Related party transactions and corporate groups : when Eastern Europe meets the West
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6. CHOICE OF STRATEGY FOR RPTs IN UKRAINE

6.1. FACTORS INFLUENCING THE CHOICE OF STRATEGY

6.1.1. Introduction

The strategies described in Chapter 5 are capable of being applied in various jurisdictions. The effect of their use differs, however, depending on the specific circumstances. This section presents the factors that the legislature should take into account when choosing the best strategy or strategies for dealing with RPTs, based on empirical and legal evidence from the jurisdictions in focus.[1687]

6.1.2. Implementation of RPT-related strategies in Germany, Poland and the Netherlands

According to a study published by the OECD based on the 2008 CFA Institute Report, from a sample of 95 German companies, 7 per cent reported RPTs; from a sample of 14 Polish companies, 14 per cent reported RPTs; and from 30 Dutch companies 0 per cent reported RPTs.[1688] These data should not be interpreted as meaning that companies in the Netherlands do not employ RPTs at all: the scope of the research was limited to the companies included in the major market index, and other companies that might conduct RPTs were omitted. Nor does it imply that the RPTs reported in Germany and Poland were disadvantageous to the reporting companies: to conclude that a particular RPT caused damages would require applying special cost/benefit measurements to evaluate both the costs and savings of the transaction.[1689] In other words, this information shows only that RPTs existed, without proving any specific details of what they mean to the enterprises concerned. The only conclusion that can be drawn based on the figures presented in the OECD report, which is consistent with the view expressed in academic works,[1690] is that concentrated ownership systems show a higher frequency of RPTs.

Similarly to how information concerning the number of RPTs in a given jurisdiction does not reveal what is behind those RPTs, information about the ownership structures of companies does not automatically give evidence of RPTs in a certain jurisdiction, nor does it provide reliable information as to their nature (detrimental or not). Nevertheless, details of the stock market structure and the key shareholders in companies as established in a particular jurisdiction have value from the perspective of showing what transactions are most likely to be conducted in that jurisdiction.

[1687] The empirical data from the relevant jurisdictions has already been discussed in Chapter 1.
[1688] OECD, *Related Party Transactions and Minority Shareholder Rights* (OECD Publishing, 2012), 31.
[1689] Pacces AM, 2.
[1690] Sáez MI and Riaño D, 362.

The commonly heard observation that corporate ownership in Continental Europe is becoming increasingly concentrated[1691] might seem, to a certain extent, misleading, from a closer look at specific jurisdictions. As discussed in section 1.5, since the beginning of the 1990s, the development of the stock markets in Germany, Poland and the Netherlands has picked up pace. In Poland, the stock market emerged through the effectively organized privatization processes emerging from the ashes of Communist rule, when private property was recognized only for individuals and extended to private belongings only. The story was different in Germany and the Netherlands, where private property had existed for a long time, but where the capital markets, until the 1990s, were not as developed as in the US and UK. The data presented in section 1.5 shows the new trends that emerged in the 1990s,[1692] for example that German banks retreated from ownership of companies, while in the Netherlands substantial blocks of shares came to be owned by foreign investors.

Although the stock markets in Germany and the Netherlands have become more dispersed in recent decades, the numbers quoted indicated that ownership concentration was still the rule.[1693] This is not necessarily a negative, however: concentration of capital is often viewed as a natural reaction to inadequate investor protection.[1694] Increased share capital allows investors to exert greater influence over their controlled companies and establish long-term relationships with their partners.[1695] This is not always feasible with dispersed ownership, where reconciling the interests of shareholders is a prominent and difficult issue.

At the same time, concentrated ownership is not without its drawbacks. It creates a risk of private benefits extraction.[1696] Controlling shareholders might be tempted to tunnel corporate assets, especially if investor protection is weak.[1697] Yet even if the controlling shareholder behaves fairly and reasonably, concentrated ownership does not prevent a firm from economic failure. For instance, in Germany a positive correlation was observed between corporate control and firm performance in the 1970s and 1980s, and this changed to a negative correlation in the 1990s.[1698] Even assuming that malicious intent was not the reason for the firm’s performance failures, and that the real cause lay in unintentional errors in business decisions initiated by blockholders, those blockholders would still have been more likely to succeed if their errors could have been properly monitored and constrained.

Germany previously had a reputation as a jurisdiction where financial institutions, notably banks, coordinated their efforts with shareholders in corporate policy efficiently.[1699] According to academic sources, those banks now lack the same strong oversight, although thoughts on its effect are mixed: while some scholars have expressed the opinion that the result will be disastrous without proper external oversight,[1700] others have highlighted the absence of reliable evidence confirming the banks’ positive monitoring role.[1701] Whatever the real effect of that monitoring is, the argument posited by Zohar Goshen cannot be ignored: sophisticated investors are capable of

[1691] Lannoo K, ‘Corporate Governance, West and East: A Synthesis of the EU Framework in the Perspective of Enlargement’ in Balling M (ed), *Corporate Governance, Financial Markets and Global Convergence* (Springer 1998), 212.
[1692] Bolt W and Peeters M, 95.
[1693] Tamowicz P, 95.
[1694] Becht M and Mayer C, ‘Introduction’, 4.
[1695] Mayer C, ‘Corporate Governance, Competition and Performance’ in Balling M (ed), *Corporate Governance, Financial Markets and Global Convergence* (Springer 1998), 256.
[1696] Ibid, 256.
[1697] Friedman E, Johnson S and Mitton T, 748.
[1698] Goergen M, Manjon MC and Renneboog L, ‘Recent Developments in German Corporate Governance’ (2008) 28 International Review of Law and Economics 175, 190.
[1699] Goshen Z, ‘The Efficiency of Controlling Corporate Self-dealing: Theory Meets Reality’, 434.
[1700] Tröger T, ‘Germany’s Reluctance to Regulate Related Party Transactions: An Industrial Organization Perspective’, 22-23.
[1701] Goergen M, Manjon MC and Renneboog L, 190.

designing effective counteractive measures.[1702] So, if the banks' participation in the corporate governance of German companies was successful in preventing any looting of corporate assets, its disappearance could have created an apparent gap.

