entered into within the time period and in accordance with the procedure set forth in the stock exchange rules. Finally, the securities trader is required to maintain its books and records regarding the sale and purchase of securities in accordance with the requirements established by the SCSSM (as approved by the Ministry of Finance and the National Bank).

In addition to regulating the contracts of securities traders, the Securities Law contains specific guidelines with respect to the liquidity of securities traders. Specifically, the Securities Law requires that the value of open position contracts entered into between a securities trader with other securities traders (i.e., contracts that have not been fulfilled as of any given moment) may not exceed five times the amount of the securities trader's authorized capital.

In conducting activities connected with the issuance of securities, parallel to commission or commercial activities with such securities, the value of open position contracts with other securities traders may not exceed ten (10) times the amount of the securities trader's authorized capital. The sale or nominal price of securities owned (or in reserve) by a securities trader, as well as the value of all open positions, may not collectively at any given moment exceed fifteen (15) times the amount of the securities trader's authorized capital.

In the event a securities trader violates the terms of its license, the SCSSM may undertake the following actions:

1. issue a cautionary statement;
2. suspend the subscription and sale of securities for a term of up to one year;
3. suspend the conclusion of contracts for certain types of activity connected with the issuance and circulation of securities for a term certain; or
4. in the event of repeated sanctions, annul the trader's license altogether.

D UKRAINIAN STOCK EXCHANGES, PROFESSIONAL ASSOCIATIONS, AND THE SCSSM

I. Ukrainian Stock Exchanges

A. Introduction

According to the Securities Law, a stock exchange is both an organization and a continuously operating securities trading market. A Ukrainian stock exchange has the legal status of a joint stock company, whose function is to govern the supply and demand of securities, promote the formation of the exchange rate for securities and carry out activities in accordance with the Securities Law, other laws of Ukraine, its charter (by-laws) and the existing rules and regulations of the stock exchange.

A stock exchange is established exclusively to arrange and facilitate the conclusion of sale-purchase agreements for securities and their derivatives. Significantly, unlike most joint stock companies, stock exchanges may not be established for the purpose of obtaining profits, nor may they carry out any securities transactions on their own behalf or on the basis of agency agreements with its clients. Stock exchanges also may not perform any depository functions.

A stock exchange must have at least 20 founders, each of which must be a securities trader with a license to engage in commissions and commercial activities with securities. Such founders must contribute no less than 10,000 non-taxable minimum incomes (currently the equivalent of 170,000 Hryvnia) to the authorized capital of the stock exchange. A stock exchange becomes a legal entity from the moment of its registration with the State Commission for Securities and the Stock Market (the "SCSSM").

If the number of members of a stock exchange drops below 10, the activity of the exchange will be terminated; if the membership drops to exactly 10 members, the activity of the exchange will be terminated if no new members are admitted within 6 months. Naturally, the activity of the stock exchange may be terminated for any other reasons provided by Ukrainian legislation.

Only companies, which have created a stock exchange in compliance with the requirements set forth in such exchanges' charter and the stock exchange regulations, may use the term "stock exchange" in their firm name or for advertising purposes. In accordance with the requirements

of the Securities Law, the charter of a stock exchange must contain the following information:

- the name and address of the stock exchange;
- the names and addresses of its founders;
- the amount of its authorized capital;
- the conditions and procedures for admitting or excluding members from the stock exchange;
- the rights and obligations of the members of the stock exchange;
- the organizational structure of the stock exchange;
- the scope of authority of the governing bodies of the stock exchange and the procedure for their creation;
- the procedures and conditions for visiting the stock exchange;
- the procedures and conditions for the application of sanctions;
- the procedure for terminating the activity of the stock exchange; and
- any other terms applicable to the creation and activity of a stock exchange.

In addition, the rules and regulations of a stock exchange must include the following:

- the types of agreements entered into at the stock exchange;
- the procedures for trading on the stock exchange;
- the conditions for accepting securities for trade on the stock exchange;
- the conditions and procedures for subscribing for securities quoted on the stock exchange;
- the procedure for formulating prices and exchange rates and their publication;
- a list of securities quoted on the stock exchange;

- the obligations of the members of the stock exchange with respect to accounting and information, as well as the internal rules of stock exchange committees and the procedures for their activities;
- the information support system of the stock exchange;
- the types of services rendered by the stock exchange and the prices charged for such services;
- the procedure for account settlements at the stock exchange; and
- other regulations applicable to the activities of the stock exchange.

As the state organization authorized to exercise control over the issuance and circulation of securities (except privatization bonds, which are controlled by the State Property Fund (the SPF)), the SCSSM (and its local branches) appoints the state representatives to a stock exchange. These representatives are empowered to supervise the drafting of the charter, rules and regulations of the stock exchange, and have the right to participate in the management committees of the stock exchange. The SCSSM requires strict compliance by the stock exchange with its charter and regulations and, in the event of noncompliance by the stock exchange, may suspend its activities.

The Ukrainian Stock Exchange (“USE”) was registered in accordance with Resolution No. 292 of the Cabinet of Ministers, dated October 29, 1991. The USE officially began its activities in January 1992. At the time, the USE was the only stock exchange registered in Ukraine. In 1994, an attempt was made to register another stock exchange, the Kiev International Stock Exchange; however, the myopic Ministry of Finance refused to register the issuance of stock by interpreting the Securities Law as authorizing the existence of only one stock exchange within the territory of Ukraine. A decision of the High Court of Arbitration in October 1994 determined that this interpretation of the Securities Law is incorrect, and that Ukrainian law does not limit the quantity of stock exchanges in Ukraine. Despite the High Court of Arbitration’s wise decision, the USE retained a monopoly in this area for a long period of time thereafter.

Currently, the Ukrainian Stock Exchange (USE), Kiev International Stock Exchange (KISE), Ukrainian Interbank Currency Exchange (UIBCE), Donetsk Stock Exchange, Prydniprovsk Stock Exchange and Crimea Stock Exchange are registered and exist in Ukraine.

The Ukrainian Stock Exchange is the oldest in Ukraine and has a number of regional offices. Under the Presidential Decree “On Making Changes

and Addenda to Presidential Decree of May 25, 1994 ‘On Electronic Circulation of Securities and National Depository’,” dated March 2, 1996, the National Depository of Ukraine was established on the basis of the national depository of USE. Among the five exchanges, the USE has the largest securities trading volume, although this pales in comparison to the Over-the-Counter Trading and Information System, (a.k.a., “PFTS”), which currently operates in Ukraine. The PFTS was formed as an alternative to stock exchanges and has more liberal requirements for stock trading. Importantly, the Regulations “On Organized Over-the-counter Trading and Information Systems,” which governs the establishment and operation of similar systems, was adopted only after the PFTS commenced successful operations.

The shares of enterprises undergoing privatization constitute a major part of all trading turnover on the USE. Consequently, the trading volume on the USE depends directly on the “investment attractiveness” of the enterprise offered for sale by the SPF.

Shares of stock in state-owned enterprises (i.e., enterprises in which more than 26% of their authorized capital is owned by the state) and bills of exchange of the National Dispatching Center were the most commonly traded securities on the Kiev International Stock Exchange (KISE), which was registered pursuant to Resolution No. 341 of the Cabinet of Ministers, dated May 15, 1995.

At the beginning of 1997, the SCSSM granted a stock exchange license to the Ukrainian Interbank Currency Exchange (UIBCE). Today, the UIBCE has regional offices throughout Ukraine, including all necessary technical facilities, and is perhaps the most experienced in trading state bonds. However, the UIBCE mostly trades the securities of state-owned enterprises.

The Donetsk Stock Exchange (DSE) is engaged in trading Donetsk oblast securities, which greatly narrows the scope of its activities. The DSE was registered on January 9, 1996 pursuant to Resolution No. 29 of the Cabinet of Ministers. Further, the stock exchange located in Dnepropetrovsk, was registered on July 31, 1998, in accordance with the SCSSM’s Decision No. 104. Finally, the latest stock exchange, Crimea Stock Exchange, was registered on November 2, 1999, pursuant to the SCSSM’s Decision No. 221.

The lion’s share of all trades on these exchanges occurs due to the SPF’s initial placing of state-owned shares of stock. Regrettably, the secondary market of these exchanges is not yet well developed.

B. Alternative Securities Trading Systems

Currently, several professional associations exist, uniting securities traders other than stock exchanges, including, among others:

1. The Ukrainian Association of Investment Business (UAIB), which unites several types of licensed securities market participants, including investment funds, investment companies, trust companies and securities traders;
2. The Professional Association of Registrars and Depositories (PAR), which was initiated by independent registrars, potential depositories and custodians, and by the commercial banks providing depository services to investment funds and investment companies; and
3. The Ukrainian OTC Stock Trading System Association (PFTS), which is a non-governmental, USAID funded, member-governed association of licensed Ukrainian securities traders, and which has over 200 members from ten (10) major Ukrainian cities: Kiev, Donetsk, Lvov, Dnepropetrovsk, Kharkov, Odessa, Kherson, Kramatorsk, Sevastopol, and Vinnitsa.

The creation of the PFTS dates back to October 23, 1995, when representatives of the an AID-funded consultancy company held a meeting with the 16 most active securities traders of Ukraine. The PFTS was promptly registered in February of 1996; the first bid was carried out on July 5, 1996, with the first reported transaction on July 11, 1996. Since then, there has been dramatic growth in the volume of transactions on the PFTS; so much, in fact, that today the PFTS occupies one of leading positions among other trading systems in the volume of transactions on the secondary market.

On the PFTS system, securities trades are executed via of an electronic trading and information network (similar to the NASDAQ system used in the United States), which allows trading in “real time.” Firm quotations with an indication of price and number of securities are immediately posted to video monitors as the information is entered into the system by broker-dealers. Information on the price and volume of concluded agreements is also posted immediately upon entry into the system. The PFTS can provide information on concluded agreements not only to participants, but also to settlement banks, registrars and other institutions that render services to securities traders. The PFTS publishes this information daily and it is available through Reuters.

The PFTS trades common stock, compensation and privatization Ukrainian Treasury Bills, municipal bonds and NDCE promissory notes.

PFTS members may gain access to trades and trading information as one of the following:

1. as a registered trader (a trading regime) where all offers for sale/purchase are available to the trader and the trader may submit its own quotation or enter into transactions; or
2. as a non-registered trader (non-trading regime) where all offers for sale/purchase are available, but the trader cannot submit its own quotation and enter into transactions.

The PFTS has developed a rating system of securities listed by the PFTS, and a rating system of the traders working on the PFTS with such securities. This rating depends on the volume and amount of transactions concluded on the PFTS with certain shares of stocks, the number of their quotations, spreads between the best sale/purchase price, etc. A trader's rating depends on the general volume and quantity of transactions concluded by such trader within the system and the number of quotations submitted by such trader.

The increase in the number of issuers within the PFTS system attests to the growth of the privatization process in the country. The expansion of trade volume within the system is due to the growth of both the number of securities available and the number of traders, but one cannot deny the increase in state-owned stock in comparison to that of only a few years ago.

In 1997, a subsidiary of PFTS was established, the "PFTS Technical Center," and the SCSSM granted it the first license for a "trading and information center." In August, 1997, the PFTS 15 Stock Index was made available on a daily basis and on October 31, 1997, the Technical Center was granted the status of a self-regulatory organization. As a self-regulatory organization, the PFTS elaborates upon and seeks to enforce various protection methods for securities traders, clients, and investors, provides a high professional level of securities market activities, and monitors observance of the ethics rules and norms that govern relations between securities traders and clients. PFTS also maintains active committees on arbitration (available to members and non-members), mediation, discipline, trading, and clearance and settlements.

The infamous financial crisis of August 1998 negatively affected the Ukrainian stock market and, accordingly, trading volumes dropped on stock exchanges and the PFTS. The decrease in the prices of Ukrainian securities further disheartened foreign investors from carrying out speculation transactions with securities. As fate would have it, however, this factor attracted strategic investors interested in purchasing "cheap" Ukrainian enterprises in a specific sector (e.g., cement factories).

In fact, the investments by the strategic investors into the real economic sector led to a 20% increase in the prices of Ukrainian securities on the PFTS. Such resurgence of interest in trading on both the PFTS and the stock exchanges resulted in the adoption of a resolution by the SCSSM, which states that Ukrainian liquid "blue chip" enterprises must be sold and listed only on officially organized stock markets (i.e., USE or PFTS). Not surprisingly, representatives of both USE and PFTS extensively lobbied for the above resolution.

C. Sale of Privatized Stock for Cash to Investors

For a very long period, only three companies officially traded their shares of stock on the USE: UkrRechFlot, (a privatized river boat company), Ukraina stock bank (which is currently undergoing liquidation), and Olbi Ukraina. At the same time, however, a number of unregistered firms offered their shares for unofficial quoting on the USE. Unofficial reports indicate that the volume of trading in any given day closed at approximately 62,200 shares, or a total of US \$77,820. By the end of 1997, the volume of trading exceeded an average of \$1,500,000 daily for the PFTS alone, and this conservative estimate reflects only one third to one fifth of the total activity, as the majority of trades still remained unreported.

The volume of trading increased dramatically in 1995, following Presidential Decree No. 146, issued on February 27, 1995, entitled "On Participation of the Ukrainian Stock Exchange in the Privatization Process," which allows the stock exchange to trade in shares of open stock companies in exchange for cash. In a typically broad-handed, optimistic fashion, the above Presidential Decree ordered the SPF to select a minimum of 100 companies to begin selling shares on the USE.

As usual, the beginning was quite slow, which turned out to be fortunate, because it allowed the traders to learn their business without making too many irreversible and costly (financially and reputation-wise) mistakes. From the requested 100 enterprises, only 19 factories were selected for sale; from these, 6 enterprises ("ZmievMetalService," "NefteGazTechnica," the tourist complex "National," "Ternopol Electromechanical Factory," "Steel," and "UkrStroyResoursi") were quietly lobbied out of the project, leaving only 13 available factories. Eventually, on June 8, 1995, shares of the first four enterprises were offered for sale at the USE.

Altogether, approximately 120 broker firms (all registered at the USE) participated, as well as USE members and financial intermediaries acting on behalf of their clients (purchasers). The amount of stock in each factory was rather minimal, ranging from 6.2% to 17.7%, so to begin the trading on a good note, the best factories (e.g., "Ukrainian Down

[Feather] Products”) were offered on that day. It was not surprising, therefore, that the bidding for “Ukrainian Down” went from 31 to 40.5 times the nominal value, nor was it surprising that the investor (a Danish company called “Dia,” specializing in down products) purchased all of the available shares.

Ukraine’s painstaking privatization efforts foreshadow the monstrous procedural and administrative task that lies ahead for the emerging Ukrainian stock exchanges, which have only recently become active and busy institutions. As the pace of privatization continues to increase, the number of shares trading on the stock exchanges will expand accordingly. Effective administration of this process will depend entirely on the conceptual approach (backed by technical means and laws) for the activities of the stock exchange.

Currently, the SPF sells shares of stock of state-owned enterprises to legal entities (including foreign legal entities) only for cash via the PFTS and USE, and to individuals via the SCSSM. If an enterprise is considered to be very attractive or somehow unique, its shares are usually sold at tenders or auctions which often involved one or more foreign investors. More recently, some shares of stock may be purchased via depository receipts on international stock markets.

D. The Development and Functioning of the Ukrainian Securities Market

The concept of trading on the securities market was initially set out in a resolution of the Cabinet of Ministers, issued in April of 1994. This resolution envisioned a maximum centralized securities market, where the USE provides the only place for quotation of securities accepted for circulation and for quotation on the exchange. In other words, a single central depository for securities must be maintained at the USE, which records the circulation of securities by means of computerized account records.

Since this concept did not correspond to the reality, on September 22, 1995, the Parliament approved Resolution No. 342/95 “On the Concept of Functioning and Development of the Securities Market” (the “Resolution”) stating quite a different concept of trading on the securities market, one based on the principles of decentralization of government control of the securities market. According to this resolution, the main goal was to establish an integral, highly liquid, efficient and transparent securities market, regulated by the state and integrated into the world securities market. To this end, the resolution provided that the emerging securities market will be based on the following principles:

1. *social justice* – to ensure the creation of equal opportunities and simplify access for investors and borrowers to the financial market, thereby preventing monopolization and discrimination of the rights and freedoms of the securities market participants;
2. *effective protection for investors* – to create the necessary conditions (social, political, economic and legal) for the realization of the securities market participants’ interests, as well as to ensure protection of their property rights;
3. *ability to manage* – to create a flexible and effective system of managing the securities market;
4. *control* – to create an effective mechanism for accounting and control on the securities market, as well as the prevention of abuse and criminal actions;
5. *effectiveness* – the maximum realization of the securities market’s capacity to attract and allocate finances in the long-term branches of the national economy, facilitating its progress and satisfying public needs;
6. *legal order* – to create a developed legal infrastructure for the functioning of the securities market, which will unambiguously stipulate the rules of behavior of its participants;
7. *liquidity and openness* – to ensure that investors are given full and accessible information regarding the conditions for the issuance and circulation of securities, as well as publicly available information on the business activities of issuers and the prevention of discrimination on the securities market; and
8. *competition* – to provide the necessary freedom of economic activities for investors, issuers and financial intermediaries to create competition conditions to most advantageously allocate free financial resources and to establish non-monopoly prices for the services of financial intermediaries, provided they adhere to fair competition rules.

Further, according to this concept, the integrity of the securities market is assured a unified stock exchange system, acting under the aegis of the National Stock Exchange, National Depository System and Securities Clearing. It also proclaims the necessity of introducing general pricing rules for the securities market.

For purposes of supporting the securities market, increasing discipline among its participants, maintaining trust in the securities market and promoting its dynamic development, the Resolution provides that stock market activities are subject to state regulation. The major principle of securities market regulation is the priority realization of national interests, as well as the guarantee and safety of investment activities in Ukraine.

To effectuate the said purposes and principles of the fledgling national securities market, the Resolution sets forth that the state regulation of the securities market must be carried out by the SSCSM, the Ministry of Finance, the National Bank, the Antimonopoly Committee, the SPF and other authorities, as may be required, within their respective powers.

The state regulation of the securities market is carried out in the following manner:

1. obligatory publication of all essential information regarding the securities market;
2. licensing and controlling of financial intermediary activities, especially those involving trust activities on the securities market, and establishing economic standards as to the accuracy of finances, the scope and type of financial intermediary activities;
3. supervising the activities of organized securities trade systems, establishing, if necessary, obligatory trade rules, and observing adherence to antimonopoly legislation;
4. determining and imposing criminal and administrative liability for (i) persons using internal and confidential information for the purpose of obtaining benefits thereof or (ii) preventing damages as a result of operations with securities; and
5. ensuring property rights to securities and, in particular, the rights of minority shareholders (by providing access to the issuer's financial reports, participation in the management, etc.).

Pursuant to the Resolution, securities are divided into the following groups:

1. shares of stock, whereby the issuer is not obliged to reimburse expenses invested into its activities, but which evidence a proportional share in the authorized capital of a stock company, membership in the company and the right to participate in the management of the company. Such shares of stock also entitle the owner to receive a portion of the profits of the company, in the form of dividends, as well as the right to participate in the division of property upon liquidation of the company;

2. debt securities, whereby the issuer is bound to reimburse, within a definite period of time, the expenses invested into its activities, but which do not entitle the owner of such securities to participate in the management of the issuer's activities; and
3. derivative securities, the circulation of which is connected with shares, debt securities or other financial instruments and the rights thereto.

In addition, to enhance the development of the securities market, the Resolution guarantees tax exemptions for operations with securities at the initial stage of the securities market development in Ukraine. The latter is confirmed by the VAT Law, whereby the operations as to issuance, allocation and sale for cash of securities are exempt from VAT.

Finally, the Resolution envisages that someday the Ukrainian securities market will join, and hopefully even become an integral part of, the world financial market. This will occur whenever foreign investors are given a reliable mechanism for carrying out portfolio investments in Ukraine. The necessary condition for this has always been the establishment of a network of enterprises which specialize in securities, stock exchanges and the development of a national depository system. Most recently, the latter is now able to enter the international network of central depositories and international organizations for standardization to ensure worldwide access to the Ukrainian securities market.

E The SCSSM

On February 14, 1997, President Kuchma executed a Decree "On the State Commission for Securities and the Stock Market" (the "Decree"), which provided for the creation of the SCSSM. In contrast to the initially established SCSSM under the Presidential Decree of June 12, 1995, the "new and improved" SCSSM finally has an independent status, though it is still subordinated to the President and must report to the Parliament. As stated in the Decree, the SCSSM is established to assure the development and effective functioning of the securities market, fair trade and competition. The number of employees within the SCSSM system is limited to 800 persons, including 250 persons who work in the central body of the SCSSM.

The SCSSM's principal goals in regulating of the development the Ukrainian securities market are: increased transparency, liquidity, integration, efficiency and fairness. The development of a well-regulated securities market will, in turn, foster its integration into the global market.

As part of its mandate, the SCSSM is responsible for the following:

1. preparing and reviewing proposals for the formation of a state policy in regulating the issuance and circulation of securities;
2. coordinating the activities of all ministries, agencies and local state organs for the implementation of state policies regarding the development of the securities market;
3. protecting investors' rights by taking measures to prevent violations of the law, and applying sanctions within its area of jurisdiction;
4. instituting state control over the issuance and circulation of securities, thereby eliminating monopolies;
5. identifying issues aimed at improving the organization of the securities market for expanding investors' opportunities to invest in prospective areas of the economy; and
6. generally facilitating the development of a securities market.

In carrying out its activities, the SCSSM is required to meet at least once a month and present an annual report to the President of Ukraine.

In May 1996, pursuant to the Presidential Decree of March 1996, authorizing the creation of a national depository, the SCSSM adopted a "Temporary Provision on Depository and Depository Activity," which was subsequently replaced on May 26, 1998 by the "Regulations on Depository Activity," approved by Resolution No. 61 of the SCSSM. The former determined the basic definitions, rules and requirements as to depositories and depository activity before introduction of the respective legislative act.

At the same time, pursuant to the aforementioned Presidential Decree "On Amendments and Changes to the Decree of President of Ukraine of May 25, 1994, 'On Electronic Circulation of Securities and the National Depository,'" the Law No. 710/97-VR "On the National Depository System and Peculiarities of the Electronic Circulation of Securities," dated December 10, 1997, as well as the Presidential Decree "On the General Grounds for the Operation of the National Depository of Ukraine," dated June 22, 1999, a national depository was finally created (the "National Depository").

The National Depository was established as an open joint stock company, in accordance with the Law "On Economic Associations." The shareholders of the National Depository may be only state-owned and other legal entities, which are the participants in the National Depository System (depositories, custodians and registrars), and cannot earn any profit from the National Depository's activities.

The National Depository assures the performance of the following functions:

- standardization of depository registration pursuant to international norms and standards;
- standardization of the circulation of documents regarding securities transactions;
- numeration (codification) of securities issued in Ukraine in accordance with international norms;
- establishing relations and constant interaction with depository institutions of other countries;
- entering into bilateral and multilateral agreements on direct membership or correspondent relations for servicing international transactions with securities of the National Depository System's participants; and
- exercising control over correspondent relations with depository institutions of other countries.

Recently, the SCSSM became a member of the International Organization of Securities Commissions (IOSCO), an organization which seeks to coordinate the activities of securities regulators in over seventy-eight (78) countries. Within the IOSCO, the SCSSM is a member of the "New Markets Committee," and works together with the "European Regional Committee." One of the many benefits of IOSCO membership is access to its database containing securities-related legislative acts from various countries. Other benefits include access to international experience in regulatory matters and the opportunity to receive advice from highly regarded IOSCO specialists.

F. Recent Developments on the Ukrainian Securities Market

During 1996-2001, the Parliament and the President adopted a number of legislative acts governing activities in the Ukrainian securities market. Among them, the most important are:

1. the Presidential Decree "On the State Commission for Securities and the Stock Market," dated June 12, 1996;
2. the Law "On Introduction of Changes to the Law of Ukraine 'On Securities and the Stock Exchange,'" dated June 18, 1991 (with further amendments made in July of 1996, September of 1997 and June of 1999);

3. the Law "On State Regulation of the Securities Market in Ukraine," dated October 30, 1996;
4. the Presidential Decree "On the State Commission for Securities and the Stock Market," dated February 14, 1997;
5. the Presidential Decree "On the Coordination Council on Issues Concerning the Operation of the Securities Market in Ukraine," dated May 10, 1997;
6. the Law "On the National Depository System and Peculiarities of the Electronic Circulation of Securities," dated December 10, 1997;
7. the Presidential Decree "On Introducing Changes and Addenda to the Presidential Decree of May 25, 1994 'On Electronic Circulation of Securities and National Depository,'" dated March 2, 1996;
8. the Presidential Decree "On Issues of the State Commission for Securities and the Stock Market," dated May 19, 1999;
9. the Presidential Decree "On the General Grounds for the Operation of the National Depository of Ukraine," dated June 22, 1999;
10. the Law "On Introduction of Changes to the Law of Ukraine 'On State Regulation of the Securities Market in Ukraine,'" dated July 14, 1999;
11. the Presidential Decree "On the Principal Directions of the Development of the Stock Market in Ukraine in 2000," dated October 30, 1999;
12. the Law "On Licensing Certain Types of Economic Activity," dated June 1, 2000; and
13. the Law "On Joint Investment Institutions (Share and Corporate Investment Fund)," dated March 15, 2001.

All of the above legislative acts were adopted with the direct input of the SCSSM, whose strategic goal is to enable foreign investors to allocate their capital in Ukraine.

The adoption of the aforementioned legislation created a two-level system, regulating the securities market. The first level is represented by the SCSSM, acting on behalf of the State, and the second level is represented by self-regulatory organizations and professional associations (such

as the PFTS), the latter influencing the activities of the securities market participants. The SCSSM may in turn authorize the self-regulatory organizations to develop and/or implement certain rules, standards and requirements for carrying out activities on the securities market via the issuance of licenses for entities engaged in professional activities on this market.

Ukrainian legislation outlines all types of professional activities, which can be carried out on the securities market, including securities trading (i.e. broker and dealer activities), depository activities (a new sphere), clearing activities (an emerging sphere), securities management, securities ownership registration (formed in 1996), as well as activities of securities trading institutions. Naturally, all activities are licensed by the SCSSM. As previously mentioned, the SCSSM also provides the mandatory requirements, standards and rules for all securities market participants.

The SCSSM specifies the rules of securities emissions and additional requirements for securities emissions by commercial banks (with the prior consent of the National Bank). It also registers each issuance of securities, as well as necessary related information. The SCSSM is responsible for determining the rules for a functioning organized securities market, the reporting procedure for securities market participants, the state registration of stock exchanges, over-the-counter trading and information systems, self-regulatory mechanisms, and appointing the state representatives on the stock exchanges, depositories and the trading and information systems.

G. The Securities Market Infrastructure

(i) Registrars

Today, the services of independent registrars are required for all open joint stock companies with more than five hundred (500) shareholders. Until the middle of 1995, however, information regarding the ownership rights to shares of stock was registered by the stock companies themselves, which maintained the relevant information in a registry book.

The first attempt toward regulating this rather basic component of the securities market was made in January 1996, when the SPF issued its Interim Provision "On Shareholder Registrars of Open Stock Companies' Created on the Basis of the Privatization of Enterprises." With the aim of simplifying the re-registration of ownership rights to securities, an institution of independent registrars was born.

Registrar activities are licensed by the SCSSM and were firstly governed by the Regulation "On the Procedure for Granting Licenses to Maintain Registers" (approved by the SCSSM's Regulation of April 1, 1996, and fur-

ther amended by the SCSSM's Resolutions of July 17, 1997 and June 23, 1998 respectively). By the end of 1997, the SCSSM had granted over 350 licenses for carrying out this type of activity. Thereafter, on May 26, 1998, the SCSSM by its Resolution No. 60, detailed a new procedure for maintaining registries, which is currently in effect, although questions about the price for registration services are not yet completely settled by Ukrainian legislation. Nevertheless, according to the Regulation of May 26, 1998, the registration term of a title transfer under civil law agreements is 3 days.

Currently, the requirements for obtaining a registrar's license; and the license requirement for carrying out the registrar's activities are defined in the License Terms and Conditions for Carrying Out Professional Activity on the Securities Market, approved by Order No. 318/5509 of the SCSSM, dated March 14, 2001.

As mentioned above, there is no current standard price-list for services provided by registrars. The majority of the registrars, however, set their prices according to the volume of the transaction. There are several payment systems for employing a registrar's services, including a flat payment for one transaction or a percentage from the price of the transaction. Registrar fees can range from as low as one percent (1%) to five percent (5%) of the transaction amount. However, the SCSSM, with the consent of the Antimonopoly Committee, establishes the maximum tariffs for services provided by registrars.

In a relatively short period of time, the Ukrainian registry system has finally taken shape. With the introduction of the Law on Depositories, some consolidation of the registrar industry is expected, resulting in greater efficiency and reliability in this previously murky area of ownership registration.

(ii) The Depository System

Until the relatively recent adoption of legislative acts governing depository activities, no active depository functions were performed for common stock in the whole of Ukraine. Custodial services were provided by banks and served the banks' needs only. To encourage the development of this segment of the market, the SCSSM adopted a number of regulations related to depository activity in 1996, such as the Interim Provision "On Depositories and Depository Activity." Licensed securities traders and banks have used various forms of "nominee" ownership to facilitate the safekeeping and re-registration of shares for foreign traders (investment funds).

Reliance on these nominee ownership forms carries a significant risk since the legal concept of fiduciary responsibility is almost non-existent in

Ukraine. Custodial services were dramatically improved with the establishment of local representative offices of internationally recognized custodians such as ING, Societe Generale and CSFB.

By the end of 1997, the SCSSM had granted 28 licenses to custodians and the first temporary license (for a period of 1 year) to a local depository, the Interregional Stock Union (MFS). Among the MFS's founders are the National Bank, Privatbank, Bank "Ukraina" (which is currently undergoing liquidation) and "Pershyi Ukrainsky Mizhnarodny Bank" (First Ukrainian International Bank). Recently, the above number of the licensed custodians has significantly increased, but the only acting depository still remains MFS.

In an effort to create a depository system, on November 25, 1996, the Cabinet of Ministers and the National Bank approved a joint Resolution No. 1411 "On Approval of the Plan to Create a National Depository System for Securities in 1996-1997." As a result of these efforts, and of the natural evolution of the securities market, the Parliament adopted a bill "On the National Depository System and Characteristics of the Electronic Circulation of Securities." President Kuchma signed it into law on December 10, 1997, and it entered into force on the date of its publication, January 6, 1998 (the "Depository System Law"). Currently, only the National Depository of the National Bank operates a reliable depository system, which is dedicated solely to servicing the T-bill market.

A necessary requirement for the development of the securities market is to provide liquidity of securities and insurance of transactions with them. Not surprisingly, these are the primary objectives of the National Depository System. The Depository System Law provides the legal grounds for securities circulation within the National Depository System, defines the participants, the types of permitted activities and the depository system itself, and separates the spheres of regulatory competence of the various governmental agencies. According to the Depository System Law, the Ukrainian National Depository system will now consist of direct and indirect participants. The direct participants are further divided into an upper and lower level.

The upper level of direct participants includes:

1. the National Depository, which functions as a local depository and provides for standard depository accounting and codification of securities issued in accordance with international standards. The National Depository also establishes relations with depository organizations of other countries, enters into either bilateral or multilateral agreements on direct membership or establishes correspondent relations with foreign or

international depositories in order to service the international securities transactions of its participants; and

2. local depositories, defined as legal entities established as open joint stock companies, the shares of stock of which are publicly traded. A local depository may be set up by no less than 10 custodians and may only engage in providing depository services. The share of an individual shareholder in the authorized capital of a local depository may not exceed 25%. In addition, a depository may become a clearing depository, allowing it to conduct clearing operations for securities transactions upon receipt of a license from the SCSSM.

Local depositories are responsible for the safe-keeping of securities and servicing their circulation in security accounts, servicing issuer's transactions with securities, maintaining records of securities owners, security clearing and transaction settlements. In order to carry out transaction settlements, a clearing depository is required to employ the services of a bank with which such depository concludes an agreement for carrying out transaction settlements.

The lower level consists of:

1. custodians, defined as commercial banks or securities traders holding a license for custodian activities and for servicing securities and transactions of an issuer with securities on securities accounts. Such custodial and servicing operations may be carried out both with regard to securities owned by the custodian and securities held by the custodian under a securities account agreement; and
2. registrars of securities owners, defined as legal entities holding a license to maintain registries of registered securities owners.

As defined by the Depository System Law, indirect participants include:

- organizers of securities trades;
- banks, which may acquire the status of settlement banks if they enter into an agreement with a depository to effectuate cash settlements for securities transactions;
- securities traders; and
- issuers of securities.

Currently, the requirements for obtaining a depository's license, as well as the license requirements for carrying out a depository's activities are

defined in both the Regulation on Depositary Activity, approved by the SCSSM's Decision No. 61, dated May 26, 1998, and the License Terms and Conditions for Carrying Out Professional Activity on the Securities Market, approved by Order No. 318/5509 of the SCSSM, dated March 14, 2001.

The payment rates for providing depository services are set by the depository itself. However, the SCSSM, together with the Antimonopoly Committee, establishes the maximum level for such payments. Currently, Ukrainian authorities are closely working with USAID to activate depository activities. To assist them, on January 27, 1998, the SCSSM adopted Resolution No. 11-a "On Approval of the Regulations on Settlement and Clearing Activity" (as lastly amended on June 1, 2000). The SCSSM is also developing software, which will allow the participants of the stock market to enter into agreements via an electronic system. The above factors should allow the Ukrainian stock market to operate in accordance with international stock market standards, and will allow investors to carry out securities transactions according to "Delivery Versus Payment" principles.

III. Conclusion

The Ukrainian securities market is in a constant cycle of continually entering new stages of development. Several past events have given hope that the Ukrainian securities market is developing in accordance with international standards, and moving towards integration into the world's capital markets. For instance, Ukraine established a system of independent registrars to protect the rights and interests of shareholders. A decentralized OTC trading system (similar to the US NASDAQ system), the PFTS, was established and began operations in 1996, increasing the transparency and liquidity of the market. In addition, the SCSSM is a member of the International Organization of Securities Commission (IOSCO), an organization which seeks to coordinate the activities of securities regulators in 78 countries and is planning to introduce several widely anticipated changes to securities laws to provide a solid "securities legislation foundation." This legal and structural platform, coupled with the influx of stock from privatization efforts, enables Ukraine to absorb investment, if and when it is ready to return to Ukraine.

VI. Miscellaneous

A ENERGY LAW

I. Introduction

Once, a long, long time ago, Ukraine was one of the most industrial and productive Soviet republics in such areas as metallurgy, chemical manufacturing, military manufacturing, machinery production, among others. Importantly, all of the above fields demanded significant energy sources.

The development of energy power resources, and the corresponding energy infrastructure, gives Ukraine a unique geo-political status in the former Soviet territories. Ukraine's border with Poland served not only as a military barrier to threats from Western countries, but also facilitated the flow of energy resources to the rest of Eastern Bloc countries, which relied on a constant supply of the Soviet Union's energy for their fight against the "evil" forces of capitalism.

When Ukraine declared its independence in 1991, it became the successor of a relatively highly developed energy sector with a complex infrastructure. However, this uniquely developed energy sector had its own peculiarities. For instance, as a result of the State's former stronghold over this militarily important asset, the energy sector remains non-transparent and poorly adapted toward involvement by independent private entities. Add to this other inherited problems, such as the Chernobyl disaster, the complicated sale of "OblEnergos" (regional energy distribution companies) and the arrest of Prime-Minister Pavel Lazarenko (for laundering millions of dollars derived from energy-related deals), no wonder many foreign investors tend to smile, very sarcastically, when they hear the phrase "investment in the Ukrainian energy sector."

Nevertheless, the 2000-2002 Privatization Program (which incidentally is still effective as of March 2004) called for comprehensive privatization of the energy sector and modernization of the energy market along with its cohesive procedures. Unfortunately, due to Ukraine's regulated prices for electric power, the energy sector continues to be one of the roughest markets to enter in Ukraine for foreign investors, raising a legitimate question whether foreign investment in this arena is worth the trouble. And yet, the allure of investing in energy distribution companies with monopolistic-like holds on certain regions has caught the attention of several potential foreign investors.

Below we limit our discussion to the legal aspects of the energy sector.

II. The Energy Sector

A. Introduction

As a rule, only two principal ways exist for a foreign company or an individual to invest in the Ukrainian energy sector: (i) purchase shares in an existing company; or (ii) participate in the formation of a new energy-related company. In order to invest in the energy sector, it is important to know that each Ukrainian energy company maintains a monopoly-like hold over a certain region of the country. It is equally essential to be familiar with the relevant laws, governing electrical energy and entities that participate in energy-related businesses.

Law No. 575/97-VR “On Electric Power Engineering,” dated October 16, 1997 (the “Law”) provides the necessary legal and organizational basis for activities in the energy sphere. The Law also regulates all relations in connection with the production, transfer, supply and use of energy, the maintenance of energy safety in Ukraine, competition and the protection of consumer rights and workers’ rights. Under the Law, the term “energy” includes electrical or heating energy, produced by electrical power stations for further sale.

Although not always apparent in practice, the Law provides for certain functional requirements for the energy sector, including: (i) a constant and uninterrupted balance between production and use of electricity via the establishment of a single, controlled (operative-technological) management of the “unified energy system”; and (ii) a centralized heat supply to consumers via heating networks and boilers which are a part of the unified energy system. Incidentally, the Law defines “unified energy system” as the aggregate of power stations, the electricity and heating networks and other objects, which are unified by a joint mode of production, transmission and distribution of electrical and heating energy under centralized management.”

B. State Control

As the imprisoned ex-Prime Minister Lazarenko knew all too well, the energy sector is one of the biggest moneymakers for the State budget. It is not surprising, therefore, that the Law provides for a great deal of governmental regulation in the said sphere, beginning with a Vice Prime Minister, who is responsible solely for fuel and energy issues. The next rung in the hierarchy of the energy sector is the Ministry of Fuel and Energy, which regulates strategic issues regarding the energy availability conditions for the Ukrainian economy. Under the Vice Prime Minister and the Ministry of Fuel and Energy, there are numerous other state organs involved in regulating the energy sector.

The Law stipulates a number of general principles which shape state policies in the energy sector, including the state regulation of activity in the energy sphere, the creation of safety measures, ensuring rational use of heat and energy, the observance of common state norms, rules and standards by all establishments in the energy sector, the development and improvement of technology, ecological safety, consumer rights protection, cooperation in developing a competitive energy market, etc.

So-called “objects of the energy sector” are defined as power stations (excluding nuclear power stations), electrical sub-stations and the electrical network, which are connected to the unified energy system, as well as boiler stations, connected to the main thermal pipeline, and the pipeline itself (hereinafter “Energy Objects”). Some of the Energy Objects are subject to privatization and others are not. On January 12, 2001, the SPF issued a list of companies, whose shares of stock were subject to privatization, for the first time opening the door for foreigners to invest in Ukrainian companies with strategic importance (Order No. 33). Six OblEnergos were privatized in the first round of tenders.

However, the Law clearly states that “certain” energy-related properties are not subject to privatization, such as property which “ensures the completeness of the unified energy system and the centralized controlled management and the main and international electrical networks.” As a result, the Ukrainian government retains sufficient control over many of the energy companies.

Once a foreign investor becomes involved in the highly regulated energy sector, it is inevitable that such an investor will come into contact with the government representatives in almost all facets of its business activities. This includes dealing with the following two agencies: (1) the State Inspection Agency for the Exploitation of Power Plants and Grids (“SIAEPPG”) and (2) the State Inspection Agency for Energy Supervision Over the Consumption of Electricity and Heat. Both of these agencies are responsible for the State-sanctioned supervision of the energy sector and concrete issues affecting energy companies. Immediately below, we describe these two animals in greater detail.

