

**Presentation for the Country Focus Workshop on Ukraine
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*by Dr. Irina Paliashvili
President of the Russian-Ukrainian Legal Group, P.A.*

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I. Overview of Ukraine's Legal System

Ukraine's Legal System

Ukraine gained its independence in 1991. As a newly independent country, creating a modern and stable legal system became one of Ukraine's top priorities. Today, after almost seven years of independence, certain progress has been made, but the task is far from complete. The current legal system is still undergoing reforms and lacks essential basic components, such as, for example, a modern civil code.

At the same time, there is a common misperception in the West that a legal system and a legal tradition in Ukraine is totally absent, a sort of *tabula rasa*, a clean sheet of paper. On the contrary, Ukraine always had an established legal system based on continental law. In the United States, this system is referred to as a civil law (European) system as opposite to the common law (Anglo-American) system. Therefore, there is no need to build absolutely every legal institution from scratch. Even in the worst days of Communist rule, the core of Ukrainian civil law was quite viable - it was BGB, the German Civil Code. Of course, there was socialist doctrine grafted on top, but the principal areas of law, such as the law of contracts, civil law obligations and liability, torts and labor law, as well as applicability of choice of law and international arbitration to international business transactions, were based on European tradition.

Therefore, the current legal system in Ukraine, despite its flaws and complications, does provide a certain legal basis for doing business and for protection of the legitimate interests of parties involved in it.

Hierarchy of Legislation

As with any civil law system, Ukraine's system is based on laws adopted by the Supreme Rada (the Parliament), with the Constitution being the fundamental law, followed by various codes (Civil Code, Criminal Code, Labor Code, Subsoil Code, etc.), followed by laws of general nature and laws of special nature. The general problem with Ukrainian laws are their often inadequate quality and instability. With different laws sometimes contradicting each other and ever-changing legislation, it is difficult for everyone, including judges, to clearly understand which rules are applicable to a particular relations at a particular time, or even more so, to plan for the future. The main specific problem in the area of civil legislation is the absence of a modern civil code. The civil code, which is currently in effect, was adopted in 1964 and is not sufficient to regulate modern economic relations. There are various drafts of the new Civil Code appearing and reappearing in the Rada from time to time, but unfortunately until now no serious attempt to adopt a new Civil Code has been made.

The implementation of laws adopted by the Rada is based on subsequent edicts, decrees, regulations, etc., adopted by the President, Cabinet of Ministers, National Bank and various ministries (regulations adopted by the ministries are subject to mandatory

review and registration by the Ministry of Justice).

It is important to mention one unusual although temporary feature of the current Ukrainian legal system: the President of Ukraine is empowered to issue Presidential Edicts that have in essence the force of a law on economic issues that are not governed by existing laws. Such edicts take effect if they are not vetoed by the Rada within 30 days. This feature was aimed at encouraging a more conservative Rada to speed up adoption of market oriented laws and to allow the President to step in when the Rada was too slow. In practice, however, because such Presidential Edicts often exceed the scope of available authority (for example governing issues already covered by existing laws), they sometimes add to instability and confusion.

It should be mentioned that the body of regulations adopted by the executive branch suffers from the same problems as the body of laws adopted by the Parliament: insufficient quality, instability and over-regulation.

The Judiciary and Enforcement of its Decisions

As Ukraine's legal system in general, the judiciary system in particular has been undergoing reforms for the past several years. Ukrainian state courts are divided into general courts and arbitration courts. Arbitration courts, despite its misleading name, are not arbitration bodies, but state commercial courts that review business disputes. There is also the Constitutional Court, which is independent and is empowered to interpret the Constitution and review the constitutionality of legislation. Finally, Ukraine allows arbitration tribunals (*treteiskie sudy*), including international commercial arbitration, whose decisions are generally enforceable.