Despite the arguable lack of a pre-existing element of German corporate governance, as represented by financial institutions, I am far from convinced that the reduction of the banks' influence is catastrophic. The German jurisdiction possesses sufficient and flexible means to address the issues of abusive actions by shareholders, in particular through claims to compensate loss or damage caused by breaches of the shareholder's duty of loyalty.[1703] In the Netherlands, the provisions of tort law in combination with the principles of reasonableness and fairness, which principles also play a key role in Dutch inquiry proceedings, have been used to successfully penalize shareholder misconduct. In addition, Germany, Poland and the Netherlands have capital maintenance regulations that can be used against shareholders seeking to extract corporate wealth. These ex post mechanisms may all be helpful in combatting inappropriate extractions of corporate benefits, in accordance with the idea of remedying distributions to shareholders that are not pro rata.[1704]

While ex post remedies for RPTs carry much weight in Germany, Poland and the Netherlands, it would be a mistake to underestimate the effect of ex ante tools in these jurisdictions. This is another argument for overcoming any concerns about the banks' retreat from corporate governance. The value of ex ante procedural scrutiny lies not only in its preventive effect,[1705] but also in the presence of various different types of stakeholders whose interests must be taken into account in these countries: employees, who enjoy representation in company bodies based on co-determination provisions in the relevant jurisdictions (Germany and the Netherlands), and institutional investors, whose monitoring function is supported in literature.[1706] Their input might be crucial in preventing detrimental transactions by controlling shareholders. In other words, even without banks as a major influence, companies in these jurisdictions apparently have other stakeholders that can effectively monitor RPTs.

For RPTs with shareholders and their related parties, one major obstacle stands in the way of effective monitoring: statutory law in Germany, Poland and the Netherlands is not much concerned with procedural and informational scrutiny of transactions with shareholders or their related parties.[1707] The focus is primarily on misconduct by managers, supervisory board members and their related parties. This is surprising: while the main issue with dispersed ownership is the agency conflict between shareholders and managers, with the concentrated ownership that is said to be so intrinsic in Germany, Poland and the Netherlands, the need to limit controlling shareholder's behaviour is apparent.[1708] This does not mean that controlling shareholders should be treated as suspects in the company and be deprived of its benefits; nor does it mean, however,

[1702] Goshen Z, 'The Efficiency of Controlling Corporate Self-dealing: Theory Meets Reality', 424.
[1703] Some authors have argued that the mechanisms to protect against self-dealing by controlling shareholders in Belgium, France and the Netherlands are insufficient (Hallemeesch N, 'Self-Dealing by Controlling Shareholders: Improving Minority Protection in Light of Article 9 c SRD' (2018) 15 European Company and Financial Law Review 197, 235). Nonetheless, these countries are all developed economies where the legal principles are enforced to a high level, and the courts provide a highly satisfactory standard of protection compared with developing legal systems.
[1704] Rock E and Wachter ML, 'Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression' in McCahery J and Vermeulen EM (eds), *The Governance of Close Corporations and Partnerships: US and European Perspectives* (Oxford University Press on Demand 2004), 130.
[1705] Chugh D, Bazerman MH and Banaji MR, 'Bounded Ethicality as Psychological Barrier to Recognizing Conflicts of Interest' in Moore DA and others (eds), Conflicts of interest: Challenges and Solutions in Business, Law, Medicine, and Public Policy (Cambridge University Press 2005), 91; Issacharoff S, 201.
[1706] Mezzanotte FE and Fung S, 'Do Institutional Owners Monitor? Evidence from Voting on Connected Transaction Proposals in Hong Kong-Listed Companies' (2018) 7 Michigan Business & Entrepreneurial Law Review 221, 240.
[1707] So far as the SRD II is not implemented therein.
[1708] Davies P and others, 91.

that any liability of officers is always groundless. In fact, even in controlled closed corporations, officers can deviate from their shareholders' instructions and cause harm. What I am saying here is that, given the need to balance the interests of various stakeholder groups in a society with concentrated corporate ownership, ex ante safeguards for RPTs with shareholders and their related parties would be too important to neglect.

Lastly, ownership structure, while being undeniably important for the design of RPT-related strategies in a given jurisdiction, is not the only influencing factor that should be taken into account. Other significant aspects must also be considered. For instance, company law itself shapes investors' decisions to buy shares or exit companies.[1709] Where the legal requirements for entering a market are excessively onerous, potential investors might be deterred from establishing companies or acquiring equity. In terms of their appeal to investors, Germany, Poland and the Netherlands are all positioned higher in the 2019 Doing Business ranking of jurisdictions than Ukraine.[1710] This and other factors are discussed in paragraph 6.1.3.

6.1.3. Factors to consider in the design of RPT-related strategies

In order to provide for efficient regulation of RPTs in a country, it is vital to take account of the existing situation in that country. The ownership structure of companies, demonstrating who the key participants in corporate relationships are, is a crucial factor for designing rules to deal with conflicted behaviour. Information about the key owners of companies provides powerful insight into the principal stakeholders and their interests. This does not diminish the need to draft laws and regulations in order to attract new stakeholders, particularly investors, to the country; instead, it presents an argument for considering the interests of the existing players. As has been seen above, concentrated ownership is common in Continental Europe, meaning that large blockholders provide the context of corporate governance in Europe.

Their influence is twofold. On the one hand, blockholders are positioned strongly to monitor the company's management.[1711] A majority stake in the company's capital is usually sufficient to dismiss managers who breach their duties; this allows controlling shareholders an effective way to curb self-dealing.[1712] The fear of dismissal is expected to cause managers to act with greater loyalty towards the company and with due care. However, this is contingent on large shareholders being interested in improving the firm's performance. On the other hand, blockholders can become tempted to extract private benefits of their control.[1713] These value-destructive extractions often take the form of RPTs, and as such are viewed as the major cost of concentrated ownership.[1714] For instance, empirical evidence from China in the 2001-2008 period showed that the most severe instances of tunnelling occurred in companies with ownership concentration varying between 34.46 and 39.01 per cent.[1715] The equilibrium of negative consequences produced by concentrated ownership is embodied in control premium, showing the

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[1709] Cheffins BR, 33.
[1710] *Doing Business 2019: Training for Reform*, 5.
[1711] Sulaiman ANM, 'Responding to Concentrated Ownership - the Related-Party Transaction Provisions of Some Asian Countries' (2007) 3 Corporate Governance Law Review 70, 71.
[1712] Enriques L, Hertig G and Kanda H, 'Related-Party Transactions' in Kraakman R and others (eds), *The Anatomy of Corporate Law A Comparative and Functional Approach, 2nd ed* (Oxford University Press 2009), 178.
[1713] Dyck A and Zingales L, 'Private Benefits of Control: An International Comparison' (2004) 59 The Journal of Finance 537, 589.
[1714] Hopt KJ and Pistor K, 'Company Groups in Transition Economies: A Case for Regulatory Intervention?' (2001) 2 Eur Bus Organ Law Re 1, 11.
[1715] Chen W, Li S and Chen CX, 2.

difference between the market price of shares and how much the controlling shareholders are willing to pay to maintain their control.[1716]

Acknowledging the potential negative effect of concentrated ownership does not mean that large shareholders bring destruction only, however. This point, which has been stressed before and deserves emphasizing again, is confirmed by empirical data.[1717] Where regulation makes blockholdings excessively onerous, this move may turn strongly performing firms owned by large shareholders into market failures. Still, allowing blockholders to have too much power can result in expropriation.[1718] Shareholder conduct must be managed carefully, to balance the interests of other stakeholders, including minority shareholders and employees.