The “SIAEPPG” supervises observance of the requirements for technical exploitation of electrical stations and grids, and the technical requirements for exploitation of energy equipment by energy companies connected to the unified energy system. This governmental body has the following rights:

- a) *unimpeded* access to Energy Objects to inspect whether they are in observance of the normative acts related to the energy sector, as well as those acts within SIAEPPG’s exclusive competence. Effectively,

SIAEPPG has the right to demand information regarding the fulfillment of such acts from all companies;

- b) to submit orders to the chief executives of Energy Objects to cure any violations of normative acts; and
- c) to apply sanctions on enterprises that own Energy Objects which are connected to the unified energy system of Ukraine for violation of energy-related legislation, if any.

The State Inspection Agency for Energy Supervision Over the Consumption of Electrical and Heating supervises electrical and heat-consuming facilities and the consumer heating networks. This governmental body has an even wider range of rights than the former, including, but not limited to, the following rights:

- a) *unimpeded* access to electrical and heat-consuming facilities and the consumer heating networks;
- b) to issue mandatory orders to consumers regarding violations of normative or legal acts, as well as to receive from consumers information which is necessary to carry out its tasks in accordance with the relevant normative acts;
- c) to issue orders to consumers on bringing reporting, control and regulation of the use of electrical and heating energy into compliance with the norms, rules and standards of the energy sector;
- d) to issue orders terminating electrical and heat-consuming services to consumers, if such continuance will endanger the life of personnel or the health of the population; and
- e) to apply sanctions on subjects of entrepreneurial activity for the violation of normative-legal acts.

In addition to the above agencies, the local bodies of the executive branch and the bodies of local self-governance also have certain authorities in relation to the entrepreneurial activities of companies which produce, transmit and supply electricity or heat within the centralized heat and energy supply systems. For example, the above bodies can give their consent to energy distribution on their territories, participate in the development of supply plans and measures for extraordinary situations, regulate the tariffs for heating, etc. In other words, this is yet another layer of the infamous Ukrainian bureaucracy investors will have to please in order to get their operations up and working.

The state involvement in the energy sector does not end with the inspection agencies and the local administrative bodies. In fact, all activities within the energy sector are regulated by the so-called National Commission on the Regulation of Electrical Energy of Ukraine (hereinafter the "Commission"), including the activities of monopolies and businesses in related markets. The Commission is responsible for granting permission to carry out all activities in the energy sector, forming tariff policies and controlling the quality of services within the energy sector.

According to the Law, the Commission's formidable tasks include formulating a unified policy for the development and functioning of a wholesale energy market, promoting competition in production and supply of energy, ensuring the observance of price and tariff policies, protecting consumer rights, issuing licenses to commercial businesses to produce, transmit and supply electricity, and monitoring the licensees' adherence to the terms and conditions of licensed activities. Basically, the Commission can play a hand in virtually every area of the energy sector. In order to carry out its tasks, the Commission:

- a) participates in regulating payment relations on the wholesale energy market;
- b) establishes restrictions on the combined activities of entrepreneurs in the energy sector;
- c) determines whether company liquidation, reorganization, participation, acquisition or alienation of more than 25 percent of the shares in the assets of businesses conforms with the terms, conditions and rules of licensed activities;
- d) considers cases regarding violations of the terms and conditions of licenses (and issues decisions thereon);
- e) levies property-related sanctions on companies and administrative sanctions on officers of enterprises, institutions and organizations; and
- f) carries out unimpeded inspections for compliance with the terms and conditions of licensed activities.

C. State Management of Energy Objects

As mentioned, Ukraine's energy sector is based on a unified, centrally controlled system of operative-technological management of the production, transmission and supply of energy. In this regard, one state-owned enterprise, appointed by the executive branch of the government, carries out the

function of controlling the above unified energy system. Such central management even applies to subjects of entrepreneurial activity (i.e., private entities) with Energy Objects that are connected to the unified energy system.

Specifically, such centrally controlled management provides for the following:

- a) planning and operative management of the output of power stations, taking into consideration the operating conditions of centralized heat supply;
- b) planning and control over the observance of the working conditions within the unified energy system;
- c) the prevention of emergency situations and the elimination of their consequences within the unified energy system by maintaining the necessary balance of capacity and energy, and ensuring the reliable and stable functioning of the unified energy system and its parallel operations with the energy systems of other countries;
- d) the development and control over the introduction of new automatic safety systems, as well as communication and controlled management means; and
- e) supervising the exploitation of automatic safety and protection systems.

All operative commands and instructions of this state-owned management enterprise are mandatory and binding on all subjects of entrepreneurial activity with Energy Objects linked to the unified system. Such entrepreneurs must submit to the state-owned controller all relevant reports and information provided by the normative and technical documents regulating the energy sector. Interestingly, the Law provides that other state bodies, public organizations and political parties or movements may not interfere in the central management of the unified system, unless specifically provided otherwise by Ukrainian law.

Aside from the Law, there are two additional laws, which regulate the creation and functioning of atomic energy. These laws include Law No. 39/ 95-VR "On the Use of Atomic Energy and Radiation Safety," dated February 8, 1995 (as lastly amended on July 10, 2003), and Law No. 1370-XIV "On Permitted Activities in the Atomic Energy Use Sphere," dated January 11, 2000. The atomic energy sphere is additionally regulated on the ministerial level, as well as by the State Commission for the Use of Atomic Energy. A discussion on the atomic energy sector is beyond the scope of this brief overview.

D. Licensing

All activities connected with the production, transmission and supply of electricity in Ukraine require a license in accordance with Article 4 of Law No. 698-XII "On Entrepreneurship," dated February 7, 1991 (all but Article 4 of this Law has lost force on the basis of the new Civil and Economic Codes). As always, the Commission is in charge of issuing the special permission (license) to carry out such activities. Naturally, foreign investors who desire to participate in an energy-related activity will need to apply for such a license.

If foreign investors wish to carry out multiple activities in the energy sector, they have to receive a separate license for each type of desired activity. Each license is issued in accordance with the Commission-approved instructions, terms, conditions and rules for carrying out the respective activities. Note that some low-volume activities may be carried out without a license in accordance with the rules for carrying out entrepreneurial activities in the electrical energy production sphere. Licenses are issued to energy suppliers, which have electrical heating plants within their structure, for activities in the energy sector, taking into account the special terms and conditions for the priority guarantee supply of the consumer need for heat on the territory where such licensed activities are to take place.

Importantly, foreign investors interested in purchasing shares in existing energy companies will not have to apply for a license to purchase such shares. However, such foreign investors should undertake strict due diligence on the targeted company, especially with the aim of determining whether such company was issued a license for its activities and whether such license is still in effect.

In accordance with the Law No. 741-IV "On the Introduction of Changes to Article 18 of the Law of Ukraine 'On Electric Power Engineering,'" dated May 15, 2003, foreign investors were finally given the same rights to participate in the designing, construction and reconstruction of Energy Objects as Ukrainians. Before these amendments to the Law, priority was given to Ukrainian Producers to design, construct and reconstruct Energy Objects. As a result, foreign investors may now participate in tenders to win such projects on an equal-footing basis.

E. Economical and Organizational Principles

The Ukrainian energy sector consists of four links: (i) electrical power stations; (ii) state-owned enterprises of the so-called "Energorynok" (the wholesale energy market) (iii) enterprises which receive energy from the

“energy market,” supply electrical energy to consumers, receive payment and, in turn, make the relevant payments to the state-owned enterprises of the “energy market” (also known as “OblEnergos;” each oblast (region) in Ukraine has one OblEnergos); and (iv) energy consumers (companies and mortal citizens).

The Cabinet of Ministers approved the charter of the wholesale energy market via its Resolution No. 922, dated June 5, 2000, and, at the same time, amended the Law. The Parliament approved the Cabinet’s amendments on June 22, 2000, requiring that all payments received from consumers must be transferred to the wholesale energy market without first going through the respective “OblEnergos.” By way of background, “OblEnergos” often neglected to collect payments from consumers or to effectuate the subsequent transfer of such payments to the wholesale energy market. On February 12, 2002, the Constitutional Court of Ukraine via its Decision No. 3-rp/2002 introduced amendments to the Law, which were related to the introduction of so-called “distribution accounts of the wholesale electrical energy market.” Such distribution accounts will be opened exclusively in an authorized bank and are specifically designated for all electrical energy payments in cash form only by energy consumers for participation on the wholesale electrical energy market.

In Ukraine, the purchase of all electrical energy produced at power stations, the capacity and output volume of which exceed established limitations, and the sale of such energy at wholesale prices must take place on the wholesale energy market. The Law strictly allows for the formation of only one wholesale energy market for the sale or purchase of electrical energy on the basis of agreements.

In accordance with the Law, the wholesale energy market is formed on the basis of an agreement between subjects of economic activity. Specifically, these subjects must carry out economic activities connected with the following:

- a) the controlled (operative-technological) management of the unified energy system of Ukraine;
- b) the production of electrical energy at power stations;
- c) the transmission of electrical energy via local and interstate electrical networks; and/or
- d) the supply of electrical energy via local electrical networks.

Further, the wholesale energy market must observe the following requirements:

- a) all companies producing and supplying electrical energy enjoy equal access to the wholesale energy market and services of the electrical network after receipt of the relevant licenses;
- b) electrical energy is sold and purchased according to the strictly formed rules of the wholesale energy market; and
- c) prices for electrical energy of generating companies and wholesale prices are determined according to the above rules.

Recently, the Ukrainian government decided to privatize practically all of the “OblEnergos.” According to the current privatization program, industrial investors have a priority right to purchase shares of the “OblEnergos.” Several internationally recognized companies that have worked for many years in the relevant sector, including the big power companies from the West, are thus given an advantageous position in purchasing shares of “OblEnergos,” which are considered blue chips on the Ukrainian securities market.

F. Antimonopoly Regulations

Due to the nature of the business, any activity on the Ukrainian energy market is subject to the Law of Ukraine No. 2210-III “On Protection of Economic Competition,” dated January 11, 2001. Significantly, this directly relates to the purchase of shares on the stock market. Before purchasing shares in energy companies, investors must receive permission from the Antimonopoly Committee if the amount of shares and/or value of such shares exceed certain quotas established by the Antimonopoly Committee.

Therefore, before investing in the energy sector, investors should inquire whether the targeted energy company holds a monopoly on the market (which such companies usually hold) and, if so, whether it owns the proper license to carry out such monopolistic activity. If the targeted entity possesses a license as a monopoly, then such entities cannot suspend their activities or decrease their volume if it will cause a deficit of electrical energy, unless Ukrainian legislation specifically provides otherwise. As an alternative, a foreign company can also effectuate its investment in a form which permits a monopoly hold on the relevant market for a specific period of time, such as via a concession agreement with the Ukrainian State. In a concession agreement with the investor, the State may undertake the obligation to obtain the relevant licenses.

The Law and the Law of Ukraine No. 1682-III “On Natural Monopolies,” dated April 20, 2000 (as lastly amended on November 20, 2003), also provide for the regulation of wholesale tariffs and retail prices on the energy

market by various state entities, as well as the regulation of tariffs on heating energy. Additionally, enterprises supplying electrical energy via networks, which are not under their ownership, must purchase electrical energy on the wholesale energy market and make payments for the use of local electrical networks. The supply of electrical energy to consumers by such enterprises is carried out according to the tariffs, which are set forth in agreements for the supply of electrical energy.

G. Employment Peculiarities of the Energy Sector

Ukraine has been blessed with a highly trained and very skilled work force. For instance, Ukrainian specialists have assisted many developing nations, including Egypt, Vietnam and China, in the construction of various energy objects. Therefore, foreign investors who will eventually acquire stock in Ukrainian energy companies will have a well-trained work force already on the ground.

In this regard, foreign investors should be aware of the peculiarities provided by the legislation on labor conditions in the energy sector. For example, enterprises, institutions and organizations working within the energy sector must fill all employment positions with highly qualified personnel, regularly upgrade the qualifications of such employees and guarantee reliable social protection for all personnel.

Further, employees involved in the energy production process must go through special preparation and an examination of their knowledge (so-called "attestation"). The detailed list of such professions and positions is approved by the Ministry of Energy with the consent of the State Committee of Ukraine for Supervision of Labor Protection. Significantly, all employees that work within radiation, thermal and electromagnetic emanating zones are subject to special medical examinations and mandatory insurance at the expense of the employer.

H. Obligations and Liabilities of Energy Suppliers; Consumer Rights Protection

First and foremost, energy suppliers are obliged to provide a reliable supply of electrical energy pursuant to the terms and conditions of their licenses and agreements. Interestingly, energy suppliers, which provide electrical energy via their own networks on allotted territory, cannot refuse to supply their energy to consumers located on such territory. Further, energy suppliers, which carry out the transmission of electrical energy via their own networks, must ensure equal access to such networks by all licensed companies that execute agreements for energy supply.

The protection of consumer rights and the mechanism for carrying out such protection are regulated by the Law and by the laws "On Consumer Right Protection," "On Protection of Economic Competition," "On Energy Supply," and other normative acts. For example, prices for electrical energy are regulated by the Law "On Natural Monopolies," thereby protecting consumers from the abuses of "evil monopolists."

Further, according to the Law, all energy consumers are guaranteed the following rights:

- a) connection to the electrical network, provided the rules of electrical energy use are followed;
- b) choice of an electrical energy supplier;
- c) receipt of information on the quality of electrical energy, prices, payment procedures, terms and conditions and methods of energy use;
- d) receipt of electrical energy according to government quality standards; and
- e) compensation for damages caused as a consequence of the violation of their rights.

III. Conclusion

With a rather complicated and highly regulated infrastructure in place, involvement in the Ukrainian energy sector can result either in an extraordinarily profitable investment or a huge loss. As with Ukraine itself, the potential of privatized companies in the energy sector is unlimited. For a variety of practical and legal reasons, careful due diligence on targeted energy objects or potential joint venture partners is absolutely indispensable in any meaningful transaction.

Of the OblEnergos privatized in the recent past, the largest complaints of the foreign investors is the inability to quickly change the socially-based laws, which do not permit them to shut off the power of companies and consumers who refuse to pay their electricity bills. This problem is compounded by the fact that these foreign investors must invest substantial amounts of money in upgrading the crumbling infrastructures they have inherited. As these foreign investors are still getting their feet off the ground, it is difficult to predict whether their investments will be diamonds in the ruff or utter and complete loss-generating investments.

B LAW “ON CONCESSIONS”

I. Introduction

On July 16, 1999, Ukraine passed its first law “On Concessions,” No. 997-XIV (the “Law”). As with many Ukrainian legal terms, the meaning of “concession,” as set forth in the Law, does not correspond to the Western understanding of concession. To understand the reasons for this curse, it is necessary describe the history of “concessions” on the territory of Ukraine.

In the beginning of the 20th century, the Russian Empire, of which Ukraine was an integral part, saw the most dynamic development of foreign investment in its long history. In that period, 55% of the total investments in the Russian Empire’s economy were foreign. At the time, the most widespread vehicle for foreign businesses were concessions (grants for assisting the State in exploiting important natural resources). These concessions were granted on minerals, transportation, etc. The list of foreign investors who took part in concessions included such famous names as Rudolph Diesel and the Noble brothers. Even after the 1917 revolution, concessions remained as the only islands of economic activity where operations could be effectuated with the injection of private foreign capital.

The Decree of the Council of the Peoples’ Commissars, dated January 20, 1920, entitled “General Economic and Legal Terms and Conditions of Concessions” was subsequently issued, which unequivocally favored granting concessions for the exploitation and extraction of natural riches. True, the above Decree was later canceled and, as a result, all concession agreements between Soviet Russia and foreign concessionees were canceled. Consequently, the properties of many famous foreign concessionees, such as the Swiss Sandoz, French Credit Lyonnais, etc., were nationalized without any compensation.

After the fall of the Soviet Union, the former republics rich in oil and gas saw the renaissance of foreign concessions. Immediately after Ukraine’s independence, Ukrainian legislation also stated that significant foreign concessions could be effectuated on the territory of Ukraine, but only with the permission of the Parliament. Henceforth, Ukrainian legislation continued to improve the conditions for carrying out foreign aided concessions. For example, Decree No. 55-93 of the Cabinet of Ministers of Ukraine “On the Foreign Investment Regime,” dated May 20, 1993, encouraged foreign concessionees to effectuate concessions after signing a separate agreement with the Cabinet of Ministers. These separate agreements gave the foreign concessionees

immunity from the frequent changes in the legislation and established more transparent rules for carrying out concessions.

Unfortunately, few foreign companies were interested, and for a good reason. As a consequence of the swift development of Ukrainian legislation, a rather unique meaning for the legal term “concession” arose as the original text of the Law “On Concessions” excluded the prospecting of mineral wealth and other natural resources as objects of concessions. This omission with respect to the regulation of mineral rights was corrected when the Parliament adopted Law No. 1039-XIV “On Production Sharing Agreements” on September 14, 1999, but the Law “On Concessions” remained rather impotent.

The Law defines a concession as a grant of rights from the State or local bodies of self-governance to legal or physical entities (which are registered subjects of entrepreneurial activity) to create, construct and/or administer concession objects with the purpose of “satisfying the social needs of the Ukrainian people.” Grants are made on the basis of a concession agreement to any subject of entrepreneurial activity, resident or non-resident, who expresses interest in receiving a concession. As a rule, the State must hold a concession tender to determine who offers the most favorable conditions for exploiting a specific concession object. Both the concession tender and the concession agreement are discussed in more detail below.

II. “Concession Objects”

In a nutshell, the following spheres of activity may be the subject of a concession agreement: the construction and exploitation of hotels, tourism complexes, camping grounds and other similar objects of the tourism industry (new as of 2002); water-supply; draining and cleaning of sewage waters; collection and utilization of garbage; provision of services connected with the supply of heat, cable television, communication, postal services and undertakers’ services; construction of roadways, roadway facilities and infrastructures, airports, freight and passenger ports, and residential buildings; transportation and distribution of natural gas; manufacture and/or transport of electrical energy; and public parking for automobiles, among many others. Additional spheres may be added to the list of activities in which communally-owned organizations may be granted for concession upon approval by local councils at plenary sessions.

The above list of concession objects includes property that belongs to an enterprise, which is a part of the system of integrated property complexes used to provide the above services, as well as unfinished construction which needs to be completed in order to satisfy the public needs and specially built objects for carrying out any of the above activities.

III. Announcement of a Concession Tender

Once an object is included on the consideration list for concession, the Cabinet of Ministers (if the object is under state ownership) or the authorized body of local self-governance (if the object is under communal ownership) decides to hold a concession tender on the specific object. Thereafter, an official announcement of the tender must be prepared.

All information on the announcement of a concession tender for granting a new concession (or renewing an existing concession whose period has expired) must be published in either of the official state newspapers (“Uryadoviy Kourier” or “Golos Ukrainiy”) or in the official publication of the relevant body of local self-governance. The published announcement must include the following: the name of the state body granting the concession; the object of concession; the terms and conditions of granting a land parcel (if necessary); the volume of work which must be financed (fulfilled) by the concessionee; the volume of goods the applicant guarantees; the basic obligations of the eventual winner of the concession tender; financial or other guarantees required from the applicants; amount of the registration fee; term of the concession; period for submitting applications and announcing results; and the authorized body to contact for additional information.

Applications to participate in a concession tender must be submitted within 120 days from the date of the publication of the announcement. Applications must include the name of the applicant (physical or legal entity); the applicant’s offer for fulfilling the terms and conditions of the concession tender; the present, confirmed ability of the applicant to secure the proper financing for its proposed concession activity; and the applicant’s experience and technical/organizational ability to maintain the proposed activity.

IV. The Concession Tender

A representative of the executive branch or the corresponding local body of self-governance, authorized by the Cabinet of Ministers to conclude a concession agreement (“Concessioner”), is responsible for organizing and holding a concession tender if more than one investor applies for a concession grant. This includes approving the terms and conditions of the concession agreement; forming the concession tender and its procedure; preparing the tender documentation; determining the size of the registration fee; confirming the submission of applications; providing the tender candidates with all necessary information and documentation for preparing bids; deciding to include or preclude tender candidates (noting the grounds for refusal); and informing the tender candidates about the acceptance or refusal to include them in the tender.

If the Concessioner refuses to accept an application to participate in a concession tender, he must inform the applicant on the grounds for refusal. Such grounds may be the failure to include any necessary information in the application, as well as incomplete information or the inclusion of false information. If an application is received by the Concessioner after the submission period has expired, the Concessioner can refuse to review the application and will return it to the applicant at the applicant’s own expense. Importantly, if only one investor submits an application to participate in a concession tender, a concession agreement may be concluded with the investor without holding the concession tender.

In order to participate in a concession tender, an applicant must pay a registration fee, which can range from one to ten non-taxable minimum incomes. The applicant must transfer the registration fee via bank wire, as cash is wisely not accepted. These funds are used for preparing the concession tender procedure and will not be returned to the applicants who are not chosen for the concession grant.

Procedurally, all applications, documents and materials sent by candidates are reviewed within 90 days from the day an application is submitted. Candidates have the right to introduce changes to their offers or to withdraw their applications entirely before the end of the 90-day review term. Any changes submitted must take place no later than 15 days before the period for review expires.

A tender commission is formed to review applications, documents, and materials submitted by candidates. The tender commission compares the candidates’ offers with the terms and conditions of the concession tender, determines their compliance and selects the best conditions offered by the candidates to carry out the concession. Naturally, the candidate who offers the best conditions for effectuating the concession is deemed the winner of the concession tender based on the conclusions of the tender commission, with subsequent approval by the Concessioner.

Thereafter, notice must be sent to the winner of the concession tender no later than 5 days from the day the winner is decided with the confirmation that the winner (hereinafter the “Concessionee”) has the right to conclude a concession agreement based on the terms and conditions offered in its application.

V. The Concession Agreement

As discussed above, the winner of the tender earns the right to carry out concession activities on the basis of a concession agreement. The parties to the agreement are the winner of the tender and the State body granting the

given object for concession. The term of concession activity must be defined in the agreement, but can be for no less than 10 years and no more than 50 years. Of course, the parties are free to later amend the term of the agreement within the 10-50 year time frame.

Although contracts in Ukraine may be drafted under the principle of “freedom to contract,” as with any law in Ukraine, the concession law defines a number of terms and conditions which must be included in concession agreements. These so-called essential terms and conditions include:

- a) the parties to the agreement;
- b) types of activity, work and services carried out according to the terms and conditions of the agreement;
- c) the object of concession (inventory and value of the property or technical and financial conditions for creation of the object of concession);
- d) the terms and conditions of granting a land parcel, if it is necessary for carrying out the concession activity;
- e) the list of types of activities, which are subject to licensing;
- f) the conditions for establishing and changing the price (tariffs) for manufactured (granted) goods or services by the Concessionee;
- g) the effective term of the concession agreement, the terms and conditions of hiring and using Ukrainian labor;
- h) the terms and conditions for the use of national (Ukrainian) technology, machinery, raw materials and other materials;
- i) the terms and conditions and improvement needs of the object of concession, as well as the procedure for compensating such improvements;
- j) the terms, conditions, size and procedure for making concession payments;
- k) the procedure for use of depreciation (amortization) deductions;
- l) the restoration of the object of concession and the terms and conditions of its return;
- m) the obligations of the parties (and liability for non-fulfillment);

- n) insurance by the Concessionee of the objects taken for concession;
- o) the procedure for extending and terminating the agreement; and
- p) the procedure for settling disputes between the parties.

The parties may agree upon other terms and conditions to be added into the concession agreement, including those provided by specific laws on concession activity in other spheres of economic activity.

If the concession activity calls for the use of a land parcel, a lease agreement or relevant act on granting the use of a land parcel must be affixed to the concession agreement. Note that the terms and conditions of concession agreements remain valid throughout the term of the agreement, even if subsequent legislative acts create worse conditions for the Concessionee. Additionally, the reorganization of a Concessionee may not be grounds for changing the terms and conditions of a concession agreement.

According to the terms and conditions of the concession agreement, the Concessionee must pay a concession payment for the right to create, construct or otherwise administer objects granted for concession. Concession payments are transferred directly to the state budget or the relevant local budget. If the concession object is somehow damaged or generates low profits but has important social value, the Concessioner can discount the concession payment or provide for subsidies, compensation or privileges in the concession agreement.

Concession agreements, involving objects still under state ownership, must be registered with the State Property Fund (the “SPF”). The state body, authorized to conclude the concession agreement, is responsible for informing the SPF that the finalized concession agreement can be entered into the registry of concession agreements. If the concession object is under communal ownership, then the concession agreement must be registered with the relevant local council along with a corresponding notification to the SPF.

Accordingly, on January 18, 2000, the Cabinet of Ministers passed Resolution No. 72 “On the Register of Concession Agreements,” which approved the procedure for registering concession agreements and the procedure for maintaining the concession agreement register. Resolution No. 72 provides that the SPF is responsible for maintaining such register.

Pursuant to Resolution No. 72, the authorized state body must submit an application to register a concession agreement within five (5) days after the

signing of such agreement. If the concession object is under communal ownership, the application must be submitted to the register within five (5) days after the concession agreement is registered with the executive committee of the relevant local council of people's deputies. The concession agreement itself must also be submitted along with the application.

The registration application must provide a description and value of the property to be granted for concession, its location, the type of entrepreneurial activity for which the concession is granted, the address and telephone number of the parties to the concession agreement, as well as the identification code of the Unified State Register of Enterprises and Organizations (for legal entities) or the tax identification number of the State Register of Physical Entities/Taxpayers (for physical entities/natural persons).

Concession agreements can be terminated for a number of reasons, such as the expiration of the term for which they are concluded, the liquidation or bankruptcy of the Concessionee by court decision, or the destruction of the concession object. The parties may also mutually consent to the termination of a concession agreement. Unilateral termination is also possible, but only if a court of law or arbitration court rules that the other party failed to fulfill its obligations.

Upon termination, the Concessionee must return the concession object to the Concessioner under the terms and conditions provided in the concession agreement. The Concessionee must compensate the Concessioner for the deterioration or destruction of the concession object, unless the Concessionee can prove that the destruction or deterioration of the concession object occurred through no fault of its own. On the other hand, the Concessioner must compensate the Concessionee for any improvements to the concession object made at the Concessionee's own expense. Likewise, any costs for concession objects created by the Concessionee, which are not compensated for as a result of the concession activity, must be compensated by the Concessioner.

Any disputes arising from concession agreements will be considered by a court of law. If one of the parties to the concession agreement is a non-resident, any disputes arising out of the concession agreement can be considered by an international arbitration court, at the venue stipulated in the agreement.

VI. The Rights and Obligations of the Parties

On the one hand, the Concessioner has the right:

- to effectuate control over the adherence to the terms and conditions of the concession agreement;

- to grant the exclusive right to construct or manage the concession object;
- to demand premature termination of the concession agreement upon violation of its terms and conditions by the Concessionee; and
- to demand compensation for damages resulting from the fault of the Concessionee.

Consequently, the Concessioner is obligated:

- to transfer the object of concession to the Concessionee in the condition and within the term provided by the concession agreement;
- to present the complete documents provided by the concession agreement in a timely manner to the Concessionee, which confirm the right of the Concessionee to create (construct) and/or exploit the concession object;
- to demand a report on the use of depreciation (amortization) deductions;
- to preserve the commercial secrets of the Concessionee;
- to refrain from interfering in the economic activity of the Concessionee; and
- if a parcel of land is necessary for carrying out the concession activity, to ensure the granting of the land parcel complies with the procedure established by the Land Code of Ukraine.

On the other hand, the Concessionee has the right:

- to carry out the concession activity;
- to construct or manage the concession object exclusively (if so provided in the concession agreement);
- to demand termination upon violation of the terms and conditions of the concession agreement by the Concessioner;
- to extend the concession agreement upon fulfillment of its terms and conditions;
- to receive payment for goods produced as a result of the concession activity;

- to use depreciation deductions for restoration of fixed assets received for concession; and
- to attract third parties to fulfill special or technical work on the concession object. Interestingly, if third parties are hired to perform specific work, the Concessionee bears full liability for any work done by such third parties.

Accordingly, the Concessionee is obligated:

- to fulfill the terms and conditions of the concession agreement;
- to conclude labor agreements (employment contracts) in accordance with Ukrainian legislation (as a rule, preferentially with employees who are Ukrainian citizens);
- to use technology, materials and machinery of national manufacture on the object of concession, unless otherwise provided by the terms and conditions of the agreement;
- to maintain the object of concession in the proper technical condition; and
- to return the concession object to the Concessioner in sound technical condition, in accordance with the terms of the agreement, after expiration of the concession agreement's term.

The Concessionee can carry out concession activity in any legal form available under Ukrainian legislation. The transfer of concession objects to the Concessionee does not entail the full transfer of ownership rights to such objects to the Concessionee, however, nor does it terminate the rights of state or communal ownership for such objects. Consequently, any property the Concessionee utilizes in its concession activity remains under state or communal ownership.

Any property acquired by the Concessionee during the fulfillment of its obligations, however, belongs to the Concessionee and can be transferred to the Concessioner upon expiration of the concession agreement in accordance with the terms and conditions of Ukrainian law and the concession agreement. Likewise, the Concessionee holds the ownership rights to profits and production received as a result of the concession activity. If the concession object is improved by the Concessionee, at its own expense, the object still remains under State or communal ownership but the Concessionee's expenses are compensated, unless otherwise provided in the concession agreement.

As owners, the state or communal body granting a concession bears the risk of accidental destruction or damage of the concession object, unless the parties otherwise agree in the concession agreement. The Concessionee, however, must insure any property granted for concession in favor of the Concessioner or other participant in the concession who bears the risk of accidental destruction or damage.

Property received for concession is included in the balance of the Concessionee/legal entity with an indication that such property is received for concession purposes only. If the Concessioner does not transfer the concession object in a timely manner and according to the terms and conditions of the concession agreement, the Concessionee can demand immediate transfer of the concession object and the compensation of damages caused by the delay of transfer. Alternatively, the Concessionee can terminate the concession agreement and seek compensation for damages due to the non-fulfillment of the terms and conditions in the concession agreement.

VII. Conclusion

The above Law provides clearly written terms and conditions of concession agreements while extending to foreign companies the possibility of entering into concessions. If the provisions of this Law are actually utilized, certain concession objects may give a foreign company a natural monopoly without the need to seek additional permission from the Antimonopoly Committee of Ukraine. Because the above types of activities are either currently absent or poorly developed, foreigners who effectuate concession activities in Ukraine have the unique possibility of running a stable business at minimal expense and taking part in monopoly-like activities.

A final note relates to the newly passed Civil and Economic Codes, which both provide for so-called "commercial concessions". Commercial concessions are defined as the transfer into use on a payment basis of a complex of rights for purposes of the manufacture and/or sale of a certain type of good and/or provision of services. Since commercial concessions are not closely related to concessions under the Law, we deal with the topic of commercial concessions in a separate publication.



LAW “ON PRODUCTION SHARING AGREEMENTS”

I. Introduction

In the past, Ukrainian mineral resources were rich and plenty, but the primitive Soviet-era extraction methods and lack of investments led to poor quality and mind-boggling waste. Still, many opportunities for mineral extraction can be found in Ukraine today. Because of Ukraine's desperate need for money, we are witnessing a renewed balancing act in attracting foreign investment as President Kuchma struggles to bring the mineral extraction business up to date while simultaneously attracting cash for the state budget.

Foreign investors have been interested in exploring Ukraine's natural resources since Ukraine won its independence in 1991. Until now, however, no clear and transparent mechanism existed that would allow foreign investors to assist Ukraine in extracting the raw product while gaining a profit. Often investors were not even allowed to freely export their share of extracted minerals for sale on the world market. Finally, on September 14, 1999, President Kuchma signed Law No. 1039-XIV “On Production Sharing Agreements” (the “Law”).

Below, we review the Law and analyze its applications for foreign investors.

II. Discussion

A. Overview

The Law governs relations between investors and the State connected with the exploration, extraction and/or production of mineral resources. Its main purpose is to create favorable conditions for foreign investors, while developing and modernizing mineral production on the territory of Ukraine, its continental shelf and its maritime economic zones. The scope of this Law is quite broad and still requires numerous supporting instructions, but it is a precedent which requires review.

Ukrainian production sharing agreements are very similar to the western understanding of concession agreements, whereby a government grants specific privileges to investors to effectuate the development of natural riches or other economic resources over which the government usually exercises a monopoly stranglehold. The Law grants privileges to investors to extract minerals and export the final products for sale abroad and/or on

the Ukrainian market. Investors can be Ukrainian and/or foreign citizens and legal entities. The only condition is that such investors have the appropriate qualifications, including the technical and financial capabilities necessary to extract and process the mineral resources. Potential investors must submit various documents, issued in the investors' country of registration, confirming these capabilities.

The Law called for the Cabinet of Ministers to create a so-called Interdepartmental Commission, empowered to supervise the organization, execution and implementation of production sharing agreements. The Interdepartmental Commission (the “Commission”) is comprised of representatives of the State, bodies of local self-governance and local councils people's deputies (where required). If necessary, the Commission may enlist production and scientific experts, as well as other experts and consultants.

The Law defines a production sharing agreement as a written agreement, entered into between the State and an investor (or several investors) for a specified term, to carry out prospecting, exploration and extraction of mineral resources in areas designated by the State as having mineral deposits ready for extraction. Under the Law, the foreign investor undertakes to extract, transport, treat, store, process and perform any other obligations provided for in the agreement at its own risk and expense. In turn, the investor shall be compensated for its costs and expenses with a portion of the extracted materials, designated for sale at a profit.

The extracted raw materials are typically shared amongst the parties to a production sharing agreement and fall into one of the following three categories:

- 1) “extracted products,” defined as the total volume of the products extracted pursuant to a production sharing agreement, which are delivered to a designated point of measurement where the extracted minerals are divided between the parties;
- 2) “compensation products,” defined as part of the production which is transferred directly to the ownership of the investor as compensation for the costs and expenses for extracting the mineral resources; and
- 3) “profit products,” which comprise the portion of the production which is shared between the State and the foreign investor and is determined as the difference between the produced and compensation products.

As an additional incentive for entering the Ukrainian market, the State guarantees to provide the foreign investor with (i) all of the necessary

consents, quotas, permits and licenses to use the mineral resources, (ii) the relevant acts for mining allocation, (iii) documents evidencing the right to use land and (iv) other permits related to the activities contemplated by the production sharing agreement. The specific deposit sites available for development by foreign investors will be disclosed in the “List of Mineral Resources (Deposits) Sites Which Can be Provided for Use Pursuant to Production Sharing Agreements” (the “List”).

Prospective investors are encouraged to apply to the Cabinet of Ministers or the Commission with their suggestions to include a specific deposit site into the above List. Inclusion of a specific mineral deposit site is effectuated according to various criteria, including, but not limited to:

- a) the inability to gain profit from significant mineral sources, the conservation or liquidation of which can lead to negative social consequences and financial losses;
- b) the absence of state financing and technical means for the development of new, significant mineral sources which are necessary for the social development and economic security of Ukraine;
- c) the necessity for special, high-priced technology to process significant resources which are difficult to extract;
- d) the necessity for providing regions with local fuel-energy and mineral raw materials, the extraction of which would create new jobs in regions where employment of the population is at a low level; and
- e) the necessity of developing mineral deposits which can be processed only under difficult conditions.

The Law guarantees that the List cannot be changed in relation to mineral deposits for which production sharing agreements have already been concluded or which the Cabinet of Ministers or the Commission are currently negotiating. Furthermore, once the winner of a tender for a production sharing agreement on a mineral deposit has been declared, these mineral deposits cannot be excluded from the List. Currently, several foreign investors are in preliminary negotiations concerning mineral deposits, in order to make sure that the targeted deposits are on the List.

B. The Process

The Cabinet of Ministers holds tenders for specific deposits, which have potentially profitable mineral content, and the eventual winner of the tender has the right to enter into a production sharing agreement with

the State. Fortunately, a tender is considered valid if at least one (1) investor submits an application to participate and fulfills all of the terms and conditions of the tender.

Note that production sharing agreements may be concluded without a tender in respect to parcels with insignificant reserves of minerals. If the relevant state bodies conclude that such reserves are in fact “insignificant,” the Cabinet of Ministers and the relevant body of local self-governance may agree to enter into a product sharing agreement without holding a tender. Additionally, if an investor who has an existing license to use mineral resources has already begun its activity and wishes to conclude a production sharing agreement, the agreement may be concluded without a tender according to the relevant decision of the Cabinet of Ministers.

As previously noted, all tenders are held pursuant to the decision of the Cabinet of Ministers of Ukraine. Accordingly, the Law sets forth the procedure for holding a tender and the requisite information to be included in the announcement of tenders by the Cabinet of Ministers. For instance, the announcement must contain information such as the terms and procedure for holding the tender, the identity of the specific mineral deposit and the conditions which the parties taking part in the tender must meet. These conditions include the term for fulfilling the work, the minimal amount of investment, the production sharing terms, the obligations of the State, environmental protection measures, the deadline for applications, the tender fee amount, the required background and technical documents, the address to which documents must be submitted by investors and the banking requisites for transferring the tender fee.

The initial terms and conditions of the tender are developed by the Commission, based on various technical and economic calculations, which are then approved by the relevant local body of self-governance (at the actual mineral deposit site). Within two (2) months of the decision to hold a tender, the Commission must prepare the necessary tender documents and publish an announcement concerning the tender in the Ukrainian official publications and foreign mass media.

The period between the publication of the announcement and the deadline for submission of applications for participation can be no less than three (3) months, thereby assuring that all interested parties have the opportunity to participate. The period for holding a tender should not exceed three months from the expiration date of the deadline for application submissions, which should expedite the process considerably.

First and foremost, any investor interested in participating in a tender must submit the application to take part in the tender in accordance with

the terms and conditions contained in the announcement. This application must include standard information about the investor. For instance, if the potential investor is a Ukrainian *citizen*, then the full name, citizenship, residency and specialty of the investor are required. If the investor is a *legal entity* or *association of legal entities*, the address, country of registration, principle type of activity as provided in the entity's Charter and the size of the entity's authorized capital must be included.

All of the above information must be confirmed by properly executed documents. The application also requires a brief description of the investor's work experience in the field of mineral deposit exploitation. Additionally, the investor must present documentation confirming its technical and financial ability to undertake the work outlined in the production sharing agreement, as well as information on the technology to be applied in carrying out the tasks.

Along with the application, the investor must present a work program for the targeted mineral deposit. Similar to a business plan, the program must set forth the investor's intended steps in fulfilling the conditions of the tender, any measures aimed at protection of the mineral deposit and the surrounding environment, as well as a complete description of the work to be done from commencement to completion. Finally, the investor must include the amount and type of its projected investment, any additional proposals regarding the conditions of the tender and any other information that should be included in the tender's terms and conditions.

The Commission registers all applications on the day of their receipt and evaluates all of the registered applications and any additional proposals contained therein. The Commission is also responsible for preparing and submitting to the Cabinet of Ministers its conclusions and suggestions, which should greatly assist the Cabinet with its final selection of the winner. Theoretically, the Cabinet of Ministers selects the winner on the basis of the Commission's evaluation and findings.

Article 7 of the Law provides a list of criteria that is used to determine the winner of the tender. These criteria include:

- a) the most rational work program submitted by the investors;
- b) the most effective technological decisions of the investors;
- c) the most optimal measures for protection of the environment;
- d) the most attractive terms and conditions of investment;

- e) the international experience of the investor(s), if any; and
- f) sufficient financial security.

Based on the above criteria, the winner is announced in the official publications of Ukraine and a corresponding notice is sent to each participant in the tender.

C. Negotiating a Production Sharing Agreement

The final production sharing agreement must be signed with the winner within twelve (12) months from the date of publication of the tender results. Upon written request of the investor, this period may be extended for six (6) months. This timeframe is fairly realistic because the investor must prepare an action program, containing the realistic terms for performance, the volumes and types of available financing, the required technical equipment and other details, which all must be set forth in the final production sharing agreement.

