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Need for Corporate Law reform in Ukraine

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In the modern market economy, corporations play a leading role. They are the main consumers of investment resources and the largest employers and producers. Effective regulation of corporations plays a decisive role in creation of an attractive investment climate and a favourable entrepreneurial environment. For a long time, the Ukrainian authorities have not pay sufficient attention to development of the national company law, despite of their obligation to approximate the Ukrainian legislation «on companies» to the EU Company Law, which Ukraine took on itself in accordance with the 1994 Partnership and Cooperation Agreement (PCA)., Lack of an adequate system of corporate governance and guarantees for investors' rights is one of the causes for Ukraine's low competitiveness in rivalry for investment resources on the world's financial markets. For a long time, the Ukrainian company law consisted of the Law «On Business Associations» (1991), which established five legal organisational forms for economic activities (a joint stock companies, a limited-liability companies, an additional-liability companies, a commandite (limited-liability partnership) and a full partnership). The Law « On Business Associations», however, is extremely fragmentary and contains numerous gaps. The 2003 Civil Code of Ukraine, although eliminated a number of gaps in regulation of legal entities, did inherit most of the serious drawbacks and collisions that the Law « On Business Associations» contained. As in other countries, structures that envisage limited liability have become the most popular in Ukraine — a joint stock company (due to privatisation) and a limited-liability company (in case of a new business being established) — which have become predominant in the private sector of economy (approximately 30 thousand joint-stock partnerships and 400 thousand of limited-liability partnerships).

Systemic shortcomings of the Law «On Business Associations» include the absence of effective tools to protect the rights of minority shareholders (participants). This entails an excessive concentration of property and threatens with expropriation of minor partners by corrupted managers and major shareholders. The Law «On Business Associations» combines both an extremely general and indistinct nature of many provisions and the fragmentary nature of regulations, as well as numerous gaps in them. Imperfections of legal regulations of joint-stock companies and limited-liability companies have entailed abuse of control, withdrawal of profits, depletion of assets, excessive concentration of capitals, redistribution of property and overtly unlawful acts (corporate raids), which have deteriorated the investment climate, undermined macroeconomic stability and inhibited the development of the Ukrainian economy.

On September 17, 2008, the Supreme Rada of Ukraine passed the Law «On Joint-Stock Companies», which introduced to the Ukrainian corporate law a number of important norms and principles, such as:

- strict supervision over managers on part of the Supervisory Board,
- conferring a broad scope of powers on the Supervisory Board as a body that can be the most effective in protection of shareholders' interests,
- formation of the Supervisory Board by cumulative voting, which ensures proportional representation of shareholders and gives minority shareholders a possibility to elect their representatives to the Supervisory Board.

The Law effectively protects minority shareholders from erosion of their shares in the charter capital through a clear regulation of the shareholders' pre-emption right. The Law also properly regulates the rights of shareholders who own privileged stock. An effective tool to protect interests of minority shareholders is assured by granting them the right to demand

buyout of their stock in case they disagree with individual important decisions taken by the company (appraisal rights).

At the same time, reform of the corporate law and formation of the national system of corporate governance cannot be regarded as completed. The Law «On Joint-Stock Companies» still contains a considerable number of imperfect and ineffective norms, which may cause a considerable harm to Ukrainian joint-stock companies and the national economy. These shortcomings need to be rectified.

For example, it is necessary to cancel the requirement about mandatory listing of shares of public joint-stock companies on a stock exchange. The majority of joint-stock companies have neither a will nor a possibility to raise funds through selling of their stock on a stock exchange and to maintain liquidity of their stocks. Investors will also have no interest in purchasing that kind of securities at obscurely set prices and with notional liquidity. Besides, it is apparent that Ukrainian stock exchange lacks technical capacity to list over 10 thousand stock issuers. Requirements to sale and purchase of public companies' stocks exclusively on the stock exchange must be cancelled, because it makes stock an unattractive investment instrument for small investors.

The rule that approval of decisions by shareholders general meeting requires a qualified majority of three-quarters vote, calculated on the basis of the total number of shares rather than on the number of shareholders attending the meeting, may paralyse the process of decision making at the majority of joint-stock companies.

The norm on a strict subordination of a member of the Supervisory Council to the shareholder that appointed them, and preference to protection of such shareholder's interests over the interests of the corporation may often transform the Supervisory Council into a puppet body that serves interests of external subjects rather than given company. Accountability of supervisory board members to external parties deprives minority shareholders/small investors of any chance to influence/improve efficiency of company management.

Many important regulations in the Ukrainian law are, for a significant part, of decorative nature, since they are not supported by any tools to ensure their enforcement. This concerns regulation of related-party transactions, mechanisms of bringing executive officers to responsibility, regulation of acquisition of the controlling block of shares, requirements to audit the accounting documents of company.

Unless the significant shortcomings in the Law «On Joint-Stock Companies» are removed, the Ukrainian joint-stock companies will hardly be able to adequately perform their function of organisations of competitive production, interesting for potential investors, and supplying reliable and attractive investment instruments (securities) to the Ukrainian stock market.