In general, the judiciary is still quite weak and prone to political influences. Not long ago, for example, a top Government official expressed his outrage at judges who deny the claims of tax authorities against businesses. In addition to a weak judiciary, enforcement remains a top problem in Ukraine. Hopefully, with the adoption of the new Law on Judicial Marshals, who are now included in the Ministry of Justice system, some progress will be seen in the enforcement area.

The weakness of judiciary had led to the creation of all sorts of supplementary, quasi-judicial mechanisms aimed at pre-court resolution (akin to mediation) of disputes between investors and government authorities. Last year, for example, President Kuchma created a Chamber of Independent Experts on Issues of Foreign Investment. Although it is not entirely clear whether the decisions of the Chamber are binding on government authorities, they are sent to the President, as well as to relevant government authorities and are often effective in resolving investors' problems.

Commercial, Contractual and Investment Laws

Ukraine has a substantial body of commercial, contractual and investment laws. Although most were adopted in the last several years, they very quickly became outdated and can hardly cope with the developing business environment. Moreover, the absence of the new Civil Code remains a major problem. As Russia's experience demonstrates, a modern Civil Code makes a big difference in improving the country's legal environment. Ukraine has several tax laws which are constantly revised with the latest idea being to codify all tax laws in one comprehensive tax code.

At the start of independence, foreign investment legislation was extremely favorable and provided for all sorts of privileges and exemptions. Gradually these privileges and exemptions were revoked, with attempts by the Government to revoke even those which were grand-fathered (at present, a combined claim filed by a large number of such investors is pending at the Constitutional Court of Ukraine). Currently, foreign investors are generally subject to a national regime with minor exceptions provided by relevant legislation and international treaties.

Ukraine's Participation in International Treaties and Conventions

One bright spot is that Ukraine has undertaken a growing number of international commitments, some of which were inherited from the Soviet times when Ukraine, as an independent member of the United Nations, participated in most of its conventions. Other commitments have been undertaken since Ukraine gained its independence. Ukraine already is, or plans to become, a member of several major international organizations, as evidenced by its pending application in the WTO. One more membership that would enhance Ukraine's investment climate is participation in the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the ICSID Convention). Ukraine already signed this Convention, but ratification is still pending in the Supreme Rada.

Among the most prominent multinational conventions to which Ukraine is a party are 1958 UN Convention on Recognition and Enforcement of International Arbitral Awards and the 1980 UN Sales Convention. Incoterms 1990 were enforced in Ukraine by a Presidential Decree (a quite unusual development, since states traditionally leave application of Incoterms to the discretion of the parties). It should be also noted that Ukraine participates in major intellectual property rights conventions, including the Paris and Madrid Conventions. In addition to multinational conventions, Ukraine is party to a number of bilateral tax, trade and investment treaties.

Closer cooperation has developed between Ukraine and the other ex-Soviet republics, both on a multilateral (CIS) and bilateral bases. Although Ukraine is not a member of the Customs Union, it has bilateral free trade agreements with most CIS countries and participates in a number of multilateral CIS agreements.

Comparative Analysis of Legal Developments in Russia and Ukraine

Because many of the Conference participants are more familiar with the Russian legal system, our observations on how the Ukrainian and Russian legal systems are developing independently after having been under the same system for 70 years may help to better understand Ukraine's legal environment. In Soviet times, virtually all legislation was drafted in Moscow. Although each Soviet Republic, including Ukraine, had its own Civil, Labor, Administrative and other Codes, all of them looked surprisingly similar. Such ultimate unification was based on dictates from Moscow. It was not, therefore, surprising that after the dissolution of the Soviet Union, each Soviet Republic started to move in a different legislative direction, rejecting to various degrees what was created in Russia and trying to create their own unique legislation.

This reaction is emotionally understandable, but Ukraine's mistake was that it also ignored the positive legislative developments achieved in Russia and missed an opportunity to learn from Russia's mistakes.