Specifically, the Law lists up to 30 principle terms and conditions which must be included in production sharing agreements. Required terms and conditions of production sharing agreements include, among others:

- a) the names and requisites of the parties;
- b) a complete legal/technological description of the mineral deposit;
- c) the plans for re-cultivation of the land after the work has been completed;
- d) future uses for the mineral resources;
- e) a labor program;
- f) the quality requirements and projected volume of extracted minerals;
- g) the rights and obligations of the parties;
- h) the procedure for determining the value of the extracted minerals;
- i) the measurement point (referred to below);
- j) the procedure and conditions for the distribution of profit products between the State and the investor;

- k) the procedure for transferring ownership rights to the extracted products;
- l) the procedure for obtaining a part of the profit products by the investor;
- m) the procedure for transferring ownership rights to property from the investor to the State;
- n) the procedure for controlling the mineral extraction;
- o) the procedure for amending, terminating and extending the agreement;
- p) the environmental and worker safety measures; and
- q) the procedure for dispute resolution.

Naturally, the parties to a production sharing agreement are free to agree upon additional terms and conditions as well. Any appendices attached to the agreement (i.e., plans, tables, calculations, rules and norms) also become an integral part of the agreement.

The Ukrainian government, however, has not given free reign to foreign investors in choosing the providers of services and their employees. The Law specifically provides that investors are obligated to give preference to Ukrainian production, works, services and other materials, taking into consideration price, term of execution and quality in accordance with international standards. Further, Ukrainian citizens must be given priority in filling employment positions to assist in the exploration, exploitation and production processes. The investor must also provide training for Ukrainian employees hired to undertake the work described in the production sharing agreement.

In addition to the aforementioned terms and conditions, if a production sharing agreement contemplates the extraction of hydrocarbon raw materials or deposits with considerable mineral reserves, the agreement must reflect a significant number of other details. This additional information includes:

- a) an annual declaration of extraction characteristics;
- b) the procedure and specific details concerning expenses for industrial and technological needs;
- c) obligations regarding the utilization of gas and gas condensation, and the terms for performing such work;

- d) the procedure and assessment terms of the level of pollution to the environment;
- e) the volume, value and terms for effectuating measures for protection of the environment;
- f) the terms and conditions for responsible protection (custody) of the State's share of the extracted minerals; and
- g) the insurance conditions (including exclusive risk conditions), among others.

If more than one investor is a party to a production sharing agreement, the investors must appoint a so-called "Operator" to represent their interests in dealing with the State. In this case, the production sharing agreement must determine the legal status of the Operator, its obligations before the other participants, the procedure for conducting mutual relations through the Operator, and the terms and conditions for terminating participation by one or more investors. The Operator is responsible for managing the entire project, including accounting and reporting. Significantly, all of the investors are liable jointly and separately for the actions of the appointed individual entity.

The winner of the tender must produce the first draft of the production sharing agreement in the Ukrainian language. In certain situations, the drafting of the agreement can be delegated to the Commission via a decision of the Cabinet of Ministers. This draft must be finalized within three (3) months from the date of the official publication of the results of the tender. The first draft must be registered with the Commission. If a production sharing agreement will be concluded for a long term (i.e., more than ten (10) years) or will involve substantial capital investments, the drafts are subject to mandatory state examination of financial, legal, environmental and other issues. Otherwise, such examination is normally undertaken only upon request by one of the parties.

Within three (3) months, the Commission must present the investor with its comments, conclusions and examination results or, alternatively, a new version of the draft production sharing agreement. The investor may complete the draft agreement using the Commission's conclusions, or prepare its own comments regarding the new draft. Thereafter, the most recent version of the draft is once again reviewed and, this time, agreed upon by all parties.

Within six (6) months from the date of registration of the first draft, a party, at its own initiative and expense, may request additional or repeat

examination of issues which were not initially agreed upon by the parties. If the investor so desires, it may appeal to a well-known, international, non-governmental organization or a special scientific/technical organization with a request to examine the various issues that still require additional substantiation.

After completing the final draft of the production sharing agreement, and after the relevant (local or regional) body of self-governance where the deposit is located approves the agreement, the final version is once again registered with the Commission and sent to the investor for its signature. The agreement is then signed by the authorized representatives of the investor and the Cabinet of Ministers, acting on behalf of the Ukrainian government.

The production sharing agreement is presented to the foreign investor in its final form in both the Ukrainian and English languages. The party who drafts the agreement is responsible for providing the English translation of the final version of the agreement. Both English and Ukrainian versions are given equal legal force, and the authenticity of the copies is ensured by the Cabinet of Ministers itself. The Commission is responsible for registering the final version of the production sharing agreement according to the procedure established by the Cabinet of Ministers. The Law clearly provides that no payment for state registration of production sharing agreements is collected from the investor.

Cases involving multilateral agreements with several investors or participants, where such co-investors will bear joint responsibility for the fulfillment of their obligations under the agreement, can become problematic. Granted, the Cabinet of Ministers can easily procure all necessary documents, permits and licenses in the names of all the investors. Instead, the negotiations may become protracted because each investor must separately voice its agreement to the final version of the production sharing agreement. If any investor refuses to accept the final version of the agreement, it can be then be concluded by the remaining investors with the appropriate changes to the text of the agreement.

D. Mandatory Terms and Conditions of Production Sharing Agreements

The term of production sharing agreements cannot exceed fifty (50) years. Upon the consent of the Cabinet of Ministers and the relevant body of local self-governance, however, production sharing agreements can be extended, provided the investor has performed all of the obligations within the first term of the agreement. Such extensions are effectuated via additional agreements, under which the terms of the licenses

and other permits issued for performance of the original production sharing agreement are simultaneously extended.

The State reserves the right to terminate the agreement and demand compensation if the investor does not commence fulfillment of the agreement within the term provided in the production sharing agreement. Similarly, the Cabinet of Ministers reserves the right to limit or temporarily prohibit (suspend) the use of minerals or terminate the production sharing agreement in the event of the appearance of a direct threat to the life and/or welfare of the population or environment. The agreement can be renewed to the full extent only after the investor removes the threatening conditions.

Production sharing agreements may also be prematurely terminated in accordance with the procedure contained in the agreement. Both the extension and the premature termination of a production sharing agreement must be registered according to the same procedure as the state registration of the original agreement.

Importantly, investors who take part in production sharing with the State, as well as their contractors, are not subject to licensing and quotas while importing equipment, materials, machinery and other property (owned or leased thereby), in order to carry out the work envisioned in a production sharing agreement. Likewise, such property may be exported from Ukraine without being subjected to the licensing and quota regime.

Minerals, extracted under the auspices of a production sharing agreement, are shared between the State and the investor(s) on a quarterly basis, unless otherwise provided in the agreement, and are divided according to the procedure outlined in the agreement. However, the quarterly portion of the minerals extracted for compensation may not exceed seventy percent (70%) of the total amount of minerals extracted for that quarter until the investor has been compensated in full for its costs and expenses. As stated above, these minerals are used only to compensate for the exploration of a deposit, which occurs after the production sharing agreement is signed.

The State remains the owner of the extracted minerals until the moment they are “shared” between the parties in accordance with the procedure contained in the production sharing agreement. This means that the investor is prohibited from selling the extracted products prior to the “sharing” between the parties, unless the investor obtains written consent from the State (and the other parties to the agreement, if applicable).

As mentioned above, production sharing agreements must contain detailed provisions describing the terms, conditions and procedure for:

- a) determining the total volume and value of the extracted products;
- b) determining the portions of the compensation products;
- c) dividing the profit products between the State and the investor; and
- d) transferring the portion of the extracted products to the State (or its cash equivalent).

Conveniently, the Law provides certain requirements for calculating the costs and expenses subject to compensation by the State to the foreign investor. Compensation products are distributed to the investor according to the following requirements:

- a) only the costs and expenses incurred by the investor after the execution of the agreement are compensated;
- b) the composition of the costs and expenses may differ from existing legislation on compensation of costs and expenses included into gross production and turnover costs;
- c) compensation must be carried out no later than the first quarter of the project, unless otherwise provided by the agreement; and
- d) compensation is effectuated via the transfer of ownership rights to the compensation products to the investor.

Upon the distribution between the parties of the extracted products at the so-called measurement point (i.e., the place where the raw materials are split among the parties), the investor acquires full ownership rights to the compensation products and a specific amount of profit products (as provided in the production sharing agreement). The Ukrainian government retains ownership of any remaining extracted products, which may be used or sold in accordance with the relevant procedure of the Cabinet of Ministers, taking into account the specific needs of the territory in which the mineral deposit is located.

The Law specifically provides foreign investors with the right to freely dispose of their share of the extracted products, unless otherwise agreed upon in the production sharing agreement. According to the Law, free disposal includes sale in Ukraine, export, exchange, gratuitous transfer and "other operations regarding such products." As an incentive, the quota and licensing regime for export and similar restrictions do not apply to such products even if they are sold in Ukraine.

If the terms and conditions of the tender and the agreement call for exclusive sale of the products within the territory of Ukraine, the investor may insist on a price no lower than the existing price of such products on international markets. Rest assured, however, such restrictions may only be applied if they flow from the original tender for the mineral deposit (i.e., these restrictions cannot come from the production sharing agreement alone).

Any property acquired by the investor to effectuate the production sharing agreement remains under the ownership of such an investor, but can be transferred to the Ukrainian government at an agreed-upon price, payable in compensated product. In such cases, the ownership rights transfer from the investor to the State on the date when the value of such property is fully compensated by the extracted products or on the date of termination of the activity of the production sharing agreement. After the transfer of the ownership rights to the State upon product sharing, and in case the activity of the production sharing agreement continues, the investor has the preferential right to continue using such property to carry out the work stated in the agreement.

Not surprisingly, any geological, geographical, technical, financial or any other related information obtained by the investor concerning the deposit, including samples of the extracted minerals, is deemed the property of the State. The investor must provide the State with all data and information gathered during the project so that they may carry out independent examination, registration and accounting of such information. Both the State and the investor are held liable for any disclosure of confidential information gathered during the term of a production sharing agreement.

E. Tax and Customs Issues

During the life of the production sharing agreement, the collection of general state and local taxes and duties from the investor is substituted with the sharing of the extracted products between the State and the investor. Such substitution, however, does not mean tax exemption. Interestingly, as discussed below, the payment of profit tax and VAT is not necessary if the foreign investors' share of production is exported from Ukraine for sale on international markets.

Naturally, foreign investors must pay a profit tax, according to a specific procedure established by the Cabinet of Ministers. Upon demand by the investor, the relevant tax authorities must provide official confirmation of the profit tax payment no later than (10) calendar days from the date of demand. The basis for taxation of the investor is the investor's profit products, which are taxed at a 25% rate. The profit tax may be paid in-kind if the production sharing agreement provides for such a payment procedure.

If the investor decides to sell its share of the products in Ukraine, then 20% value added tax will apply under the procedure provided by effective legislation on the date the production sharing agreement was executed. Investors may choose to pay the value added tax in-kind, in an amount equivalent to the tax amount. Payment is credited to the state budget under the procedure and mechanism determined by the Cabinet of Ministers.

If, however, the foreign investor wishes to export its profit products from Ukraine, value added tax will be applied to such exported products at a zero rate. Further, upon exportation of the investor's share of production, no customs payments (except customs fees), excise tax and other taxes and mandatory payments are due.

In sum, the 20% value added tax and the 25% profit tax are only the beginning. Additionally, foreign investors must pay a duty for geological exploration performed at the expense of the state budget, mandatory social security contributions for its Ukrainian employees and foreign citizens hired for work in Ukraine, the state pension insurance for employees and foreign citizens hired for work in Ukraine, and any other payments for use of mineral resources as set forth in the production sharing agreement.

Importantly, any goods (works or services) and other material valuables imported into Ukraine by an investor under the production sharing agreement, and which are provided for in the agreement itself and approved by the Cabinet of Ministers, are exempt from customs payments (except customs fees) and value added tax. In case such equipment or goods are not used for the purposes designated in the agreement due to the fault of the investor (or its subcontractors, deliverers, carriers and other counteragents), the investor (or the entity at fault) pays the full amount of value added tax and import duty.

These above-mentioned import/export terms and conditions apply to the legal entities (contractors, subcontractors, etc.) who also participate in the implementation of the production sharing agreement on the basis of contracts with the investor. Notably, however, the other tax "privileges" given to the investor by the Law do not apply to the investor's counteragents (who remain subject to the usual tax regime). Finally, a repatriation tax is not withdrawn from income earned by foreign investors under production sharing agreements.

F. Miscellaneous Issues

Investors may transfer their rights and obligations under a production sharing agreement to third parties, in part or in full, provided that the Cabinet of Ministers consents to such transfer and that such entity has sufficient

financial and technical resources, as well as experience in undertaking the necessary activities. The Cabinet must give substantial grounds for its refusal to transfer an investor's rights and obligations in a production sharing agreement to any third parties. If the Cabinet does not respond to an investor's request to transfer its rights and obligations to a third party within ninety (90) days of the receipt of such a request, then it is deemed to have automatically granted its consent.

The transfer of rights and obligations to a third party must be effectuated in writing, according to the same procedure provided in the Law for state registration of the original production sharing agreement. The agreement with the third party becomes an integral part of the original production sharing agreement. In the event that a Ukrainian investor transfers its rights and obligations to a foreign investor (physical or legal entity), the foreign investor has the right to request a more precise specification of the terms and conditions of the production sharing agreement, taking into account the benefits of the latest foreign investment legislation in Ukraine (if any).

An important feature of the Law for foreign investors is the State's guarantee that the rights and obligations in a production sharing agreement will be governed by the Ukrainian legislation in effect at the time the agreement is signed. That is, subsequent legislation will not negatively affect the terms and conditions of the original agreement. Naturally, this guarantee does not apply to any changes in legislation related to issues of national defense, national security, securing civil order and environmental protection.

In another attempt to side-step the infamous Ukrainian bureaucracy, the Law provides that investors will not be subject to the normative and legal acts of executive and local bodies of self-governance if such acts restrict an investor's rights as provided in a production sharing agreement. However, investors are still subject to any directive orders of state supervision bodies over the use of mineral resources, which are issued in accordance with Ukrainian legislation for purposes of creating a safe working environment, protection of mineral resources, environmental protection and the general health of the population. Such directives are mandatory for any investor even though they may lead to restrictions, temporary or permanent, or termination of the production sharing agreement.

The Cabinet of Ministers oversees the implementation of production sharing agreements, assuring that some income actually reaches the state budget. This authority may be delegated to the Commission or to the local body (bodies) of the central executive branch of the government. At least once every five (5) years, the Cabinet of Ministers, with the participation of the Commission, must organize and carry out a complete examination of whether the parties are in compliance with the terms and conditions of

the agreement. If any violations are discovered during the examination, the Cabinet of Ministers can annul the agreement and demand compensation of damages. To conduct such an examination, the authorized representatives of the Cabinet of Ministers have the right to unrestricted access to work sites and all documentation related to completed work.

It is the investor's responsibility to ensure full compliance with the terms and conditions of the production sharing agreement by any contractors, subcontractors or other organizations independently hired by the investor. Both parties bear responsibility for failure to perform or improper performance of their obligations as set forth in the agreement.

Foreign and Ukrainian investors alike are liable for any environmental damage caused by the investor, unless such investor can prove that the damage was caused by natural disaster or through no fault of its own. If the investor is unable to prove that the damage was caused through no fault of its own, the investor must reimburse the damages in full, regardless of any prior payments for pollution of the environment and the deterioration of natural resources. In cases when damage is caused as a result of legitimate activities performed in compliance with a production sharing agreement, and the Commission has given its prior consent to such activities, the State and the investor are liable in the proportion provided in such agreement.

Investors are required to obtain insurance for any possible civil liability, including environmental damage or any hazards to the health of the local population, unless otherwise provided in the production sharing agreement. The Law also provides for the possibility of including an ecological risk insurance program directly into the framework of the agreement.

The State and investor(s) are free to decide upon a dispute resolution procedure and venue in a production sharing agreement. If no choice of law and forum is made, all disputes will be subject to review by a Ukrainian court of law. To carry out the activities provided in a production sharing agreement, the investor (and its agents) must open a bank account in Ukrainian currency and/or foreign currency with a Ukrainian bank. This account is to be used exclusively for servicing the activities foreseen in the production sharing agreement.

Finally, foreign investors who wish to employ foreign or Ukrainian employees for the work anticipated in a production sharing agreement must do so via employment contracts, which must meet the form and content requirements of Ukrainian labor legislation. Fortunately, foreigners hired for special positions determined by production sharing agreements may carry out their duties without obtaining the infamous "employment permits."

III. Conclusion

After ten long years since Ukraine achieved its independence, it appears that the Ukrainian government has finally recognized that its underdeveloped natural resources can be a source of profit for the State if extracted properly. As a result, foreign investors are suddenly encouraged to use their innovations and technology to earn a profit for themselves while assisting in the growth of the Ukrainian economy. Unless a political decision alters the current climate, this match should lead to a more promising future for Ukrainian mineral and energy-related business transactions.

D LAW "ON FINANCIAL LEASING"

I. Introduction

Rather than become party to a joint venture, foreign investors (and Ukrainians) have the option of leasing their property to Ukrainian entities under the protection of a well-drafted lease agreement.

Originally, the Law of Ukraine No. 723/97-VR "On Leasing," dated December 16, 1997, provided for two forms of leasing, operative and finance, depending on the final goal of the leasing (i.e., buyout or return). On December 11, 2003, the President of Ukraine signed amendments to the law on leasing effectively removing the concept of operative leasing from Ukrainian legislation. The amendments re-named the law as the Law of Ukraine No. 1381-IV "On Finance Leasing" (the "Leasing Law"). Notwithstanding the substantial amendments, the Leasing Law still allows foreign lessors to work with Ukrainian residents through a clearly defined legal regime rather than the off-shore structures and various customs loopholes that were previously used to lease property to Ukrainian residents (e.g. agreements on joint cooperation and/or production).

This article briefly describes leasing in Ukraine and the legal principles governing its implementation.

II. Discussion

The Leasing Law provides that under an agreement on finance leasing a lessor acquires into ownership an object from a seller or supplier in accordance with the conditions and specifications determined by a lessee and transfers such object for use by the lessee for a specified term of no less than one year on a payment basis.

A more detailed review of the Leasing Law reveals that a foreign lessor may let out any unused fixed assets defined by specific characteristics. Although almost all kinds of property can be subject to a leasing arrangement, a few exceptions exist. For example, land plots, natural objects and unified property complexes of enterprises and their structural subdivisions (branches, departments, etc.) may not be the subject of a leasing agreement. The Leasing Law also yields to the Civil Code of Ukraine with respect to its provisions on leasing, rent, sale-purchase and supply.

Leasing agreements are usually concluded between three parties, a lessor, a lessee and a seller (supplier). The lessor can be any legal entity

transferring the right of possession and use of an object to a lessee. The lessee may be a legal entity or natural person receiving the right of possession and use of an object from a lessor. A seller is defined as a legal entity or natural person from which a lessor acquires an object, which will be subsequently transferred to a lessee. Other legal entities or natural persons may become party to a leasing agreement in certain cases.

Formerly, the Leasing Law provided for two types of leasing: finance leasing and operating leasing. Operative leasing was defined as "a leasing agreement under which, as a result of its conclusion, a lessee, at its own order, receives a lease object from a lessor for non-gratuitous use and for a period of no less than the period for which 90% of the value of the lease object is depreciated." This type of leasing was abolished upon the passing of the amendments to the Leasing Law on December 11, 2003

The Leasing Law, however, now provides for sub-leasing, which allows for a lessee under a leasing agreement to lease an object to a sub-lessee for use on a payment basis for an agreed upon term under a sub-leasing agreement. In this case, all claims of the sub-lessee toward the seller transfer to the lessee, who must subsequently deal with the seller itself in case any issues arise. The lessee must obtain written consent of the lessor to transfer an object into sub-lease and the provisions of the leasing agreement will apply to the sub-leasing agreement, unless the leasing agreement provides otherwise.

As previously mentioned, a leasing agreement must be in writing and contain all of the material terms and conditions provided by the Leasing Law, including:

- 1) the subject of leasing;
- 2) the term for which the lessee is granted the right to use the leased object;
- 3) the size of the leasing payments;
- 4) other terms and conditions pursuant to which the consent of at least one of the parties must be achieved upon demand.

A lessee may opt out of a leasing agreement unilaterally if the lessor fails to transfer the leased object within 30 days unless the leasing agreement provides for another transfer term. In this case, the lessee may demand the compensation of damages and the return of any leasing payments made to the lessor. From its side, the lessor may opt out of a leasing agreement if the lessee failed to pay the leasing payments in part or in full and the delay of payment is more than 30 days. In this case, the lessor may refuse the leasing agreement pursuant to an indisputable procedure only on the basis of an endorsement of a notary.

If the ownership rights to a leased object are transferred to a third party, the rights and obligations of the lessor under the leasing agreement transfer to such third party as well. The parties may also provide for the sale of the leased object upon the payment of the full price for the object pursuant to a sale-purchase agreement. A leased object may not be confiscated or arrested in connection with the lessee's actions or omissions to act.

Under a leasing agreement, the lessor has the following basic rights:

- 1) to invest in the acquisition of an object for leasing either with its own funds or with attracted and borrowed funds;
- 2) to inspect the observance by the lessee of the terms and conditions of use of the leased object and its maintenance;
- 3) to opt out of a leasing agreement in the cases provided by the leasing agreement and by law;
- 4) to demand the termination of the agreement and return of the leased object in cases provided by law and the leasing agreement;
- 5) to execute collection from the lessee of delayed indebtedness pursuant to an indisputable procedure on the basis of an endorsement of a notary;
- 6) to demand from the lessee the compensation of damages in accordance with the law and the leasing agreement; and
- 7) to demand the return of the leased object and the performance of monetary obligations under a sub-leasing agreement directly in case of the non-performance or delayed performance of monetary obligations by the lessee under the leasing agreement.

In turn, the lessor has the following basic obligations:

- 1) to provide to the lessee, within the term provided by the leasing agreement, the leased object in the condition fit for its purpose and pursuant to the terms and conditions of the agreement;
- 2) to notify the lessee regarding known special properties and deficiencies of the leased object, which may present danger to the life, health and property of the lessee or other entities or may cause damage to the leased object during its use by the lessee;

- 3) to timely and fully perform the obligations with respect to the maintenance of the leased object in accordance with the terms and conditions of the leasing agreement;
- 4) to compensate to the lessee expenses for the improvement of the leased object, for its maintenance or for the removal of defects pursuant to the procedure and in the cases provided by law and/or the leasing agreement;
- 5) to accept the leased object in case of the premature termination of the leasing agreement or in case of the expiration of the term of its use.

On the other hand, the lessee has the following basic rights:

- 1) to choose the object for leasing and its seller or to establish its specifications or authorize the lessor to choose;
- 2) to refuse to accept the object for leasing if it is not fit for its purpose and/or does not meet the terms and conditions of the leasing agreement or its specifications;
- 3) to demand the termination of the leasing agreement or opt out of the agreement in the cases provided by law and the leasing agreement;
- 4) to demand from the lessor the compensation of damages caused by the non-performance or improper performance of the terms and conditions of the leasing agreement.

And, the lessee has the following basic obligations:

- 1) to accept the leased object and use it in accordance with its purpose and the terms and conditions of the leasing agreement;
- 2) to timely and fully perform the obligations for the maintenance of the leased object and keep it in the proper condition in accordance with the terms and conditions of the leasing agreement;
- 3) to timely pay leasing payments;
- 4) to grant the lessor access to the leased object and provide the possibility to carry out inspections of the conditions of its use and maintenance;
- 5) to inform the lessor and, within the guarantee term, the seller of the leased object in writing regarding all malfunctions, break downs or errors during the operation of the leased object;

- 6) to inform the lessor in writing regarding the violation of the terms for conducting or the failure to conduct regular and seasonal technical servicing and regarding any other circumstances, which may negatively affect the condition of the leased object, immediately, but no later than the second working day after the appearance of the above-mentioned events or facts, unless otherwise established by the leasing agreement;
- 7) to return the leased object in the condition in which it was accepted into possession, taking into account normal wear and tear, or in the condition agreed upon in the leasing agreement in case of the expiration of the term of leasing, the premature termination of the leasing agreement and in other cases requiring the premature return of the object.

Both the lessor and the lessee may possess other rights and obligations pursuant to the leasing agreement, the Leasing Law or other legislative acts. The lessor and the lessee may also agree upon the technical servicing of the leased object under a separate service agreement. In certain cases, the leased object may be subject to registration.

Once the leased object is transferred into the possession of the lessee, the risk of accidental damage or destruction of the object will transfer to the lessee unless otherwise provided by the leasing agreement. The leased object may be subject to insurance under Ukrainian legislation or pursuant to the leasing agreement and the lessee is responsible for paying for insurance unless otherwise provided by the leasing agreement.

During the leased object's use by the lessee, the lessee is responsible for maintaining the object in the proper condition and is responsible for the maintenance expenses in connection with its use, technical servicing and repair unless the parties to the leasing agreement agree otherwise. If the lessee wishes to improve the leased object, it must obtain the consent of the lessor or the improvements will be subject to removal if such removal is possible without damaging the object. Any improvements made with the consent of the lessor are subject to compensation of their value or the cost of improvements may be taken into account in the leasing payments.

The amount and procedure of leasing payments must be set forth in the leasing agreement. Leasing payments may include an amount which compensates a part of the value of the leased object, remuneration to the lessor for the property received into leasing, compensation of interest under a loan and other expenses in direct connection with the performance of the leasing agreement. Finally, the leasing agreement must provide for a dispute resolution procedure (either local or international) and amortization deductions (normal or accelerated).

III. Conclusion

For many years, foreign entities have had the right to lease their equipment to Ukrainian residents, which allows them to earn profit without creating a legal entity. Acknowledging the harsh reality of doing business in Ukraine, the Leasing Law provides legal protection against various unpredictable actions of Ukrainian counterparts by allowing the foreign lessor to legally terminate its leasing agreement with a Ukrainian partner in case of misuse of the leased property. It also sets forth a general framework for the return of the leased property or full compensation if the leased property somehow disappears at the hands of the Ukrainian parties.

E LAW “ON BANKS AND BANKING ACTIVITIES”

I. Introduction

The old Law “On Banks and Banking (Activities)” (the “Old Banking Law”) was adopted during the heyday of Ukraine’s independence in 1991. Like other antique laws, the Old Banking Law was drafted on the basis of Soviet banking legislation, which was incompatible with the theories of an open market economy.

The ongoing political and economic changes that have taken place since the adoption of the Old Banking Law in 1991 resulted in innumerable amendments, revisions and supplements (over 30 times). All efforts to patch up the Old Banking Law’s flaws failed. Comprised of only fifty-four articles, of which less than forty were in force, the Old Banking Law has become obsolete and ineffective even in terms of the limited issues purportedly covered thereby, including its terminology and definitions. Thankfully, the majority of issues, which should have been covered by the Old Banking Law, were delegated instead to a multitude of supporting legislative acts (e.g., instructions, regulations, resolutions and decrees).

As Ukraine enters the 21st century, it faces the formidable task of adopting a comprehensive and transparent banking law. Ideally, such law would encompass the lessons learned from past mistakes and provide a comprehensive (and transparent) regulation for the banking sector. Of course, the new banking law should also correspond to the worldwide standards of banking regulation.

In order to accomplish these goals, a new version of the Law “On Banks and Banking Activities” (the “New Banking Law”) was successfully passed by the Ukrainian Parliament on December 7, 2000. Not surprisingly, adoption of the New Banking Law by the end of 2000 was, among others, one of the conditions of the World Bank’s \$100 million Financial Sector Accommodation Loan to Ukraine. Signed by the President of Ukraine on January 11, 2001, the New Banking Law entered into force six days later upon its official publication on January 17, 2001.

Below, we discuss the New Banking Law’s impact on Ukraine’s banking system.

II. Discussion

Drafted by the National Bank (the “NBU”), and further elaborated by the Parliamentary Committee governing financial and banking issues, the New Banking Law, in comparison with its predecessor, is three times larger, with a total of 99 articles comprised in 16 chapters and organized in seven sections. A cursory review of this document reveals that the prevailing goal of the New Banking Law is to maintain Ukraine’s banking system via strict control over all commercial banks. At the same time, the Law introduces utterly new provisions, which, if implemented as intended, will bring Ukraine closer to the world standards of conducting banking business operations.

A. Major Novelties of the New Banking Law

One of the first departures of the New Banking Law is the new opportunities offered for existent and prospective banks with respect to organizational forms, selecting a certain field of specialization, and forming banking groups and corporations. For example, in addition to the classic joint stock and limited liability companies, the New Banking Law introduces a new possible form for banks, the cooperative bank. According to Article 8 of the New Banking Law, a cooperative bank can take deposits only from its members. One of the hurdles, however, is that a cooperative bank must have at least fifty (50) members; if the number of bank members falls below the 50-member mark, the bank has one year to bring its membership up to the minimally required number or terminate its activities.

Generally, the cooperative banking system is aimed at promoting mutual crediting among farmers and other agricultural institutions. Whether these good intentions will achieve their goal, or suffer the fate of other financial experiments in Ukraine (i.e., trust companies in the mid-nineties), depends on the practical application of subsequent legislation (i.e., instructions), which would supervise and control these unproven financial institutions.

As to the field of specialization, the Law sets forth that a bank may operate either as a universal bank or a specialized one. According to Article 4 of the New Banking Law, a bank acquires the status of a specialized bank if more than 50% of its assets are of the same nature or origin. Further, a bank acquires the status of a specialized savings bank if more than 50% of its liabilities are deposits of physical persons. Pursuant to the New Banking Law, four types of specialized banks may be established: savings banks, investment banks, mortgage banks or clearing banks. The difference between the above types of specialized banks and universal banks are described in the New Banking Law.

For example, according to Article 50 of the Law, an investment bank, unlike any other bank, is not required to obtain written authorization from the NBU in order to conduct investment activities, including investment in legal entities if the amount of investment does not exceed 5% of the bank's regulative capital, investment in legal entities exclusively providing financial services or the regulative capital of the bank fully complies with the requirements for investment established by the National Bank. An investment bank is also free from the limitation imposed by the New Banking Law on the amount of direct or indirect participation of a non-investment bank in other legal entities. Under the New Banking Law, a non-investment bank's participation in a legal entity may not exceed 15% of the value of its total capital. Additionally, the New Banking Law provides that the aggregate amount of all investments of a non-investment bank may not exceed 60% of the value of its total capital. In contrast, the above mentioned limitations do not apply to investment banks.

Another advantageous provision set forth in the New Banking Law relates to savings banks. According to Article 48, a specialized bank may not receive deposits from individuals in an amount that exceeds 5% of its total capital. This rule, however, does not apply to savings banks. Generally, analysts believe that the introduction of specialized banks will facilitate the accumulation of financial resources and help channel the flow towards the economy's first areas of priority (e.g., investments in capital construction/building, etc.). Once again, however, the realization of these goals will depend on the practical implementation of subordinate acts, which could make specialized banking attractive for Ukrainian banks.

The introduction of the banking groups/unions, such as banking corporations, bank holding groups or financial holding groups, is also new to Ukrainian banking laws. Article 9 of the New Banking Law allows banks to participate in only one banking group/union. Thus, if a certain bank participates in a banking corporation, it is prohibited from joining any other banking groups (e.g., bank holding group, financial holding group or any other banking corporation) unless, of course, such bank first withdraws from the said banking corporation.

The New Banking Law further defines each type of banking group and provides the minimal amount of requirements as to such group's establishment and operation. Specifically, a banking corporation is defined as a legal entity, the founders and shareholders of which are exclusively banks. One of the banking corporation's goals is concentrating its participants' capital and increasing their general liquidity and financial soundness. Banks participating in the formation of a banking corporation must vest this corporation with the powers to conduct certain financial facilities, as well as provide a centralized exercise of certain functions (e.g., settling payments, establishing correspondent accounts, monitoring credit risks, etc.).

Much like a banking corporation, a bank holding group may be formed by banks only. Unlike a banking corporation, however, a bank holding group is not a legal entity but rather a contractual union of banks where a main bank (i.e., a parent bank) executes control over the rest of its members (i.e., subsidiary banks) via possession of no less than 50% of such other member banks' authorized capitals or voting rights. Importantly, the subsidiary banks retain their legal and operational independence within the framework laid down by the charter and agreement on the formation of the bank holding group.

Unlike the previous types of banking groups, members of a so-called "financial holding group" need not all be banking entities. According to Article 12 of the New Banking Law, a financial holding group must consist mainly or exclusively of institutions that provide financial services. This provision implies that members of a financial holding group may belong to the financial sector (though not necessarily the banking sector) while others may be from a non-financial sphere. However, the New Banking Law requires that the parent company of a financial holding group must be a financial institution and at least one bank must participate in the group. Finally, much like bank holding groups, more than 50% of each participant's share capital in a financial holding group must belong to the parent company.

An overall analysis of the relevant provisions of the New Banking Law regarding banking groups reveals that the drafters tried to implement ideas, which mirror the concepts of financial groups and bank holding companies in the West. Although it is highly unlikely that these provisions will be put into practice by Ukrainian banks anytime soon, they still serve as good legal foundation for further development of Ukraine's banking system.

B. Supervision of the Banking System

Much like any other country, Ukraine implements control over its banking system via relevant legislative norms governing the issues of a bank's registration, operation and liquidation. Until recently, however, this sector of Ukrainian legislation was notoriously under-developed because of the lack of relevant provisions in the Old Banking Law itself, which yielded legal governance over the banking sector to innumerable and constantly changing subordinate acts.

Some of these supportive acts contained loopholes that allowed a commercial bank to misuse deposits, leading many seemingly reliable banks (such as Gradobank and Inkobank) to the brink of collapse. Other banks were simply impregnable to any bankruptcy procedure. In fact, up to 50 banks, which ceased to operate years ago, still continue to formally exist due to deficiencies in the current bankruptcy legislation.

Unlike its predecessor, the New Banking Law envisages a comprehensive framework for the registration, operation and liquidation of any bank. For example, an entire section of the New Banking Law deals with bank registration only. It covers a wide array of issues associated with registration, licensing or reorganization of banks, as well as the establishment of branches and representative offices or foreign participation in the Ukrainian banking business.

Section III of the New Banking Law sets forth the requirements as to the bank's capital requirements and management; provides the rules and limits on transactions with the bank's clients and affiliated persons, and envisages the legal procedure for conducting direct investments and disclosing confidential information. Section IV stipulates the procedure for conducting banking supervision by the NBU, as well as accounting, reporting and auditing requirements and measures for avoiding money laundering. Finally, Section V of the New Banking Law is dedicated to the liquidation procedure for banks, which, unlike its predecessor, facilitates and accelerates the liquidation procedure for the NBU and bank creditors.

Without going into all of the details and aspects of these provisions, we focus on some of the new aspects, which are vital in terms of their legal consequences.

1. New Registration Requirement

Article 14 of the New Banking Law contains a new hurdle that could be difficult for some individuals to overcome: founders, participating in a bank, must have a completely clean business reputation and a stable financial status. In this connection, and well-aware of who they are regulating, the lawmakers introduced new terms for banking activities (i.e., "substantial participation" or "business reputation") which are further defined in the text of the New Banking Law.

Accordingly, "substantial participation" implies a direct or indirect, sole or joint possession of 10% or more of a legal entity's authorized capital or voting rights or, irrespective of formal possession, the ability to substantially influence the governing body or activity of such legal entity. Further, "business reputation" is determined as the aggregate of confirmed information regarding a person, which enables one to make conclusions regarding the professional and managerial qualities of such person, his/her overall reputability and the compliance of his/her activity with the requirements of law.

Notwithstanding the above definitions, the New Banking Law fails to determine the criteria whereby a business reputation can be defined as

"clean" or "spotty." Further, the Law omits the definition of "financial status," and how such status may be regarded as "stable." Fortunately, Article 14 of the New Banking Law provides that the NBU is entitled to further define the requirements as to the founders' or participants' business reputation and their financial status. Importantly, this provision grants the NBU indirect authority to revise the activity of even non-banking enterprises (i.e., those which become founders and/or participants of a bank).

Article 18 of the New Banking Law provides that the NBU may reject the state registration of a bank on the basis of, among others, "insufficient proof of a high business reputation or the inappropriate financial status of any of its founders." Unfortunately, the New Banking Law vaguely defines "insufficient proof," "high business reputation" and many other terms, thereby allowing its representatives to subjectively exercise their discretion in defining such terms themselves.

2. Bank's Capital, Operation and Reporting Requirements

Issues regarding a bank's capital, management and day-to-day operation requirements are addressed Section III of the New Banking Law. One of the major breakthroughs in this regard is Article 30 of the Law, which, for the first time in Ukraine's banking history, defines the legal meaning "bank capital," as well as its components. Accordingly, a bank's capital consists of the principal capital and additional capital. Principal capital includes the bank's authorized capital, disclosed reserves and risk-covering funds, while additional capital includes non-disclosed and reappraisal reserves, subordinated debt and hybrid capital instruments.

At the same time, the New Banking Law empowers the NBU with the right to adopt resolutions that would include other components into the bank's additional capital requirement. Generally, the provisions of Article 30 of the Law are progressive in terms of future perspectives because many of the intricacies provided therein are not currently practiced by Ukrainian banks, however they are expected to be applied in the future as Ukraine's commercial banking continues to develop.

The most debated provisions of the New Banking Law in the Parliament dealt with the minimum authorized capital requirement. Initially, the minimum authorized capital was expected to be five times more than the current requirement (i.e., in the amount equivalent to approximately 5 million Euro instead of the currently effective 1 million). The primary objective of such provision was to consolidate Ukraine's banking system by forcing small banks either to form banking groups/unions among themselves or to join the larger banks.

Thus, the minimum authorized capital for banks is set forth as follows: (a) regional cooperative banks – Euro 1 million; (b) commercial banks which operate in certain regions or oblasts – Euro 3 million; and (c) banks operating over the whole territory of Ukraine – Euro 5 million. The NBU may also set up a differentiated minimum authorized capital requirement for certain banks. Such differentiated amount will depend on the bank's specialization but may not be lower than the above-listed figures.

Once again, Article 32 stipulates that a bank's authorized capital cannot be formed from "unconfirmed sources." Although the main goal of this provision is to prevent illegally accumulated funds from being channeled into legitimate businesses, the New Banking Law is still unclear as to the procedure for confirming any sources. Thus, the New Banking Law practically leaves this issue at the full discretion of NBU officials. Another curious provision deals with bank secrecy requirements. Unlike its predecessor, the New Banking Law provides the concise definition of the term "banking secret" and, more importantly, defines the documents and information that fall under this term, identifies the state bodies that can obtain access to such secrets and describes the circumstances.

Information related to legal and physical entities, which is deemed to contain a banking secret, may be revealed by banks as follows:

- 1) upon a written request or written permission of the owner of such information;
- 2) upon the written demand of a court of law or pursuant to a court decision;
- 3) to the prosecutor's office, the state security service, the Ministry of Internal Affairs or the Antimonopoly Committee — upon their written demand regarding operations with bank accounts by a specific legal or physical entity, which is a subject of entrepreneurial activity for a concrete period of time;
- 4) to the state tax authorities upon their written demand regarding issues of taxation or currency regulations regarding operations with bank accounts by a concrete legal or physical entity, which is a subject of entrepreneurial activity for a concrete period of time;
- 5) to a specially authorized state body for issues of financial monitoring upon its written demand regarding financial operations, which are subject to financial monitoring pursuant to legislation on the prevention of and countermeasures against the legalization (laundering) of incomes received by criminal means;

- 6) to state enforcement bodies upon their written demand regarding issues connected with the status of bank accounts of a concrete legal entity or physical entity, which is a subject of entrepreneurial activity. This last point was added pursuant to Presidential Decree No. 835-IV, dated May 22, 2003.