Norms of the Law of Ukraine «On Joint-Stock Companies» and other legislative acts still need to be harmonised with the EU Company Law directives and adjusted to common conceptual approaches of company law, which have long been established in the legislations of the EU member states.

Limited-liability companies are the most typical legal organisational form for small and medium businesses. The quality of legal regulation of limited-liability companies is an important component of a favourable economic climate and a powerful tool for stimulation of economic growth and overcoming of consequences of the financial crisis. The effective legislation that currently regulates activities by limited-liability companies, which consists of provisions of the Civil Code of Ukraine and the Law of Ukraine «On Business Associations», is inconsistent, fragmentary, and does not meet the present-day requirements regarding flexibility and preciseness of regulation. The main shortcoming of the effective legislative acts

is their inability to provide participants in limited-liability company with effective tools to protect their rights and to ensure a balance of interests. Therefore, Ukrainian limited-liability companies predominantly become one person's companies through capturing of control by one of the participants, or they soon go bankrupt in case of a conflict between participants on control over cash flows. The existing legislation does not ensure that economic entities perform their main function – providing of a mechanism that makes it possible to consolidate capitals and efforts by several participants in order to conduct economic activities and guarantee a fair distribution of profits, generated by the company, between its participants. Inability of the current legislation to ensure adequate protection of interests of participants in a limited-liability company, predominance of the model of an «effective owner» - one person, in the conditions of the financial crisis, leaves many Ukrainian enterprises with no chances for survival by raising additional capital from outside investors or by merger with other companies; in addition, that structure inhibits attraction of direct foreign investors due to lack of trust to local partners.

In the conditions of the financial crisis, problems caused by errors in regulation of the process of winding up of legal entities may seriously aggravate. Provisions in the Civil Code that regulate winding up of legal entities actually allow creditors to turn a merger or a division of a legal entity into its liquidation, and debtors — to evade fulfilment of their obligations before creditors through manipulations with the book value of assets. A threat of abuse and acute conflicts is posed by the requirement, contained in the Code, about establishment of such a unique body as «winding up commission» with an indefinite status, broad scope of powers and an indefinite term in office. Serious problems may be caused by norms on regulation of liquidation of legal entities, since the priority list of creditors whose claims are to be satisfied in the course of liquidation missed the creditors whose claims are not secured and, therefore, allows for their satisfaction only after settlements with the participants in the legal entity.

Absence of a clear doctrine of a legal entity produced a negative effect on regulation of the issue of invalidity of a legal entity. Instead of regulation of invalidity of a legal entity (corporation) in accordance with the stipulations of the First EU Company Law Directive, the Ukrainian legislation, including the Civil Code, followed the path of «cancellation of the state registration of a legal entity».

A significant harm to development of the company law in particular, and to regulation of economic activities as a whole, is done by the existence of the Economic Code of Ukraine. The Code envisages alternative notion of legal entities. Their rights and obligations are dependent on the category of owner. This undermines the internationally recognised legal concept of a legal entity. Additionally, the types of legal entities, envisaged in the Economic Code, violate the following fundamental principles of corporate legislation: permanent existence of corporation regardless of changes of its participants, separation of the property of a corporation from that of its participants, independence of decision making by the corporation's management. Exotic management structures of legal entities - «subjects of economic activities» - have no parallels in the world and are remarkable for their lack of functionality, leaving beyond regulation the issues related to definition of that entity's governing bodies, the scope of their competences, and rights and responsibilities of such a structure.

While structures contained in the Economic Code, due to their irreparable shortcomings, are not popular in the private sector, the widespread use of those structures in the state sector leads to: inefficient management of huge state sector assets, misappropriations, uncontrolled interference of the state bodies with operations by individual enterprises, distortions in the action of market forces, emergence of a system of collective irresponsibility and aggravation

of corruption. In addition, the Economic Code rejects the principles of freedom of contract, restricts the legal entities' legal capacity, and discriminates against private sector enterprises and foreign producers. It is obvious that ensuring of the normal development of Corporate Law of Ukraine and other branches of law that regulate various aspects of economic activities without the repeal of the Economic Code is impossible.

The BRAAC has developed the following three legislative proposals addressing above shortcoming of corporate legislation in Ukraine:

1. Draft Law "On amendments to Law of Ukraine "On Joint stock Companies"" (in Ukrainian)

<http://brc.undp.org.ua/img/publications/JSCAmd2010%20.doc>

2. Draft law of Ukraine "On Limited Liability Companies" (in Ukrainian)

http://brc.undp.org.ua/img/publications/Draft_LL.C.doc

3. Draft law "On amendments to Civil Code of Ukraine concerning regulation of winding up, liquidation of legal entities and declaring legal entities void" (in Ukrainian)

<http://brc.undp.org.ua/img/publications/ProposalsCivCode%20.doc>