Today a process of unification of Russian and Ukrainian law is slowly reemerging, but this time on a voluntary basis. The tendency is positive for Ukraine because it can learn from Russia's more advanced legislation, including the new Civil Code modeled after the Dutch Civil Code, the JSC Law, LLC Law and the General Part of the Tax Code. As if to confirm this new process, the Ukrainian Supreme Rada recently created an inter-factional Deputy Group for direct contacts with the Russian Duma.

II. Contractual Law and Agreements

Ukrainian Legislation Governing Contracts

The principal general law governing contracts is the Civil Code. As was mentioned above, Ukraine is still using the old Soviet Civil Code of 1964 (which was essentially based on the German BGB) with some amendments that were introduced in the last several years. In addition, selected types of contracts and agreements are governed by special laws, for example lease agreements are governed by the Law on the Lease of State Property, pledge agreements by the Law on Pledge, the leasing of land by the Law on Lease of Land, corporate foundation agreements by the Law on Commercial Companies (Economic Partnerships), intellectual property agreements by laws on intellectual property, etc.

There is also a special body of law governing international business transactions, or IBTs (the term used in Ukraine is "foreign economic transactions"). IBTs are primarily governed by the Law on Foreign Economic Activity. In addition, selected types of IBTs are governed by special laws and international conventions to which Ukraine is a party. For example, IBTs on sales-purchase are governed by the 1980 UN Sales Convention (if applicable) and Incoterms 1990 (the latter document was adopted in Ukraine by

Presidential Decree). IBTs in different areas of international freight are governed by special laws and relevant international conventions.

Selected Rules Applicable to Most Frequently Used Types of Contracts

While entering into a specific type of contract or agreement, it is necessary to examine all applicable legislation, as well as Presidential Edicts, decrees and regulations of the executive branch, which often contain very important specific rules, such as, for example, bans or restrictions on certain types of transactions (e.g., barter of certain types of goods was banned by a Presidential Edict). It should also be mentioned that laws of Ukraine have strict procedural rules applicable to the form of transactions (written form, notarized form, number of signatures, etc.) and violation of these rules may result in the invalidation of transactions.

Below are just a few practical examples of specific rules applicable to selected types of contracts or agreements:

* A Presidential Edict issued in April, 1998 specifically prohibited assignment of claims and transfer of debts. Although this ban is essentially unconstitutional (both assignment of claims and transfer of debts are allowed by the Civil Code), in practice it is advisable to avoid entering into these types of transactions, unless the parties are willing to challenge the validity of the Presidential Edict in courts.

* Leases of state property are governed by the Law on the Lease of State and Communal Property. In the past, this Law was applicable to leases of non-state property only if the parties to such a lease agreed on its applicability by mutual consent. Recently, however, the Law on the Lease of State Property was amended to provide that it is directly applicable to leases of non-state property, unless the parties of such lease explicitly exclude the application of this Law.

* The Law on Foreign Economic Activity contains an archaic rule inherited from Soviet times (and, by the way, no longer applicable in Russia) that IBTs must be signed by a Ukrainian party (if this party is a legal entity) with two signatures. Despite the absurdity of this rule, failure to observe it may result in invalidation of the entire transaction (to which there are quite a few practical examples), as confirmed by a decision of the Constitutional Court in December 1998.

* Selected types of transactions are subject to mandatory registration with relevant authorities, including real estate pledges (and as of March 1999 of movable property pledges), licensing agreements and selected IBTs.

The above examples clearly demonstrate the importance of careful review of applicable current legislation while entering into a specific transaction. Despite this confusing and complicated legal environment, government authorities and courts demand strict compliance even with most absurd legalistic requirements and failure to observe them

often may result in quite unpleasant surprises for uninformed parties.

Choice of Law, Language, Dispute Resolution

Such provisions as choice of law, language and dispute resolution are applicable mostly to IBTs. Domestic transactions may only be governed by Ukrainian law and if by mistake the parties to a domestic transaction provide for a choice of foreign law (this happens sometimes when the parties to a transaction are foreign owned Ukrainian subsidiary companies), the court would simply invalidate this provision.