On a related note, according to Article 62 of the New Banking Law, banks are required to report to the state authorities about any person that carries out an operation, which has a so-called "doubtful character." Such provisions exemplify the Ukrainian government's efforts to prevent its banking system from facilitating the money laundering process. As proof of this effort, the New Banking Law was substantially amended on February 6, 2003 to bring its text into compliance with the Law of Ukraine No. 249-IV "On the Prevention of and Countermeasures Against the Legalization (Laundering) of Incomes Received by Illegal Means," dated November 28, 2002. These amendments introduced new internal financial monitoring rules for banks, very specific rules regarding the identification of clients during all transactions and the right of the National Bank to inspect banks at least once a year for compliance with the legislation against money laundering. As presently drafted, many provisions in the New Banking Law lack the necessary precision to determine whether a transaction is "unusual", "tangled/complicated" or "economically unjustified." This problem, like many others, will most likely be addressed in future legislation.

C. Inspection and Liquidation of a Bank

This section of the New Banking Law is the most voluminous and, surprisingly, the most developed. A careful analysis of this section of the Law reveals that the adoption of the New Banking Law substantially strengthens the NBU's position, enabling it to thoroughly control the Ukrainian banking system by adding to its already substantial powers. Of course, this would be a surprise if not for the fact that the New Banking Law was initially drafted within the walls of the NBU itself, which closely observed and participated in even the smallest changes to the text in the Parliament.

According to Article 73 of the New Banking Law, the NBU is entitled to discharge bank officials or deprive bank founders (participants) of their voting rights if such persons are merely accused of criminal charges. This provision, which may seem rather positive at first glance, remains absolutely silent as to what happens if the charges against the bank official/founder (participant) are lifted. At the very least, it does not contain a provision whereby the NBU would be required to revoke or automatically annul its decision. Further, Article 72 gives the NBU the right to inspect bank founders (participants) if the NBU's officials somehow conclude that such founders (participants) are not in compliance with the requirements of the New Banking Law.

Overall, the NBU is vested with vast authority to supervise banks undergoing financial hardships or liquidation. In the latter case, the NBU appoints a receiver/liquidator who is empowered to reject creditor claims if he has doubts as to the validity of such claims. In case of financial hardships, the NBU appoints a provisional administration consisting of NBU officials. In reality, this is simply another way of delegating full management over the bank to the NBU. In fact, the NBU may appoint an acting administration if the bank manager is accused of criminal activity regardless of whether such accusations are subsequently deemed unfounded. Perhaps the most infringing provision, however, is set forth in Article 81 of the Law, in which the acting administration is given the right not only to manage the bank, but to annul the bank's commercial operations which were carried out as far back as three years ago.

The Law only reveals the tip of the enormous iceberg that is "the powers of the NBU." Undoubtedly, strong and thorough control over commercial banks is justified by the necessity to protect the financial system as a whole, especially when recalling the reasons behind some of the infamous bankruptcies that occurred in the past decade (such as the collapses of Inkobank and Gradobank). Although the New Banking Law clearly seeks to legitimize all banking operations and wipe out corruption in business transactions, it may serve to undermine one of the main principles of banking, confidentiality between a bank and its clients.

III. Conclusion

In an effort to establish a comprehensive legal framework for Ukraine's banking system, the Parliament passed the New Banking Law. As compared with its predecessor, the New Banking Law has more concise definitions than its predecessor (e.g., bank, banking, banking operations). It also introduces a higher capitalization requirement and a procedure for a more thorough regulation and supervision of the Ukrainian banking system (admittedly not free of its own peculiarities). All in all, the New Banking Law takes into consideration both positive and negative experiences in seeking to consolidate, and somehow bring order into, the often mysterious activities of Ukrainian banks.

F UKRAINIAN INSURANCE INDUSTRY

I. Introduction

Prior to the adoption of the Law of Ukraine No. 2745-III "On Introduction of Amendments to the Law of Ukraine 'On Insurance'" (the "Insurance Law"), dated October 4, 2001, by the Ukrainian Parliament, foreign insurance companies found that doing business in Ukraine independently was impossible due to the 49% limitation on foreign ownership of Ukrainian insurance companies. Finally, the above-mentioned amendments to the Insurance Law lifted this discriminatory limitation and allowed foreign insurance companies to freely carry out their intended activities in Ukraine. In effect, foreign insurers are able to form fully controlled companies or possess a controlling interest in joint insurance companies in Ukraine.

The insurance market in Ukraine started in 1991. The number of insurance companies operating in Ukraine has fallen since 1994, when there were more than 700. However, this reduction had a positive effect, as insolvent companies and pseudo-insurance firms have been removed from the insurance market. This process was in part the result of legislative regulation of the insurance business, strengthening of state control over the insurance market and tougher requirements for the size of insurance companies' authorized funds.

In Ukraine, unfortunately, confidence in the insurance sector was seriously undermined within 1991-1997, when many Ukrainian insurance companies went bankrupt. At the same time, the potential of Ukraine's insurance market is rather high. According to expert estimates, in Ukraine today only approximately 10 percent of risks are insured, while in most countries, this figure is 90-95 percent.

The domestic insurance market is developing dynamically and is one of the few sectors of the Ukrainian economy that has been able to boast of a steady growth in turnover over the last couple of years. Over the last three years, the insurance market has continued to develop very fast with a 2-3% growth each year. However, certain key domestic insurance incentives are still missing, such as mortgage insurance and mandatory motor liability, which may potentially boost the market with the inflow of premiums from rank and file people.

Ukrainian Insurance Market Indicators

(All figures in UAH million unless otherwise indicated)

INDICATORS	1995	1996	1997	1998	1999	2000	% change, 2000 on '99
Insurance premiums	244.4	317.8	408.4	789.2	1,164.1	2,136	+ 83
Claims payments	144.3	147.3	129.2	177.8	360.9	407	+ 13
Loss ratio % (claims/premiums)	59	46	32	23	31	19	—
Formed insurance reserves*	65.2	92.7	159.8	447.7	537.0	819	+ 52.5
Paid authorized funds*	22.6	64.2	118.7	150.6	327.0	531	+ 62

The years 2001, 2002 and 2003 confirmed that the market is becoming healthier, i.e., less companies and higher capitalization. It also demonstrated phenomenal growth which continues to take place. Property insurance volume is growing constantly covering industrial, corporate and personal objects. Even life insurance, which was almost dead within the period of 1996 through 1999, has started to show progress with the introduction of changes in the personal income tax law and the Law "On Insurance".

Type of insurance	2001	2002	2003
	In million Hryvnas	In million Hryvnas	In million Hryvnas
	Premiums – Claims	Premiums – Claims	Premiums – Claims
Personal Lines Insurance	214,8 – 120	281,5 – 149,5	441,1 – 185
Including Life insurance	15,7 – 4,8	23,9 – 2,7	72,9 – 2,6
Property Insurance	2 222,3 – 147,5	3 413,8 – 227,4	7 734,4 – 447,9
Liability	243 – 45,6	341,2 – 54,8	451,3 – 56,2
Mandatory Insurance,	76,8 – 42,3	350,5 – 59,2	459,6 – 124,4
Non-governmental Mandatory	73,6 – 68,7	55,1 – 52,2	48,9 – 47,1
Insurance, Governmental			
Total	3 030,5 – 424,1	4 442,1 – 543,1	9 135,3 – 860,6

Insurance companies, which accumulate huge financial resources, assist in developing various areas of business, in addition to ensuring stable production. Continuous changes in taxation legislation and insurance regulation, however, remain to be key problems for insurance managers, who are unable to make long-term plans.

At the end of 2002, the insurance regulatory and supervisory authority was handed over to the State Commission for Regulation of Financial Services Markets of Ukraine, which was established pursuant to the Law "On Financial Services and State Regulation of Financial Services Markets" by Presidential Decree of December 11, 2002, No. 1153/2002. The Regulation on the Commission was approved by Presidential Decree No. 292/2003, dated April 4, 2003.

The Commission is comprised of five departments headed by Directors, who are members of the Commission. These departments include:

1. The Department for the State Regulation and Development of Financial Services Markets;
2. The Insurance Supervision Department;
3. The Credit Union Supervision Department;
4. The Financial Institution Supervision Department;
5. The Non-State Pension Fund Supervision Department.

The Commission has issued Instructions approving each department's Regulations and defining their tasks, terms of reference and powers. The main tasks of the Commission as a whole and its departments within the terms of reference provided by law include:

1. To implement unified and effective state policy regarding the provision of financial services;
2. To elaborate and implement market development strategies for financial services;
3. To exercise state regulation and supervision over the provision of financial services and compliance with the law in the industry;
4. To ensure consumer protection in the industry by enforcing law in order to prevent or stop violations on financial services markets;

5. To generalize application practices of financial services legislation in Ukraine, and to develop and propose improvements in the legislation;
6. To introduce internationally-accepted market development rules for financial services;
7. To perform state financial monitoring of financial services markets in order to ensure implementation of the Law of Ukraine "On Prevention of Money Laundering;"
8. To facilitate integration into European and world financial services markets.

Today, as of April 2004, the total number of insurance companies that are licensed and regulated by the State Commission is 357, of which 30 provide life insurance services. Among these 30 there are well established Ukrainian and foreign companies, including the fast growing local AIG — Alico Life.

Local insurance companies today have two tasks before them: (i) to eliminate the negative attitude that most people have towards insurance, and (ii) to disseminate more information about their services. Below we provide you with the legislative analysis of this emerging sector of the Ukrainian economy.

II. Discussion

A. Overview

The creation and operation of insurance companies, including companies with foreign ownership, are regulated by the Laws "On Insurance," "On Economic Associations," "On the Foreign Investment Regime," "On Profit Taxation of Enterprises" and other legislative acts. In combination, these laws set up a system whereby any person may insure any proprietary interest permissible under Ukrainian legislation.

Specifically, Article 1 of the Insurance Law governs the legal protection of individuals and legal entities in case of insured accidents. Depending on the type of insured object, insurance may be divided into one of the following categories: (i) *personal* (insurance of proprietary interests associated with life, health or labor capabilities); (ii) *proprietary* (insurance of proprietary interests connected with the possession, use and disposal of property); and (iii) *liability* (insurance shielding an individual or company against liability for certain acts resulting in damage to any third party or its property).

Furthermore, insurance may be either voluntary or obligatory. Voluntary insurance is documented by an agreement between the insurer (i.e., insurance company) and the insured. The general principles and terms and conditions of voluntary insurance are described in the insurance rules, which are established independently by each insurance company. Specific terms and conditions of voluntary insurance should be defined in the insured individual's personally tailored agreement.

The terms and conditions of mandatory insurance are set forth by the relevant legislative acts. Mandatory insurance is usually required for companies or individuals who perform acts which are potentially dangerous either to themselves or to those for whom they perform services (e.g. doctors, sportsmen, firemen, soldiers and officers and construction workers). In most cases, an individual is free to choose the insurance company, unless otherwise provided by applicable laws.

B. Legal Forms of Insurance Companies

Regarding the creation of new insurance companies, the founders must keep in mind that Ukrainian law mandates specific legal forms for insurance companies. Insurance companies must have at least three participants and can structure themselves only as:

- 1) a joint stock company;
- 2) a general partnership;
- 3) a limited partnership; or
- 4) a company with additional liability.

Importantly, the amended Insurance Law prohibits the creation of insurers by way of re-profiling existing enterprises, even if such re-profiled enterprises will meet all requirements of Ukrainian law.

As briefly mentioned above, currently, foreign investors may have a majority ownership in Ukrainian resident insurance companies. This is significant because a minority 49% ownership stake by a foreign investor only gives such an investor the right to receive dividends and exercise control over a limited amount of strategic issues as the resolution of most issues requires more than 51% of votes of the participants. In other words, thanks to the amendments to the Insurance Law, foreign participants are able to freely adopt so-called "fundamental" decisions, which include the all-encompassing right to amend the charter of the company and to terminate the activity of the company, among others.

C. Insurance Intermediaries

Some foreign insurance companies, however, prefer to reinsure risks already insured in Ukraine rather than directly providing insurance services in Ukraine. Such foreign insurers typically carry out reinsurance activities through reliable Ukrainian insurance companies and, in most cases, are satisfied with the level of their Ukrainian activities.

Reinsurance activities may also be carried out with the assistance of reinsurance brokers. Ukrainian law expressly allows foreign reinsurance brokers to provide intermediary services associated with the reinsurance of risks insured in Ukraine by foreign re-insurers. However, foreign reinsurance brokers may only render intermediary services in Ukraine through permanent representative offices, which must be registered in accordance with Ukrainian legislation. Note that the right to render reinsurance brokerage services is granted only to those brokers, who are duly certified and are entered into the State Register of Reinsurance Brokers.

On the April 29, 1999 the new Regulation On Special Terms of Activity of Insurance Brokers was approved by Resolution No. 747 of the Cabinet of Ministers of Ukraine (the "Regulation"). The Regulation provides for mandatory certification and registration of insurance brokers in the State Register of Insurance Brokers. In 2004 and 2005, the State Commission for the Regulation of Financial Services Markets of Ukraine plans to amend certain documents, which currently regulate the activity of intermediaries, and even propose a specific law, which will govern the activity of agents and domestic and foreign brokers operating in Ukraine.

Both certification and registration of insurance brokers is performed by the State Commission for Regulation of Financial Services Markets of Ukraine. Non-resident insurance brokers are permitted to provide their services only through their permanent establishment in Ukraine, being registered as a taxpayer in accordance with the Ukrainian legislation.

1. Certification of Insurance Brokers

Certification is arranged through attending an appropriate academic course or the passing of a relevant test by insurance brokers' managers, which must be confirmed by the respective Certificate of Improved Insurance Education. Education, testing and issuance of certificates shall be performed by appropriate educational establishments having the respective license of the Ukrainian Ministry of Education.

2. Registration of Insurance Brokers

According to the Regulation, all insurance brokers registered as subjects of business activity along with non-resident brokers performing their activity on the territory of Ukraine are subject to registration in the State Register of Insurance Brokers. The State Register of Insurance Brokers contains the following characteristics of insurance brokers: identification, classification, informative data, registration data and economic data.

In order to be registered in the State Register of Insurance Brokers, insurance brokers must submit to the State Commission for Regulation of Financial Services Markets of Ukraine the following documents:

1. an application for registration in the State Register of Insurance Brokers;
2. a copy of the relevant state registration certificate with the local state authorities;
3. a copy of the certificate of registration with the Ukrainian Ministry of Statistics;
4. a copy of the Certificate of Improved Insurance Education obtained by the relevant insurance broker manager;
5. an economic substantiation of the intended intermediary activity of the insurance broker.

D. Structure of the Authorized Capital of Insurance Companies

As previously mentioned, the Law "On Insurance" was amended and signed by the President on October 4, 2001. These latest amendments provide new requirements for the authorized funds of insurance companies and abolish the ban of 49% ownership of the authorized capital by a foreign investor. From now on, foreign investors may control 100% of the authorized funds of insurance companies.

To minimize the chances of an insurance company's failure to pay its clients due to the lack of available funds, Ukrainian legislation provides rather strict capitalization requirements for insurance companies. Specifically, the total amount of the authorized capital may only be paid in cash. Certain exemptions exist, however. For instance, cash contributions to the authorized capital may be effectuated by contributing state

securities at par value, provided that such contribution does not exceed 25% of the total amount of the authorized capital.

Other assets, including any intangible assets, credits and secured loans, may not be contributed to the authorized capital of an insurance company. Furthermore, cash from the insurance reserve fund may not be used for forming the authorized capital. An insurance reserve fund is created in each company for the purpose of assuring future payments of insured sums, depending on the insurance and reinsurance types.

Limitations also are placed on an insurance company's investment activities. For example, the total amount of an insurance company's contribution to the authorized capital of other Ukrainian insurance companies cannot exceed 30% of its own authorized capital. Further, the amount of investment contributions by an insurance company to each individual insurance company cannot be more than 10%. These limitations, however, are not applied to those non-life insurance companies that make investment contributions to the authorized funds of life insurance companies.

The amended Insurance Law also establishes minimum capitalization requirements for insurance companies, which are harsher than the previously existing minimum capitalization requirements. Currently, the authorized capitals of existing insurance companies must be increased from 100,000 EURO to 500,000 EURO (likewise, insurance companies involved in providing life insurance services must increase their authorized capitals from 500,000 EURO to 750,000 EURO) within 2 years following the effective date of the amended Insurance Law. Further, during the third year after the effective date of the amended Insurance Law, such insurance companies will be required to increase their authorized capitals up to 1,000,000 EURO, while insurance companies which are involved in providing life insurance services must increase their authorized capitals up to 1,500,000 EURO. Importantly, the minimum capitalization requirement of newly-created insurance companies (i.e., insurance companies established after the effective date of the amended Insurance Law), which render insurance services other than life insurance, is one million (1,000,000) EURO, whereas the minimum amount of capital contributions to newly created insurance companies, which are involved in providing life insurance services is one million five hundred thousand (1,500,000) EURO.

E. Types of Insurance-Related Activities

Ukrainian law provides for an exclusive list of activities, which an insurance company may carry out. Such activities include:

- a) insurance;
- b) reinsurance; and
- c) financial activities in connection with the formation, allocation and management of insurance reserves.

An insurance company may also carry out the above activities by providing its services to other insurance companies via joint activity agreements. In addition, an insurance company may also carry out transactions required for the ensuring of its own economic needs.

F. Licenses

In order for an insurance company to begin its insurance activities, it will need to obtain a license from the State Commission for Regulation of Financial Services Markets of Ukraine (the "Commission"). To do so, an insurance company must first file an application with the Commission, along with the following documents:

- copies of the company's founding documents and a copy of its certificate of state registration;
- a bank certificate or audit statement, which confirms that the company's authorized capital has been paid in full;
- a certificate, confirmed by a licensed auditing firm, evidencing the financial status of the insurance company's founders (if the insurance company is established in the form of a general partnership, limited partnership or a company with additional liability);
- the insurance conditions and rules (i.e., policies);
- the economic grounds for planning insurance (reinsurance) activities; and
- information about the founders of the insurance company and the chairman and deputies of the management board; a copy of the diploma of the chief executive or his first deputy, evidencing his or her higher economics or legal education; a copy of the diploma of the chief accountant evidencing his or her higher economics education; and information on the availability of the above certificates if the Ministry of Finance so requires.

As could be expected, the application process is quite lengthy. The Commission has thirty (30) calendar days to review the above documents and decide whether to grant or deny a license to the insurance company. In case of refusal, the Commission must state in writing the reasons for such refusal. Significantly, an insurance company, which receives a license to sell life insurance, does not have the right to carry out any other forms of insurance activities.

G. Taxation

1. Taxation of Resident Insurers

The Ukrainian taxation system is notorious for its instability and constant changes. Each year, several amendments are made to the Law “On Profit Taxation of Enterprises” (the “Profit Tax Law”).

The Profit Tax Law categorizes insurance-related activities as a special type of transaction, subject to a specific tax rate. According to the Profit Tax Law, gross income obtained by Ukrainian resident insurers from insurance activities (except for life insurance) are taxed at a rate of 3%. For taxation purposes, gross income means the amount of insurance contributions and payments or premiums (except for sums of gross contributions transferred into reinsurance) earned by insurers during the reporting period under agreements for insuring and reinsuring risks on the territory of Ukraine or abroad.

Please note again that transactions associated with life insurance are treated (and registered) separately. Income earned by insurance residents from life insurance and reinsurance is generally not taxed. However, if a life insurance agreement is terminated prior to its expiration date, and such termination is not triggered by the death of the insured, then income earned from life insurance activity will be determined as the difference between received insurance payments and the returned buyout amounts, and is taxed at a rate of 3%.

2. Taxation of Non-Resident Insurers

Ukrainian law is highly sensitive about enforcing the taxation of foreign insurance companies earning income from Ukrainian sources. Specifically, current legislation provides that any income obtained by

Ukrainian non-residents from Ukrainian sources as a result of carrying out business activities will be taxed in accordance with the procedure and rates provided by the Profit Tax Law. Income earned by Ukrainian non-residents from Ukrainian sources includes contributions and premiums for insurance or reinsurance against risks in Ukraine (including life insurance) or insurance of Ukrainian residents against risks outside the territory of Ukraine.

Income earned by Ukrainian non-residents in the form of insurance contributions, insurance payments or insurance premiums for risk *reinsurance*, including life insurance on the territory of Ukraine and insurance against risks of Ukrainian residents outside of Ukraine, is taxed at a rate of 15%. It is collected at the source of payment of, and from, such income.

In addition, any income obtained by Ukrainian non-residents in the form of insurance contributions, insurance payments or insurance premiums for risk *insurance* and life insurance on the territory of Ukraine is taxed at a rate of 0% or 15%, at the source of payment of, and from, such income. Income obtained by non-residents for the payment of advertisement services in Ukraine is taxed at a rate of 20%.

H. Accounting Books and Reports

Ukrainian resident insurers must file, on a quarterly basis, their balance statements, profit and loss reports and other information, as approved by the owners of such insurance companies, with the Ministry of Finance. The above reports must be prepared in the manner established by the said Ministry. The Ministry may also require that insurers provide the relevant explanations regarding the above reports. Further, insurance companies must publish their annual balance statements according to the procedure established by the Ministry of Finance. Finally, a licensed auditing firm must confirm the authenticity and completeness of such balance statements.

III. Conclusion

The Ukrainian insurance market is clearly a fast growing child, and requires significant improvements. In more diplomatic terms, the Ukrainian insurance industry has great potential, which remains largely

untapped by Western insurance companies. With nearly forty eight million interested customers, eagerly awaiting the giant foreign insurers and their multi-millions in foreign currency reserves, the potential Ukrainian market is worthy of consideration.

Reluctant as they may be, foreign investors now have a greater opportunity to explore Ukraine's "great potential." Should this occur, undoubtedly, a massive influx of foreign insurers into the Ukrainian market will eventually restructure the existing insurance sector. As always, time and fair competition will demonstrate whether such hopes will be realized in Ukraine.

Frishberg & Partners would like to thank Heath Lambert Group for their invaluable contribution to the insurance section of this book, especially for their knowledgeable additions regarding the current status of the insurance market. Heath Lambert Group can be reached at: Off. 35, 7/10 Lyuteranska St., Kyiv, 01001, Ukraine; tel: (380 44) 490-5908, 490-7328, 496-0851; fax: (380 44) 490-7332; e-mail: office@heathlambert.kiev.ua.

G ARBITRATION/BANKRUPTCY/LIQUIDATION

1. SECURED TRANSACTIONS (COLLATERALS)

I. Introduction

Ukrainian law provides for the classic forms of secured transactions, such as fines, warranties, suretyship, deposit, etc. One of the most effective methods securing a transaction is through the taking of collateral. While secured transactions involving collateral in Ukraine may differ somewhat from the general methods applied elsewhere in the world, transactions secured by collateral in Ukraine allow a creditor to immediately receive the indebtedness owed by a debtor instead of engaging in a lengthy, drawn-out court procedure.

Unfortunately, all too many preventable fraudulent transactions routinely take place in the real estate sector today by employing the inadequacy of the legal and technical infrastructures (i.e., enforcement of laws). In a most basic swindle scheme, an owner uses his real property as collateral to secure a loan from an investor. Later, the same owner sells the real property to a third party and leaves the country without leaving a forwarding address. Amazingly, there is no legal procedure to resolve this common problem with any degree of predictability.

Notwithstanding the relatively low cost (0.1%) of registering a collateral agreement with a notary public, there are other problems, which include mandatory insurance, valuation of the collateral, and the lack of an effective and accessible registration system that could permit reliable monitoring of collateralized property. For information purposes only, the Cabinet of Ministers introduced a registration system of collateralized property on July 30, 1998 via its Resolution No. 1185-98-P. Under this Resolution, the Cabinet approved the Regulation No. 1185 "On the Procedure for Conducting the State Register of Collateralized Movable Property." Obviously, the coming into effect of the new Land Code in January of 2002 also necessitated a register of immovable property subject to collateralization. As a result, the Ministry of Justice approved the procedure for registering ownership rights to immovable property on January 28, 2003 under Order No. 7/5.

The last, but by far not the worst, problem is the registration authorities themselves and their arbitrary decisions. For instance, while the legislation clearly provides that all types of property, including shares of stock, may be subject to collateral, notary publics regularly refuse to execute

collateral agreements that contemplate using shares of stock as a security. The analysis of the relevant legislation, described below, strongly suggests that this area of Ukrainian legislation requires significant improvement.

II. The Law “On Collateral”

The Law “On Collateral,” No. 2654-XII, dated October 2, 1992, as lastly amended on November 18, 2003, generously allows the use of various types of property as security to assure that the parties’ obligations with respect to existing or future claims, in particular claims which arise from loan agreements, sale-purchase agreements, lease agreements, shipment transfer agreements, etc.

On January 12, 1993, the Cabinet of Ministers executed Resolution No. 14 “On Registries of Collateral,” which contained a detailed procedure for the maintenance of collateral registries. For instance, all entries in the collateral registry must be timely, and take place no more than 3 days following a notary’s execution of a collateral agreement. This resolution, however, did not provide for the creation of any depositories, nor any means of effectuating foreclosure in the often likely event of default.

Skipping such minor details, the Law “On Collateral” simply states that in the event a debtor breaches its obligations, its creditor has the right to seek satisfaction by disposing of such debtor’s secured property. As in developed countries, the secured creditor takes precedence over any unsecured creditors in bankruptcy proceedings.

Most forms of property may serve as security, including personal and real property, property rights, production results, etc. Transactions involving foreign investors are usually sufficiently large enough to require real property to serve as security. Therefore, for purposes of this topic, we will concentrate on the issue of using real property as collateral, and the procedure for effectuating the transfer of such real property to the creditor in case the debtor fails to fulfill its obligations.

Generally, any party with real property rights, including legal entities and individuals, may use its land and any construction thereon as security for an underlying obligation. Apartments, unfinished construction buildings and whole industrial enterprises, both state-owned and private (unless undergoing the process of corporatization or the law prohibits their privatization), may be pledged as security under Ukrainian law. Further, by obtaining security rights in freestanding buildings, the creditor also obtains the right to use the land thereunder in the event that such creditor becomes the owner of the real property.

Procedurally, in order to validate a creditor’s legal right to real property located in Ukraine, the parties must execute a security (pledge/collateral) agreement (“Agreement”) before a notary public at the place of location of the said property. The Agreement should contain certain information, such as the names and addresses of the parties, details concerning the underlying obligation, a detailed description of the secured property, etc.

It is advisable to include a provision in the Agreement, requiring a notary to issue an order prohibiting the sale of the secured property at the time of the signing of the Agreement. This order will be documented in the notary’s books and will serve as notice to potential third-party purchasers that the Property is subject to a prior lien. The creditor’s rights arise from the moment of execution of the Agreement by a notary public.

During the term of the Agreement, both the creditor and the debtor have certain rights to the real property. For instance, the creditor has the right to (i) inspect all documentation related to the property and the physical condition of the property; (ii) demand that the debtor repair the property; and (iii) prevent any third party from asserting rights over the real property.

Unless otherwise provided by the Agreement, the debtor has the right to (i) own and use the real property during the term of the Agreement; (ii) fulfill its obligations to the creditor prior to the due date; (iii) sell the property upon the creditor’s prior written consent and transfer the sums owed to the creditor; and (iv) lease the property upon the creditor’s prior written consent.

The debtor, however, has certain obligations with reference to the Property. For instance, the debtor must (i) preserve the condition of the property (e.g. undertake necessary capital repairs, etc.); (ii) insure the property to the benefit of the creditor if the parties agree on the terms and conditions of such insurance or the law provides for mandatory insurance; (iii) in case of the property’s destruction, provide other property, similar in value, or, alternatively, provide the creditor with specific performance of the underlying obligation or a part thereof; and (iv) receive the creditor’s permission to undertake any action that would alter the parties’ ownership rights to the property.

If the debtor fails to preserve the property, the creditor has the right to demand that either the debtor fulfills the underlying obligation or, if necessary, transfers the property in accordance with the Agreement. If the debtor fails to insure the property pursuant to the Agreement, the creditor may demand an immediate execution of the underlying obliga-

tion or, alternatively, the creditor has the right to insure the property at its own cost and seek to recover such expenses from the debtor.

Please note that unless the Agreement specifically provides for transfer to the creditor of all of the debtor's rights to a definite piece of real estate, the property may be sold at a public auction and the proceeds will go toward compensating the creditor. This may present certain problems for non-resident creditors under Ukrainian currency regulations, therefore such matters should be specifically addressed in the Agreement.

Several developments indicate that reforms may be underway in the area of registering and disposing of collateral when debtors cannot meet their obligations. For instance, on October 21, 1997, President Kuchma signed a Law "On Amending the Law 'On Collateral,'" which provides for the creation and maintenance of the State Register of Pledges, and provides that this information must be available to all physical and legal entities. This amendment to the Law "On Collateral" finally came into effect on March 1, 1999.

Soon after President Kuchma signed the above law, on December 22, 1997, the Cabinet of Ministers issued a very helpful Resolution No. 1448 "On the Procedure for Conducting Auctions (Public Trades) to Sell Collateralized (Pledged) Property." This resolution, as lastly amended on August 17, 1998, sets forth various important rules related to the auction process, including the time-frame for conducting auctions, the amount of deposit (10% of the initial value of the collateralized property subject to sale), and the ownership rights to acquired property following purchase at an auction. A detailed discussion of the auction process, however, is beyond the scope of this brief summary.

Finally, on November 18, 2003, the Law of Ukraine No. 1255-IV "On Ensuring the Demands of Creditors and the Registration of Encumbrances" was approved and provided the legal regime for protecting the rights of creditors with respect to moveable property. In addition, Law No. 898-IV "On Mortgages," dated June 5, 2003, came into effect on January 1, 2004 and this vitally important law has created a system whereby Ukrainians are able to purchase real estate on credit terms. Slowly, but surely, the rules governing secured transactions, credit arrangements and real property are taking a cohesive form.

2. UKRAINIAN ARBITRATION SYSTEM

I. Introduction

Companies pray for orderliness and predictability in effectuating their international transactions. Recognizing the general rule that "everything always goes wrong at the worst possible moment," the contracting parties often agree to resolve their disputes with each other in an international, and therefore presumably unbiased, arena.

In an effort to accommodate the business needs of multi-national corporate clients, the world's leading nations have entered into bilateral or multilateral international arbitral agreements. Such agreements set the stage for implementing the accepted international arbitration rules and executing the resulting judgments on a local level.

Similarly, Ukraine has established a forum for international commercial disputes at the Ukrainian Chamber of Commerce and Industry, the rules of which are based on the Law of Ukraine "On International Commercial Arbitration." Actually, the Law of Ukraine "On International Commercial Arbitration" is based on the UNCITRAL Model Law. Additionally, Ukraine adheres to many international agreements previously entered into by the former Soviet Union. For instance, Ukraine is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, and the European Convention on Commercial Arbitration of 1961.

Following the declaration of its independence in August 1991, Ukraine passed comprehensive legislation governing dispute resolution in the context of both domestic and foreign transactions and investments. These laws included the Law No. 1142-XII "On Commercial Courts," dated June 4, 1991 (lost force in February 2002), the Law No. 4002-XII "On International Commercial Arbitration," dated February 24, 1994, the Law "On the Foreign Investment Regime," dated March 19, 1996, No. 93/96-VR and the Law "On Foreign Economic Activities," dated April 16, 1991, No. 959-XII, among others.

Overall, Ukraine's local and foreign arbitration legislation is in accordance with world standards. As in other countries, the parties to international agreements have the freedom to select either the domestic (Ukrainian) national court system or international arbitration in any country (including Ukraine). The final award or ruling can be executed in Ukraine under the 1958 New York Convention, assuming that all parties involved in the arbitration are signatories to that Convention. The biggest problem lies not in the legislation itself, however, but in the issue of practical enforcement of international arbitral decisions.

This chapter examines the various commercial arbitration issues involving foreign investors and Ukrainian entities.

II. Arbitration Options for Foreign Investors

Under Ukrainian legislation, foreign investors may submit disputes for resolution to either (1) the Ukrainian national arbitration courts or (2) any other international arbitration tribunal. The second option can be further separated into two categories: (a) arbitration conducted in Kiev at the Ukrainian Chamber of Commerce and Industry or (b) arbitration held in a third country (e.g., Sweden, Great Britain, U.S.A.)

Recognizing that Ukraine is a young nation without a long history of rendering and enforcing international commercial arbitral awards involving foreign investors, Western parties naturally prefer dispute resolution to take place in a third country, such as Switzerland. Considering the current Ukrainian economic climate, however, decisions concerning the place of arbitration must be made in light of each particular transaction.

For instance, a foreign arbitration provision probably would not serve its intended purpose in a transaction where a private Ukrainian company or an individual cannot afford the arbitration fees and costs. Similarly, a foreign partner in a Ukrainian joint venture that has minimal capitalization or comparatively small project matters may not seek to effectuate such foreign arbitration provision, particularly if the international arbitration took place in a third (and rather expensive) country. Linguistic restrictions and extensive document production may also impact on the choice of the forum for arbitration.

As of January 15, 2002, foreign investors were provided with yet another option for settling any disputes with their Ukrainian counterparts with the coming into effect of Law No. 2860-III "On the Recognition and Enforcement of Foreign Court Decisions in Ukraine," dated November 29, 2001. Law No. 2860 is designed to solve the age-old problem in Ukraine when foreign investors (or other holders of valid foreign judgments) would go through the lengthy process of obtaining a foreign judgment in their favor, only to find that enforcement of such judgment is impossible in Ukraine.

Fortunately, Law No. 2860 broadly encompasses the decisions of most foreign courts involving civil, labor and family matters, as well as those portions of criminal verdicts, which are related to the confiscation of property and the compensation of damages to victims. The Law also applies to the decisions of foreign arbitration courts and acts of other bodies of foreign governments empowered to consider civil, labor and family matters.

Importantly, Law No. 2860 applies to the said decisions only if they have come into force and are subject to enforcement on the territory of Ukraine in accordance with international agreements to which Ukraine is a party. Conversely, if a decision is made by a foreign court in a country without an international agreement with Ukraine, such decision is not subject to enforcement under Law No. 2860, and may only be subject to enforcement under a special procedure in Ukrainian legislation, if such special procedure exists.

Unless an international agreement states otherwise, the foreign judgment holder must submit a petition to recognize the foreign judgment, along with the following documents:

- a) a certified copy of the decision of the foreign court;
- b) an official document, confirming that the foreign court decision has come into legal force (if this is not indicated in the decision itself);
- c) a document certifying that the absent party (defendant) was timely and duly notified of the time and place of the court proceeding;
- d) a document defining in which parts or from what time the foreign court's decision is subject to enforcement;
- e) a document certifying the authority of the representative of the foreign judgment holder (if the petition is submitted by a representative); and
- f) a legally certified translation of the attached documents in the Ukrainian language or other language provided by the relevant international agreement.

Overall, Law No. 2860 has covered many of the gaping holes that existed in foreign court enforcement legislation contained in Ukrainian international agreements. However, the Law should not be viewed an automatic vehicle for foreign investors to quickly line up and obtain judgments against their breaching Ukrainian counterparts. Both, (a) careful review of the various international agreements to which Ukraine is a party, and (b) meticulous adherence to a well-structured dispute resolution provision, are absolutely mandatory prerequisites to relying on Law No. 2860 as a guideline to legal enforcement.

A. The Ukrainian National Court System

Like all of its legislation, Ukraine inherited its court system structure from the Soviet Union. The court system has been recently undergoing reforms

with passage of a number of laws. The initial steps were made on June 1, 2001 with the passage of amendments to various laws, including Law No. 1789-12 "On the Prosecutor's Office," Law No. 1142-12 "On Arbitration Courts," Law No. 2862-12 "On the Status of Judges," etc. Reform-minded amendments were also made to the Civil, Criminal and Arbitration Procedural (now known as the Commercial Procedural Code) Codes.

Under the reformed judicial system, a system of general jurisdiction courts exists in accordance with the Constitution. The currently effective judicial system is as follows:

1. The district and city courts have been re-classified as local courts of the first instance;
2. The oblast courts, the Supreme Court of Crimea, and the Kyiv and Sevastopol City Courts have been re-classified as appellate courts and the Appellate Court of Ukraine;
3. Highest specialized courts; and
4. All of the above are subordinate to the Supreme Court, which is the highest judiciary authority in the system of general jurisdiction courts.

Apart from the abolishment of inter-oblast courts, another major novelty in this hierarchy is the introduction of specialized courts, which consider matters in specialized fields (i.e., civil, criminal, etc.). In the future, administrative courts and courts, which review exclusively land, family, tax and intellectual property cases will be established into the judicial system. As a result of the reclassification, commercial courts (formerly known as arbitration courts) have also been subordinated to the Supreme Court, subjecting their decisions to reconsideration by the Supreme Court as is the case with any other court of general jurisdiction.

All foreign investors, as well as Ukrainian residents (such as joint ventures and wholly-owned foreign subsidiaries), have the right to submit their disputes with other Ukrainian entities to commercial courts. In fact, unless a provision in an international agreement specifically defers arbitration to take place elsewhere (e.g., the Ukrainian Chamber of Commerce and Industry), then national commercial courts have jurisdiction. While many foreigners may be skeptical of their efficiency and fairness, both the Ukrainian Chamber of Commerce and Industry and the national commercial courts are actually good choices of forum because they handle many international cases per year.

As an observation, Ukrainian commercial courts are generally fair, as demonstrated by various rulings. For instance, a German company "Vero Handels GmbH" applied to the then High Court of Arbitration to settle its dispute with the Ukrainian joint venture "Minolta Trading." In its complaint, Vero Handels alleged that Minolta Trading failed to pay 68,680 US Dollars, due after Vero Handels' delivery of goods. In the course of the proceedings, the High Court of Arbitration determined that the joint venture underwent reorganization during the time of payment by separating into two companies. One of the resulting companies, "Ukrinvaluttorg," was ultimately held liable for payment.

The Highest Commercial Court of Ukraine is the highest body for resolving economic disputes. The Highest Commercial Court of Ukraine supervises the lower courts' judgments and exercises control over their activities. The Highest Commercial Court of Ukraine is also responsible for the preparation and selection of candidates for judgeships, the improvement of the qualification of the commercial courts' employees, among other functions.

In the past, submitting a case to arbitration required the plaintiff to undergo a fairly simple administrative or so-called "pre-arbitration" procedure. In fact, this "pre-arbitration" procedure was mandatory for all disputes considered by arbitration courts. Today, as a result of changes to the Commercial Procedural Code the "pre-arbitration" procedure is strictly voluntary in all cases (i.e., only if the parties to a dispute previously agreed to apply the "pre-arbitration" procedure).

Under the "pre-arbitration" procedure, the plaintiff must first send a written letter, which also serves as a complaint, by confirmed or registered mail, return receipt requested, to the respondent. According to the Commercial Procedural Code, this letter must contain information on the plaintiff, the grounds for the complaint, confirmation of the circumstances under which the complaint arose, the demands of the plaintiff, the amount in controversy, various documents which confirm the complaint, among others.

The respondent then has a one month period to consider the letter (complaint) from the day it is actually received, which period can be suspended if any necessary supporting documents are absent from the letter. The respondent must provide a written answer regarding its consideration of the complaint. The response must indicate the full information concerning the respondent, the acceptance or rejection of the plaintiff's demands, any necessary documents proving the respondent's position, etc.

Further, if the respondent admits to allegations contained in the letter/complaint, it must indicate the amount of the claim it is prepared to

repay. If such admission (together with the transferred amount) is absent, the plaintiff may appeal to the respondent's bank after 20 days from the receipt of the response, seeking a so-called "indisputable debit" of the relevant funds from the respondent's account. If the respondent altogether fails to respond to the complaint within a month, it may be subject to a fine in an amount of up to 100 non-taxable minimum incomes (currently, one non-taxable minimum income is the equivalent of 17 Ukrainian Hryvnias).

