

Now is the time to dramatically reform

Ukraine's legal system

IRINA PALIASHVILI

In light of the fundamental and systematic economic reforms needed in Ukraine, and the ongoing sharp increase in foreign and domestic investment, it is imperative to ensure that Ukraine's legal system is prepared to serve as a modern pillar for the economy and society.

The current legal foundation is inadequate and to a large extent, sabotages the development of a market economy in Ukraine. It is archaic, anarchic, and at times absurd.

The market responds to this situation in a healthy way by avoiding the legal and regulatory regime and corrupt judiciary, while ignoring the more absurd laws and concentrating on developing the best modern business practices.

Unfortunately, this creates an ever widening gap between what is written in law, what is understood by those who administer the law (government authorities, regulators, judges), and the business community.

At first, this may seem like a reasonable truce, as it does not interfere with the steady development of Ukraine's markets. But this solution is not harmless – it encourages non-compliance, greatly increases the risks of doing business, provokes artificial commercial disputes, and fosters such ugly trends as corruption, lack of enforcement, corporate raiders, and lack of corporate governance.

The new government's top priority, therefore, should be to act, swiftly and decisively. Ukraine's legal system, and consequently the business climate, could be immediately and dramatically improved by simply cancelling the most archaic and damaging legislation, using the so-called "guillotine" principle, which worked successfully in other countries that successfully undertook modernization reforms.

However, some of the problems are of course fundamental and cannot be solved in a vacuum and require significant unified political will along with rational systematic effort.

The fundamental problems include overall outdated, contradictory, ambiguous and low-quality laws, statutes and regulations; an excessive, inefficient, and poorly qualified bureaucracy; and a corrupt and underdeveloped judicial system. These problems cannot be solved overnight and will require generations of work.

There are some problems; however they can be resolved much faster and could have a tremendously positive impact on the business climate.

Corporate legislation is underdeveloped and nonexistent in key areas such as joint-stock companies and limited liability corporations.



Irina Paliashvili

The existing commercial code is anti-market and the civil code is flawed, and each is in fundamental conflict with the other. Simply axing the commercial code would have a significantly positive impact.

Chronic overregulation and the resultant government interference in business affairs are chaotic, arbitrary, excessive, and incredibly costly. This is loosely referred to as the "permits system," or by the broader, internationally known term, "regulatory governance." Various Ukrainian governments made several half-hearted attempts at deregulation, but in the absence of true political will, they generally resulted in yet more overregulation and chaos.

The highly publicized government effort to eliminate several thousand regulatory acts in 2005 failed because the cancelled acts turned out to be archaic documents, which had little to do with business regulation and were not applied in any case.

The tax system and multiple tax bureaucracies are complicated, with the worst offenders being the value-added tax (VAT) and unjustifiably high social taxes.

There are two key problems with VAT. First, the problem exporters have in obtaining their rightful refunds. Second, the 2005 law imposing a 20 percent VAT on in-kind contributions by foreign investors into Ukrainian companies' charter capital, in effect representing a 20 percent non-refundable tax on in-kind foreign investment.

The currency regime and financial sector need liberalization. Unnecessary obstacles and hidden charges include the overregulation of ordinary financial activities.

For example, in order to perform many one-time simple financial activities, companies need to be registered with the State Commission of Ukraine for the Regulation of Financial Services Markets of Ukraine.

Furthermore, any sale-purchase of Ukrainian securities (even outside of Ukraine between non-residents) must be carried out only with the participation of a Ukrainian securities trader.

Meanwhile, the National Bank of Ukraine (NBU) has excessive licensing requirements with regard to foreign currency transactions and payments outside Ukraine. The NBU also has draconian international loan requirements, and it constantly interferes with the investment regime, inventing new barriers to investment.

Inconsistent government policies discourage foreign investment in the vital energy sector. Although a first-ever Production Sharing Agreement was concluded in 2007 with the US-based Vanco, most of the energy, and especially the oil and gas sectors, remain virtually closed to foreign investors.

Moreover in 2007, the government declared the traditional method of joint

activity agreements used by foreign investors involved in natural resource exploration and development unlawful. It further drove out foreign investors by introducing restrictions and price controls on the sale of natural gas extracted in Ukraine.

"NO GOVERNMENT SO FAR HAS BEEN WILLING TO DEVELOP A STRATEGIC PROGRAM OF REFORMS FOR THE LEGAL AND REGULATORY SYSTEM, AND IT REMAINS TO BE SEEN WHETHER THE NEW GOVERNMENT WILL MAKE A SERIOUS AND HONEST EFFORT TO ADDRESS THEM."

**— Irina Paliashvili
RULG-Ukrainian Legal Group
president and senior counsel**

Anti-monopoly legislation is unnecessarily broad and ambiguous, over-regulating economic concentrations with extremely low thresholds, which in turn forces companies to seek the Antimonopoly Committee of Ukraine's prior approval of actions that have no bearing on competition in the Ukrainian market at all.

Intellectual and industrial property protection is lacking, especially in enforcement.

Another concern is the ongoing moratorium on sale of agricultural land, and restrictions on land ownership by foreign investors.

Property rights remain tenuous and corporate raids are increasing. All of these problems, although constantly and loudly criticized by the business community, have been neglected by several generations of the country's leadership.

No government so far has been willing to develop a strategic program of reforms for the legal and regulatory sys-

tem, and it remains to be seen whether the new government will make a serious and honest effort to address them.

The good news, however, is that the business community has not given up, and demand for reform is reaching critical mass.

One of the major market tendencies, which will inevitably result in the modernization of legal and regulatory regimes, is the immense hunger of Ukrainian companies for growth. This is equally true for multi-industry giants, medium-sized companies, and small businesses.

All are looking for financing on both the domestic and international markets through initial public offerings (IPOs), mergers & acquisitions, strategic and portfolio investment, issuance of corporate debt instruments, and direct borrowing from domestic and international lenders. They can no longer tolerate the obstacles created by the antiquated legal regime and bureaucracy.

Several sporadic positive developments of the last two years, such as the adoption of a modernized version of the Securities and Stock Market Law, the adoption of several progressive laws to promote Ukraine's World Trade Organization (WTO) accession, the adoption of stronger anti-piracy optical media licensing rules, the creation of a regulatory framework for mortgage lending, and liberalization of incorporation procedures, were similarly driven by the business community and international organizations and institutions.

2008 will be the pivotal year in terms of the desperately needed reforms and modernisation of Ukraine's legal regime and business climate for two main reasons.

The business community no longer wants nor can afford to tolerate obstacles created by the legal chaos and inefficient bureaucracy and second, because the new government will be unable to remain in power while ignoring the business community's demands.

Irina Paliashvili is chair of the legal affairs working group of the US-Ukraine Business Council (USUBC). She is also president and senior counsel of the RULG-Ukrainian Legal Group, P.A.