Although it is one of the key defining factors in shaping corporate governance practices, including practices regarding conflicts of interest, ownership structure is far from the only factor available.[1719] Drafting rules for RPTs based exclusively on ownership structure reflects a one-sided approach. Information about ownership structures, taken out of its economic and legal context, has little practical effect. Some economies with ownership concentration prosper while others fail: Continental Europe, which is known for concentrated ownership, has examples of both. That is why this analysis would be incomplete if it did not consider other circumstances as well.

In order to design RPT-related strategies properly, it is important to take account of the general state of a country's economy. The success of the economy in developed countries correlates to how the legal system is protected there.[1720] Developed countries have invested vast sums of money in their legal systems, by supporting institutions and relevant enforcement mechanisms. In these jurisdictions, the judiciary possesses sufficient knowledge, skills and resources to properly resolve complex cases, by simply drawing on the available guidelines and principles. Any self-dealing will therefore encounter strong control by institutions.[1721] The same does not hold true for weak institutions in transitional countries, which are prone to using rules rather than standards.[1722] This does not automatically mean that standards should be neglected in the latter jurisdictions, however. On the contrary, application of standards should be encouraged and improved by supporting institutions to allow them to respond to real challenges with more sophisticated court decisions,[1723] for example by being able to assess a company's corporate policy or to identify instances of mismanagement, as the case is in the Netherlands.

Historically, rules have come first to developed economies.[1724] Those countries had to undergo centuries of wins and losses to achieve their high level of judicial enforcement. Introducing well-developed standards or replacing rules by vague standards, including the duty of loyalty for shareholders in Germany or the Rozenblum doctrine in France, or extrapolating the use of the principles of reasonableness and fairness from the Netherlands to transitional economies would not match the stage of those economies' development. These elaborate solutions might be used in ways that do not match their initial goals.[1725] This is different with rules. Their advantages, including fewer court delays, less corruption and substitution of human capital, have been amply

[1716] McCahery JA and Vermeulen EP, *Corporate Governance of Non-Listed Companies*, 224.
[1717] Hopt KJ and Pistor K, 12.
[1718] Morck RK and Steier L, 50.
[1719] Hopt KJ and Pistor K, 39.
[1720] Berglöf E and Claessens S, 'Enforcement and Corporate Governance' World Bank policy research working paper 3409, September 2004 Available at: http://documentsworldbankorg/curated/en/516141468765315959/pdf/wps3409.pdf, accessed on 18 November 2018, 2.
[1721] McCahery JA and Vermeulen EP, *Corporate Governance of Non-Listed Companies*, 225.
[1722] Schaefer H-B, 'Rule Based Legal Systems as a Substitute for Human Capital: Should Poor Countries Have a More Rule Based Legal System?' (2002) 2001 German Working Papers in Law and Economics 2, 27.
[1723] Schäfer H-B and Cooter RD, 'Growth-Oriented Legal Reforms' in Parisi F (ed), *Production of Legal Rules* (Edward Elgar Publishing, Chaltenham 2012), 415.
[1724] Schaefer H-B, 21-23.
[1725] Hopt KJ and Pistor K, 30.

described by Hans-Bernd Schaefer.[1726] It is easier for courts to deal with breaches of clearly defined rules than to draw on sophisticated expertise or analyze capital markets.[1727]

At the same time, transitional economies should not be barred from moving towards developing standards. The great advantage of standards is that they can fill gaps, which is a role that rules cannot fulfil. That is why the most desirable solution in transitional economies is to implement standards for RPTs gradually, starting with detailed rules and gradually increasing their flexibility and discretionary application.

It is of course more likely for developing legal systems to wish to learn from their developed counterparts, meaning that legal transplants are more probable to flow into developing regimes than the other way around. For standards, it is doubtful that wholesale transplants from developed to developing regimes would prove beneficial,[1728] at least at some stages in the country's development. Nevertheless, dismissing the possibility of legal transplants out of hand is not the solution either. Successful cases of such transplants do exist, as illustrated by Japan's effective incorporation of German law.[1729] Still, legal vehicles for RPTs or other aspects of corporate life should be implemented judiciously, with due consideration of some key factors.

The first of these is path dependency. This characteristic refers to both domestic peculiarities and, more generally, how a country relates to a specific family of legal systems. It is conceivable for a country to borrow rules from another country in the same legal family,[1730] which would match its legacy.[1731] However, altering a country's affiliation from the Continental legal system to the common law system would require too a high price. The change is not only a matter of laws and their enforcement, but also of people's minds, which is a very delicate issue.

Path dependency has one notable exception: rules that are universally applicable. While these rules are not many,[1732] with the development of law and enforcement mechanisms they have become either self-explanatory, or else have risen to the level of best practices. An example of a self-explanatory provision is the limited liability of companies, which, while not without exceptions (piercing of the corporate veil), has become widely accepted as a necessary feature of modern companies.[1733] Best practices in turn originate in certain jurisdictions and are recommended for introduction based on empirical evidence, extensive research and discussion. The following techniques may be viewed as the best practices for dealing with RPTs: introduction of audit committees and disclosure through accounting standards.[1734]

The second factor is the balance between freedom and coercion. The regulation to be introduced should not be so prohibitive as to exclude routine or beneficial agreements. Conflicts of interest are one of the major constraints limiting the choice of business form by market participants.[1735] Overly restrictive rules governing conflicts of interest are more likely to cause business owners to abandon the idea of establishing a company in that jurisdiction, and instead move to a more favourable jurisdiction that has no rules on conflicts of interest. This is especially true for large enterprises, which can afford to cherry-pick their jurisdictions. However, this

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[1726] Schaefer H-B, 5-8.
[1727] Tajti T, 'Corporate Governance: An Oversold Elitist Idea of No Interest to or for the Central European Transitory Economies' (2005) 1 Corporate Governance Law Review 21, 60.
[1728] Berglöf E and Claessens S, 29.
[1729] Morck RK and Steier L, 59.
[1730] Mäntysaari P, *Organising the Firm: Theories of Commercial Law, Corporate Governance and Corporate Law* (Springer Science & Business Media 2011), 31.
[1731] Hopt KJ and Pistor K, 15.
[1732] Their existence is even denied by some authors (see Tajti T, 26).
[1733] Kraakman R and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, Oxford University Press 2017), 8.
[1734] Berglöf E and Claessens S, 10; Hopt KJ and Pistor K, 15; Djankov S and others, 463.
[1735] Vermeulen EM, *The Evolution of Legal Business Forms in Europe and the United States: Venture Capital, Joint Venture and Partnership Structures* (Kluwer Law International 2003), 183.

analysis has its limitations. Moving to a different jurisdiction is not beneficial in every case, as the cost of a particular business form in another country might outweigh the cost of doing business in compliance with the conflict of interest rules.