If the respondent's response calls for dispute resolution via arbitration, the plaintiff should send a copy of the letter (complaint) and a copy of the mail receipt, along with an official claim and proof of payment of the government fee, to the relevant arbitration court in order to initiate arbitration proceedings.

As a side matter, foreign investors should note that unpredictable financial issues will most certainly arise unless they are specifically addressed in the claim. Thus, the claim should state both the amount in controversy and the currency of payment. For instance, if foreign currency is involved in a given transaction, the complaint must state its equivalent at the official National Bank exchange rate as of the date of submission of the application. Further, the complaining party should specifically seek remuneration in foreign currency in order to avoid problems associated with repatriation under currency regulations and the risk of loss due to hyper-inflation if forced to accept the award in Hryvnia with a view to subsequently convert it into foreign currency for ultimate transfer abroad.

Upon receiving the claim, the judge of the commercial court will decide whether to proceed with the case. If so, the judge will send a notice ("Notice") to the parties initiating the process within five (5) days after receiving the plaintiff's complaint. The respondent may send a response to the complaint after receiving the Notice.

The commercial court will resolve the dispute within two (2) months from the date of receiving the Notice, unless both sides ask for an extension. The commercial proceeding results in a written decision and an order to execute such decision.

In contrast to the finality of international arbitration, any litigant can appeal the final decision of a Ukrainian national commercial court within ten (10) days from the date of a decision. Appeals are submitted via the commercial court that issued the final decision. If the parties to the dispute are not satisfied with the decision at the appellate level, they may further appeal the decision to the Highest Commercial Court, whose decision may only finally be appealed to the Supreme Court.

Please note that as of June 1, 2002, the new Law of Ukraine No. 3018-III "On the Judiciary System," dated February 7, 2002, came into effect ("Law No. 3018"). This law defines the legal bases for the organization of the judiciary branch of power and the service of justice in Ukraine, the system of general jurisdiction courts, the basic requirements in the forming of the professional judges' corps, the system and procedure of carrying out of judicial self-regulation, etc. Law No. 3018 also legalizes the relations, which already exist between the branches of the executive and judicial powers.

Law No. 3018 provides the overall structure of the new judicial system after June 1, 2002. In addition to the existing courts, Law No. 3018 calls for the creation of an appellate court, a cassation court, the highest criminal court, the highest civil court and a branch of administrative courts. Upon the coming into force of Law No. 3018, the following laws lost their force: the Laws of Ukraine "On the Judicial System" (as it presently exists), "On Commercial Courts," "On Qualification, Attestation and Disciplinary Responsibility of Judges of Ukrainian Courts," and "On Bodies of Judicial Self-Governance."

B. International Arbitration

Generally, Ukrainian commercial law is quite liberal where foreign investors are concerned. For instance, as an alternative to national commercial courts, parties engaged in so-called "foreign economic activities" have the option of submitting their disputes for resolution to any international arbitration forum, applying any substantive law the parties chose in their agreements, except in cases when disputes arise between the parties to a joint venture. In cases of joint ventures, the law of the country of registration of the joint venture governs disputes arising between the parties, regardless of the desire of the parties to submit disputes to another arbitration court.

Under Ukrainian laws, the parties to a foreign trade agreement may provide for arbitration to take place in any forum and in accordance with established international rules, including the United Nations Commission on International Trade Law ("UNCITRAL"), the International Convention on Settlement of Investment Disputes ("ICSID"), or the Rules of the Court of Arbitration of the International Chamber of Commerce ("ICC"). This effectively results in two choices: holding international arbitration in Ukraine or anywhere else in the world. Below we discuss the first option in greater detail.

(i) International Arbitration in Ukraine

In 1991, the Parliament created the Ukrainian International Commercial Arbitration Court (the "Court") at the Ukrainian Chamber of Commerce

and Industry (the “Chamber”). In its usual less-than-swift response to changing circumstances, on February 24, 1994, the Parliament finally adopted the Law “On International Commercial Arbitration,” which permits litigation, either on the basis of a court order or the agreement of the parties, by an arbitrator or panel of arbitrators approved by the Court. The above law incidentally also acknowledged the “Maritime Arbitration Commission” of the Ukrainian Chamber of Commerce and Industry as a forum for numerous maritime disputes (most of which took place overseas anyway).

The Court is an independent arbitral tribunal engaged in the resolution of economic disputes involving foreign parties. The Chamber uses UNCITRAL-based rules as the Court’s procedural rules to be applied to international arbitration cases. The Chamber selects the Court’s Presiding Officers and prepares a list of recommended arbitrators that are “independent and impartial in fulfilling their duties” in accordance with Ukrainian legislation. In contrast to the national arbitration system, the Court currently handles numerous international arbitration cases a year at a surprisingly efficient and fair rate. In fact, the Chamber’s reputation has grown increasingly over the past 10 years and many law firms recommend choosing arbitration through the Chamber.

In order for the Court to hear a case, the parties should specifically provide an arbitration clause to that effect at the time they negotiate and document their agreement. Such clauses must be evidenced in writing and can be part of an agreement or signed as a separate agreement. To avoid additional expenses in the future, and to provide greater predictability, the arbitration clause should declare the substantive law regulating the matter, the place of arbitration, the number of arbitrators (1 or 3), the language of the proceedings, translation costs, etc.

To initiate arbitration proceedings, the plaintiff must submit to the Court its complaint and various documents confirming the complaint (with copies of such documents for the respondent). The signed claim must include various statements, including the circumstances on which the plaintiff bases its claim, evidence that supports the claim; well-grounded calculations of the amount in controversy, the applicable legislation upon which the plaintiff bases its claim, the list of documents and any other evidence attached to the claim, etc. If the claim is improperly submitted, the plaintiff has thirty (30) days to rectify it or such claim may be terminated. Based upon the above documents, the Court decides whether sufficient reasons exist to proceed with the case and issues its decision to proceed or not within ten (10) days from receiving the complaint.

At that time, the Court’s secretary will send to the plaintiff a list of recommended arbitrators and an invoice for the arbitration fees and costs,

payable to the Chamber (the “Information”). At the same time, the Court’s secretary will send to the respondent a copy of the complaint, the attached documents and the list of recommended arbitrators and administrative (arbitration) costs.

In addition to selecting arbitrator(s), the plaintiff and the respondent have other responsibilities. For instance, the plaintiff must pay the arbitration costs within 30 days from the date of receipt of the Information. As should be expected, failure to pay the arbitration fees is grounds for an outright dismissal of the case.

On the other hand, once a claim has been filed, the respondent must submit to the arbitration court a written response to the claim, all documents supporting any objections to the claim and a statement of offsets or counter-claims (if applicable) within thirty (30) days after receipt of the copy of the plaintiff’s complaint. Copies of the respondent’s explanations must also be sent to the plaintiff. At the respondent’s request, the 30-day period may be reduced or extended, but for no more than one (1) month. Failure to submit documents or to participate in the arbitration proceedings may result in continuation of the proceedings in the respondent’s absence, which usually concludes in a default judgment.

Unless otherwise provided in the parties’ agreement, under the Court’s rules (which were collated into the Law “On International Commercial Arbitration”), the parties must agree on the number of arbitrators (1 or 3). If no such agreement exists, the arbitration court will require the selection of 3 arbitrators by default. A single arbitrator may be selected by mutual agreement between the parties or, alternatively, by the chairman of the Court at the parties’ request. In the case of three arbitrators, each of the parties will nominate one arbitrator and these two arbitrators will in turn appoint a chairman of the arbitration tribunal.

Failure by either the plaintiff or the respondent to appoint an arbitrator in a timely fashion will result in the Court appointing an arbitrator or arbitrators on their behalf. The parties can challenge the appointment on only two grounds: (1) circumstances exist which cast doubts about such arbitrator’s independence and impartiality; or (2) the arbitrator’s lack of necessary qualifications, as specified by the parties. If the challenged arbitrator continues to participate in the arbitration for any reason, an appeal may be brought to the Presidium of the Court, and the challenged arbitrator will probably be substituted. A new arbitrator is appointed by the same procedure as the substituted arbitrator.

Assuming the arbitration selection proceeds smoothly, the Court’s secretary will collect all documents and notify the parties, listing the time and

place of arbitration and the arbitral panel selection, at least thirty (30) days prior to the first sitting. This timeframe, however, may be extended by an agreement between the parties. Unfortunately, the Court's rules concerning discovery, evidence and hearings are not as extensive or as detailed as those of the UNCITRAL model.

During the actual arbitration process, the arbitration tribunal will apply any language and substantive law selected by the parties to the agreement, as well as the trade customs relevant to the particular case. Provided such conditions are met, the arbitration tribunal may decide to examine the case verbally (i.e., presentation of oral evidence and discussions) or to examine the case based on solely written documents and other printed materials. Note that the UNCITRAL Rules are substantially the same, except Article 15.2 of the UNCITRAL Rules specifically gives the parties a right to hold hearings, witness presentations or oral arguments at any stage of the arbitral proceedings.

Like the UNCITRAL rules, awards or rulings made by a three-person arbitration tribunal are made by a majority vote, unless the parties specifically agreed otherwise. The chairman of the arbitration tribunal, however, may resolve certain procedural issues if such individual is empowered so by the parties or, alternatively, the members of the arbitration tribunal.

Proceedings should not exceed six (6) months from the date the Court receives the plaintiff's complaint or arbitration fees; however, this term may be extended for reasonable cause as demonstrated by the arbitration tribunal or one of the parties. The arbitration proceeding is completed after the arbitration tribunal has delivered its final award or ruling.

The arbitration decision is announced at an arbitral sitting after the proceedings are completed. The final arbitration ruling must be in writing and signed by the arbitrator(s). The ruling must state the specific reasons for the final decision, unless the parties agree ahead of its rendering that such reasons should not be disclosed. The Court sends a copy of the ruling to each of the parties within ten (10) days from the date of issuing the ruling, along with the written conclusions of the experts and other documents or evidence upon which the arbitration tribunal based its award.

As in the UNCITRAL Rules, within thirty (30) days of the ruling, any of the parties may request the Court to rectify an administrative error, such as mathematical miscalculations or misprints, or request a clarification of any part of the ruling. If the arbitration tribunal finds the request justified, it will rectify the ruling or award or, alternatively, give the necessary explanations within thirty (30) days from receiving the request. Any party may submit a request to the arbitration court to hand down additional decisions

on claims which were submitted during the arbitration proceedings but not included in the final decision. Such requests must be made within thirty (30) days from the day of the arbitration court's initial decision. Thereafter, if the arbitration court finds grounds for making such additional decision(s), it must do so within sixty (60) days.

Significantly, the Court's awards are final, and must be carried out by the parties within the period indicated by the Court. Awards or rulings not carried out voluntarily are enforced in accordance with Ukrainian legislation.

(ii) International Arbitration in a Foreign Forum

As mentioned earlier, foreign parties may provide in their agreements with Ukrainian entities for the arbitration process to take place in any third country. Instead of duplicating a voluminous body of publications, which distinguish between the various international arbitration forums, enforcement of arbitral awards in Ukraine will be discussed separately.

3. ENFORCEMENT OF MONEY JUDGMENTS IN UKRAINE

I. Present attitude toward enforcement of foreign money judgments

In general, Article 427 of the Code of Civil Procedure of Ukraine provides that the procedure for enforcement in Ukraine of the judgments of foreign courts and awards of foreign arbitration is determined by the corresponding international treaties of Ukraine and the laws of Ukraine.

The succession of Ukraine in respect of the rights and duties of the USSR under its various treaties is governed by the Law of Ukraine "On Legal Succession of Ukraine." Under Article 7 of this Law, Ukraine became a legal successor under any international agreements to which the USSR was a party so long as these agreements were not inconsistent with the Ukrainian Constitution and interests of Ukraine. Further, Article 6 of the Law provides for succession of Ukraine under any agreements signed by the Ukrainian Soviet Socialist Republic prior to proclamation of independence.

On August 10, 1960, both the USSR and Ukraine, in a separate capacity, became a party to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitration Awards (subject to the proviso that awards issuing from a state not a party would be enforced only in the event of reciprocity), and on September 17, 1966, to the 1954 Hague Convention on Civil Procedure. Further, the Ukrainian Soviet Socialist Republic became a party on January 25, 1964 to the 1961 European Convention on International Commercial Arbitration.

The USSR also concluded bilateral agreements providing for the recognition and enforcement of arbitration awards with Afghanistan (1974); Albania (1958); Austria (1955); Bulgaria (1948); China (1958); Cyprus (1976); Czechoslovakia (1947); Democratic People's Republic of Korea (1960); Federal Republic of Germany (1958); Finland (1947); Hungary (1947); Iraq (1973); Italy (1948); Japan (1957); Laos (1976); Mongolia (1957); Norway (1925); Poland (1945); Rumania (1947); Sweden (1940); Switzerland (1948); Syria (1965); Vietnam (1958); and Yugoslavia (1940).

With reference to the enforcement of foreign court judgments, the only treaties concluded by the USSR were (i) those concluded with the Communist states of Eastern Europe and Asia; (ii) an agreement on assistance and service of court documents and letters rogatory with the Federal Republic of Germany; (iii) a treaty on judicial assistance and extradition with Iraq; and (iv) treaties on judicial assistance with Algeria, Greece, Cyprus and Italy.

In addition to the above-mentioned multi- and bilateral agreements of the USSR, on May 16, 1995, Ukraine ratified the Stockholm Convention on Reconciliation and Arbitration within the Council on Security and Cooperation in Europe.

After 1991, Ukraine concluded a number of bilateral agreements providing for the recognition and enforcement of foreign judgments and arbitration awards which can be classified into two groups:

- (i) agreements on providing legal assistance in civil, criminal, family, etc. cases entered into between Ukraine and Azerbaijan (1993); Russia (1993); Kirgisia (1993); China (1993); Belarus (1993); Lithuania (1993); Moldavia (1994); Poland (1994; 1998); Estonia (1995); Georgia (1995); Latvia (1995); Mongolia (1995); Greece (1996); Turkmenistan (1996); and Turkey (2000); and
- (ii) agreements on mutual encouragement of investments which provide for mutual recognition and enforcement of court/arbitration judgments as far as investments are concerned. Such agreements were concluded with Denmark (1992); Egypt (1992); Poland (1993); Germany (1993); United Kingdom (1993); Vietnam (1994); Armenia (1994); Lithuania (1994); U.S.A. (1994); Slovak Republic (1994); the Netherlands (1994); Argentina (1995); Bulgaria (1995); Estonia (1995); France (1995); Georgia (1995); Canada (1995); Kazakhstan (1995); Korea (1995); Czech Republic (1995); Sweden (1995); Austria (1996); Benelux (1996); Belarus (1996); Lebanon (1996); Chile (1996); Cuba (1996); Greece (1996); Hungary (1996); Israel (1996); Italy (1996); Moldavia (1996); Switzerland (1996); Turkey (1996); Azerbaijan (1997); Croatia (1997); Latvia (1997); Indonesia (1997); Iran (1997); Spain (1998); Macedonia (1998).

In line with the aforementioned multilateral and bilateral agreements, Ukraine signed a number of multilateral agreements providing for the enforcement mechanism within the Commonwealth of Independent States. Among them is the Agreement on the Formation of the Commonwealth of Independent States, which was ratified by Ukrainian Parliament on December 10, 1991. Article 12 of this Agreement provides that the High Contracting parties will guarantee, in accordance with their national legislation, performance of international obligations, which are binding on them under treaties of the former USSR. Ukraine is also a signatory to the 1992 Agreement on Procedure of Settling Disputes with Regard to Carrying on Business Activities. On November 10, 1994, Ukraine became a party to the 1993 CIS Convention on Legal Assistance and Legal Relations in Civil, Criminal and Family Cases. These two documents provide for enforcement procedure of foreign judgments and arbitral awards between the CIS member states that are parties to the Convention.

Finally, in line with Ukraine's goal of shoring up its national legislation with respect to foreign investment, the enforcement of foreign judgments is touched upon in the Law of Ukraine No. 2860-14 "On Recognition and Enforcement of Foreign Court Decisions in Ukraine," dated November 29, 2001, Articles 35 and 36 of the Law of Ukraine No. 4002-12 "On International Commercial Arbitration, dated February 24, 1994 and in Article 84 of the Law of Ukraine No. 606-14 "On Enforcement Procedure," dated April 21, 1999. Currently, the Parliamentary Committee is considering a draft law "On Arbitration Courts," which has yet to be passed by Parliament.

While the decisions of arbitration cases involving foreign money judgments are not publicly published, the Judicial Collegium on Civil Matters of the Supreme Court of Ukraine has published two examples of attempts to enforce foreign money judgments in Ukraine. The first was published in the Collegium's Resolution of June 26, 1996. According to the decision of the International Commercial Arbitration Court of the Chamber of Commerce and Trade of the Russian Federation, which was handed down on June 27, 1994, the Institute of Ethereal Oil and Medicinal Plants (hereinafter the "Institute") was obliged to pay a judgment of 663,252 USD to "Akvacoop" (Czech Republic) and 3,324 USD in compensation to "Akva-coop" for arbitration expenses. The Supreme Court of the Autonomous Republic of Crimea decided to enforce the petition of "Akvacoop" regarding recognition and enforcement of the decision of the International Commercial Arbitration Court of the Chamber of Commerce and Trade of the Russian Federation on the territory of Ukraine.

The Institute appealed the decision of the Supreme Court of the Autonomous Republic of Crimea with the Supreme Court of Ukraine. Using the arguments that the International Commercial Arbitration Court of the Chamber of Commerce and Trade of the Russian Federation lacked jurisdiction and that notice on the forum and time of consideration of the case was improperly served, the Appellant requested to cancel the decision of the Supreme Court of the Autonomous Republic of Crimea as unlawful. In the end result, the Judicial Collegium on Civil Matters of the Supreme Court of Ukraine upheld the Institute's appeal.

The second example is related to a petition to the Kiev City Court, which was submitted on September 22, 2000 by the company "Carlsbad Enterprises Limited," requesting compulsory enforcement of a decision of the International Commercial Arbitration Court of the Chamber of Trade and Industry of Ukraine. The decision of the International Commercial Arbitration Court of the Chamber of Commerce and Trade of Ukraine was handed down on August 16, 2000 and called for the collection of a debt incurred by the Public Bureau (Embassy) of the Great Socialist Libyan Arab Republic in the amount of 779,341.82 USD.

On September 25, 2000, the Kiev City Court resolved to refuse the consideration of the petition of "Carlsbad Enterprises Limited." Thereafter, "Carlsbad Enterprises Limited" appealed the decision of the Kiev City Court in the Supreme Court of Ukraine, asking the Supreme Court to cancel the Kiev City Court's decision and review the case matter in hand. The Judicial Collegium on Civil Matters of the Supreme Court of Ukraine decided that the appeal would not be satisfied based on the following grounds:

According to Article 425 of the Civil Procedure Code of Ukraine, the submission of a claim against a foreign government, its enforcement and the levying of execution on the property of such government, which is located on the territory of Ukraine, may be permitted only with the consent of the competent bodies of the corresponding government. In the decision of the International Commercial Arbitration Court of the Chamber of Trade and Industry, the subject matter of the case is the levying of execution on the property of a foreign government (the Great Socialist Libyan Arab Republic), represented by its Embassy. Therefore, the collection of the debt may only be enforced according to the norms of Article 425 of the Civil Procedure Code of Ukraine and the relevant international agreement.

On the basis of the above-mentioned grounds, the Judicial Collegium on Civil Matters of the Supreme Court of Ukraine upheld the decision of the Kiev City Court of September 25, 2000 and refused to satisfy the appeal of "Carlsbad Enterprises Limited."

In accordance with the Presidential Order "On Preparing Draft Intergovernmental Agreements on Legal Relations and Legal Assistance" of January 4, 1995, an Expert Group within the Ministry of Justice of Ukraine has been set up. One of the primary goals of the Group is to prepare draft intergovernmental agreements on legal relations and legal assistance in civil, criminal and family law. Such agreements are the primary and most effective tools in providing the enforcement mechanism between states.

As briefly mentioned above, the Ukrainian Parliament is currently considering a draft law "On Arbitration Courts." As of this date, the Parliamentary Committee commissioned with the drafting procedure has yet to pass a draft law which is satisfactory for the President's signature.

II. Procedure to enforce a foreign money judgment

A. General Summary of Procedure

Ukrainian courts consider issues on the recognition and enforcement of foreign money judgments of courts of countries, which have concluded

international agreements with Ukraine covering the issues of recognition and enforcement. As a matter of introduction, please note that in Ukraine, enforcement of a foreign court judgment and that of an arbitration tribunal are subject to two separate procedures. Accordingly, the discussion below will provide the analyses of both enforcement mechanisms taking into account this peculiarity of the Ukrainian legal system.

1. Enforcement of foreign court judgments.

In accordance with Article 84 of the Law of Ukraine "On Enforcement Procedure," an enforcement document, which is issued pursuant to the established procedure on the basis of a foreign court or arbitration decision, may be presented for compulsory enforcement within 3 years from the moment such foreign court or arbitration decision comes into force. In addition, Article 3 of the Law of Ukraine No. 2860-14 "On Recognition and Enforcement of Foreign Court Decisions in Ukraine," dated November 29, 2001, provides an exception for decisions on the collection of periodical payments for a term exceeding 3 years. Such decisions may be presented for compulsory enforcement during the entire term of the collection period including the discharge of indebtedness over the past 3 years.

Further, Article 427 of the effective Code of Civil Procedure of Ukraine similarly provides that a foreign judgment must be presented for compulsory enforcement within three (3) years from the date it is effective. The procedure for enforcement of judgments of foreign courts and arbitral awards varies on a case-by-case basis depending on the nationality of the plaintiff.

The general requirements for enforcement of a foreign court judgment, set forth in relevant multi- and bilateral agreements, concluded by Ukraine and further ratified by its Parliament, are as follows:

1. the foreign judgment must enter into force;
2. if the relevant agreement does not provide for the list of documents to be forwarded to the Ukrainian court, then the following documents must be submitted by the plaintiff:
 - (i) the original, authenticated court/arbitration judgment or a duly certified copy thereof;
 - (ii) the document evidencing that the respondent was duly notified of the place and time of the case consideration;
 - (iii) an official document stating the date when the judgment came into effect if it is unclear from the text of the judgment;

- (iv) the document determining which part or from what time the decision of the foreign court is subject to enforcement (if it was already enforced at an earlier date);
- (v) the document, which certifies the authority of the representative of the judgment creditor (if the petition is submitted by the said representative);
- (vi) the certified translations of the above-mentioned documents in Ukrainian or in the language provided for in the relevant international agreement.

Pursuant to Article 11 of the Law of Ukraine "On the Recognition and Enforcement of Foreign Court Decisions in Ukraine," in the event of the submission of a petition on the recognition of a decision of a foreign court, which is not subject to compulsory enforcement, only the documents indicated in points 2 (i), (iii) and (vi) above must be attached to the petition.

3. the documents must be properly served to the Ukrainian court via diplomatic channels or according to the relevant international agreement or treaty.

If a bilateral agreement provides the relevant clause, a foreign judgment does not require mandatory enforcement and, therefore, is subject to automatic recognition after service of the documents mentioned hereinabove. Some agreements, however, provide for mandatory enforcement of certain foreign judgments. The procedure for obligatory enforcement of foreign court judgments is governed by the Law of Ukraine "On Recognition and Enforcement of Foreign Courts Decisions in Ukraine," dated November 29, 2001. The judgment creditor may request mandatory enforcement by petition to the court of origin of the judgment. In this case, the petition must be properly served (i.e., via diplomatic channels) to the Ukrainian national court authorized to issue permission for obligatory enforcement. According to Article 4 of the above Law, a petition for obligatory enforcement can be considered by the Appellate Court of the Autonomous Republic of Crimea, or the corresponding regional, provincial or municipal court, or the court of the autonomous province at the place of residence of the debtor. If the debtor has no residence, or it is not identified, then the petition may be served at the place where the debtor's property is located.

According to Article 6 of the Law "On Recognition and Enforcement of Foreign Courts Decisions in Ukraine," a petition for obligatory enforcement must contain the following:

- (i) the name of the creditor or his representative, and their permanent or temporary address or location (place of business if a legal entity);
- (ii) the name of the judgment debtor and its permanent or temporary address or location (place of business if a legal entity); and
- (iii) the grounds for submission of the petition.

All documents required by the relevant international agreement must be attached to the petition and, if no such documents are listed in the agreement, then the documents mentioned in point 2 above must be submitted. If the judgment has been enforced previously, the petition for mandatory enforcement should state what portion of the judgment is requested to be enforced and for what period of time.

If the petition and the documents attached thereto are not executed pursuant to the requirements of the Law of Ukraine "On Recognition and Enforcement of Foreign Court Decisions in Ukraine," or if the petition does not include all of the required documents, the corresponding Ukrainian court will return the petition (and all documents attached thereto) to the creditor (or its representative) without consideration. For purposes of considering a petition to recognize and enforce a foreign court judgment, a Ukrainian court may not require any other documents or information except those set forth in Article 6 of the Law of Ukraine "On Recognition and Enforcement of Foreign Court Judgments in Ukraine."

The Ukrainian court must inform the debtor regarding its receipt of a petition to recognize and enforce a foreign court judgment within a 5-day period from the day of receipt. The debtor has one month to submit all possible objections to the petition.

After the submission by a debtor of its objections to a petition in written form, or if such debtor fails to submit any objections for any reason within the one month term, the corresponding judge will issue a ruling with a determination of the time and place of the judicial review of the petition. Such ruling must be sent to the creditor and debtor in writing no later than 10 days before the judicial review.

Pursuant to the request of the creditor or debtor, and upon the presence of reasonable grounds, the court may change the time of the review of the petition and the court must inform the parties regarding such change. The review of a petition for compulsory enforcement of a decision of a foreign court judgment is carried out by the relevant court alone in an open court sitting. If the foreign court decision was enforced earlier, then the corresponding court of Ukraine will determine which part or from what time such decision is subject to enforcement.

After considering the above-mentioned documents, the appropriate Ukrainian court (i.e., the district court of the respondent's permanent residence or place of business, in case of legal entity, or the district court where the respondent's property is situated) renders permission for mandatory enforcement. A petition on the granting of permission for the compulsory enforcement of a foreign court judgment will not be satisfied in the cases provided by specific international agreements to which Ukraine is a party. If an international agreement does not provide for such cases, then the corresponding permission may be refused for any of the following reasons:

- (a) the foreign court's/arbitration court's judgment has not yet come into effect under the law of the applicable foreign jurisdiction, unless the said judgment is specifically subject to enforcement before it comes into legal effect;
- (b) the respondent was not properly or timely notified of the foreign court's hearing (i.e., service must occur according to law or the relevant international agreement);
- (c) a prior Ukrainian court's/arbitration court's judgment exists between the same parties, on the same subject and on the same basis, or consideration of the matter was earlier initiated by an institution of the other country of the agreement, or a recognized judgment exists from a court of a third country;
- (d) the case is in the exclusive jurisdiction of the Ukrainian court or another Ukrainian agency;
- (e) the three-year statute of limitations has expired under international agreements or Ukrainian law for requesting enforcement;
- (f) enforcement of the judgment could threaten the interests of Ukraine;
- (g) the subject of the dispute is not subject to judicial consideration according to Ukrainian legislation; and
- (h) in other cases provided by Ukrainian legislation. In other words, this last point provides Ukrainian courts with wide discretion in refusing to permit enforcement of foreign court judgments.

A court's refusal of enforcement may be appealed to a higher court within fifteen (15) days of the decision for refusal.

Pursuant to Article 21 of the Law of Ukraine No. 606-14 "On Enforcement Procedure," dated April 21, 1999, documents may be presented for

enforcement in the following terms: (a) enforcement letters and other court documents — within 3 years; (b) orders of commercial courts — within 3 months; and (c) other enforcement documents — within one year, unless otherwise provided by law.

Further, according to Article 5 of the Instructions on the Execution of Enforcement Activity, approved by Decree No. 74/5 on December 15, 1999 by the Ministry of Justice and registered under No. 865/4158 on the same date (hereinafter the “Instructions”), the execution of enforcement on a judgment debtor’s property is carried out via the identification of such property (by way of inquiries with the state tax inspection, banks, the automobile inspection authorities, the bureau of technical inventory, notaries, etc.), its inventory, its arrest, its seizure and its mandatory sale. Firstly, execution of collection pursuant to enforcement documents is imposed on the foreign currency and local currency funds and other valuables, including funds in the accounts and investments of a judgment debtor in banks and other credit institutions and/or on securities accounts with depositaries.

In case of the judgment debtor’s insufficient funds and/or material valuables for satisfying collection, collection is imposed on other property belonging to the judgment debtor. The judgment debtor has the right to indicate the types of property or objects on which it will be necessary to impose collection in the first priority. The state enforcement officer must satisfy the demands of the judgment debtor if such demands do not conflict with the interests of the judgment creditor and will not complicate the enforcement procedure. However, the final priority for collection on the judgment debtor’s funds and other property is determined by the acting state enforcement officer.

If the value of the judgment debtor’s property does not exceed 10 non-taxable minimum incomes, the valuation of the judgment debtor’s property is carried out by the state enforcement officer according to the market prices effective during the valuation procedure, except in those cases when valuation is carried out according to regulated prices. If the judgment creditor or debtor objects to a valuation by the state enforcement officer, then the state enforcement officer must appoint an expert appraiser for carrying out the valuation. All expenses for carrying out the valuation are borne by the party, which objects to the valuation by the state enforcement officer. In addition, the parties have the right to dispute the results of the valuation in a court of law.

2. Enforcement of foreign arbitration awards

The 1958 New York Convention, to which Ukraine is a signatory, requires courts of member states to recognize that written arbitration agreements

take precedence over normal rules of jurisdiction, and to enforce arbitral awards rendered abroad. Accordingly, the same Ukrainian procedure for enforcing arbitral judgments applies to both a foreign arbitration court’s decision and to Ukrainian arbitral decisions. However, in the specific case of arbitration, the 1958 New York Convention also requires that a certified original or copy of the written agreement of the parties to a dispute to subject themselves to arbitration be attached to an arbitration decision. Such written agreement may be either an arbitration clause in a contract or an arbitration agreement, signed by the parties or contained in an exchange of letters and telegrams.

According to Article 35 of the Law of Ukraine “On International Commercial Arbitration,” an arbitration award, regardless of the state of origin, is recognized as mandatory (binding), and after submission of a written petition to a competent court is subject to enforcement. Pursuant to Article 5, paragraph 1 of the New York Convention and Article 36 of the Law of Ukraine “On International Commercial Arbitration,” the recognition and enforcement of an arbitration decision may be refused at the request of that party against which such decision is rendered only if such party provides the competent authority of the place where recognition and enforcement is requested with evidence that:

- a) the parties to the arbitration agreement were, under the law applicable to them, under some incapacity, or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country where the award was made; or
- b) The party against whom the award was invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case; or
- c) The award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, that part of the award which contains decisions on matters submitted to arbitration may be recognized and enforced; or
- d) The composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties, or, failing such agreement, was not in accordance with the law of the country where the arbitration took place; or

- e) The award has not yet become binding on the parties, or has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made.

As Ukraine is also a signatory to the European Convention on International Commercial Arbitration, during the consideration of a petition on the recognition and enforcement of decisions of international commercial arbitration courts, it is important to take into account the provisions of Article IX of the said Convention regarding the recognition of an arbitral decision as invalid. Specifically, paragraph 2 provides that in the relations between states, which are signatories to the European Convention and simultaneously signatories to the New York Convention, paragraph 1 of Article IX limits the application of Article 5, paragraph 1(e) (see above) of the New York Convention in certain cases.

Further, an arbitral decision may be declined for recognition and enforcement if the competent authority (in Ukraine, the competent court) of the country in which the relevant request for recognition and enforcement determines the following:

- a) The object of the dispute cannot be the subject of arbitration under the law of such country; or
- b) The recognition and enforcement of such decision contradicts such country's public order.

The provisions of international agreements and Ukrainian legislation provide that the refusal to recognize and enforce a decision of a foreign court or foreign arbitration court is carried out at the request of the party against which such decision was rendered. Importantly, however, it is possible that the party against which such decision was rendered may appeal to the competent court with a request for the refusal to recognize and enforce a decision of a foreign court even if the party in whose favor the decision was rendered does not file a petition on the recognition and enforcement of the decision, but at the same time uses the decision against the interests of the debtor.

According to the New York Convention, arbitral awards are enforced according to the procedure provided by legislation of the country where the enforcement is requested. In Ukraine, a foreign arbitration decision can be enforced according to the procedure set forth in Section 1 above.

Finally, according to Article 2 of the Law of Ukraine "On Recognition and Enforcement of Foreign Court Judgments in Ukraine," foreign judgments may be enforced in Ukraine if a bilateral or multilateral international

agreement of Ukraine provides for such enforcement. If no treaty provides for recognition and enforcement of foreign court/arbitration decisions, then the principle of reciprocity, according to an ad hoc agreement with the relevant foreign state, shall apply (i.e., a foreign court/arbitration decision can be enforced in Ukraine provided that Ukrainian court rulings are recognized and enforced in the country of issuance of such decision). If a foreign court decision is so enforceable, then the same procedure set forth in Section 1 above is applicable.

B. Procedural Details

Pursuant to Article 4 of the Law of Ukraine "On Recognition and Enforcement of Foreign Court Judgments in Ukraine," Article 2 of the Decree of the Presidium of the Supreme Soviet of the USSR "On Recognition and Enforcement of Foreign Courts of Law and Arbitration Judgments in the USSR," dated June 21, 1988, and Point 2 of Resolution No. 12 of the Plenum of the Supreme Court of Ukraine "On the Practice of Review of Petitions on the Recognition and Enforcement of Foreign Courts of Law and Arbitration Decisions and on the Overruling of Decisions Rendered in the Process of International Commercial Arbitration on the Territory of Ukraine," dated December 24, 1999, the Ukrainian courts, which have jurisdiction to review petitions on the recognition and enforcement of foreign court and arbitration decisions, are the regional, Kiev and Sevastopol city courts and the Supreme Court of the Autonomous Republic of Crimea at the place of residence (location) of the debtor. If the debtor does not have a place of residence (location) in Ukraine, then the court at the location of the debtor's property will have jurisdiction.

In addition, according to Articles 6, 16 and 34 of the Law of Ukraine "On International Commercial Arbitration," a petition to overrule a decision (resolution) rendered in the process of international commercial arbitration on the territory of Ukraine may also be reviewed by the above-mentioned competent courts of Ukraine at the location of the arbitration proceedings.

When a Ukrainian court resolves the issue of whether a foreign court was competent to render a decision, which is subject to the recognition and compulsory enforcement according to a submitted petition, and the issue of whether such court itself has the jurisdiction to review the case (in which one of the parties resides or is located on the territory of Ukraine and the other party resides or is located on the territory of another member state), the Ukrainian court must take into consideration the general and specific provisions of the corresponding international agreement. If such provisions do not resolve the above issues, then the Ukrainian court must take into consideration the legislation of the relevant member state which establish the exclusive competence of courts of such contracting state for the review of specific categories of cases.

If the parties undertake to submit to arbitration in an arbitration agreement or in an arbitration clause in a contract, then during the review of a petition regarding the lack of jurisdiction of an arbitration court the will of the parties must be taken into account. If a dispute arises as to who will conduct arbitration, such issue must firstly be decided by the parties themselves because they have the sole authority to determine which body will conduct the arbitration proceedings. A court may conclusively consider an arbitration body as competent only if the parties willingly decided such issue in writing in an arbitration agreement or an arbitration clause in a contract.

Pursuant to Article 84 of the Law of Ukraine "On Enforcement Procedure," the procedure for enforcing decisions of foreign courts of law and arbitration courts in Ukraine is established by corresponding international agreements (Conventions), the said law and other laws of Ukraine. In cases when a Ukrainian court receives a petition for enforcement of a decision of a court or arbitration court of a state, which is not a signatory to a convention or an agreement with Ukraine, such Ukrainian court will not consider such petition and will refuse to accept such petition on the basis of Article 136 of the Civil Procedure Code of Ukraine with the exception of cases when arbitration decisions are enforced on the principle of reciprocity pursuant to Ukraine's reservations to the New York Convention.

According to the required procedure, the foreign court's decision together with the documents, mentioned in Section A1 above must be translated into Ukrainian. The translation must be certified by an official translator or sworn translator or by a diplomatic or consular agent. Thereafter, these documents (or a copy thereof) with a translation into Ukrainian must be certified by a notary public in the country of issuance of the decision, authenticated in the Ministry for Foreign Affairs (or other competent authority) and finally legalized in the Consular Department of that country.

Taking into consideration the corresponding international agreements and the effective legislation of Ukraine on currency regulations (including Decree No. 15-93 of the Cabinet of Ministers of Ukraine "On the System of Currency Regulation and Currency Control," dated February 19, 1993 (as further amended), and Resolution No. 349 of the National Bank of Ukraine "On Introduction of Mandatory Sale of Receipts in Foreign Currency in Favor of Residents," dated September 4, 1998 (as further amended)), in certain cases obligations must be fulfilled in foreign currency (for example, upon settlements for obligations arising in foreign currency before non-residents regarding payment for goods, services, intellectual rights, etc.). In other cases, such settlements must be paid in Ukrainian currency according to the effective official exchange rate of the National Bank of Ukraine. In other words, the answer to this

issue depends upon the type of activity of the resident based upon which the corresponding foreign court or arbitration judgment was made. Moreover, in accordance with Article 1 of Resolution No. 349 of the National Bank of Ukraine "On Introduction of Mandatory Sale of Receipts in Foreign Currency in Favor of Residents," fifty (50%) percent of funds received in foreign currency in favor of residents (legal and physical entities — subjects of entrepreneurial activity) are subject to mandatory sale via authorized banks and financial institutions on the interbank currency market of Ukraine pursuant to the procedure established by the National Bank of Ukraine.

III. Conclusion

As Ukraine makes its push toward joining the World Trade Organization and, perhaps eventually, the European Union, the practical aspects of enforcing foreign money judgments will become more transparent than they are at present. Notwithstanding this observation, Ukrainian courts have become more and more conducive to rendering fair judgments and following the rules of the international treaties to which Ukraine has become a party. As a consequence, Ukrainian courts have also become more transparent and fair in rendering decisions regarding domestic disputes and dispute resolution clauses in foreign economic contracts on the territory of Ukraine.

APPENDIX I

LEGISLATIVE PROVISIONS GOVERNING ENFORCEMENT
OF FOREIGN MONEY JUDGMENTS

1. The Code of Civil Procedure of Ukraine No. 1503-06, dated July 18, 1963 (as further amended)
2. The Law of Ukraine No. 1543-12 "On Legal Succession of Ukraine", dated September 12, 1991
3. Decree No. 15-93 of the Cabinet of Ministers of Ukraine "On the System of Currency Regulation and Currency Control," dated February 19, 1993 (as further amended)
4. The Law of Ukraine No. 4002-12 "On International Commercial Arbitration, dated February 24, 1994
5. Presidential Order No. 3/95 "On Preparing Draft Intergovernmental Agreements on legal relations and legal assistance" of January 4, 1995 (as further amended)
6. Resolution No. 349 of the National Bank of Ukraine "On Introduction of Mandatory Sale of Receipts in Foreign Currency in Favor of Residents," dated September 4, 1998
7. The Law of Ukraine No. 606-14 "On Enforcement Procedure," dated April 21, 1999
8. The Law of Ukraine No. 2860-14 "On Recognition and Enforcement of Foreign Court Decisions in Ukraine," dated November 29, 2001

APPENDIX II

LIST OF INTERNATIONAL AGREEMENTS RELEVANT
TO ENFORCEMENT OF FOREIGN MONEY JUDGMENT

1. The 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitration Awards;
2. The 1954 Hague Convention on Civil Procedure (the effectiveness of this treaty is unclear following the dissolution of the USSR);
3. The 1961 European Convention on International Commercial Arbitration;
4. The 1995 Stockholm Convention on Reconciliation and Arbitration within the Council on Security and Cooperation in Europe (the Convention has not yet come into effect);
5. The 1992 Agreement on Procedure of Settling Disputes with regard to Carrying on Business Activities;
6. The 1993 CIS Convention on Legal Assistance and Legal Relations in Civil, Criminal and Family Cases;
7. Treaties with eight (8) states on legal relations and provision of legal assistance;
8. Treaties with thirty three (33) states on mutual encouragement of investments.
9. Treaties concluded by the USSR with twenty five (25) states providing the enforcement of arbitration awards (the effectiveness of these treaties is unclear following the dissolution of the USSR);
10. Agreements of the USSR providing for the enforcement of court judgments (the effectiveness of these agreements is unclear following the dissolution of the USSR).

