

TO: Clients and Friends of the Firm
FR: Frishberg & Partners
RE: 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 funds 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.

.....
: If you wish to receive the entire article, please
: contact us at: office@frishberg.com.ua.
:
: Thank you.
:.....