The issue of balancing rights and prohibitions is especially critical in the regulation of listed and non-listed companies. Listed companies have traditionally been more strictly regulated, due to the existence of outside shareholders. This is evidenced by the volume of EU company law regulating listed companies, compared with how non-listed companies are handled. The instruments of EU law governing non-listed companies are confined to a few Directives, while listed companies are subject to a much broader set of documents, including Regulations, Directives and Recommendations. Even the Commission Recommendations for dealing with non-executive and supervisory directors,[1736] despite being soft law, are directed exclusively at listed companies. Similarly, non-listed companies are not covered by the scope of national CGCs. To a certain extent, this leaves a gap in the regulation of non-listed companies.[1737] To close it, McCahery and Vermeulen have put forward optional guidelines for non-listed companies, in support of a one-size-fits-all approach.[1738] Among other possibilities, they suggest establishing audit committees.[1739] Still, this suggestion might not be appropriate for all non-listed companies, especially those with little capital and small workforces. Considering that every company is a separate mechanism of inner operations governed by conflicting interests and complicated rules, which become even more sophisticated in corporate groups, it is unlikely that legislatures will be capable of producing a single solution for this issue that fits all companies.[1740] For this reason, flexibility is indispensable in the regulation of non-listed companies.

This is also where the dilemma lies between the top-down and bottom-up approaches. For instance, it has been claimed that the key to improving board performances is not government action, but rather board action. This view was based on interviews with board members, many of whom opposed additional regulatory interference, arguing that is was unnecessary and inefficient. The board members interviewed rejected the one-size-fits-all approach, and instead preferred individual policies that could be adopted by different companies.[1741] While the results of these interviews should not be treated as irrefutable truth, given that they are likely to reflect the interests of specific companies or their beneficiaries, these statements are nevertheless laudable. Success stories of firms adopting sufficiently specific business practices to efficiently deal with detrimental RPTs carry more weight than top-down recommendations or mandatory requirements.[1742] A bottom-up approach of introducing best practices based on firm-specific considerations deserves to be incentivized and promoted by governments.

The third factor is the issue of ex ante safeguards versus ex post remedies. The choice between these two options relates to the issue of enforcement and how well developed institutions are. If institutions, i.e. primarily courts, are capable of employing expertise at a high level, by reaching findings on mismanagement or determining a fair price for an RPT, then ex post remedies are reliable. Conversely, if those institutions are weak, it is more efficient to rely on ex ante disclosure and approval procedures, reserving a limited role for court interference and granting shareholders appraisal and buy-out rights.

[1736] Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies [2004] OJ L 385/55, 29.12.2004; Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board [2005] OJ L 52/51, 25.2.2005.
[1737] Sulaiman ANM, 92.
[1738] McCahery JA and Vermeulen EP, *Corporate Governance of Non-Listed Companies*, 203.
[1739] Ibid, 203.
[1740] Davies P and Hopt K, 371.
[1741] Lorsch JW, 'Board Challenges 2009' in Sun W, Stewart J and Pollard D (eds), *Corporate Governance and the Global Financial Crisis: International Perspectives* (Cambridge University Press 2011), 167.
[1742] Berglöf E and Claessens S, 41.

Although countries sometimes emphasize one type of protection (either ex ante or ex post),[1743] it is possible for these safeguards to exist side by side. Their ultimate effectiveness depends on factors beyond institutional development. The wording of these remedies in statutory law and their subsequent interpretation is also important. Concerning ex post remedies for RPTs, two main remedies are identified: nullification and damages.[1744] Commenting on the regulation of RPTs in Russia, Bernard Black criticized them both. He argued that nullification had an excessive scope, by penalizing every procedural breach, even if an RPT was fair.[1745] With damages, Black criticized the limited standing of parties to claim damages, suggesting that minority shareholders, as key victims of tunnelling, and not the company alone should have the right to claim damages.[1746] This criticism demonstrates how minor details of statutory regulation, worded in abstract terms,[1747] can undermine the whole idea of regulation. The situation is similar for ex ante safeguards. Djankov and others advocate using the following safeguards: disclosure, approval by disinterested members and a limited degree of criminal liability.[1748] The role of disclosure is also prized by the World Bank in its Doing Business rating.[1749] However, these safeguards are susceptible to failure if the disclosure rules are not inclusive or if the notion of a related party is too narrow to apply to conflicted members. These strategy-related issues have been discussed in greater detail in Chapters 3 and 5.

Fourthly, and most importantly, laws for RPTs should not be paper laws only. If access to courts is impeded, and it is impossible to enforce the written rules and standards, this manner of regulation is no different from a non-intervention approach to RPTs.[1750] It is not enough to lay down best practice provisions in statute without ensuring their actual implementation. It takes time and resources for statutory provisions to reach the point of successful implementation. Implementation of RPT-related strategies can also be precluded by non-legal obstacles, such as cultural or attitude issues, or by influential players with rights of veto.[1751] Overall, implementation and enforcement require a more in-depth discussion of process characteristics and the related issues that would extend the scope of this work significantly.

Lastly, despite the existence of specifically designed strategies for dealing with RPTs, which have been the subject of many heated discussions among scholars, one further important factor must be mentioned. Some countries have applied unusual measures to successfully combat tunnelling. China reduced tunnelling through an unprecedented anti-corruption campaign.[1752] This and other measures have improved the population's welfare and helped to create a more pleasant business environment.[1753] In other words, the reduction of tunnelling was only one of the results of a complex state policy. This was an extraordinary case. While it is possible to conceive all manner of sophisticated and reasonable solutions for dealing with RPTs, if the overall environment promotes fraudulent conduct, this will undermine the effect of the most meticulously designed anti-tunnelling measures. That is why tunnelling in companies should not be considered without also considering the environment where it occurs. To efficiently combat tunnelling, it is vital to create conditions that make it excessively dangerous and largely superfluous to perpetrate tunnelling (and of course other wrongful conduct).

[1743] Ibid, 8.
[1744] Sulaiman ANM, 86.
[1745] Black BS, Kraakman RH and Tarassova AS, *Guide to the Russian Law on Joint Stock Companies* (Kluwer Law International 1998), 460.
[1746] Ibid, 462.
[1747] Tajti T, 78.
[1748] Djankov S and others, 463.
[1749] *Doing Business 2019: Training for Reform*, 4.
[1750] Goshen Z, 'The Efficiency of Controlling Corporate Self-dealing: Theory Meets Reality', 408.
[1751] Schäfer H-B and Cooter RD, 401.
[1752] Xu G and others, 27.
[1753] Schäfer H-B and Cooter RD, 411.

6.2. IMPLEMENTATION OF RPT-RELATED STRATEGIES IN UKRAINE

As discussed in section 6.1, company ownership is one of the most principal factors to be considered in the design of a jurisdiction's RPT strategy. As it is in other countries in Continental Europe, company ownership in Ukraine is concentrated. However, in contrast to how concentrated this ownership came about in Germany and in the Netherlands, in Ukraine it resulted primarily from slow, non-transparent and destructive privatization processes that led to the formation of many JSCs. As explained in section 1.2, privatized plants and factories in the form of JSCs exist in which small numbers of ultimate beneficiaries exert dominant influence, while thousands of shares are distributed among minority shareholders with small percentages of the share capital, if even that.