4. BANKRUPTCY

I. Introduction

From the time of its adoption until its replacement, the Law “On Bankruptcy,” No. 2344-XII (dated May 14, 1992, effective July 1, 1992), was never actually very effective. Although it was in force during the most difficult times of the Ukrainian transitional economy, the strict enforcement of the old bankruptcy law would have led to mass bankruptcy of most Ukrainian enterprises since the definition of “bankruptcy” could theoretically have applied to over half of the existing Ukrainian enterprises. Economic collapse, resulting from mass bankruptcies, would be unavoidable if the Ukrainian government tried to apply Article 1 of the old bankruptcy law, which quite fairly defined “bankruptcy” as the debtor’s inability to satisfy creditor demands due to insufficient liquidity of funds.

On June 30, 1999, the Parliament passed Law No. 784-XIV “On Introducing Changes to the Law of Ukraine ‘On Bankruptcy.’” The modest title of the Law, notwithstanding, these so-called “changes” are actually an entire re-working of the old bankruptcy law, starting with the current name. Henceforth, the Law “On Bankruptcy” shall be referred to as the Law “On Restoration of the Solvency of a Debtor or Recognition of a Debtor as Bankrupt” (the “Law”). The new version of the bankruptcy law took effect on January 1, 2000 and the provision regarding the prohibition of bankruptcy proceedings against the producers of agricultural products until January 1, 2004 has been cancelled. As significant changes are still being introduced to the Law as improvements, below we analyze its current and projected effects.

The difference between the old and new bankruptcy laws is striking: whereas the old bankruptcy law focused primarily on liquidating the indebted enterprise, the new bankruptcy law focuses first and foremost on restoration of the debtor’s solvency. Under this approach, an enterprise may accordingly be deemed bankrupt and liquidated only if implementation of the procedures in the new law to restore solvency have failed. At this stage, creditors must put their faith in a so-called “arbitration administrator” to gather up the pieces of the indebted enterprise and attempt to generate a rebirth of the economic activity of the enterprise in order to restore its ability to repay creditors. The role of this new entity in Ukrainian legislation, the arbitration administrator, is discussed in more detail below.

Importantly, the new bankruptcy legislation provides for bankruptcy of certain physical entities (i.e., individual, citizen entrepreneurs and sole-proprietors). In contrast to the former bankruptcy law, which did not permit the seizure of the property of citizens-subjects of entrepreneurial activity,

the new Law provides that property of citizens may be seized during bankruptcy proceedings in order to satisfy the claims of creditors. If enforced, this can prove to be a useful deterrent to those individuals who once felt confident striking deals without the consequence of losing their personal property. The Law also provides a barrier for any legal schemes to alienate property to related persons/entities before bankruptcy proceedings set in. In particular, any agreements on the alienation of the property of citizens made in the year before bankruptcy proceedings are initiated can be recognized as invalid.

As a background, the Law was drafted by the State Agency on Bankruptcy Issues, which has the authority to define policies and set the procedures for preventing the bankruptcy of debtors. Not surprisingly, the drafters of the Law took upon themselves a wide variety of responsibilities in ensuring the proper implementation of the organizational, economical and other terms and conditions of the Law. These responsibilities include: proposing the candidates and providing training for arbitration administrators; creating a unified database of enterprises subject to bankruptcy proceedings; and organizing the expert examination of state-owned enterprises and enterprises with 25% or more state-owned shares for purposes of bankruptcy proceedings, among others.

II. Initiating Bankruptcy Proceedings

In Ukraine, bankruptcy proceedings are carried out in commercial courts (formerly known as arbitration courts), rather than in specialized bankruptcy courts, and take place at the location of the debtor. According to the Law, either creditors or the debtors themselves may submit an application to a commercial court to initiate bankruptcy proceedings. Bankruptcy proceedings may only be initiated if the amount of the indisputable claims of creditors toward the debtor aggregately equal no less than 300 minimum monthly salaries. As of the date of publication, this figure is approximately 61,500 Ukrainian Hryvnia (or approximately 11,600 US Dollars), based on the current minimum monthly salary of 205 Ukrainian Hryvnia per month (which is expected to increase to 237 Ukrainian Hryvnias per month after November 1, 2004). This threshold can be critical to the rights of smaller creditors because an enterprise can legally avoid fulfilling its obligations by keeping the amount of its indebtedness within the above limit.

On April 3, 2003, the Ukrainian Parliament adopted amendments to the Law (the amendments came into effect on May 31, 2003), which place creditors into various prioritized groups rather than the formerly established equal possibilities for the satisfaction of creditor claims. Thus, creditors are further broken down into “competitive creditors” and “current creditors.”

The former are defined as follows: “creditors with claims toward a debtor which arose *before* the initiation of bankruptcy proceedings, and claims, which are not secured by pledge of property of a debtor.” Creditors, whose claims toward the debtor arose as a consequence of legal succession are also considered competitive creditors on the condition of the appearance of such claims *before* the initiation of bankruptcy proceedings. “Current creditors” are defined as creditors with claims toward a debtor, which claims arose *after* the initiation of bankruptcy proceedings.”

As a result of this grouping of creditors, the moratorium on the satisfaction of claims (discussed below) will not apply to obligations arising for the debtor after the initiation of bankruptcy proceedings. Thus, the debtor is now able to create new debts, but some obligations of creditors will be covered immediately and other earlier debts subject to the moratorium will be covered in deferment.

A. Documentation

1. The Application

In order to initiate bankruptcy proceedings, a written application must be submitted to the relevant commercial court and subsequently signed by the chief executive of the debtor, a creditor or a citizen-subject of entrepreneurial activity (or its representative). The application must include the following information:

- a) the name of the commercial court to which the application is submitted;
- b) the name (surname, first name and patronymic) and mailing address of the debtor;
- c) the name of the creditor and its mailing address (if the creditor is a legal entity), or the surname, first name and patronymic, as well as place of residence (if the creditor is a physical entity);
- d) the tax identification number (code) which identifies the creditor as a payer of taxes and duties;
- e) a summary of the obligations confirming the insolvency of the debtor, indicating the creditor's or creditors' claim amount(s), as well as the period for their fulfillment, the size of forfeiture (fines and penalties), and the requisites of the settlement document on the writing off of funds from the debtor's bank account, as well as the date of its acceptance for fulfillment by the debtor's banking institution; and

- f) the list of documents attached to the application.

2. Initiation of Bankruptcy by the Debtor Itself

The debtor itself may initiate bankruptcy proceedings only if such debtor has sufficient property/funds to cover the legal costs of the bankruptcy proceedings. In this case, the debtor must submit additional information along with its application, including:

- a) the amount of creditor claims for monetary obligations which the debtor does not contest;
- b) the amount of indebtedness for taxes and other mandatory payments;
- c) the amount of indebtedness for compensatory damages caused to life and health, employment salaries, severance pay to employees of the debtor and the payment of royalties;
- d) information on the status of the debtor's property, including monetary amounts and accounts receivable; and
- e) the name of the banks which effectuate the settlement, cash and credit services of the debtor.

Moreover, the debtor must attach the following documents to its application:

- a) the decision or resolution of the owner of the debtor's property (or the body authorized to manage such property), authorizing the debtor's application to an commercial court to initiate bankruptcy proceedings (except in cases when the debtor is obliged to initiate bankruptcy proceedings);
- b) the account balance as of the last reporting date, signed by the relevant authorized executive and accountant of the enterprise-debtor;
- c) the list and complete inventory of pledged property, indicating the location and value of such property at the moment the right to pledge arises;
- d) the minutes of the general meeting of the debtor's employees, at which the representative of the debtor's employees was chosen for participation in the arbitration process during the bankruptcy proceedings. If the convening of such meeting proves impossible, then the debtor may provide a decision of a conference of representatives of the debtor's employees; and

e) other documents which confirm the insolvency of the debtor.

The Law makes it mandatory for debtors themselves to initiate bankruptcy proceedings in certain circumstances within one month after such circumstances arise. Such circumstances include, but are not limited to, cases in which: (i) the satisfaction of claims of certain creditors will lead to the impossibility of completely fulfilling the debtor's remaining obligations toward other creditors; (ii) the authorized body of the debtor decides to initiate bankruptcy proceedings; or (iii) the liquidation of a debtor reveals its inability to fully repay creditor claims. When the debtor initiates bankruptcy proceedings, it must also present a so-called "sanation" plan (see discussion on sanation plans below).

3. Initiation of Bankruptcy by a Creditor

The bankruptcy applications of creditors must contain the following additional information:

- a) the amount of the creditor's claim against the debtor, indicating the amount of forfeiture (fines and penalties) which must be paid by the debtor;
- b) a summary of circumstances confirming the presence of the debtor's obligations before the creditor according to which the claim(s) arose, as well as the period for their fulfillment;
- c) evidence that the amount of confirmed claims exceeds three-hundred (300) minimum monthly salaries;
- d) evidence confirming the grounds of the claim(s); and
- e) any other circumstances upon which the application of the creditor is based.

Creditor applications must be accompanied by:

- a) the decision of the court (commercial court) which considered the creditors' claims against the debtor;
- b) copies of all documents evidencing the grounds of the claim (i.e., the unpaid settlement document, the debtor's bank confirmation on the acceptance of the settlement document, enforcement documents, etc.); and
- c) evidence regarding the value of any property subject to collateral agreements (if the creditor is secured).

The Law liberally permits a creditor to consolidate all of its claims toward the debtor into one application. Further, several creditors may unite their claims into a single application, which entails affixing the signature of each creditor on the application and creating a so-called "creditor committee" to represent the interests of all creditors.

Upon submission of an application, the creditor(s) must send a copy of the application and all documents attached thereto to the debtor. Of course, the creditor(s) must also pay an application fee. Once all of the above documents and information are properly submitted, the court begins to review the application in the order it was presented on the court's docket.

The commercial court judge may reject an application for any number of reasons. For example, an application may be refused if the debtor was never included in the proper state register (the Unified State Register of Enterprises and Organizations of Ukraine or the Register of Subjects of Entrepreneurial Activity) or bankruptcy proceedings have already been initiated in relation to the debtor. The judge's decision will be sent to the applicant within five days from the date of the application's submission, and will be accompanied by the application itself and the supporting documents. However, the applicant can successfully appeal the judge's decision and set the application's submission date back to the original date of submission.

In accordance with Ukrainian court procedures, the judge of the relevant commercial court will refuse to accept any applications that have not been duly executed. Reasons for refusal may include improper signature authorization, omission of the applicant's position or omission of the required personal information concerning the applicant. Applications may also be refused if they are not submitted in a timely fashion, or if the document evidencing payment of the application fee is not attached. Other reasons provided by Article 63 of the Commercial Procedural Code of Ukraine may be grounds for refusal as well.

If an application is submitted but rejected, the applicant can make the proper amendments and re-apply with the commercial court for consideration of the amended application. In cases when several creditors submit applications against a debtor, and one or more applications are returned without being reviewed, the judge will still consider the remaining duly filed applications. Any applicant may appeal a judge's decision to return an application.

Finally, applicants may recall their applications any time before the official announcement on the bankruptcy proceedings is published. An application may be recalled after publication if no other creditors submit appli-

cations on the satisfaction of their claims within one month from the publication date. In any case, the court will refuse to recall an application if such a recall will violate any of the rights of the debtor or other creditors.

Once the above application procedure has been closed, the judge must decide whether to accept the application(s) within five days from the date of submission. The decision to accept an application is sent to the interested parties and the State Agency on Bankruptcy Issues. At this point, the initiation of the bankruptcy proceedings begins.

B. Initiation of Bankruptcy Proceedings

After the court has decided to accept an application, it must (i) notify the parties that the procedure for disposal of the debtor's property is about to commence, (ii) appoint the asset administrator and (iii) place a moratorium on the satisfaction of creditor claims. The decision will also indicate the date and time for carrying out a preparatory sitting of the commercial court, which must take place no later than thirty days after the date the application is accepted. The judge may also choose to appoint the asset administrator at the preparatory sitting rather than upon acceptance of the application.

The debtor must officially respond to the initiation of bankruptcy proceedings. This written response should contain: (i) any objections the debtor has towards the claims of the applicant(s); (ii) the total amount of indebtedness of the debtor, including salaries in arrears, taxes and duties; and (iii) information concerning the debtor's property, including all funds in bank accounts and the postal address of its banks.

1. The Preparatory Sitting

The first time the parties gather to prepare for the bankruptcy procedure is at the preparatory sitting of the commercial court. At this hearing, the judge considers all of the documentation submitted by the parties and listens to any objections or explanations by the parties. As discussed earlier, the judge will try to keep the debtor afloat economically in order to restore its solvency. Therefore, the judge uses the preparatory sitting to begin the search for investors, willing to provide the debtor with "medical treatment" (i.e., provide credit to pay back debts and undertake measures to cure the "ills" of the debtor).

For this purpose, the judge instructs the applicant to publish an announcement, at its own expense, in the appropriate official publications, concerning the initiation of bankruptcy proceedings. In order to notify and uncover all of the debtor's creditors, the announcement must include the full information of the debtor, the commercial court and the asset admin-

istrator, as well as the specific case number assigned to the bankruptcy proceedings. If the applicant fails to publish the announcement within ten days from the judge's instructions, the judge has the right to refuse consideration of the application.

Further, the judge uses the preparatory sitting in order to determine the extent of the debtor's insolvent status. If necessary, the judge may require the State Agency on Bankruptcy Issues and its hired specialists to conduct an expert examination of the debtor's financial status or may require the debtor to undertake an independent audit of its activities. If the debtor has insufficient funds to carry out such an audit, the judge may appoint the creditor(s) to undertake the audit at its own expense, but only with the creditor's (or creditors') consent to do so. All creditors with additional claims toward the debtor must submit such claims during the preparatory sitting. For example, at this stage, secured creditors may submit claims toward the debtor as to unsecured collateral, if the value of the collateral which the creditor holds is insufficient to satisfy its claim in full.

Upon review of the creditor's (or creditors') application, and the official response by the debtor thereto, the judge will issue a decision to determine the following:

- a) the amount of the creditor claims, as submitted with the application to initiate bankruptcy proceedings;
- b) the date the register of creditor claims was drawn up by the asset administrator. The register must be drawn up and presented to the commercial court for confirmation no later than two months and ten days after the date the preparatory sitting was carried out;
- c) the date of the preliminary sitting of the court, which must take place no later than three months after the date the preparatory sitting of the court was carried out;
- d) the date of convocation of the first general meeting of creditors, which must take place no later than three months and ten days after the date the preparatory sitting was carried out; and
- e) the date of the court hearing at which the decision on "sanation," bankruptcy, or termination of the bankruptcy proceedings will be taken. This must take place no later than six months after the date the preparatory sitting was carried out.

If the debtor does not submit an official response or objection to the creditor claims, the judge will not suspend the bankruptcy proceedings. After publication of the announcement on the initiation of bankruptcy

proceedings, all creditors have the right to submit their claims against the debtor, even if the term for the debtor to fulfill its obligations toward such creditor has not yet arisen.

During bankruptcy proceedings, the commercial court has the right to take measures to secure the claims of creditors according to a petition of the asset administrator, creditors or on its own initiative. In this case, the commercial court may issue a decision mandating the prohibition of the conclusion of transactions without the consent of the arbitration administrator and it may oblige the debtor to transfer securities, currency valuables and other property for custody by third parties or accept other measures for the safe-keeping of property.

Moreover, the commercial court has the power to dismiss the director of a debtor and transfer his responsibilities to the asset administrator if a petition is submitted by the parties, the participants in the bankruptcy proceedings or the asset administrator containing information to the effect that the debtor's actions have hindered the asset administrator's activity or the debtor's actions have violated the rights and legal interests of the debtor or creditors. In this case, the commercial court will issue the relevant resolution, which the director may appeal pursuant to the established procedure.

The above measures will remain effective until one of the following situations occurs: (i) the sanation procedure is commenced and a sanator is duly appointed; (ii) the commercial court issues a decision on the recognition of the debtor as bankrupt; (iii) the liquidation procedure is commenced and a liquidator is duly appointed; (iv) a settlement agreement is approved by the commercial court; or (v) the commercial court issues a resolution on the refusal to recognize the debtor as bankrupt. The commercial court also has the right to cancel or change the said measures before any of the aforementioned circumstances occur.

The moratorium on the satisfaction of creditors claims commences simultaneously with the initiation of the bankruptcy proceedings. During the moratorium, any application of penalties against the debtor is prohibited, as is the collection of penalties, fines and all other economic sanctions for non-fulfillment or undue fulfillment of obligations.

Notably, this provision of the Law can be quite advantageous for the debtor because, among other things, it allows the debtor to avoid payment of penalties agreed upon with the creditor. Quite often, the size of such penalties exceeds the value of the principal debt; therefore, the debtor is safe from further application of penalties and can hold off on payment of the accrued penalties until the end of the moratorium. By then, however, the debtor may find an investor willing to take over its debts, or the liquida-

tion procedure may commence, which will further suspend the payment of the penalties. In contrast, the moratorium on the satisfaction of claims does not apply to the payment of salaries, alimony payments, compensation of damages caused to the health or life of citizens, royalties, etc.

Moreover, whereas the original version of the Law provided that the moratorium on the satisfaction of creditor claims applied to those claims which arose after the initiation of bankruptcy proceedings against the debtor, the currently amended version of the Law provides that the moratorium only applies to claims and obligations which became due before the initiation of the moratorium. The result is twofold: the debtor will not wish to create anymore debts after bankruptcy proceedings, however, if it does, such obligations will be covered immediately and the earlier debts covered by the moratorium will be settled at a later date.

2. The Debtor's Arbitration Administrator

As part of the commercial court's duty to save as many debtors as possible from bankruptcy, an arbitration administrator is appointed to supervise all of the debtor's activities during bankruptcy proceedings. The arbitration administrator can play several roles simultaneously. In order for the arbitration administrator to successfully achieve the goal of pulling the debtor from its financial crisis, the Law provides such individuals with a wide range of authorities to keep the debtor afloat so that it is ready for the next stage of bankruptcy: either sanation or liquidation.

The arbitration administrator is a completely new animal in Ukraine, which explains the reason the Law provides that the State Agency on Bankruptcy Issues is responsible for training this new breed. The position of arbitration administrator is limited to individuals (subjects of entrepreneurial activity) possessing a higher legal or economic education and so-called "special knowledge." Presently, the State Agency on Bankruptcy Issues has prepared hundreds arbitration administrators and has created numerous training centers for such specialists in Kiev, Kharkov, Ivano-Frankovsk and other Ukrainian cities. Once an arbitration administrator has successfully passed the course, he or she must successfully pass an exam given by the Ministry of Economy and for Issues of European Integration.

Accordingly, the arbitration administrator may not be an interested party in relation to the debtor or the creditor, and must possess a relevant license, which is subject to revocation upon abuse of authority. Individuals who have previously managed the debtor's affairs may not be appointed as the debtor's asset administrator, unless at least three years have passed since the individual was dismissed by the debtor. In addition, individuals, who were previously convicted for committing an "economic crime" (crimes of

ill gain), and individuals in a directorship position may not be appointed as arbitration administrators.

After appointment, the asset administrator may exercise a number of rights in relation to restoring the debtor's solvency. These rights include convening the meeting of the creditor committee, participating in the creditor committee with an advisory vote, submitting appeals to the commercial court in all cases provided by the Law, engaging third parties to assist in carrying out his obligations, and requesting various documents or copies thereof from third parties.

As the arbitration administrator occupies a central role in the treatment of the debtor or its recognition as bankrupt, the arbitration administrator has a heightened duty to act in good faith and rationally by taking into account the interests of both the debtor and its creditors. Therefore, recent amendments to the Law have stipulated the requirement of mandatory insurance of the arbitration administrator's activity in case of any damages caused to the debtor or its creditors.

The arbitration administrator is entitled to receive compensation for his or her work at the expense of cash funds received from the sale of the debtor's property or at the expense of cash funds received from creditors or as a result of the debtor's production activity. Payment for the services of an arbitration administrator (asset administrator, sanator or liquidator) for the period from the day of the decision by a commercial court to initiate bankruptcy until the first sitting of the creditor committee must be carried out by the party (creditor or debtor) initiating the bankruptcy proceedings in the maximum allowable amount. The creditor committee with the approval of the commercial court will establish the monthly salary of the arbitration administrator which may be no less than two minimum monthly salaries and no more than the average monthly salary of the debtor's director for the last twelve months of his labor before the initiation of bankruptcy proceedings.

Creditors may create a fund for the payment of the arbitration administrator's services, the compensation of his or her expenses and the payment of any additional compensation amounts. Such fund and the procedure for using the cash funds therein must be established by the creditor committee and approved by a resolution of the commercial court. Accordingly, creditors have the right to establish and pay additional compensation to the arbitration administrator in an amount established by the commercial court pursuant to the results of his or her activities.

As asset administrators are loaded with various functions that may be impossible for one individual to fulfill, the Law permits the asset administra-

tor to hire specialists on a contractual basis to ensure that his or her responsibilities are met. Since a large number of enterprises go bankrupt because of ineffective management level employees, this provision enables the asset administrator to avoid working with the existing ineffective management, and to assemble his or her own team of specialists, which are better equipped to bring the debtor back to a level of profitability and enable the repayment of debts.

Among a myriad of responsibilities, the arbitration administrator is obliged to apply measures for the protection of the debtor's property, analyze the debtor's financial, commercial and investment activity and its market status, and provide the state body on bankruptcy issues with information necessary for maintaining the unified database on enterprises involved in bankruptcy proceedings, etc.

An arbitration administrator's failure to fulfill or improper fulfillment of his or her obligations may be grounds for the annulment of his or her license if significant damage is caused to the debtor or its creditors. In such cases, the commercial court sends a resolution regarding the failure to fulfill or undue fulfillment of the obligations placed on an arbitration administrator to the state body on bankruptcy issues. If no significant damage to the debtor or creditors is proved, then the arbitration administrator may still face discharge from the performance of his or her obligations if only the failure to fulfill or improper fulfillment of duties is proven.

3. The Asset Administrator

At the first stage of bankruptcy proceedings, an asset administrator is appointed to supervise all of the debtor's activities. Please note that the asset administrator is one of only several "faces" an arbitration administrator may wear depending on the stage of the bankruptcy proceedings. Likewise, the asset administrator can play several roles simultaneously and has similar authorities to the arbitration administrator's (in fact, they may be one and the same person). For example, an asset administrator can play the role of the debtor's property manager, the controller of the "sanation" process and the liquidator. When an arbitration administrator wears the hat of an asset administrator, the Law provides such individuals with more specified range of authorities to prepare for the outcome of the bankruptcy proceedings and all stages in between. As one role of an arbitration administrator, the position of asset administrator is limited to individuals (subjects of entrepreneurial activity) with a higher legal or economic education or so-called "special knowledge."

As is the same with arbitration administrators in general, the asset administrator may not be an interested party in relation to the debtor or

the creditor, and must possess a relevant license, which is subject to revocation upon abuse of authority. Individuals who have previously managed the debtor's affairs may not be appointed as the debtor's asset administrator, unless at least three years have passed since the individual was dismissed by the debtor. In addition, individuals who were previously convicted for committing a mercenary crime (crime of ill gain) may not be appointed as asset administrators.

Unlike an arbitration administrator, the asset administrator may be appointed for a term of no longer than six months. This term may be extended or reduced by the commercial court upon submission of a petition from either the creditor committee, the asset administrator or the owner of the debtor's property.

After appointment, the asset administrator may exercise a number of rights in relation to restoring the debtor's solvency. These rights include convening the meeting of creditors, participating in the creditors' meeting with an advisory vote, analyzing the debtor's financial condition, and recommending the various measures for financial recovery. The asset administrator is entitled to receive compensation for his or her work in the amount of the average monthly salary of the debtor's former chief executive, and may only prematurely terminate his/her obligations upon receipt of permission to do so.

Asset administrators, much like arbitration administrators, can be charged with various duties that may be physically impossible for one individual to carry out. Therefore, the Law also permits the asset administrator to hire specialists on a contractual basis to ensure that his or her responsibilities are met. As mentioned above with respect to arbitration administrators, since a large number of enterprises go bankrupt because of ineffective management level employees, this provision enables the asset administrator to avoid working with the existing ineffective management, and to assemble his or her own team of specialists, which are better equipped to bring the debtor back to a level of profitability and enable the repayment of debts.

The Law specifically provides that the asset administrator is obligated to: (i) review all creditor applications with the debtor's authorized individuals; (ii) maintain a register of creditor claims; and (iii) inform all creditors regarding the debtor's acceptance or refusal of their claims. Moreover, the asset administrator, as the "master of ceremonies," must take all possible measures to protect the debtor's property during his or her term of duty. In choosing these measures, the asset administrator must analyze the debtor's financial, economic and investment activities, including the debtor's market status.

The asset administrator is also responsible for uncovering any signs of fictitious or forced bankruptcy, presenting information to the State Agency for Bankruptcy Issues for the unified database on enterprises subject to bankruptcy proceedings, etc. Finally, the asset administrator must prepare and present to the commercial court and the creditor committee a report, concerning its activity and the debtor's financial condition, as well as a detailed assessment of the possibilities for restoring the debtor's solvency.

Significantly, the asset administrator bears liability for the improper effectuation of its authority. Although asset administrators go through a strict selection process by the State Agency for Bankruptcy Issues, the Law still requires them to answer for any damages they cause to the debtor-enterprise according to Ukrainian legislation. For example, the Criminal Code provides punishment for negligence or abuse of authority and the Civil Code provides for liability for causal damages. It is impossible to completely insure an enterprise against abuses by the asset administrator, but the Law at least minimizes the risk.

Once selected, the asset administrator continues his or her duties until the commercial court approves a "settlement agreement" between the debtor and its creditor(s) or an investor is willing to cure the debtor's ills. If the commercial court decides that the debtor is hopelessly bankrupt (i.e., restoration of solvency is entirely impossible), the asset administrator's duties terminate upon appointment of a liquidator (see discussion on liquidation below), unless the asset administrator is appointed to carry out the debtor's liquidation as well.

After the asset administrator is appointed, the debtor's management body loses its right to decide on so-called "significant issues" without the consent of the asset administrator. These significant issues include decisions on: (i) the reorganization (merger, acquisition, split up, spin off, transformation) and liquidation of the debtor; (ii) the creation of legal entities or participation in other legal entities; (iii) the creation of affiliates and representative offices; (iv) the payment of dividends; (v) the issuance of securities; and (vi) the exit/exclusion of the debtor's participants (i.e., founders or shareholders) and the acquisition of previously issued shares of the debtor's stock by its shareholders.

Notwithstanding the above, the debtor's management body still retains the right to render decisions regarding the debtor's participation in unions, associations, alliances, holding companies, industrial-finance groups or other associations of legal entities, but only with the consent of the asset administrator. In effect, the appointment of an asset administrator does not lead to the complete termination of the chief executive or management

body's authority. In fact, the chief executive or management body will still be in control of the debtor's day to day operation without interference from the asset administrator.

The authority of the debtor's chief executive and management bodies is limited by the requirement that they must obtain the asset administrator's consent before exercising their authority in regard to the conclusion of transactions necessary for restoring solvency. Much like the commercial court's power to prohibit the following actions, the asset administrator has the power to prohibit the disposal or transfer of real property for lease, collateral or as a contribution to the authorized capital of another company. Additionally, the chief executive or management body of the debtor must obtain the asset administrator's consent before receiving or issuing loans or guarantees, settling claims, transferring debt or transferring property into trust management. Generally, any action related to property with a book value of more than one percent of the book value of all of the debtor's assets must be approved by the asset administrator, unless the commercial court has flatly prohibited such actions.

Of great importance to creditors, who are forced to stand by and wait during the seemingly endless process of restoring the debtor's solvency, is the provision that enables the dismissal of the debtor's chief executive or management body if such bodies fail to take the proper measures to secure the debtor's property, or if they create obstacles for the asset administrator. In this case, upon petition of the debtor's creditors, the commercial court will transfer the responsibility of the debtor's chief executive or management to the asset administrator until a new chief executive is appointed. Consequently, all accounting documents, seals and stamps, and material and other valuables must be transferred to the asset administrator within three days of the dismissal decision. The commercial court's decision on terminating the authority of the chief executive or management board can also be appealed.

4. Identification of Creditors and Potential Investors

After the asset administrator is appointed, all of the debtor's creditors must be identified and an attempt must be made to find investors who are willing to participate in the restoration of the debtor's solvency. The official publication on the initiation of bankruptcy proceedings serves as notice to all competitive creditors that they must make their claims known to the commercial court, as well as notice to all investors who wish to provide "treatment" to the insolvent debtor.

All competitive creditors with claims, which arose before the initiation of bankruptcy proceedings, must submit a written application to the com-

mercial court, indicating their monetary claims toward the debtor within one month after the announcement on the initiation of bankruptcy proceedings is officially published. Creditor claims must be accompanied by the supporting documents which confirm such claims. Creditors must also send copies of their applications, along with copies of the documents attached thereto, to the debtor and the asset administrator. Thereafter, the debtor, together with the asset administrator, will either accept or reject such claims and send written notice of such acceptance or rejection to the creditor-applicant and the commercial court. If claims are submitted after the established term for submission, such claims will not be considered and will be deemed settled.

The asset administrator will record all claims accepted by the debtor into the register of creditor claims. The asset administrator must separately introduce creditor claims secured by pledge into the register and all information regarding such pledges from the State Register of Pledges.

At this time, all investors (physical or legal entities) are invited to submit applications to take part in the "sanation" of the debtor (hereinafter "Sanator/Sanators"). "Sanation" will be discussed in more detail below.

5. The Preliminary Hearing of the Commercial Court

The next hearing of the commercial court must be held no later than three months after the preparatory sitting of the court is held. All parties to the bankruptcy proceedings must be informed of the time and place of the preliminary hearing. The purpose of the preliminary hearing is for the commercial court to review the register of creditor claims, as well as the claims of creditors, which were rejected and not subsequently included into the register. The commercial court also determines the date for the meeting of all of the debtor's creditors at this preliminary hearing.

After a final review, the commercial court determines the final amount of creditor claims to be included into the register. The register must include information on each creditor, the size of its claim for monetary obligations or payment of taxes and duties, as well as the priority of each claim. The register must also separate the amount of forfeitures (fines and penalties) from the principal claims. This final decision of the commercial court serves as the basis for determining the number of votes, which will belong to each creditor for purposes of decision-making at the meeting of creditors, and is sent to all parties and the State Agency on Bankruptcy Issues.

6. The Meeting of Creditors and the Creation of the Creditor Committee

Within ten days after of the preliminary hearing of the commercial court, the asset administrator must inform all creditors included in the register of creditor claims about the time and place of the creditors' meeting. The asset administrator is also responsible for organizing the convocation of the meeting of creditors. The representative of the debtor's employees and the asset administrator may participate in the meeting with the right to an advisory vote only. The meeting of creditors is deemed valid upon simple confirmation that all creditors were informed, in writing, of the time and place of convocation. The Law provides that the place of convocation must be at the location of the debtor.

A meeting of creditors may be convened by the arbitration administrator at its own initiative, at the initiative of the creditor committee (which is created at the first meeting), at the initiative of other creditors whose claims make up at least one-third of the registered claims, or at the initiative of a one-third vote of all creditors. If the creditor committee or separate creditors present a written demand for convocation of a meeting of creditors, the arbitration administrator (asset administrator, Sanator or liquidator) must convene the meeting within two weeks from the day the written demand is received.

At the meeting of creditors, all creditors, including the State tax inspection and other State bodies, are given the number of votes, proportionate to the amount of the registered claims of each creditor, divided by one-thousand Hryvnias. The meeting of creditors has the authority to elect the members of the creditor committee and to determine the number of members of the creditor committee, its scope of authority and the premature termination of its activity or of certain members.

The creditor committee is elected for the entire term of the bankruptcy proceedings, and can be composed of no more than seven members. Elections are held at an open voting session and are determined by a majority vote of those present at the meeting of creditors. The final decision on the creation and composition of the creditor committee must be sent to the commercial court. The arbitration administrator, the employee representative and other relevant bodies have the right to participate in the creditor committee with the right to an advisory vote.

In accordance with the Law, the creditor committee has the authority to decide specific issues, including but not limited to the following:

1. the election of the chairman of the committee;

2. the convocation of the meeting of creditors;
3. the preparation and conclusion of a "settlement agreement" with creditors;
4. proposals to the commercial court on extending or reducing the term for disposing the debtor's property or the debtor's sanation; and
5. the application to the commercial court with a petition to (i) commence sanation; (ii) recognize the debtor bankrupt and commence liquidation; (iii) terminate the authority of the arbitration administrator and appoint a replacement; and/or (iv) consent to significant transactions of the debtor by the arbitration administrator.

The arbitration administrator, the representative of employees of the debtor and, if necessary, the representative of the body authorized to manage the property of the debtor and the representative of the body of local self-governance have the right to participate in the work of the committee with the right to an advisory vote. All decisions of the meeting (or committee) of creditors must be approved by a majority of votes of creditors if such decisions were voted for by those present at the meetings (committee) of creditors.

Below we review the two most common outcomes in bankruptcy proceedings: (i) sanation and (ii) bankruptcy and liquidation.

III. The "Sanation" Option

The principal aim of the new bankruptcy law is to provide debtors with the proper tools to bring about the healthy financial recovery of indebted enterprises, so it is drafted in a way that is designed to try to avoid bankruptcy to the greatest extent possible. One of the options for avoiding bankruptcy is to find a "sanator" or, simply put, a "debtor doctor," to provide treatment for the ailing enterprise.

According to the Law, "sanation" is defined as a system of measures, which is carried out during bankruptcy proceedings, to prevent the bankruptcy and liquidation of a debtor. These measures are aimed at improving the financial-economic condition of a debtor, as well as satisfying, in full or in part, the claims of creditors via the provision of credit, the restructuring of debts or capital, and/or the transformation of the organization's legal or production structure. In other words, the Law encourages a search for investors willing to contribute their time, funds and efforts into putting the pieces of the broken enterprise back together again.

Upon petition of the creditor committee, the commercial court has the right to decide whether to apply a sanation procedure for a debtor (hereinafter "Sanation") and, if so, request for the appointment of a Sanation administrator (hereinafter the "Sanator"). Sanation must be completed within a period of twelve months, with a possible extension for a further six months, or a reduction of the said period upon petition of the creditor committee.

If the commercial court decides to apply Sanation, the creditor committee has the further task of consenting to the candidates for the position of Sanator, choosing the investor(s) (hereinafter "Investor") and approving the Sanation plan. Creditors and the debtor's asset administrator have the right to suggest their candidates for the Sanator and Investor. The asset administrator or the debtor's chief executive can be considered as candidates for the Sanator and Investor as well.

Once the commercial court approves the decision on Sanation, the following events occur:

- (i) the authority of the debtor's chief executive is terminated pursuant to labor legislation, and the Sanator takes over management of the debtor (except in cases when sanation is carried out by the debtor's chief executive itself);
- (ii) the authority of the debtor's governing bodies is terminated, and such bodies must transfer all of the debtor's relevant documentation, seals, materials and other valuables to the Sanator within three days; and
- (iii) the property of the debtor may be arrested or restrictions may be imposed on the disposal of such property within the limits of the Sanation procedure in cases when such arrest or restrictions will not hinder the performance of the sanation plan and do not conflict with creditors' rights.

During Sanation, the Sanator has the right to independently dispose of the debtor's property, conclude settlement agreements and other civil law transactions on behalf of the debtor and submit petitions to the commercial court on the recognition of transactions concluded by the debtor as invalid. Along with these broad rights, the Sanator also undertakes a number of obligations, such as economically managing and inventorying the debtor's property, opening a special bank account for carrying out Sanation operations, developing a Sanation plan to be approved by the creditor committee, organizing accounting and statistical reports, collecting the debtor's accounts receivable, evaluating and, if appropriate, objecting to creditor claims, and reporting the progress of the Sanation plan to the creditor committee.

Importantly for foreign investors who wish to become Investors/Sanators, the commercial court may decide to recognize some of the debtor's transactions as invalid, including those concluded before the decision on Sanation was taken, if such transactions were concluded by the debtor with interested entities and may cause damage to creditors' interests. Further, transactions may be declared invalid by the commercial court if: (i) they were made within six months of the decision on Sanation; (ii) they give an advantage to one creditor over the others; or (iii) they give a creditor payment in the form of a portion of the debtor's property in connection with the withdrawal of such creditor's claim against the debtor's enterprise. These provisions are designed to prevent Ukrainian entities from dumping all of their assets to related entities in anticipation of bankruptcy proceedings and financial aid from possible investors.

A. The Sanation Plan

Within three months after the decision on applying Sanation, a Sanation plan must be drafted and submitted to the creditor committee for approval. The aim of the plan, not surprisingly, is the restoration of the debtor's solvency by way of investor participation and/or the satisfaction of creditor claims. The plan must contain the specific Sanation measures, the period and proposed activities for repaying creditor claims, and the terms and conditions of the Investor's liability in case of non-fulfillment of the obligations it takes upon itself.

If other Investors are involved in the Sanation process, the plan must be approved by such Investors. A sanation plan may contain the following conditions: (i) the fulfillment of the debtor's obligations by third parties; (ii) the exchange of creditor claims for the debtor's assets and/or its corporate rights; and (iii) the satisfaction of creditor claims by any legally recognized method.

The Law provides several measures, which may be included in the Sanation plan, aimed at restoring the debtor's solvency, such as restructuring, changing the production profile of the debtor, terminating loss-generating production, concluding settlement agreements with creditors (including paying off debts in installments or completely discharging debt), restructuring the debtor's assets, selling a part of the debtor's property, repayment of debt by an Investor, the receipt of credit (loans), dismissing inactive employees (taking into account Ukrainian labor legislation), etc. Investors may also acquire ownership rights to the debtor's property in exchange for the fulfillment of the obligations in the Sanation plan.

Fifteen days preceding expiration of the Sanation period, or upon the presence of grounds for premature termination of Sanation, the Sanator

must present a detailed report on the debtor's status. This report must include information on the debtor's balance, profit/loss ratio, funds available for repayment of creditors, accounts receivables, etc. In addition, evidence of the satisfaction of any creditor claims must be attached to the report. Depending on the debtor's status and the Sanator's proposals, the creditor committee will render one of four decisions within ten (10) days of the receipt of the report: (i) to prematurely terminate Sanation in connection with the restoration of the debtor's solvency; (ii) to terminate Sanation and enter into a settlement agreement with the debtor; (iii) to petition for extension of the Sanation procedure; or, (iv) to petition for adjudication of the debtor as being bankrupt and commencement of the liquidation procedure. If any circumstances arise which are grounds for terminating the Sanation procedure, then the creditor committee may render its decision without the Sanator's report.

Accordingly, the commercial court will review the Sanator's report and any complaints of creditors thereto. Both the Sanator and any creditors with complaints will be informed of the time and place of such review. If the meeting of creditors decides that the Sanation plan is fulfilled, or that the Sanation procedure should be terminated due to restoration of the debtor's solvency, then the Sanator's report is subject to final approval by the commercial court. The commercial court will refuse to approve the report if it finds grounds for the complaints of any creditors or if the report does not sufficiently prove restoration of solvency. A copy of the commercial court's final decision and a copy of the Sanator's report must be sent to the State Agency on Bankruptcy Issues.