In terms of IBTs, both the Civil Code and the Law on Foreign Economic Activity allow the parties to choose the law applicable to their rights and obligations under their transaction. If such choice has not been made by the parties, Ukrainian law contains a body of conflict rules applicable depending on a particular type of IBT.

It is important to note that non-lawyers signing IBTs often believe that application of foreign law will allow them to escape the mandatory regulatory requirements of Ukrainian law (administrative, tax, currency, etc.). This is, of course, not true because foreign law is applicable only to rights and obligations of the parties and may not replace the regulatory requirements of Ukrainian law.

The parties to IBTs are also free to choose the mechanism for dispute resolution, with the principal options being either local courts or international arbitration (*ad hoc* or institutional). Our practice shows that international arbitration is advisable when a Ukrainian party to the IBT is a large company with a solid reputation. In most other cases, local courts are recommended in order to secure quick injunctions and greater chances for enforcement.

In terms of language, although the original documents of IBTs may be executed in a foreign language only, it is strongly recommended to execute them in Ukrainian as well to avoid troubles with notarized translations, etc., while submitting them to various regulatory authorities (customs, tax inspectorate, certification bodies, etc.).

Due Diligence on Potential Business Partners and Customers

There is a joke among the Ukrainian (and Russian) legal community that the best due diligence is a full advanced payment. Unfortunately, this may not be always possible.

Because in Ukraine due diligence usually is a costly and complicated procedure that in many cases can not guarantee the success of a business transaction, it is advisable to perform due diligence only if necessary and only within the necessary scope. For example, while securing a transaction with a pledge, a limited due diligence is necessary on the legal status of the property subject to pledge. On the other hand, when mergers and acquisitions of local companies are contemplated, a full scale due diligence is strongly recommended.

Specific Regulatory Concerns

While entering into a transaction in Ukraine, a large number of regulatory issues should be taken into account, including tariff and non-tariff restrictions, taxation, newly introduced state stamps, currency, customs regime and other regulatory issues. Below are just a few examples:

- * Most imported goods are subject to a local VAT of 20% and import duties. Quite a few categories of imported goods are also subject to excise tax. For selected categories of goods, the government has established a minimal customs value for the purposes of calculating VAT and/or excise tax (which is contrary to WTO rules).

- * Import of excisable goods is subject to several additional regulatory rules.

- * Many categories of imported goods, including all food products, are subject to mandatory certification and phyto-sanitary control.

- * Selected categories of imported and exported goods are subject to import or export licensing or quotas. Mandatory registration with the Ministry for Foreign Economic Relations and Trade of IBTs related to certain categories of goods is required.

- * According to a newly-adopted Presidential Edict, as of January 1, 1999 all transactions, including IBTs, must bare State Stamps (a new type of state fee). Although the absence of such a State Stamp in a strict legal sense does not invalidate the transaction, it will result not only in penalties and criminal liability (for tax evasion), but also deprives the parties to a transaction from referring to the transaction in state bodies, or in case of a dispute, which practically means little less than invalidation.

Contracts with the Government (Production Sharing Agreements)

The Government rarely enters into civil law transactions, including into IBTs. Unlike Russia or Kazakhstan, where the new Civil Codes regulate participation of the State in civil law transactions, the old Ukrainian Civil Code has few provisions on this subject. Therefore, the lack of a sound legal basis for civil law transactions with the State (government) makes such transactions problematic. For example, it is commonly accepted practice that the State is supposed to waive sovereign immunity while entering into IBTs. In Ukraine, however, the government refuses to follow this practice, referring to a lack of legislation on this matter.

The draft Law on Production Sharing Agreements, which is currently pending in the Supreme Rada, for the first time in Ukraine's legislative history explicitly provides that the State must waive sovereign immunity while entering into production sharing agreements. If adopted, this Law could be used as a precedent when waiver of sovereign immunity will be needed for other types of transactions.