Although public companies that mostly emerged from the privatization process in Ukraine are important, they do not actually play an overwhelming role in the country's economy. Of the 200 companies with the largest profits in 2016, more than 100 were private companies and other similar business forms.[1754] According to some valuations, private companies represent more than 75 per cent of Ukraine's GDP.[1755] Ownership in these companies is also concentrated, and in 53 per cent of all companies, one of the shareholders is a director.[1756] Some lawyers have commented on these figures that owners of Ukrainian companies do not trust their executives and are not ready to relinquish control.[1757]

Corporate groups are also a prominent feature of Ukraine's corporate landscape. Most of the respondents in the Google Forms survey gave positive answers regarding the existence of corporate groups in Ukraine. However, they are less regulated in Ukraine than in Germany, Poland and the Netherlands. The legal entity doctrine dominates, although the enterprise theory emerges from time to time in legislative measures.[1758] This dominance of the legal entity doctrine means that intra-group transactions, including intra-group loans, are usually treated in the same manner as similar transactions between separate market participants. This is also true for the regulation of RPTs under the JSC Law of Ukraine, unless a subsidiary that enters into an intra-group transaction with its parent is wholly owned by the parent.[1759]

The configuration of market players described above places demands on the legislature. The key challenge is to offer better protection to investors, without disincentivizing large shareholders.[1760] This is impossible to achieve properly without allowing for the characteristics of Ukraine's legal system. Ukraine's system is part of the Romano-Germanic Continental legal tradition.[1761] By and large, the legislators drafting company laws have drawn inspiration from German law, having introduced LLCs and the two-tier board structure (which is mandatory for public companies with 10 or more shareholders).[1762] Other aspects have been borrowed from

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1754 Головньов С and Віннічук Ю.

1755 Antonenko L, 21.

1756 'Маркер незрілості: В 53% засновник є директором компанії' (2017) <https://opendatabot.ua/blog/75-founders-ceo>, accessed on 30 September 2018.

1757 Ibid.

1758 For instance, consolidated financial statements have long been recognized in Ukraine, under the Law of Ukraine 'On Accounting and Financial Reporting'.

1759 JSC Law of Ukraine, Article 71(2)(2).

1760 Berglöf E and Claessens S, 10.

1761 Bondaryev T and Zorya A, 'Ukraine' in Kawamura A (ed), *Corporate Governance* (Thomson Reuters 2015), 469.

1762 Radwan A, Nadzon A and Zdiruk V, 24.

Dutch law, including rules governing liability.[1763] The accommodation of legal transplants from those said jurisdictions has been satisfactory.[1764]

At present, Ukraine is in the process of implementing European company law, in accordance with its obligations under the EU-Ukraine Association Agreement. Ukraine's company law has already been matched to various EU Directives to a considerable extent,[1765] and had been even before the Association Agreement entered into force.[1766] This development has a downside, however: the legislature has demonstrated a clear habit of cherry-picking and oversimplification when implementing provisions of EU law.[1767] One example of cherry-picking that might concern RPTs is the area of capital maintenance rules. As described in section 5.1, Ukraine's legislature has partly implemented the rules from the Second Council Directive while omitting some of their key details.

This cherry-picking approach to implementing the capital maintenance rules clearly does nothing to benefit the rights of creditors. Moreover, the assets and net profits tests for public companies and the liquidity test for private companies cover payments of dividends in Ukraine only, as opposed to Germany, for instance, and to a lesser extent Poland, where the doctrine of hidden (i.e. concealed) distributions has its roots.[1768] In Ukraine, shareholders, and especially those who control their companies, can use a variety of methods to siphon off funds, including RPTs, without any thought for complying with capital requirements. This is especially true for non-listed companies. Creditors, having no say in the approval of RPTs, are unable to influence the approval process. The approval regulations for substantial transactions also offer creditors little succour.[1769] As a result, procedural safeguards for RPTs have little value for creditors. Similarly, the amount of a company's equity does not provide creditors with sufficient guarantees, especially in private companies, where the minimum share capital is UAH 1.[1770] Generally, creditors of both public and private companies have insufficient protection against RPTs. To better protect creditors of public companies, the asset-based test and the net profits test must be improved, and the liquidity test introduced. The assets and net profits tests should also be introduced for private companies. Similarly, from the perspective of creditor protection it is not enough for those tests to apply to dividends only: other distributions under loan agreements and excessive purchases should also be covered.

One of the problems with disguised (i.e. concealed) distributions is how they should be reviewed. While dividends, by their very nature, are always distributions to shareholders, to understand whether the distribution under a particular agreement is excessive it must be established as not being on market terms. Moreover, an agreement might not be on market terms, while nevertheless ultimately benefitting the company. For instance, a company might conclude a high-interest loan agreement with a shareholder, if it urgently needs the funds that the shareholder can provide. Other examples exist of agreements on non-market terms that nonetheless work in the company's favour, such as transactions to sell perishable goods. As such, if the doctrine of disguised distributions is introduced in Ukraine, the courts will be responsible for reviewing every transaction on a case-by-case basis.

[1763] Ibid, 21.
[1764] Ibid, 25.
[1765] Romashchenko I, 'Corporate Law Development in Ukraine: From Post-Soviet Past to European Future' (2015) 12 European Company Law 217, 222.
[1766] One illustrative example is the implementation of the Twelfth Company Law Directive in the CCU. However, whether by intent or through negligence, some previously adopted rules prohibiting the formation of companies by one-person entities were removed from the CCU under the 2018 version of the LLC Law of Ukraine.
[1767] Antonenko L, 28.
[1768] This has already been covered at length in previous chapters.
[1769] JSC Law of Ukraine, Articles 70, 72.
[1770] 'Про що говорить статутний капітал?' (2017) <https://opendatabot.ua/blog/73-fake-capital>, accessed on 30 September 2018.

Another issue that would follow if the doctrine of disguised distributions is introduced is the need for exemptions. For example, corporate groups create an obvious need to allow disguised distributions between group members. Without such an exemption, it is possible that transactions between group members would simply stop, if they are on non-market terms; this is not in the group's interests. The concept of disguised distributions should therefore certainly not be adopted if it is not accompanied by exemptions.

Besides the Second Council Directive, SRD I must also be implemented under the EU-Ukraine Association Agreement. However, Ukraine is not obliged to implement SRD II, yet SRD II might give Ukrainian law broader coverage for RPTs, and more efficient regulation, due to its rules for considering whether RPTs are on market terms. In other words, SRD II combines stricter requirements for preventing circumvention with relaxed rules for some RPTs in the form of exemptions. Moreover, SRD II's implementation in Ukraine is unlikely to meet with strong opposition, given the path dependent history of the procedural safeguards that the JSC Law of Ukraine has imposed since its adoption in 2008.