IV. Bankruptcy and the Liquidation Procedure

If the commercial court decides that the restoration of the debtor's solvency is not possible, the court will approve a resolution to this effect (hereinafter the "Bankruptcy Resolution"), and thereafter commence the liquidation procedure. According to the Law, the liquidation procedure may not exceed twelve months, with the possibility of an extension for six months, unless otherwise provided in specific cases.

The approval of the Bankruptcy Resolution leads to a series of consequences, including the following:

- a) the business activity of the debtor (hereinafter the "Bankrupt Entity") terminates with the completion of the technological cycle for the manufacturing of products and the possible sale of the said products;
- b) the repayment of the Bankrupt Entity's monetary obligations and obligations for the payment of taxes and duties will be considered due;

- c) the calculation of forfeitures (i.e., fines and penalties), interest and other economic sanctions for all types of the Bankrupt Entity's indebtedness terminates;
- d) information on the financial condition of the Bankrupt Entity ceases to be deemed confidential or that which constitutes a commercial secret;
- e) transactions, connected with the alienation of the Bankrupt Entity's property or with the transfer of its property to third parties, are permissible only under the specific conditions of the liquidation procedure;
- f) arrests placed upon the debtor's property, or other restrictions on the disposal of such debtor's property, are canceled. The imposition of new arrests or other restrictions on the alienation of the Bankrupt Entity's property will not be permissible;
- g) claims against the debtor, which arise during the bankruptcy procedure, may be brought forward only within the framework of the liquidation procedure; and
- h) the fulfillment of the Bankrupt Entity's obligations may be carried out only in the cases, and in accordance with the procedure, provided by the provisions of the Law regarding liquidation.

In addition to the above consequences, from the day of the approval of the Bankruptcy Resolution, the authority of the Bankrupt Entity's governing bodies is terminated and, unless done so previously, the Bankrupt Entity's chief executive is dismissed. Furthermore, the authority of the owner (owners) of the Bankrupt Entity's property is also terminated, unless this was done previously.

Procedurally, an announcement, declaring the debtor as being bankrupt and calling for the commencement of the liquidation procedure, must be published by the so-called "liquidator" in the official Ukrainian publications at the Bankrupt Entity's expense. This announcement must be published within five days from the day the Bankruptcy Resolution is approved. The announcement must contain specific information, including (i) the name and requisites of the Bankrupt Entity; (ii) the name of the presiding commercial court; (iii) the approval date of the Bankruptcy Resolution; and (iv) information about the "liquidator" (the "Trustee").

After approval of the Bankruptcy Resolution, the commercial court commences the liquidation procedure and appoints the Trustee. The Trustee is appointed under the same procedure as the appointment of the Sanator,

and must be specifically named in the Bankruptcy Resolution. In this regard, please note that the Trustee can be the same entity as the Sanator or Asset Administrator.

A. The Trustee and the Liquidation Commission

In order to fully appreciate the task laid upon the Trustee's frail shoulders during the liquidation procedure, one may simply review the Trustee's list of authorities, which include the power to:

1. accept the Bankrupt Entity's property into its authority and take measures for ensuring its safe-keeping;
2. fulfill management functions and dispose of the Bankrupt Entity's property;
3. inventory and appraise the Bankrupt Entity's property pursuant to legislation;
4. analyze the Bankrupt Entity's financial condition;
5. carry out the authorities of the Bankrupt Entity's chief executive (management body);
6. head the liquidation commission and form the so-called "liquidation mass" (hereinafter the "Bankrupt Estate");
7. lay claim to third parties for the return of the Bankrupt Entity's accounts receivable;
8. exercise the right to receive credit to effectuate severance payments to employees dismissed as a result of the Bankrupt Entity's liquidation. The severance payments to the Bankrupt Entity's employees must be effectuated by the Trustee on a first priority basis at the account of funds received from the sale of the Bankrupt Entity's property or credit received for such purpose;
9. inform the Bankrupt Entity's employees of their dismissal, and carry out their dismissal in accordance with labor legislation;
10. submit pursuant to the established procedure objections to current creditor claims toward the debtor for obligations, which arose during bankruptcy proceedings and are unpaid;
11. submit to a commercial court a petition to recognize the transactions of the debtor as invalid on the specific grounds provided by the Law;

12. take measures aimed at the search, identification and return of the Bankrupt Entity's property in the possession of third parties;
13. transfer the Bankrupt Entity's documents, which are subject to mandatory safe-keeping;
14. sell the Bankrupt Entity's property for satisfaction of claims included in the register of creditor claims;
15. inform the State Agency on Bankruptcy Issues of its appointment within a ten-day period from the day of the commercial court's decision and present information to the State Agency on Bankruptcy Issues for maintenance of the unified database of bankrupt entities; and
16. carry out any other authorities provided by the Law.

In order for the Trustee to carry out its authorities, the management bodies must transfer all of the Bankrupt Entity's accounting and other documents, seals, stamps, and material or other valuables to the Trustee within fifteen (15) days from the Trustee's appointment. The Trustee also takes over the rights of the Bankrupt Entity's management bodies and chief executive, including the right to order duplicate seals and stamps in case of their loss. This latter right is invaluable if the management or chief executive claims to have lost the Bankrupt Entity's seal, which loss could significantly slow down the bankruptcy proceedings.

In accordance with the Law, the Trustee, along with the creditor committee, can agree on the composition of the liquidation commission. Thereafter, the commercial court will appoint the members of the liquidation commission pursuant to a petition from the above parties. The liquidation commission must include the representatives of creditors and financial institutions. If the Bankrupt Entity has an authorized capital composed of over 25% of state-owned shares, the commercial court must appoint a representative of the State Agency on Bankruptcy Issues to serve as a member of the liquidation commission. If necessary, the liquidation commission may also include representatives from the State Body for the Supervision of Insurance Activities, the Antimonopoly Committee and bodies of local self-governance.

B. The Bankrupt Estate

All types of the Bankrupt Entity's property or property rights must be included into the Bankrupt Estate, including those which belong to it on the date the liquidation procedure is commenced as well as those which are revealed in the course of the liquidation procedure. Even fungible

goods, which are possessed or used by the Bankrupt Entity, will also be included into the Bankrupt Estate. The only property not included into the Bankrupt Estate is the Bankrupt Entity's so-called "state-owned residential fund," which includes hostels, day care centers and other objects of the debtor's communal infrastructure, if any. Such properties are transferred into the communal ownership of the relevant community without additional terms and conditions.

Additionally, all properties subject to pledge must be included into the Bankrupt Estate. However, such properties must be used exclusively for priority satisfaction of the pledge holder's claims (i.e., secured creditors). Finally, once the Bankrupt Estate is distinguished from the general property of the Bankrupt Entity, the Trustee must initiate the apportionment of the Bankrupt Estate for purposes of satisfying creditor claims.

C. Sale of the Bankrupt Entity's Property

In order to prepare for the sale of the Bankrupt Entity's property, the proceeds of which will go toward covering the claims of creditors, all property in the Bankrupt Estate must be appraised. Unfortunately, the Law does not provide a specific procedure for appraising the value of such property. Instead, all appraisals are carried out according to the presently existing appraisal procedure provided by Ukrainian legislation, and any property to be sold at an auction will be valued according to its initial cost.

Once all property in the Bankrupt Estate is properly valued and inventoried, the Trustee may begin the sale of such property using open tenders, unless the creditor committee establishes another sale procedure. The Trustee is responsible for ensuring proper notice of the sale via the mass media, including information on the composition of the Bankrupt Estate and the terms and conditions for the acquisition of property (as agreed upon with the creditor committee). Once the Trustee and a bidder agree upon an acceptable price for specific property of the Bankrupt Entity, the parties must conclude a sale-purchase agreement in conformity with the procedure provided by Ukrainian legislation.

If two or more offers are received for a specific piece of property, the Trustee must hold a tender in accordance with the procedure determined by the Law "On Privatization of Small-size State-owned Enterprises (Small-scale Privatization)." If the sale of such property is restricted only to a limited class of buyers, the sale must take place at closed tenders, with the participation of those who are permitted to buy such property according to Ukrainian legislation.

As a side note, during the liquidation procedure, the Trustee must choose one account of the Bankrupt Entity to deposit the funds to pay back cred-

itors, including funds received from the sale of the Bankrupt Entity's property. In this regard, the Trustee will close all of the Bankrupt Entity's other accounts, and transfer the funds remaining in such accounts to the main account to be used for liquidation purposes. Additionally, any other funds uncovered during the liquidation proceeding must be transferred to the main account. This main account is also used for covering the expenses connected with the liquidation procedure and any communal or utility payments that become due.

All funds received from the sale of the Bankrupt Entity's property must be paid out to satisfy the claims of creditors. Significantly, claims are repaid in the following priority:

1. The following claims must be satisfied first:
 - a) claims secured by pledge (collateral);
 - b) severance payments to the Bankrupt Entity's dismissed employees, including compensation of credit received for these purposes;
 - c) expenses of the fund for guaranteeing the deposits of physical entities, which are connected with the acquisition by it of the rights of a creditor related to the bank — in the amount of all amounts of compensation for the deposits of physical entities;
 - d) expenses connected with bankruptcy proceedings in an commercial court and the liquidation commission's work, including expenses:
 - (i) for the payment of state imposed duties;
 - (ii) of the applicant for publication of the notice regarding bankruptcy proceedings;
 - (iii) for the publication of information concerning the sale of the Bankrupt Entity's property in the official publication bodies;
 - (iv) for the mass media publication of information concerning the resumption of bankruptcy proceedings in case a concluded settlement agreement is subsequently deemed invalid;
 - (v) of the arbitration administrator (asset administrator, Sanator, Trustee, etc.) connected with the maintenance and safe-keeping of the Bankrupt Entity's property assets;
 - (vi) of creditors for carrying out an audit, if an audit was performed according to the decision of the commercial court at the expense of their own funds; and

- (vii) for payment of salaries to the arbitration administrator(s) (asset administrator, Sanator, Trustee, etc.).

The liquidation commission will compensate the above expenses after the sale of the Bankrupt Estate, unless otherwise provided by the Law;

2. Claims arising from the Bankrupt Entity's obligations to its employees, obligations arising as a result of damages caused to the life and health of citizens, as well as claims of citizens-principals (investors) of trust associations or other subjects of entrepreneurial activity;
3. Claims for the payment of taxes and duties (mandatory payments);
4. Claims of creditors which are unsecured by pledge (collateral), including creditors' claims arising from obligations during the disposal of the Bankrupt Entity's property or during the Sanation procedure;
5. Claims for the return of contributions of the workers' collective members to the authorized capital of the Bankrupt Entity; and
6. Lastly, all other claims not mentioned above are satisfied.

The claims of each of the succeeding priorities are satisfied as funds are credited to the main account of the Bankrupt Entity from the sale of its property after the complete satisfaction of the claims of the preceding priority. If there are insufficient funds to completely satisfy all claims in one priority, such claims are satisfied proportionately to the claims due to each creditor in the relevant priority group. In the end, all claims that remain unsatisfied due to insufficient property are considered to be repaid. Finally, if any property remains after the satisfaction of creditor claims of a bankrupt legal entity, it is transferred to the property's owner or its authorized body.

Before formally wrapping up the Bankrupt Entity's business activities, the Trustee must present a report and liquidation balance to the commercial court which is handling the bankruptcy proceedings. Along with these documents, the Trustee must attach an inventory of the Bankrupt Estate; information on the sale of the Bankrupt Estate (with reference to all concluded sale-purchase agreements); a copy of the sale-purchase agreements and corresponding transfer-acceptance acts; the register of creditor claims indicating the amounts repaid; and the documents confirming repayment of creditor claims.

Thereafter, the commercial court will review the Trustee's report, taking into consideration any opinions of the creditor committee or separate cred-

itors, and confirm the report and liquidation balance. Upon receiving such an approval, the Trustee must inform the State Agency on Bankruptcy Issues about the completion of the liquidation procedure. Once liquidation is completed, there are two possible results:

The Bankrupt Entity will have no more property after satisfaction of all creditor claims, or it will have insufficient property to continue its functions. In such cases, the commercial court will completely liquidate the Bankrupt Entity and send a copy of its decision to the relevant registration authority (i.e., the body that carried out the original state registration of the Bankrupt Entity), the state tax inspection, the state statistics body, among others; or

The Bankrupt Entity will have enough property to satisfy all creditor claims and enough property assets will remain to continue its activities pursuant to Ukrainian legislation. In this case, the above entity will be considered free of debt, and may carry on its business.

However, if the commercial court does not approve the liquidation report because it finds that the Trustee did not uncover or sell all of the property assets of the Bankruptcy Estate necessary to satisfy all creditor claims, then the commercial court will appoint a new Trustee. This new Trustee will head the liquidation commission and complete the liquidation procedure in accordance with the Law. Thereafter, the bankruptcy proceedings will terminate upon final approval of the new Trustee's liquidation report.

In any case, the Trustee is responsible for ensuring the proper execution, order and storage of all documents of the Bankrupt Entity during the liquidation procedure, including all financial and commercial documents. After a commercial court issues a decision on the liquidation of the Bankrupt Entity, the Trustee must send the documents for further storage pursuant to the agreement of the specially authorized central body of the executive branch in the sphere of archival activity.

V. The Settlement Agreement Option

At any stage of the bankruptcy proceedings, the debtor and its creditors may decide to enter into an agreement on the deferment of debt repayment, an installment plan for repayment, and/or debt forgiveness (write off). In this case, the creditor committee will permit the parties to enter into a settlement agreement ("Settlement Agreement"). This decision is made by a majority vote of the creditor committee, and will only be approved with the prior written consent of all creditors whose claims are secured by pledge of the debtor's property.

As a rule, Settlement Agreements may be concluded in relation to creditor claims that are secured by collateral or claims of the second and subsequent priorities. Procedurally, the State tax inspection and other taxation bodies must give their consent to satisfy a portion of the relevant claim, to write off the entire debt (or, depending on when the debt arose, to write off a portion), or to implement an installment plan. Further, the chief officer of the corresponding state tax inspection must sign the above settlement agreement.

Settlement Agreements must be in writing and must be approved by the commercial court hearing the bankruptcy case. A Settlement Agreement comes into force on the day of its approval, and becomes binding on the Bankrupt Entity and all relevant creditors.

According to the Law, Settlement Agreements must contain provisions (i) on the debt amount and the conditions and procedures for fulfilling the debtor's obligations; and (ii) the deferment, installment or forgiveness of debts or a portion thereof. In addition, such agreements may contain terms and conditions regarding the fulfillment of the debtor's obligations by a third party, as well as the exchange of creditor claims for the debtor's stock or other satisfaction methods permitted under Ukrainian law.

The arbitration administrator must submit an application to the commercial court for the approval of a Settlement Agreement within five days after its conclusion. For this purpose, the text, the minutes of the creditor committee, a list of creditors, any written objections by creditors, and the debtor's promise to compensate all bankruptcy expenses must be submitted along with the application. The commercial court considers the application at a hearing with the participation of all creditors who wish to express their objections.

On the one hand, if the commercial court approves the Settlement Agreement, the debtor must commence the repayment of creditor claims. Consequently, the commercial court has the right to terminate bankruptcy proceedings and terminate the authorities of the arbitration administrators (asset administrator, Sanator or Trustee, depending on the stage of the bankruptcy proceedings). However, the Law provides that the commercial court has the right to subsequently invalidate or cancel Settlement Agreements in certain instances. In this case, the bankruptcy proceedings will be resumed and a corresponding announcement will be published in the official sources of publication.

On the other hand, if the commercial court refuses to approve the Settlement Agreement, the bankruptcy proceedings will continue at their present stage. The commercial court may refuse to approve such an agreement

if it discovers a violation of the procedure for concluding Settlement Agreements or the terms and conditions of such agreement contradict Ukrainian legislation. In this case, the parties are free to negotiate a new Settlement Agreement on different terms and conditions, taking into consideration the court's grounds for rejecting the original Settlement Agreement.

VI. Conclusion

This article focuses on the general bankruptcy procedure for legal entities in Ukraine. Note, however, the Law contains an entire section on the peculiarities of bankruptcy for other types of businesses, including urban-development enterprises, enterprises involved in ultra-dangerous activities, agricultural enterprises, insurance companies, sole proprietors (citizens), entrepreneurs (citizens), farming enterprises, etc.

The new bankruptcy law has been met with criticism, and the results of its application still remain unseen. One of the major criticisms is that the arbitration administrator will be tempted by creditors to mold his or her decisions to the creditor's interests. The provision of the Law that allows creditors to give additional compensation to the arbitration administrator for "other" roles it plays is a perfect avenue for the receipt of "favours." Other critics complain that the local bureaucracy will be a major obstacle to realization of the Law because they will not want to accept responsibility and control over the social infrastructures they may inherit from bankrupt enterprises.

Still other critics complain that the Law is based on too many Western concepts of bankruptcy that are foreign to Ukrainian enterprises and are outright ineffective in a somewhat hostile market environment. For example, some critics perceive the moratorium on satisfying creditor demands as a potential cover for unscrupulous enterprises. According to these critics, by the time creditors receive repayment of debts after the moratorium, the inflation rate will significantly lessen the amount due to them.

In spite of these criticisms, the Law has been effective since January 1, 2000, and only minor changes have been made thus far. As more and more companies apply the new bankruptcy procedure, the major flaws of the Law will be revealed and the necessary changes will be ironed out. At this point, we can only hope that this Law will be enforced, bringing with it increased efficiency to the Ukrainian market.

H INTELLECTUAL PROPERTY

1. Intellectual Property Legislation

I. Introduction

The original body of laws regulating intellectual property rights used to be a painful topic for those seeking to protect their rights in Ukraine. Several court rulings later, however, there was an indication that at least some protection indeed existed. For instance, Bayer won the rights to its trademark in Ukraine, and thereafter other precedents began to emerge. The discussion below describes this formerly controversial area of law, taking into consideration the most recent legislative changes.

II. Discussion

On December 15, 1993, the Parliament enacted the following three legislative acts, governing industrial property:

1. Law "On the Protection of Rights to Inventions and Utility Models," (the "Invention and Model Law"), as lastly amended on May 22, 2003;
2. Law "On the Protection of Rights to Industrial Designs," (the "Industrial Design Law"), as lastly amended on May 22, 2003; and
3. Law "On the Protection of Rights to Trade and Service Marks," (the "Trade and Service Mark Law"), as lastly amended on May 22, 2003. All three laws are hereinafter collectively referred to as the "Laws."

The Laws originally entered into force on July 1, 1994, replacing the temporary regulations "On the Legal Protection of Industrial Property and Rationalization Proposals," approved by a Presidential Decree dated September 18, 1992, and an informational letter issued by the Ukrainian Patent Agency, entitled "On Transitional Provisions in the Area of Industrial Property Protection in Ukraine." In dealing with the transitional stage, the validity of patents, industrial designs, and trade and service marks in Ukraine were determined in accordance with the laws effective on the date the application was filed.

The Laws were unique in that they went practically unchanged unlike many other Ukrainian laws. In fact, their implementation resulted in amendments to other Ukrainian legislative acts that peripherally regulate intellectual property rights in Ukraine, including the Civil Code and the Labor Code, among others.

A. Industrial Property Subject to Protection in Ukraine

Formerly, the State Patent Agency (hereinafter the "Derzhpatent") was the governmental entity responsible for protection of industrial property in Ukraine. In practice, however, all applications for new patents and trademark certificates were submitted to the Ukrainian Institute of Industrial Property, which was under Derzhpatent's direct supervision. Derzhpatent, on the other hand, was responsible for maintaining the register of inventions, industrial designs, and trade and service marks, as well as for publishing official information and effectuating other actions according to the Regulations approved by the Ukrainian Cabinet of Ministers.

On December 7, 1999, the Cabinet of Ministers passed Resolution No. 2212 "On Establishment of the State Agency of Ukraine for the Protection of Industrial Property." Resolution No. 2212 liquidated Derzhpatent and replaced it with the State Agency for the Protection of Industrial Property (hereinafter the "Agency"), a self-financing state institution subordinated to the Cabinet of Ministers. The passing of Resolution No. 2212 also meant the liquidation of the Ukrainian Institute of Industrial Property and the creation of a similar subdivision of the Agency based on the property transferred from the Institute.

Approximately 6 months later, the Cabinet of Ministers passed its Resolution No. 997 "On Approval of the Regulations on the State Intellectual Property Department," dated June 20, 2000. Resolution No. 997 replaced the Agency with the State Intellectual Property Department (hereinafter the "Department"), which is a government body acting within the Ministry of Education and Science and is subordinated to the said Ministry. The main tasks of the Department are as follows:

- ensuring, within its competence, the implementation of state policies regarding intellectual property;
- forecasting and determining the perspectives and priority directions of progress in the field of intellectual property; and
- ensuring the organizational protection of rights to intellectual property objects.

1. Inventions, Utility Models and Industrial Designs

As a general matter, the Department issues patents on inventions and industrial designs. The recent amendments to the Invention and Model

Law introduced the so-called “declaration patent” for inventions and utility models (as well as for secret inventions and utility models). Declaration patents are issued only after a patent application has been formally examined by experts as to whether the object to be patented meets the relevant criteria. The amendments to the Invention and Model Law also cancelled the Cabinet of Ministers’ Resolution No. 593, dated August 29, 1994, which permitted the issuance of 5 year patents without substantive examination.

Three criteria are required for an invention to be protected in Ukraine, namely it must be novel, have a certain inventive level, and be industrially applicable. An invention must (1) be new, (2) exceed the level of currently known technology, and (3) have the ability to be reproduced industrially.

Patentable inventions (industrial models) may be a product (device, substance, strain of a microorganism, plant and animal cell culture, etc.) or a process (method) and a new application of a previously known product or technique (for example, the application of an electrochemical accumulator in the role of an electric condenser). The following items, however, may not be regarded as inventions in Ukraine:

- 1) plant species and animal breeds;
- 2) fundamental biological processes of the reproduction of plants and animals, which are not related to non-biological and microbiological processes;
- 3) topography of integral micro schemes;
- 4) results of artistic drawings.

An industrial design is the result of an individual’s creative work in the realm of art, and is characterized by its form, drawing, painting or a combination thereof which expressly defines the esthetic appearance of the work. Under the Industrial Design Law, a patentable industrial design must be novel and industrially applicable. First, an industrial design is novel if its essential features are not known in Ukraine or abroad before its priority date. Second, an industrial design is industrially applicable if it can be industrially reproduced as a useful article.

The following types of designs are not subject to protection as industrial designs in Ukraine:

- architectural structures (except some small architectural forms) and industrial, hydro-technical and other stationary structures;

- printed matter; and
- objects of an unstable form made from liquid matter, gas-like, free-flowing and other like substances.

2. Trade and Service Marks

Trade and service marks distinguish goods or services of one individual or entity from goods or services of other individuals or entities. A trademark may consist of verbal signs, graphic or three-dimensional designs, and other signs (or a combination thereof) in any color or combination of colors. Trademark certificates are issued for a period of 10 years from the date of the submission of an application for a trademark and can be extended for subsequent periods of 10 years.

As a general rule, the following marks cannot be registered in Ukraine:

1. state coats of arms, flags and emblems;
2. official titles (names) of governments (states);
3. emblems, abbreviated or full titles of international or interstate organizations;
4. official control, guarantee and hallmarks, as well as seals (stamps);
5. decorations (awards) and other marks of distinction.

The above marks may be used as unprotected elements in trademarks, if the proprietor or its authorized body expresses consent to such use. In addition to the above marks, no protection is afforded to marks, which:

6. do not possess distinguishing characteristics and never acquired such characteristics as a result of their use;
7. are generally used, such as the mark of goods and services of a specific type;
8. indicate the type, quality, quantity, peculiarities, purpose, value of goods and service, as well as the place and time of the production or sale of goods or provision of services;
9. are false or can lead to confusion regarding a good, service or the individual selling a good or providing a service;
10. are generally used symbols and terms; and

11. reflect only a form determined by the natural condition of a good or the necessity to receive a technical result or a form which provides a good with a significant value.

The images mentioned in points (6), (7), (8), (10) and (11) may be included in trademarks as unprotected elements subject to the consent of the relevant authority if they do not occupy a dominating position in the mark.

Identical or similar signs or symbols may not be registered as marks if they can be confused with:

- trademarks registered previously or pending applications for registration in Ukraine in the name of another person for the same or related goods or services;
- trademarks of other persons, if these marks are protected on the basis of international agreements to which Ukraine is a party, in particular marks which are recognized pursuant to Article 6 of the Paris Convention on the Protection of Intellectual Property;
- firm names known in Ukraine that belong to other persons who had the right to use them prior to the date of filing an application at the Agency for the same or related goods or services;
- qualified markings of the origin of goods (including spirits and alcoholic drinks), which are protected pursuant to the Law of Ukraine "On Protection of Rights to the Marking of the Origin of Goods." Such marks may be used as unprotected elements of the marks of entities, which have the right to use such markings; and
- marks of compliance (certified marks) properly registered.

Finally, the following marks may not be registered:

1. reproduced industrial designs, the rights to which are owned by other persons in Ukraine;
2. reproduced names known in Ukraine from works of science, literature or art or quotations or characters therefrom or works of art and their fragments without the consent of the owners of the copyrights thereto or their legal successors; and
3. reproduced first names, surnames, pseudonyms and derivatives thereof, portraits and facsimiles of well-known persons in Ukraine without their consent.

B. Owners of Industrial Property

The owners of patented inventions or industrial designs in Ukraine may be the following:

1. authors (inventors) or co-authors with equal rights to a patent (unless otherwise reflected in an agreement between the co-authors);
2. an employer has the right to patent an employee's invention or industrial design. In this case, the inventor gives the employer written notice on the creation of an invention (to be used in the employer's services) with a full description of the invention's essence. The employer must submit an application for a patent within four months or transfer the right to the patent to a third party or maintain the invention as confidential information (for a maximum of four years). In the same four-month period, the employer must enter into a specific written agreement with the inventor specifying the author's remuneration in relation to the invention's or design's economic value. The author will obtain a patent if the employer fails to file an application with the Department within four months from the date of the author's written notice (i.e., the employer will retain the priority right to receive a license to the patented invention); and
3. heirs of an author or employer.

C. Exclusive Right to Use Intellectual Property

1. Duration of Rights

The Laws provide the following national protection of intellectual property:

1. patented inventions for a maximum of twenty years from the date of submission of an application (declaration patents for inventions have a maximum of 6 years of validity). The term for a patent on an invention of medicine and animal and plant protection means which require special permission for use may be extended for a term equal to the period between the date of submission of the patent application and the date of receipt of the special permission, but for no longer than 5 years;
2. patented utility models (including a declaration patent for a utility model) for ten years;
3. patented (including declaration patents) "secret" inventions and utility models remain valid for the term such inventions and utility mod-

els remain “secret.” However, this term cannot exceed the validity term for the protection of usual inventions or utility models. An invention or utility model is deemed “secret” if the invention (utility model) contains information related to a state secret on the basis of Law No. 3855-XII “On State Secrets,” dated January 21, 1994; and

4. patented industrial designs for ten years with an option to extend for an additional five years.

Trademark certificates offer protection for ten years with an option for extension each ten years if the application for the extension is submitted to the Department within the last year of the certificate’s validity. A certificate will not be extended if the official state fee for extending such certificate’s validity is not paid within the last two months of the last year of validity.

2. Violation of Rights

Violation of a patent owner’s exclusive right to use an invention or industrial design occurs if, without the owner’s consent, an infringing party produces, imports, sells, intends to sell, or engages in any other activity involving an application of an invention or design or protected techniques thereof.

Violation of a patent owner’s exclusive rights, however, does not occur if the protected rights are used:

1. in the construction or upon the use of means of transportation of a foreign country, which means are located temporarily or accidentally in the waters, airspace or territory of Ukraine on the condition that the patent, utility model or industrial design is used exclusively for the needs of the said transportation means;
2. for non-commercial purposes;
3. in scientific research and/or experiments;
4. in extraordinary circumstances (Acts of God, catastrophe, epidemic) upon consent of the patent owner immediately, if such is practically possible, and the payment of the corresponding compensation.

There is no violation of patent rights upon the introduction into civil circulation of a product manufactured with the application of an industrial design after the introduction of such product into civil circulation by the patent owner or upon its special permission. Likewise, the introduction

into commercial circulation of a product manufactured with the application of a patented invention (utility model) by any entity, which product was acquired without a violation of the rights of the owner of such invention (utility model), is also not a violation of patent rights.

Moreover, the commercial use of an invention by any entity, which acquired a product manufactured with the application of a patented invention and could not know that such product was manufactured or introduced into circulation in violation of patent rights, will also not be deemed a violation of patent rights. In this case, however, after the receipt of a corresponding notice of the patent owner, the said entity must terminate the use of the product or pay to the patent owner a fee established by law or the agreement of the parties. Any disputes arising in connection with such fee and the payment procedure must be resolved in a court of law.

Finally, if a physical person or a legal entity in good faith uses an invention or industrial design before the applicant’s established priority date, such person or entity may continue to use the invention or industrial design in the same manner, but obviously the person or entity is not entitled to any patent protection. Furthermore, the “right of prior use” may be transferred by the party to any transferee only together with the production site where such use has occurred or where all preparation for it has been made.

A trademark owner enjoys the exclusive right to use and dispose of its trademark and to prohibit other individuals or entities from using its trademark. Violation of a trademark owner’s exclusive rights occurs if, without the owner’s consent, an infringing party produces, imports, sells, intends to sell, or engages in any other activity which puts the trademark into circulation. This prohibition includes the use of the trademark on packages, in commercial advertisements, in printed matter, on signs and in exhibits or fairs that take place in Ukraine.

3. Sufficient Utilization of the Right

The owner must continually use its exclusive intellectual property rights in order to retain them. For example, if a trademark is not used or is insufficiently used in Ukraine for three years from the date of entry into the trademark register or from the date when use of the trademark was discontinued, any person has the right to file a petition for the early discontinuation of the effect of such patent or trademark. In the case of inventions, utility models and industrial designs, the owner may abandon the rights thereto in full or in part on the basis of an application to the Department. Such abandonment will take effect from the date of the publication of such abandonment in the Department’s official bulletin.

D. Discontinuation of Effect and Declaration of the Certificate Invalid

The exclusive effect of a patent will be deemed invalid by a court of law prior to its expiration date if:

1. the invention (utility model) or industrial design does not meet the patentability criteria as described above;
2. certain characteristics of the invention, utility model or industrial design were not described in the submitted patent application;
3. an international application is not submitted to the Department in case of the patenting of an invention pursuant to an agreement on patent cooperation;
4. if the issuance of a patent pursuant to an application violates the rights of other parties.

The exclusive effect of a trademark is terminated under similar circumstances. Objections to the issuance of patent or trademark certificates under the Laws may be submitted to the Department's Board of Appeals. Significantly, the decision of the Board of Appeals may be disputed before a court.

Additionally, the exclusive effect of a patent or a trademark will terminate if (i) its term has expired or (ii) the owner submits an application to the Department terminating such rights. Further, patent rights and trademarks terminate if the patent or trademark owner does not pay the annual duties for continued protection. Trademark rights terminate if the legal entity owning the patent is liquidated.

E. Protection of Rights

Upon the demand of the patent or trademark certificate owner, an infringing party must cease infringement and compensate the owner of the certificate for losses incurred. The Laws provide that an infringement of rights may be claimed also by a person who owns a license if the relevant licensing agreement does not stipulate otherwise.

Furthermore, the Laws provide that disputes connected with the application of the Laws will be resolved by commercial courts or in courts of law in accordance with Ukrainian legislation. According to their competence, courts examine disputes such as:

1. establishing a certificate owner (in relation to trademarks and patents for inventions, utility models and industrial designs);

2. drawing up and execution of licensing agreements (in relation to trademarks and inventions);
3. infringement of the proprietorship of a certification owner (in relation to trademarks and patents for inventions, utility models and industrial designs);
4. compensation (in relation to patents for inventions, utility models and industrial designs);
5. establishing authorship (in relation to patents for inventions, utility models and industrial designs);
6. establishing the fact of the use of an invention, utility model or industrial design;
7. establishing the right of prior use of an invention, utility model or industrial design.

F. License Agreements

Any individual and/or legal entity, wishing to utilize a patented invention, patented industrial design, and/or registered trademark, must purchase a license from the owner of the corresponding intellectual property. Under the license agreement, the licensor will transfer to the licensee the relevant rights on the terms agreed to between the parties. Such agreements may include the rights to produce, utilize, import, offer for sale, sell, engage in any other activity that places the protected item into circulation, obtain any technical assistance necessary for utilization of the licensed object, or to subject the licensee to quality standards. License agreements must be in writing, signed by the parties and, specifically in relation to trademarks, contain a provision to the effect that the quality of goods and services produced or rendered on the basis of the license agreement will not be worse than the quality of goods and services of the owner of the trademark, who will carry out control over the performance of such provision.

G. Ukraine's Recognition of International Treaties

Ukraine has acceded to (i) the Patent Cooperation Treaty dated July 19, 1970, and the amendments and modifications thereto dated October 2, 1979, and February 3, 1984; (ii) to the Madrid Agreement on the Trade-mark International Registration Order; (iii) the Nice Agreement on the International Classification of Goods and Services for the Registration of Marks and (iv) the Paris Convention on Protection of Industrial Property.

Ukraine, however, is technically violating the provisions of the Paris Convention because, under the Laws, foreign persons pay higher registration fees although the Laws state that foreign and Ukrainian persons must have equal rights.

Specifically, industrial property registration fees are levied under the Ukrainian Cabinet of Minister's Resolution No. 543 "On Approving the Regulations on the Procedure for Paying Fees for Actions Related to Protection of Rights to Objects of Intellectual Property," dated May 22, 2001. Significantly, this document applies different standards to resident and non-resident applicants. For example, with reference to the registration of trademarks, a resident applicant (citizen or legal entity permanently residing or located in Ukraine) is charged 1,020 Ukrainian Hryvnia (or approximately 192 US Dollars) for filing a trademark application, whereas a non-resident applicant is charged 450 US Dollars. Further, the amount of fees does not include bank commissions (if any) to be paid in addition to the fees.

Finally, foreign applicants should submit applications to the Department for registration of inventions, utility models, industrial designs and trademarks via Ukrainian patent attorneys. These persons are included in the state register and have special certificates. Activities of patent attorneys are regulated by the Cabinet of Ministers of Ukraine, and are beyond the scope of this brief discussion.

2. CD PIRACY

I. Introduction

How does one find the newest releases of the most popular music in CD format? Just take a little trip to your nearest "perekhod" (underground crossing) or the infamous Petrovka market. What's more, the price of these pirated CD's is, modestly speaking, quite eye-opening: just under \$3.00. The same goes for the most recent computer games as well as professional programs.

On either the "Radio Rynok" or "Petrovka" market, diligent shoppers may even find music, games or programs that have not yet been officially released in the West. True, the packaging is not up to Western standards, but for those who care more about the contents of the discs than the glitzy covers, these local "perekhods" (and public markets) can be mini-gold-mines of precious information, worthy of copying over again and again.

For the western guardians of intellectual property rights, on the other hand, Ukraine exemplifies one of the most flourishing intellectual property piracy markets in the world. In fact, according to Joseph S. Papovich, the representative of the Trade Representative Office of the USA on Issues of Services, Investment and Ownership, Ukraine has been the center for piracy production of compact discs, exporting about 70-100 million pirated discs to Europe per year. Apparently, Ukraine has even surpassed its former supplier of pirated discs, Bulgaria, in the production of unlicensed compact discs.

In the summer of 2000, the infamous President, Bill Clinton, and now-notorious President Kuchma met to discuss future relations between Ukraine and the United States, including the issue of CD piracy. During this meeting, Clinton warned Kuchma of possible sanctions, such as the stiff increase of duties on goods imported from Ukraine to the United States if piracy is permitted to continue, and offered a U.S. "master plan" for the struggle against piracy. According to this plan, Ukraine would simply have to pass the necessary legislation and then shut down factories producing illegal compact discs. To accommodate his colleague in difficult times, President Kuchma solemnly pledged to actively terminate illegal production on the audio-video market of Ukraine, (which has been said to have an annual value of almost \$40 million).

Since then, various Ukrainian newspapers commented on the legal battle waged against such piracy by the Ukrainian government, which has come under great pressure from other Western intellectual property protection groups (and one extremely large and powerful software archi-

ted). In response to the mounting pressure, the Ukrainian Parliament passed long-awaited changes to the Laws "On Protection of Rights to Inventions and Utility Models," "On Protection of Rights to Industrial Designs," "On Protection of Rights to Trade and Service Marks," "On Protection of Rights to Topography of Integral Micro Schemes," and "On Protection Rights to Indicating the Origin of Goods." Additionally, various prophylactic laws and regulations have either already been passed or are in the works.

On January 17, 2002, the Parliament passed Law No. 2953-III "On the Peculiarities of State Regulation of the Activity of Business Entities in Connection with the Production, Export and Import of Discs for Laser Reading Systems" ("Law No. 2953"). Law No. 2953 was supposed to remove all threats of trade sanctions from the United States, which sanctions would be applied if the Law was not passed or failed to encompass certain provisions. Specifically, the United States government demanded that Law No. 2953 provide for (i) licensing for the production, export and import of compact discs; (ii) licensing for the export and import of disc production equipment; (iii) licensing for polycarbonate; and (iv) licensing for components of disc production equipment.

According to newspaper sources, there were at least five factories that produced compact discs on the territory of Ukraine (3 in Kiev, 1 in Lviv and 1 in Kherson). For a long time, their activities remain unspecified. Many asked: will legal measures alone be enough to curb the growing piracy in Ukraine? Most responded "probably not" for one simple reason: an average citizen cannot afford to spend \$15-20 US Dollars for one compact disc, because this amount of money is better spent on the necessities of life. Since the consumer demand for affordable music and computer programs remains at an all-time high, Ukrainian pirates are naturally willing to cater to these demands.

And yet, if the Ukrainian government does not continue to support the protection of American and Western authors' rights by fighting against piracy, then Ukraine would continue to be excluded from such groups as the World Trade Organization, denied foreign financial aid and/or denied future membership in the European Union. Inevitably, trade sanctions were applied on January 23, 2002 in spite of the passing of Law No. 2953. Some said the sanctions were applied because Law No. 2953 was passed too late, other said that a copy of Law No. 2953 was not timely provided to the American government before the decision on sanctions was rendered. Regardless of how one views the imposition of the trade sanctions (i.e., political bullying or a long time coming), it is clear that Ukraine must continue its struggle against piracy or continue to walk a tight rope over even more threatened sanctions.

With this aim in mind, the President issued Decree No. 85/2002 "On Urgent Measures for Strengthening the Protection of Intellectual Property Rights in the Process of Production, Export, Import and Distribution of Discs for Laser Reading Systems," dated January 30, 2002 ("Decree No. 85/2002"). Decree No. 85/2002 sets forth various measures for ensuring that intellectual property rights are not violated during the production, export, import and distribution of compact discs. Decree No. 85/2002 orders the Ministry of Education and Science, the Ministry of Internal Affairs, the State Tax Administration, the State Customs Service and the Security Service to work mutually in ensuring that intellectual property rights are not being violated.

Most importantly, especially to the United States, Decree No. 85/2002 ordered the Cabinet of Ministers to create a sub-division of the Ministry of Education and Science, which sub-division will be responsible for inspecting suspected violators of copyrights according to the new copyright law and other laws passed in the sphere copyrights rights. As a result, the Department of State Inspectors and the State Enterprise "Intelzakhist" was created within the State Department of Intellectual Property, which issues controlling stamps on works of intellectual property and maintains a unified register of recipients of controlling marks (holographic seals). Moreover, Ukraine constantly carries out actions in fulfilling its international obligations under the Agreement on Cooperation in the Termination of Rights Violations in the Sphere of Intellectual Property (ratified in 2000). Ukraine is also in the process of realizing the conception of the development of a national system of intellectual property protection, which includes the development of a law on the protection of rights to computer programs and a continued fight against the manufacture, distribution and sale of counterfeit products.

As of December 4, 2003, 10 special laws in the sphere of intellectual property are in effect in Ukraine, Ukraine is a party to 18 multilateral international agreements in the sphere of intellectual property and the protection of intellectual property rights is regulated by close to 100 supporting normative acts. In addition, the new Civil Code has a separate book dealing with intellectual property and the new version of the Customs Code has comprehensive controlling provisions regulating the import or export of products in violation of intellectual property rights. Ukrainian legislation must be in full compliance with the TRIPS Agreement of the World Trade Organization. And, in July of 2002, amendments were introduced to several laws in the sphere of intellectual property regulating the use of intellectual property via the Internet.

To predict whether these recent efforts will bear fruit, one must understand some of the underlying legislation and mechanisms of enforce-

ment. To provide you with an idea of such efforts, below we provide you with our analysis of one major piece of legislation governing protection of intellectual property in Ukraine with respect to piracy.

II. The Relevant Legislation

From a legal viewpoint, perhaps the most important first step toward eliminating piracy in Ukraine was the Cabinet of Minister's regulations on the procedure of production, storage and sale of holographic seals and the sealing of copies of audio-video products or phonograms on October 13, 2000 (as amended on May 17, 2002) (hereinafter the "Regulations"). The Regulations apply to all legal and physical entities (provided they are registered as subjects of entrepreneurial activity), which engage in distribution, import, export, wholesale and retail trade of audio-video products and records on the territory of Ukraine. These Regulations took effect on January 1, 2001.

According to the Regulations, the State Department of Intellectual Property is charged with creating so-called "holographic seals" pursuant to the Rules for preparing forms for securities and accounting documents. Interestingly, all funds received from the sale of "holographic seals" to entrepreneurs are transferred directly to the state budget, conveniently making the enforcement of the Regulations a priority for the cash-strapped Ukrainian budget.

Physically, the holographic seals resemble their Western counterparts: an 18 x 26 millimeter stickers of a hologram with special protection on its face. In order to stave off piracy of the stickers themselves, each seal must be produced for one-time use only and contain a series and specific number. Pursuant to the Regulations, audio cassettes must be affixed with a series "A" seal, video cassettes must be affixed with a series "B" seal and compact discs must be affixed with a series "K" seal. The number on each seal will consist of 8 characters, 6 of which are numbers and 2 of which are letters of the Ukrainian alphabet. The 2 letters, which are located at the end of the seal number, are for codification purposes and will be changed after the production of each group of a million seals.

Furthermore, the Regulations require that holographic seals be stored as any other accounting document, in observance of the specific conditions and procedure for their storage established by Ukrainian legislation. Only three entities have the right to store controlling seals: (i) the producer of the seals (from the moment of their preparation until the moment they are transferred to the State Department of Intellectual Property); (ii) the State Department of Intellectual Property (from the moment of receipt from the producer until the moment of their sale to the intended recipients); and

(iii) the recipients, such as importers, exporters and copy producers (from the moment of their receipt from the State Department until the moment they are affixed to the relevant product).

Only those importers, exporters and producers which are included on the so-called "Unified Register of Recipients of Holographic Seals" (hereinafter the "Register") have the right to receive holographic seals. The Regulations stipulate that such entities may be entered into the Register upon their first order of holographic seals, provided their application to receive seals is not declined by the authorized body and they submit the proper documentation. Once entered into the Register, the applicant receives an individual registration number for use upon each subsequent order of holographic seals within 3 working days from the acceptance of their original application to receive seals.

The Register contains the following information on those entities registered therein:

- 1) the requisites of the applicant;
 - a) for legal entities: full name, legal and postal address, the number and date of issuance of the certificate of state registration of a subject of entrepreneurial activity, the code of the Unified State Register of Enterprises and Organizations of Ukraine;
 - b) for physical entities (subjects of entrepreneurial activity): surname, given name and patronymic, residential address, the number and date of issuance of the certificate on state registration of a subject of entrepreneurial activity (physical entity) and individual identification number;
- 2) the date of introduction of the entity into the Register and its individual registration number;
- 3) the number of the application for purposes of receiving holographic seals;
- 4) the title of the copies of audio-video products and phonograms; and
- 5) the quantity of issued controlling seals, including their series, number and date of receipt.

The above information is deemed confidential, however, and may only be given out by the State Department of Intellectual Property only upon demand of governmental bodies pursuant to Ukrainian legislation or

upon the request of the applicant. As an exception, the government bodies, which supervise the observance of copyrights and related intellectual property rights, have the right to receive any information from the Register within the limits of their competence without the consent of the entity entered into the Register. Otherwise, any governmental body, including the State Department of Intellectual Property, receiving such information bears administrative or criminal liability for the disclosure or transfer thereof to third parties.

In order to obtain holographic seals after acceptance into the Register, an entity must submit an application to the State Department of Intellectual Property, accompanied by the list and quantity of audio-video copies to be sealed, identifying the producer or rightful owner, the name of the work, the length of the recording, the author and performer, among other information. The State Department of Intellectual Property will confirm the receipt of all proper documentation by sealing the applicant's copy of the application and will issue a written decision on the issuance or refusal to issue the holographic seals within 3 days. The only ground for refusal to issue seals is the failure to submit the proper documentation along with the application.

If the State Department of Intellectual Property permits the issuance of holographic seals, the applicant should instruct its bank to transfer the relevant funds to the state budget. The cost of one holographic seal is equivalent to one percent of an non-taxable minimum of a citizen's income. Currently, one non-taxable minimum income is 17 Ukrainian Hryvnia. The State Department of Intellectual Property will issue the relevant number of holographic seals upon presentation by the applicant of the bank document, evidencing transfer of the official fee to the state budget, and the applicant's identification documents.

All copies of audio-video works or phonograms, which are produced for sale in Ukraine or exportation, must be affixed with holographic seals, except for short outtakes of music for purposes of advertising such music to the public, personal recordings which are not for public use, works in transit through Ukraine, and other works listed in paragraph 1 of Article 10 of the Law "On Distribution of Copies of Audio-Video Products and Phonograms," dated March 23, 2000, No. 1587-III. Holographic seals must be affixed on the packaging of all products in the left upper-hand corner on the backside by the exporters or producers individually, as the case may be. Each work may only be affixed with one seal, including those works with multiple parts (i.e., double compact discs, box sets, etc.). Finally, the seals must be affixed so that the entire seal is clearly visible.

Please note that imported copies of audio-video products are sealed by the importer after they have cleared customs and before putting them into cir-

ulation. In contrast, exported copies of audio-video products are sealed by the exporter before they are passed through customs.

At long last, unsealed audio-video products are declared to be "persona non-grata:" they may only be stored in warehouses of producers or importers of such products, which have the right to own or officially use (i.e., lease agreement) the warehouses. Upon the decision of a court of law, unsealed audio-video products may be confiscated and physically destroyed. The State enforcement service carries out the destruction of unsealed works in the procedure established by Ukrainian law, at the expense of the entity from which the copies were confiscated.

III. Conclusion

Surely in the new millennium Ukraine will continue to apply seriousness in eliminating the illegal production of audio and video products. Undoubtedly, even more reforms in the intellectual property legislative base will be eventually necessary in order to effectively fight the dreaded piracy disease. Moreover, Ukraine is expending a great deal of effort in bringing its intellectual property legislation up to par with the European Union's intellectual property legislation, providing clearer licensing terms and coordinating the efforts of the customs authorities and other controlling bodies responsible for preventing and removing intellectual property violations. In the meantime, however, the present reality may be quite revealing: the rows and rows of pirated compact disc dealers in the local "perekhods" have been showing a tendency to disappear for days on end, much to the dismay of many musical bargain hunters and gaming fans.

3. NEW COPYRIGHT LAW: THE FIGHT AGAINST PIRACY CONTINUES

I. Introduction

The United States actually began to impose all of the trade sanctions it has long threatened on Ukraine due to its inactivity against CD piracy. First, on August 24, 2001, it did suspend the duty-free status of certain Ukrainian products exported to the United States under the General System of Preferences program for transitional countries. Fortunately, the Ukrainian Parliament passed the long overdue amendments to the Law "On Copyrights and Related Rights," signed by the President on July 11, 2001, which came into effect on August 16, 2001 upon its official publication (hereinafter the Law of Ukraine No. 3792-XII "On Copyrights and Related Rights," dated December 23, 1993 (as lastly amended on November 20, 2003), will be referred to as the "Law").

Shortly thereafter, on September 7, 2001, the Cabinet of Ministers of Ukraine issued Decree No. 1149, which approved the procedure for "using and exercising control over the observance of rights to objects of intellectual property in the process of production, export and import of discs for laser decoding systems." Importantly, Decree No. 1149 also set forth the procedure for obtaining licenses to produce compact disc matrixes and compact discs containing copyrighted materials with the permission of the relevant copyright holder(s). Additionally, Decree No. 1149 introduced the CID-code, a special code to be placed on all compact discs, which identifies each disc's producer (a list of which is held by the customs authorities).

Finally, on January 17, 2002, Law No. 2953-III "On the Peculiarities of the Production, Export and Import of Discs for Laser Reading Systems" ("Law No. 2953") was passed by the Parliament thereby rendering Decree No. 1149 ineffective. Law No. 2953 introduces new licensing procedures, CID-codification of produced discs, serious penalties and criminal liability and an increase in the cost of compact discs. This last step was supposed to assure a delay in the application of sanctions on Ukraine by the United States. Nevertheless, trade sanctions were applied on January 23, 2002, and not without controversy. These trade sanctions affected Ukraine's metallurgical, chemical and light production industries the most. More legislation was passed in vain, exemplified by Presidential Decree No. 85/2002 "On Urgent Measures for Strengthening the Protection of Intellectual Property Rights in the Process of Production, Export, Import and Distribution of Discs for Laser Reading Systems," dated January 30, 2002.

In addition to the Law, which for the first time provides for physical inspections of CD producing companies, Law No. 2953 empowers the

Ministry of Education and Sciences to carry out planned or unplanned inspections of CD production facilities with special enforcement agencies in search of violations of copyrights and related rights by CD producing companies. Combined with the passage of Law No. 2953 and Decree No. 85/2002, which confusingly failed to help avoid trade sanctions, Ukraine has actually taken significant legal steps to battle its infamous pirates. Although it is impossible to assess whether the Law, Law No. 2953 and Decree No. 85/2002 will remain satisfactory to the United States, it is apparent that Ukraine is feeling the pressure of the potential sanctions and is trying to mitigate its reputation as the current piracy capital of the world (surpassing even Bulgaria!).

In this light, the discussion below focuses on the major amendments and additions to the Law, as well as their effect on the effort to curb CD piracy in Ukraine.

II. The Law

A. Overview

As a starting point, the Law applies to all copyrights and related rights, which arise after August 16, 2001, with three major exceptions. First, the terms for the protection of copyrights and related rights (now 70 years) apply in all cases if the original 50-year enforcement term of copyrights following the death of the author or the 50-year enforcement term of related rights did not expire prior to the enactment of the Law. Second, the Law applies to performers and phonograms, which were created or first published prior to the enactment of the Law, if 50 years following the first recording or publication has not yet expired.

Third, objects of copyrights and related rights, which were created or first published prior to the enactment of the Law, and which are subject to an international agreement to which Ukraine is a party and which was ratified by the Ukrainian Parliament, are protected under the Law if, prior to the date the Law came into force, the said objects have not entered the public domain in their country of origin due to expiration of their protection term in such country. Finally, the Law calls for the complete and strict enforcement of Article 18 of the Bern Convention on protection of literary and artistic works in Ukraine.

A first glance at the Law reveals an extended list of definitions, including a distinction between phonographs and video cassettes, a definition of contraband copies distributed in violation of copyrights and related rights, and various expansions of definitions in the old law or clarifications of such definitions. The Law also includes databases within the def-

inition of “computer programs” (the old law specifically did not provide for protection of databases) and now includes quotations from publications under its protection.

Additionally, the new Law specifically defines the “distribution of copyright and/or related rights objects” as “*any* activity with the aid of which objects of copyright and/or related rights are directly *or indirectly* offered to the public, including the reaching of such objects to the public’s information in a way that any citizen may obtain access to such objects from any place and at any time at their own will.” This definition should leave no doubt in any pirate’s mind as to the nature of their activities.

The executive branch of the government provides a central body to deal with intellectual property issues known as the “Ukrainian Agency for Copyrights and Related Rights” (the “UACRR”). In addition to formulating state policies and monitoring the observance of copyrights and other rights, the UACRR’s functions are quite broad under the new amendments to the Law. For example, the UACRR proposes the minimum amount of compensation for author compensation and its distribution to the Cabinet of Ministers for approval.

The UACRR is also responsible for providing producers, importers and exporters of phonographs (compact discs, cassettes, video cassettes, etc.) with “controlling stamps” (holographic seals) in accordance with the Law “On Distribution of Copies of Audio-visual Works and Phonograms,” and maintaining a unified register of receivers of holographic seals. Although designed to prevent pirates from selling unauthorized works to the public, to date, many pirates have found ingenious ways of counterfeiting such seals with impunity.

Another important function of the UACRR is to accept and review applications for the state registration of copyrights on scientific, literary and artistic works and the registration of agreements related to copyrights to works, as well as the actual registration thereof. In this respect, the UACRR must periodically publish a catalog of all copyrights registered with the state, publish a bulletin on issues related to copyright and related rights, and hold educational programs. Finally, the UACRR is entrusted with representing the interests of Ukraine as to copyright and related rights protection in international organizations.

As a whole, the amendments to the Law are designed to fill the gaping holes left open by the long-effective original text. In particular, the Law now boldly states that foreign entities and individuals, in accordance with international agreements or on the basis of principles of reciprocity, have the same rights under the Law as Ukrainian entities or individuals. This

provision makes it clear that foreigners are not required to physically arrive in Ukraine to protect their copyrights and related rights. The simple provision of proof as to copyrights through representatives based in Ukraine should be enough to put a stop to infringements. The perpetual question, however, remains: are legal norms alone practically sufficient?

B. Copyrights

The list of objects subject to copyright protection has been expanded slightly by clarifying some of the objects, which fall within the definitions contained in the original text of the Law. Likewise, some of the principles, such as co-authorship and personal non-transferable, non-property rights of authors (i.e., right to recognition as author, the right to remain anonymous, right to a pseudonym or the right to demand that a work remain whole), are enlightened in the Law. However, the most important amendments to the Law are aimed at curbing the rabid existence of piracy in Ukraine.

Article 15 of the Law openly declares the beginning of the serious war against piracy. An author or any holder of a copyright has the exclusive right to either permit or forbid any other person from offering for rent or other type of alienation originals or copies of audio-visual works, computer programs, databases, sheet music or other works recorded on phonograms, video cassettes or other mediums readable by computer. This leaves the infamous retailers from the underground crossings and open air markets exposed to suspicion at all times.

The amendments to the Law finally specify the right to fair compensation to authors for their works, which are publicly performed, shown, demonstrated or announced and/or offered for rent. Such fair compensation may be distributed and paid out by a collective management organization, which is a non-profit organization designed to manage copyrights or related rights on a collective basis, or any other means.

The new version of the Law also provides protection for translations, adaptations, arrangements or other re-works. In this case, a translator or author of other types of reproductions may use his or her copyrights on the condition that he or she strictly observes the copyrights of the original author. However, the copyrights of a translator or author of other reproductions may not prohibit others from doing their own translations or reproductions.

The active term for which copyrights are protected has been extended in most cases as a result of the new amendments to the Law. For example, whereas the old version of the Law protected a copyright for the life of an author and 50 years after the death of such author, the amendments

protect a copyright for 70 years after the death of the author. Likewise, the copyright to a co-authored work remains active for the life of the co-authors and 70 years after the death of the last author. In general, where the original version of the Law afforded after-death or after-rehabilitation protection for 50 years, the amendments to the Law now afford protection for 70 years.

Finally, with respect to copyrights, the amendments to the Law specifically set forth the liability for the failure to fulfill a concluded copyright agreement on the transfer of rights to use a specific work. In accordance with Article 34 of the amended Law, a party, who fails to fulfill or improperly fulfills its obligations under a copyright agreement, is obligated to compensate to the other party all damages, including lost profits. Likewise, if an author fails to transfer the relevant work as agreed upon with the other party to a copyright agreement, the author must compensate all damages to such party, including lost profits. All disputes regarding liability for the non-fulfillment of a copyright agreement must be decided in a court of law.

C. Related Rights

For the first time, the new amendments to the Law specifically define the formerly mysterious “objects of related rights,” and significantly magnify the protection afforded to such rights. According to Article 35 of the Law, objects with related rights, regardless of their purpose, contents, value or methods and forms of expression, are (i) the performance of literary, dramatic, musical, musical-dramatic, choreographic, folklore and other works; (ii) phonograms and video recordings (on all types of mediums); and (iii) programs broadcasted over airwaves or cable.

The amended Law also stipulates those subjects who use related rights as (i) performers of works, their successors and individuals, to whom related rights were legally transferred; (ii) phonogram manufacturers and their successors; (iii) video recording manufacturers and their successors; and (iv) broadcasting organizations and their successors. All of these subjects must at all times observe the copyrights of the original authors, as well as the rights of performers and manufacturers where applicable.

Although the typical proof of related rights remains unchanged (registered rights protection mark, year of publication, names of related rights holders, etc.), the amended Law stresses that even pirates should be aware of the existence of related rights, which may be infringed upon with permission to reproduce and sell. Specifically, the Law now states that even in the absence of the typical proof, one should know that the performer and manufacturer of disks, cassettes, videocassettes, etc. are those individuals marked on the phonograms, video recordings and their copies, as well as on their packaging. In other words, ignorance is bliss.

While the old version of the Law covered most of the relevant topics related to the rights of performers and manufacturers, the amendments clarify these issues to an even further extent. For example, the amendments expand the rights of performers to permit or prohibit public announcement with their non-recorded works (live performances), reproduction of their works, the sale of their works on audio or video mediums, the commercial renting of their audio or video recordings, etc.

Those who enjoy reproducing their own homemade versions of compact discs (mixes, computer programs, etc.) for personal use will be pleased to learn that the amendments to the Law no longer leave authors, performers, manufacturers and broadcasters of such reproduced works without compensation. According to Article 42 of the Law, such compensation is collected in the form of a percentage of the cost of equipment and/or “carriers” (i.e., video recorders, CD players, blank compact discs, cassettes, video cassettes, etc., which are designated for home use only), which percentage must be transferred by manufacturers and importers to the UACRR. This percentage is not taken from the cost of professional equipment and carriers, which are not designated for home use, equipment and carriers, which are exported from the territory of Ukraine and equipment or carriers, imported into Ukraine by individuals for personal use and without a commercial purpose. The Cabinet of Ministers determines the percentage, which must be paid by manufacturers and importers of the said equipment and carriers.

The UACRR determines the destination of such compensation payments on the basis of its agreements with various collective management organizations (non-profit organization entrusted by the UACRR with managing copyrights and related rights on a collective basis). Importers transfer the percentage upon entrance of the goods onto the territory of Ukraine, while manufacturers pay the percentage at the end of each month after the sale of equipment and carriers.

Generally, the compensation percentages to authors and related rights holders are governed by Resolution No. 72 of the Cabinet of Ministers “On Approval of the Minimum Rates of Compensation (Royalties) for the Use of Objects of Copyrights and Related Rights,” dated January 18, 2003. Resolution No. 72 sets forth a complete list of compensation to authors and related rights holders for the various uses of their works, including the reproduction or publication of works on phonograms and videograms, the public performance, retranslation or showing of works, etc. For example, authors’ compensation for the reproduction and/or publication of works fixed on phonograms or other carriers, which are produced outside of Ukraine pursuant to an import agreement, must be paid in the amount of 8% of the original sale price of each reproduction

or copy. For the commercial rent of videocassettes, compensation is paid to the author of the work reproduced thereon in the amount of 5% of the rental amount.

While the Law imposes the requirement to pay authors' compensation and compensation to related rights holders, the text fails to include sanctions for the failure to pay such compensation. Moreover, the Law does not provide a term for the payment of compensation to authors and related rights holders. These two omissions, in combination, can easily create a situation where a user of copyrights or related rights can refuse to pay compensation until he or she is discovered, using the excuse that there is no set timeframe for the payment of compensation. Once a suit is filed, they will be able to pay the corresponding compensation before things come to a head. Obviously, this oversight should be remedied for the Law to be truly effective.

Notwithstanding the aforementioned, to aid in the hunt for pirates and assure fair due compensation, the UACRR is given the authority to demand from all manufacturers and importers information regarding the production, import and sale of all equipment and carriers, which enable reproduction of copyrighted and protected works in the home for personal use. If no specific agreement exists as to how the funds collected from the production, import and sale of such goods must be distributed, the amended Law calls for the following distribution: 50% to authors, 25% to performers and 25% to manufacturers.

D. Protection of Copyrights and Related Rights

Perhaps the most important steps toward battling piracy are the new provisions of the Law regarding active protection of copyrights and related rights. For the first time in Ukraine, the amended Law gives a precise definition of "piracy in the sphere of copyrights and related rights." According to Article 50, such piracy is "the publication, reproduction, importation into the territory of Ukraine, exportation from the territory of Ukraine and distribution of counterfeit copies of works (including computer programs and databases), phonograms, video recordings and broadcast programs." The amendments for the first time also specify such violations of copyrights and related rights as plagiarism, threats to copyrighted materials, code-breaking and counterfeit "controlling stamps" and fake (counterfeit) reproductions.

The amendments to the Law significantly expand the actions, which copyright and related right holders may take in case of a violation of their rights. First and foremost, they may appeal to a court of law or other competent bodies for protection. Upon a violation of a copyright or related right, the holder of such right has the right to:

- a) demand the recognition and restoration of his or her rights, including to prohibit actions, which violate his or her copyrights or related rights *or pose a threat to their violation*;
- b) submit a suit to a court of law regarding the restoration of his or her violated rights and/or the cessation of the activity, which is in violation or threatens the violation of his or her copyright or related rights;
- c) submit a law suit for the compensation of moral damages;
- d) submit a law suit for the compensation of damages (moral damages), including lost profits, or the recovery of income received by the violator as a result of its copyright violation (or violation of related rights), or the payment of due compensation;
- e) demand an injunction against preparatory activities toward the violation of his or her copyright or related rights, including the suspension of customs procedures, provided a suspicion exists that counterfeit copies of works, phonograms, video recordings and protective markings may be imported or exported from the customs territory of Ukraine (pursuant to the relevant procedure of the Customs Code of Ukraine);
- f) participate in the inspections of production facilities, warehouses, technological processes and company operations in connection with the preparation of copies of works, phonograms and video recordings in relation to which grounds exists for suspicion of a violation or a threat of violation of copyrights and/or related rights (pursuant to the relevant procedure of the Cabinet of Ministers);
- g) demand, including in a court procedure, the publication of information regarding copyright violations and/or violations of related rights and court decisions regarding such violations in the mass media;
- h) demand from copyright (or related rights) violators the provision of information about third parties active in the production and distribution of counterfeit copies of works (including works with protected related rights and technology aimed at evading protective measures) and information about their distribution channels; and
- i) demand the application of other legal measures in connection with the protection of copyrights and related rights.

While points (a)-(e) are the typical legal measures used in western countries to punish copyright violators, points (f)-(h) are quite novel in that they include the direct participation of the authors or holders of related

rights. Notably, in combination, the latter points give authors and related rights holders the ability to inspect violators' premises for signs, which the authorities could intentionally or unintentionally overlook (i.e., even the authorities are under watch), expose pirates to the public and those, whose rights may also have been violated by such pirates, and demand information about the pirates' networks and "partners in crime."

Not only are authors (and related parties) given a wider range of latitude to protect their own rights, the new amendments to the Law give promising hope to winning the war against piracy by affording the courts with a nearly absurd range of authority. For example, a court of law can now order the compensation of moral damages incurred as a result of a violation of copyrights or related rights, through no guidelines are provided for what constitutes "moral damage" in such cases. Given today's clandestine shadow market environment, the courts also have the right to demand from copyright violators information about third parties involved in production and distribution of counterfeit works and their channels of distribution.

Courts are also empowered to make the final decision on the amount of damages incurred by authors and holders of related rights. The amount of damages may be calculated on the basis of actual damages, discretionary moral damages, lost profit and legal and court fees. Courts also have the discretion to impose a penalty on violators in the amount of 10 percent of the judgment in favor of the plaintiff, which penalty will be transferred to the State Budget of Ukraine.

In its decision, a court may order the confiscation of all illegal copies of works, including all master copies, magnetic tape, photo negatives, matrices and other objects, which help in the reproduction process, as well as materials and equipment used for reproduction or evasion of copyright protection means. Upon the request of an author or holder of related rights, a court may render a decision to transfer the illegal copies to such author or holder of related rights. If there is no such demand, then the illegal copies will be destroyed, while the materials and equipment used to produce such illegal copies will be sold and the proceeds will be transferred to the State Budget.

While a case is still pending, the judge has the discretion to enjoin a suspected violator from taking any action, such as the production, reproduction, sale, lease, transportation and safekeeping of pirated copies of works, until a final decision is made on the case. If a criminal case is instituted against a violator within the confines of the Criminal Code, then the court must take all measures to search for and lay arrest on all illegal copies, materials, equipment, documents, bank accounts and other possible pieces of evidence.

If a suspected violator refuses to provide the necessary information, to hand over the required information or evidence within a specified period or otherwise hinders the commencement of court proceedings (especially if any delay causes irreversible damage to the plaintiff or there is a clear risk that evidence will be destroyed), then the judge have the right to take interim (temporary) measures even before a law suit is filed or a case has been reviewed in full. Such interim measures may include examination of the premises where the suspected illegal activity is taking place and arrest and confiscation of suspected illegal copies, materials and equipment, as well as the bank accounts and documents of the suspected pirates.

Procedurally, if an author or holder of related rights has well-grounded evidence that temporary measures are necessary to protect his or her rights, he or she may request a court to review a petition for interim measures. The court must review such petition within a two-day period from the date of submission. The petitioner must be present during such review. Before making a final decision on interim measures, the court has the right demand that the petitioner provide proof of their copyrights or related rights and proof that these rights have already been violated or proof that these rights will inevitably be violated.

In such cases, the court also has the right to require the petitioner to provide collateral or an equivalent guarantee to prevent the abuse of the interim measures in the form of cash or material valuables. The amount of the collateral can be no less than 1,700 Ukrainian Hryvnias (approximately 320 US Dollars) and no more than the amount of damages claimed by the petitioner.

If interim measures are instituted against a suspected violator, then such violator has the right to demand their alteration or cancellation altogether. Upon such protest, the petitioner must file a law suit to protect their copyrights or related rights no later than 15 calendar days from the day the temporary measures are instituted. The petitioner's collateral will be returned in full or in part if the court refuses to review his or her case. If the interim measures are cancelled, or no facts exist as to a violation, the collateral will be used to compensate any damages incurred by the suspected violator.

III. Conclusion

In practice, should the above legislation be enforced, no average Ukrainian citizen would be able to afford a compact disc. Rampant piracy exists for this very reason: to satisfy public demand.

In the past, Ukrainian legislation clearly failed to stamp out piracy. The amendments to the Law obviously strengthen what was formerly known as a very weak area of Ukraine's legal system. More and more copyright and related right holders are using the Law's new provisions to protect their own interests and participate in the war on piracy, this is especially apparent in Microsoft's and IFPI's activities on the market. This is evidence that Ukraine has begun to slowly but surely avoid international sanctions as evidenced by its newfound willingness to take significant legal steps towards cleaning up their tarnished image as a haven for pirates.

4. HIGH-TECH ACQUISITIONS

I. Introduction

There are still many disappointing aspects to direct foreign investment in Ukraine. The large companies, which have taken the risk in investing in Ukraine, have been increasing their profit margins greatly over the past few years. Alas, the small and mid-size companies are still a bit weary about investing in Ukraine. Most of these companies claim that their lack of investment is due to Ukraine's uncertain political climate, tarnished international image and reputation as a bed of corruption. Admittedly, this may be the case in some business sectors.

There is, however, one relatively unnoticed sector of foreign investment, which has, for the past few years or so, quietly attracted foreign investors to Ukraine. This new investment comes in the area of high technology. Some of these technology-related investments fall within the realm of defense conversion or genetic engineering. The goal of most such investments, however, is to utilize the relatively low cost of Ukraine's well-educated work force for the development of software code, which will later be sold to private clients in the West.

Fifteen or twenty years ago, such 'offshore software developers' set up their practices in Ireland. As Ireland began to attract greater quantities of foreign investment, the compensation needed to employ quality programmers increased to a point where Ireland was no longer a viable jurisdiction for offshore software development. In their continued quest for inexpensive, but well-educated labor, these high-tech entrepreneurs moved their sphere of operations to India and Pakistan. This too was a viable option for ten or fifteen years.

The fall of the Soviet Union and the development of faster e-mail and Internet connections, however, brought new opportunities to this group of entrepreneurial software developers. Russia and Ukraine held a wealth of highly-skilled programmers, eager to supplement their meager incomes. In the early days of the game, it was possible to hire good programmers for mere hundreds of dollars per month.

Now, of course, the wages demanded by all individuals with high-tech expertise have risen significantly in both Russia and Ukraine. Still, this underdeveloped region and sector hold numerous opportunities for the savvy entrepreneur. Before stepping into deep waters, however, one must be versed in the legislation and regulations that govern high-technology transactions. Below we provide our insight into Ukrainian high-technology law and practice. We hope you find our analysis both useful and interesting.

II. Discussion

As the internet is becoming more and more available to the average Ukrainian citizen, foreign-based internet surfers are coming into contact with the offers and propositions of Ukrainian entrepreneurs looking to sell their technology to the highest bidders. The typical situation is quite simple: a Ukrainian company offers to conclude a sale-purchase agreement for its product with a foreign company willing to pay for the product to an offshore account. Sometimes, the foreign company even wishes to hire some of the Ukrainian company's employees. As this scenario is increasingly becoming in vogue, foreign companies should be aware of the Ukrainian laws regulating such technology transfers.

Obviously, the first step in acquiring high tech from Ukraine is to find out exactly with whom you are dealing. For rather simple, one-time transactions, a bit of background research on the Ukrainian company should be sufficient. As the transactions become more complex, such as the acquisition of the Ukrainian company itself, a larger degree of due diligence is required. This may entail sending experts to the company, where they review all the legal documents and query management and employees with respect to company structure, registration, financial statements, management structure, marketing strategy, etc. The three most important aspects of this process involve asset valuation; verification of legal status and ownership rights, and the detection of both real and contingent liabilities.

For smaller companies or transactions with individual entrepreneurs, background research on the shareholders/participants or the creator(s) of the product may prove invaluable in cases when the foreign company has minimal contact with the target. Such background research mainly applies to assessing the legal capacity of the seller. Pursuant to Article 225 of the Civil Code of Ukraine, all transactions concluded by a citizen who is recognized as legally incapacitated will be deemed null and void. According to Article 216 of the Civil Code, each party to such transaction will be obliged to return to the other party all that was received from such transaction. If such return is impossible, in particular if that which was received is expressed as the use of property, the fulfillment of work or the provision of services, the party which received such use, works or services must compensate the other party the value of the use, works or services pursuant to the prices effective at the moment of compensation.

Once the foreign company has concrete information on its Ukrainian counterparts and their legal capacity to conclude the transaction, negotiations for the conclusion of the sale-purchase agreement may begin. In general, Ukrainian legislation permits citizens to freely sell their assets to foreign companies. However, the income gained by the Ukrainian citizens

after the realization of such transaction will be subject to Ukrainian taxation legislation, which creates problems for many Ukrainians who are unaccustomed to paying taxes. In many cases, Ukrainian citizens request that their foreign counterparts transfer a significant part of the purchase price for any assets to an offshore bank account. Simultaneously, the parties usually conclude a sale-purchase agreement in Ukraine for a minimal amount according to which the Ukrainian party will pay the relevant taxes and obligatory payments to the State. Though clearly illegal under Ukrainian currency regulations, this scheme is quite difficult to discover or prosecute, although enforcement tendencies are on the rise.

Under the above scheme, the mechanism is rather straightforward: Ukrainians simply sign two agreements: one is a sale-purchase agreement, usually for a minimal value (preferably in Ukrainian Hryvnia), payable, for example, to the legal owner of intellectual property. The owner is responsible for paying the taxes on the amount involved in this agreement. The second agreement (e.g., a consulting agreement or management agreement) will be executed outside Ukraine for the actual sale-purchase price in a foreign currency. Under this structure, the owner is still responsible for filing and paying taxes on the income gained under the proposed transfer and bears the sole risk of violating Ukrainian tax legislation by not reporting on the transaction.

Additionally, Ukrainian law strictly prohibits Ukrainian citizens and legal entities from maintaining foreign bank accounts, unless they have the corresponding permission from the National Bank. In spite of this rigid aspect of Ukrainian law, many Ukrainian citizens and companies open and maintain foreign bank accounts for the purpose of concluding transactions in foreign currency via the creation of offshore companies. Therefore, many Ukrainian companies wish to conclude the above-described local agreement in order to avoid any speculation by the Ukrainian authorities as to the existence of foreign bank accounts.

As an alternative, the most legally sound method for a foreign company to purchase high tech products from Ukraine is to enter into one asset acquisition agreement according to which the Ukrainian seller will transfer the proprietary rights to the software to the foreign company and the foreign company will pay the Ukrainian seller by transferring foreign currency funds to the seller's account in a Ukrainian bank. However, the Ukrainian seller may refuse to conclude the transaction in this manner because this will not allow it to minimize the effects of Ukraine's notoriously high taxes.

Foreign companies who have come into contact with such propositions should be aware that there is a risk that the first agreement concluded in Ukraine may be contested at some future date under Article 235 of the

Civil Code of Ukraine, entitled “Legal Consequences of a Sham Transaction.” Article 235 states that if a transaction is concluded for the purpose of concealing another transaction (sham transaction), then the rules regulating the transaction which the parties actually had in mind (i.e., the rules of the agreement concluded outside Ukraine) will be applied. In other words, a Ukrainian court may rule that the agreement concluded in Ukraine was executed solely for the purpose of concealing the real transaction, which is encompassed in the second agreement.

In practice, to the best of our knowledge, these articles have rarely been used to invalidate a sale-purchase transaction for failure to pay taxes or avoidance of currency regulations (with the notable exception of Pavel Lazarenko’s mind-boggling money-laundering operations). However, foreign companies wishing to keep their hands clean should insist upon including a provision into the main agreement to the effect that the Ukrainian party will be responsible for paying all taxes and mandatory payments due under such transactions in Ukraine.

III. Intellectual Property Issues

Most high tech transfers involve the transfer of specific property rights to the targeted object. For example, Articles 1, 7, 8 and 18 of the Law of Ukraine “On Copyrights and Related Rights” afford software (computer programs) a special status. Therefore, a foreign company should determine which rights it will receive upon final transfer of technology.

In this regard, if the product to be sold is listed in an official state register of intellectual property rights and/or the Ukrainian company possesses a certificate of registration, then an agreement on the transfer of such property rights (copyright agreement) should be concluded between the parties in accordance with Article 31 of the Law of Ukraine No. 3792-XII “On Copyrights and Related Rights,” dated December 23, 1993 and lastly amended on November 20, 2003 (the “Copyright Law”), which expressly provides that property rights may be transferred (conceded) by the author or other holder of a copyright to a third party. Additionally, pursuant to Article 32 of the Copyright Law, the author of high tech may permit third parties to use such high tech also on the basis of a copyright agreement. The receipt of a license may give the third party (licensee) an exclusive or non-exclusive right to use the author’s high tech product in specific situations or in a certain manner. The exclusive license allows only the licensee to use the above product, while the non-exclusive license grants both the author and other licensees the right to use the product.

According to Article 33 of the Copyright Law, a licensing or copyright agreement is deemed concluded upon agreement by the parties on the

material terms and conditions, including the manner of product use, the amount of and payment procedure of the author’s compensation, the term of the agreement and the term of the product’s use. Importantly, foreign companies must perform the required level of due diligence to uncover such licensing agreements before purchasing the high tech product. Any existing licensing agreements may create obstacles for the foreign company to buy or properly use the high tech product in the intended manner.

Similar to the Bern Convention and many copyright laws of western countries, Ukrainian law divides the rights to works (including software) into the following categories: a) personal (non-proprietary); and, b) proprietary.

Pursuant to Article 14 of the Copyright Law, personal rights belong only to the author of the work, may not be transferred to third parties, and include the following:

- a) the right to demand the recognition of his/her authorship, as well as to demand the mention of his/her name in connection with the use of such work;
- b) the right to prohibit the mention of his/her name upon public use of a work if the creator of the work wishes to remain anonymous;
- c) the right to chose a pseudonym in connection with the use of the work, and the right to indicate or demand indication of such pseudonym on the work and its copies; and
- d) the right to prevent any reproduction or change of the work which may affect the honor or reputation of the creator.

Proprietary rights belong either to the author or to the person that possesses the relevant copyrights. Such rights include the exclusive right to allow or to prohibit: the reproduction of the work; public demonstration of the work; translation of the work; change of the work; distribution of the work by way of sale; lease of the work; importation of copies of the work, etc.

According to the Copyright Law, only the proprietary rights may be transferred (conceded) to any third party by the author or the person that possesses the copyright. In other words, if a company enters into a sale-purchase agreement for high tech equipment with either a Ukrainian company or its employee/author, it will not be entitled to the transfer of the above personal rights to the software under such agreement (Article 14, paragraph 2 of the Copyright Law).

Finally, before drafting and signing the sale-purchase agreement for any high tech acquisition, a review of Ukrainian law regarding the ability to sell certain types of technology is warranted. In this regard, the purchaser should, at the very least, briefly review the Law of Ukraine "On State Secrets," No. 3855-XII, dated January 21, 1994, for any restrictions that might exist on the sale of such technology. Specifically, some types of computer programs or high tech equipment may fall under the definition of "state secret," which is defined as any information that may cause a threat to the national security of Ukraine. The above law covers various broad spheres of information that fall under the definition of "state secrets."

IV. Employment Issues

As briefly mentioned, many companies have already begun to tap the Ukrainian employment market for highly qualified technology experts, who usually come at an almost insultingly cheap rate. However, many countries, including the United States, have placed minimum salary limits for such experts if they are to be transferred out of Ukraine. Therefore, companies have started to hire Ukrainians for certain tasks, such as software development, without requiring them to leave home.

There are two ways to hire Ukrainian citizens to create high tech products: (i) the conclusion of an employment contract between the Ukrainian citizen (employee) and the foreign company (employer); or (ii) the conclusion of a civil contract between the Ukrainian citizen, as an independent contractor, and the foreign company.

Employment contracts are governed by the Labor Code and have certain limitations in comparison to civil contracts, which are governed by the Civil Code. In order to enter into an employment contract in Ukraine, the foreign company must have either a representative office or other business entity established in Ukraine. Under employment contracts, the foreign company is responsible for paying the relevant taxes and duties to the various obligatory social funds of Ukraine in respect to the employee's salary. Significantly, individual employment contracts may not provide for social guarantees and conditions that are worse than those established by Ukrainian labor legislation (i.e., minimum salary requirements, employment termination, etc.).

In contrast, civil contracts for independent contractors provide greater freedom to agree upon material terms and conditions and somewhat simplify the taxation and payment procedure for the foreign company. In turn, the independent contractor (i.e., the author) will be responsible for paying all obligatory payments on his/her own income. However, in these cases, the independent contractor (author) usually requests that

payment be made offshore, triggering the same risks in relation to the civil contract described above in the discussion on the acquisition and payment for high tech products.

V. Conclusion

Every country needs its gold mine. Perhaps one of Ukraine's greatest resources is the practicality of its professionals. For more than reasonable rates, Ukrainian experts can be hired to do the job of their Western counterparts without paying them a salary in relation to the standards of living in the West. The high tech sector may just be that undiscovered gold mine.



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