The need for further changes in the regulation of RPTs stems not only from the need to implement the EU-Ukraine Association Agreement, but also from public demands. Most of the respondents answering the Google Forms survey were unhappy with the current state of regulation of RPTs. The evaluation of RPT-related strategies leads to the conclusion that Ukraine's legislature has already examined the procedural strategy and the information rights strategy at length. As far as procedural safeguards are concerned, the regulation of approval requirements for public companies is sufficiently detailed, yet the same is not true for private companies, even large ones. It would therefore be reasonable to improve corporate governance regulations for private companies that resemble public companies in terms of shareholder numbers and share capital, and to make it mandatory for those private companies to have a supervisory board and implement the approval procedure for their RPTs.

Another obstacle to the development of Ukrainian company law and corporate governance, and one that sets Ukraine apart from countries with more developed legal systems, is that its institutions are weak. Courts are overloaded with cases and are often unable or reluctant to identify effective solutions to complex issues. Standards, including the concept of a fiduciary duty and legal principles, remain underdeveloped.[1771] For RPTs, neither minority shareholders nor creditors have an efficient way to claim damages from related parties. Statutory law does not grant those parties the right to bring direct claims; arguably, shareholders and creditors can rely only on abstract rules for civil liability.[1772]

Nevertheless, taking the opposite approach to regulation, by granting minority shareholders the right to claim damages from related parties, might not prove beneficial either. Firstly, if minority shareholders have this right 'on paper', judges will need to learn how to calculate the damages: they will have to compare the market value of shares before and after each RPT. This would be a difficult exercise, due to the influence of other factors besides the RPT on the market value, however detrimental to the company the RPT might be. Secondly, if both the company and minority shareholders are entitled under statute to claim damages, then the related party would be held liable twice for the same act (and the same argument applies to creditors), and it is incompatible with Article 61 of the Constitution of Ukraine to claim the same form of liability of a person twice for the same offence.[1773] As such, it makes more sense from the perspective of fairness to enable shareholders to bring these proceedings on behalf of the company under derivative suits. It is easier for courts to calculate loss or damage caused to a company than indirect loss or damage caused to its shareholders and creditors.

1771 Bondaryev T and Zorya A, 'Ukraine', 469; Боярчук К, 172.

1772 Similarly, subsidiaries are unlikely to succeed in damage claims against their parent companies.

1773 Constitution of Ukraine [Конституція України] of 28 June 1996, published in Vidomosti Verkhovnoyi Rady Ukrayiny, 1996, No. 30, St. 141.

Minority shareholders can be given more extensive rights in the following areas. Firstly, under the current rules shareholders with 10 per cent or more of a company's share capital have access to one type of derivative suits only: they may seek compensation for loss or damage caused by company officers. However, they do not have standing, at least in statute, to claim damages from related parties other than company officers, or to challenge transactions with interest conducted in breach of procedure. Secondly, shareholders in public companies have appraisal rights regarding RPTs only if they vote against approving the transactions with interest at the general meeting of shareholders. For situations where a supervisory board member, as the shareholders' representative, votes against the transaction, the appraisal right does not exist. Thirdly, the right of exit from private companies should be restricted; at present, it is unconditional for shareholders with less than 50 per cent of the company's share capital. This might be changed by extending the meaning to include both direct and indirect owners of share capital in companies. Lastly, statutory law does not properly regulate what the role of special audit reports is in public and private companies.

For the enforcement of regulations regarding RPTs and the use of standards, Ukrainian courts have adhered to a formal, rather than a functional, interpretation of the facts, except for the stance that the Supreme Court is now starting to display.[1774] With RPTs, the courts have developed judicial approaches that penalize breaches relating to RPT approval, without considering whether the RPT was detrimental to the company: identifying possible breaches of the approval procedure has been more important. From the perspective of fairness, this approach is not universally appropriate. Invalidating an RPT is a severe remedy,[1775] and is not justified in situations where the RPT creates value. According to the 20 September 2019 amendments to the JSC Law of Ukraine, courts now in fact have the power to invalidate approved transactions if they are not on market terms. These changes represent an attempt by the Parliament of Ukraine to introduce a substance-based evaluation of RPTs, rather than a formal review only. However, the problem with these amendments is that the formal approach will not disappear: even after 20 September 2019, transactions with interest may still be invalidated by reason of a procedural breach. As a result, two separate grounds are available for annulling transactions with interest: breach of procedural requirements, and inconsistency with market prices. Nor does the solution lie in abolishing the invalidation remedy, for being deficient. Its great advantage lies in its clear-cut and understandable rules. Rather, instead of introducing two separate grounds for invalidating transactions with interest, it would be wiser to suggest a single ground. Transactions should be invalidated if they are both contrary to procedural requirements and based on a transaction price that is less favourable than the market price. This approach could be combined with more rights for shareholders to access additional remedies, including invalidation of transactions with interest and compensation for loss or damage inflicted by interested persons, as part of derivative suits.

6.3. DEVELOPMENT OF UKRAINIAN LAW ON RPTs: PROSPECTS AND SOLUTIONS

6.3.1. Implementation of EU law on RPTs

6.3.1.1. Implementation of SRD II

[1774] Radwan A, Nadzon A and Zdiruk V, 83; Khort YV, 189.
[1775] Black BS, Kraakman RH and Tarassova AS, 460.

Ukrainian company law has been in a state of flux for some time. One of the engines driving these changes is the implementation of the EU Directives in accordance with the EU-Ukraine Association Agreement. When the Agreement was drafted, signed and ratified, the current version of EU company law, with its most recent codifications and amendments, were not yet in place, including SRD II. However, as long as the new elements inspired by EU law will help to improve investor protection and corporate governance, it makes sense to implement them.

The first notable difference between the current provisions of the JSC Law of Ukraine and SRD II is the definition of a related party. In general, the concept of a related party is broader under SRD II, being based on IAS 24. Interested persons according to the JSC Law of Ukraine (Article 71(1)) primarily consist of shareholders with 25 per cent or more of the company's share capital and company officers. Under IAS 24, applied in conjunction with IAS 28, related parties include persons possessing 20 per cent or more of the voting rights. While the difference between 20 and 25 per cent is minor, it has no proper economic or legal justification, and besides the IASs, the LLC Law of Ukraine (Article 45(1)), the CCU (Article 118(1)) and the Tax Code of Ukraine (Article 14) also stipulate the figure of 20 per cent. Therefore, for the purposes of uniformity it seems reasonable to regard shareholders with 20 per cent or more of a company's share capital (and where applicable the voting rights) as interested persons for the purposes of the JSC Law of Ukraine.

IAS 24 also makes extensive use of the notions of 'control' and 'significant influence'. Under IAS 24, the meaning of these terms is not confined to share ownership or official duties only. Other types of 'control' and 'significant influence' can also cause persons to be viewed as related parties, for example special agreements. In other words, IAS 24 applies substantive criteria, rather than formal ones, to explain control and significant influence. Using substantive criteria would pose major difficulties for any efforts to compose predefined lists of related parties, as those related parties would be subject to interpretation on a case-by-case basis. Additionally, different interpretations might be given by different actors, including courts that are ill equipped for the task. As a result, if a company enters into an RPT without approval from the appropriate body, and the court recognizes one party as being related based on substantive criteria, this interpretation may then serve as grounds for invalidating the transaction (Article 72). Therefore, for the purposes of legal certainty and the predictability of procedural safeguards, it is preferable not to apply broad categories of 'control' and 'significant influence' to define the concept of an interested person as employed by the JSC Law of Ukraine. The same reasons serve as justification for not introducing the notions of a domestic partner, his/her children and dependents in the definition of an interested person in the JSC Law of Ukraine.

The next difference where it would be worthwhile to align the JSC Law of Ukraine more closely with SRD II is that the Directive's requirements cover transactions between a company's related parties and its subsidiaries. It makes sense to include this provision in Ukrainian law: a transaction that a company's subsidiary conducts with a related party of the company, on the company's instructions, has the effect as if the parent company were involved. Excluding transactions between subsidiaries and related parties from the scope of the procedural safeguards as contained in the JSC Law of Ukraine would create a large and unacceptable gap in the RPT-related strategies. To overcome this gap, a new paragraph could be added to Article 71 of the JSC Law of Ukraine, obliging companies to publicly announce transactions between their subsidiaries and their interested persons, while simultaneously presenting a third-party report assessing whether the transaction is fair and reasonable from the perspective of the company and its shareholders who are not interested persons, and explaining the assumptions and methods applied. This new requirement should then be subject to the same exemptions and thresholds as transactions with interest are.

SRD II furthermore provides for aggregation of transactions with the same related party that are conducted within a single financial year. The JSC Law of Ukraine contains a similar provision for fundamental transactions, prohibiting these transactions from being broken into separate parts (Article 70). While this rule does not apply to transactions with interest, it would be reasonable to implement the SRD II provision, given that companies might try to avoid the rules governing transactions with interest by conducting multiple transactions that remain below the established threshold. As a suggestion for implementing these requirements, a rule might be added to Article 71 of the JSC Law of Ukraine, governing aggregation of transactions with the same interested person within any 12-month period or within a single financial year that are not otherwise subject to disclosure and other procedural requirements.

A further provision of SRD II that would be logical to carry over to the JSC Law of Ukraine is the exemption for transactions concluded in the ordinary course of business and on normal market terms. As noted above, invalidation of RPTs conducted in breach of the procedural requirements, even those that create value, is overinclusive. Invalidation is a serious remedy that should be available only where an RPT destroys value. It would be advisable, therefore, to make invalidation of transactions with interest available in connection with transactions that are not only in breach of procedure but also not conducted on normal market terms. The courts would then have the ability to verify whether an RPT is on normal market terms based on information from a third party's report, for example. The other element of this exemption ('in the ordinary course of business') might only add ambiguity to the enforcement mechanism, however, if it is applied in combination with the 'normal market terms' rule. For the courts, this might create further complexities. The approach introduced with the amendments of 20 September 2019 would be overly restrictive, as it does not eliminate the problem of formality-based jurisprudence. Instead of two separate grounds for annulling transactions with interests, it makes more sense to introduce a single ground: breach of the procedural requirements and inconsistency with market prices.

6.3.1.2. Implementation of the Second Council Directive and improvement of other capital maintenance rules

While no provision is made for SRD II in the EU-Ukraine Association Agreement, the same does not apply to the Second Council Directive. The rules on distributions under that Directive, if interpreted in a broad sense, as they are in Germany for example, have bearing on the protection of the assets and stakeholders (minority shareholders, creditors and employees) of companies. This would be amplified if Ukraine adopted the doctrine of hidden distributions, in the same manner as Germany and Poland already have. At present, the limitations on distributions under the JSC Law of Ukraine and the LLC Law of Ukraine apply only to dividends. The doctrine of hidden distributions, conversely, assumes that distributions may also take the form of loans, purchase contracts, remuneration, et cetera. This doctrine would afford additional protection to creditors, who currently have no say in the approval of RPTs and enjoy limited standing to claim damages caused by detrimental RPTs. The main remedy available to creditors is debt collection, which can be exercised to effect only if the debtor has sufficient funds remaining after its assets have been tunnelled by related parties. As such, further capital maintenance restrictions would provide additional guarantees in terms of the amount of capital that debtors must have. However, if it is adopted without proper exemptions for corporate groups, the doctrine of disguised distributions could lead to rigid and elaborate legal regulation. Another risk is that institutions might misinterpret this doctrine. Its adoption should therefore depend on whether it can be balanced by a list of necessary exemptions and be made conditional on proper enforcement by the courts.

Even if the doctrine of hidden distributions is not implemented, possibilities exist to improve the current regulation of distributions, in accordance with the Second Council Directive. Neither the asset-based test (the balance-sheet test) nor the net profits test as set forth in the JSC Law of Ukraine match the Directive's wording, having suffered from a cherry-picking exercise by the legislature.[1776] Proper implementation of the Second Council Directive's provisions could be ensured by the following changes: (1) amend Article 30(2) of the JSC Law of Ukraine to include carry-forward losses and additions to reserves for the purpose of calculating the dividends payable to shareholders (net profits test); and (2) amend Article 31(1) of the JSC Law of Ukraine, containing the restrictions on dividend payments, to include another condition that will prevent payment of dividends: if payment of the dividend *would cause* the net assets as presented in the company's financial statements to drop below the amount of the subscribed capital plus non-distributable reserves (asset-based or balance-sheet test).

For public companies, similarly, the liquidity test as posited by the self-enforcing theory is not applied. The situation is the opposite for private companies: no provision is made for the asset-based and net profits, yet the liquidity test does in fact apply. As a suggestion for increased creditor protection, the asset-based and net profits tests should be introduced for private companies, in addition to the liquidity test, and expand the capital maintenance requirements for public companies by including the liquidity test. The following changes are proposed: (1) introduce the liquidity test for public companies, add a further condition to Article 31(1) of the JSC Law of Ukraine that will prevent dividend payments: '*if a company's assets are insufficient, or will become insufficient as a result of payment of any dividends, to satisfy all due and payable claims of creditors*'; and (2) introduce the assets (or balance-sheet) test for private companies, add a further condition to Article 27(1) of the LLC Law of Ukraine that will prevent dividend payments: '*if on the closing date of the previous financial year, the net assets as presented in the company's financial statement accounts are less than, or as a result of the dividend distribution would drop below, the amount of the subscribed capital*'.

6.3.2. Special regulation of corporate groups

6.3.2.1. Recognition of the notion of a group interest

As explained above, if the doctrine of hidden (or concealed or disguised) distributions is implemented in Ukraine, it will also require the introduction of exemptions for groups. The possible measures for tackling corporate groups in Ukraine should be examined more closely in this context.

It is important to stress that corporate groups do in fact exist in Ukraine. Turning a blind eye to their existence is a poor way of regulating corporate relationships. The legislature has already introduced measures in this area, for example by exempting public companies owned by a single shareholder from the need to comply with the procedural and announcement requirements governing RPTs (Article 71). Nevertheless, group-related issues are still topical.

As discussed above, it is unclear whether company law in Ukraine grants parent companies the right to issue instructions to their subsidiaries to act in the best interests of the group as a whole. A form of regulation similar to how it is done in the Netherlands[1777] is therefore recommended: establish that a company's articles of association may stipulate that management must conduct itself in accordance with the directions of a company body in respect of the general policy to be pursued in the areas specified in the articles. A provision to this effect obliges a company's management to respect the group's interests, as well as the separate interests of the subsidiary. It also indemnifies management against liability for acting in the group's interest and contrary to the subsidiary's interests.

[1776] Antonenko L, 28.
[1777] BW, Articles 2:129(4) and 2:239(4).

This rule would be practicable for both public companies (whether listed or non-listed) and private companies. The problem associated with recognizing the notion of a group's interest, at least in part, is that it is subject to interpretation. If the rule described above were to be added to statutory law, courts deciding cases involving liability of management would be forced to interpret the notion of group interest. In the absence of earlier case law and proper knowledge of group law, this might present a serious challenge. However, these circumstances should not stand in the way of developing jurisprudence and can be overcome by introducing the concept gradually.

In addition, no specific rules regulate a parent's liability for loss or damage that its detrimental instructions cause to its subsidiary. In the present situation, these relationships are governed by the general provisions of tort law.[1778] To change this state of affairs, a clause on parental liability should be added to the CCU, by expanding Article 118 to include new paragraphs that allow for the possibility of instructions from company bodies of parent companies and parental liability for detrimental instructions:

'(a) The articles of association of the dependent company may provide that management of the dependent company must conduct itself in accordance with the directions of another company body of the parent company and/or the dependent company.

(b) Loss or damage caused to the dependent company as a result of carrying out the instructions of a company body of the parent company must be compensated'.

6.3.2.2. Intra-group loans

Intra-group loans are a popular instrument for cash pooling. Despite the increasing possibility of harmful loans, their use is widespread and often a matter of regular practice.

In Ukraine, intra-group loans of public and private companies do not face serious scrutiny from the perspective of capital maintenance rules, as the associated tests (asset-based, net profits and liquidity) are used only for dividends. To some extent, this shortcoming is compensated by the procedural and announcement obligations for fundamental transactions[1779] and RPTs.[1780] However, those requirements do not always give full consideration to the rights of creditors, who have no power to influence the approval procedure. As such, extending the doctrine of hidden distributions to various other transactions, by extrapolating the use of relevant tests that in the current regime apply only to dividends, would benefit creditor protection.

At the same time, the doctrine of hidden distributions can only be implemented in combination with recognition of the notion of a group interest. Distributions made in the group's interests, including intra-group loans, should be excluded from the strict capital maintenance rules, to avoid undermining the balance of interests. Again, the problem is that the notion of group interest is almost unknown in Ukraine's company law jurisprudence, and would present the courts with an interpretation challenge. Before they can be implemented in Ukraine, and even once they have been implemented, the doctrine of hidden distributions and recognition of the group interest notion must be discussed and reviewed at length by scholars and practitioners. If the Parliament of Ukraine introduces the hidden distributions doctrine for public and private companies, that doctrine should have associated exemptions for groups of companies. The doctrine and the exemptions could be introduced by adding a new Article 31-1 to the JSC Law of Ukraine and an Article 27-1 to the LLC Law of Ukraine, reading as follows:

[1778] CCU, Article 1166.
[1779] JSC Law of Ukraine, Article 70; LLC Law of Ukraine, Article 44.
[1780] JSC Law of Ukraine, Article 71; LLC Law of Ukraine, Article 45.

‘(a) Distributions from a company’s capital that are not dividends, including but not limited to excessive remuneration, excessive payments under agreements for the provision of services, purchase of goods and/or performance of works and other agreements that are not on normal market terms, are subject to the same restrictions that apply to dividend distributions.

(b) Distributions made in breach of paragraph 1 of this Article must be refunded to the company.

(c) Paragraphs (a) and (b) of this Article do not apply to distributions made between separate members of the same group.’

If the concept of hidden distributions is introduced in the manner described above, the regulation would be incomplete if no explanation of the group concept was set out in the JSC Law of Ukraine and in the LLC Law of Ukraine. This can be done by using the control-based group concept as used in the Accounting Directive: ‘*a parent undertaking and all its subsidiary undertakings*’.[1781]

6.3.3. Derivative suits and additional minority shareholder rights

6.3.3.1. Derivative suits

One of the areas not regulated by EU law is the area of derivative suits. In Ukraine, shareholders with 10 per cent or more of a company’s share capital may currently file only one type of derivative suit on the company’s behalf: claims for compensation of loss or damage caused by company officers. In addition, if their own rights are infringed, they may apply for resolutions passed by company bodies to be annulled.[1782] However, shareholders do not have standing under the law in derivative suits to claim annulment of transactions with interest or fundamental transactions, nor to claim compensation for loss or damage caused to the company by related parties, including controlling shareholders. The 20 September 2019 amendments grant shareholders standing to claim invalidation of transactions with interest only where the transaction was not conducted on market terms.

As a suggestion for improving the current regulation, shareholders owning 10 per cent or more of a company’s share capital could be granted standing to bring claims on the company’s behalf to seek invalidation of transactions with interest and fundamental transactions that have been concluded in breach of proper procedure and that are not on normal market terms, and to seek compensation for loss or damage caused by interested persons. Given the prevalence of abusive practices and corporate raiding in Ukraine, these changes could be introduced in combination with some or all of the additional preventive safeguards already described in literature, such as a minimum shareholding duration as a prerequisite for filing these claims.[1783] These changes could be introduced by adding an Article 54-1 to the Economic Procedural Code of Ukraine, granting shareholders with 10 per cent or more of a company’s share capital the right to claim invalidation of fundamental transactions and transactions with interest, and to claim compensation for loss or damage inflicted by detrimental transactions with interested persons, and combining this amendment with safeguards under which the right to file derivative suits vests only with

[1781] Accounting Directive, Article 2(11).

[1782] Regulation of the Plenum of the Supreme Economic Court of Ukraine ‘On Certain Aspects of Resolution of Disputes arising from Corporate Legal Relationships’ No. 4 [Постанова пленуму Вищого господарського суду України “Про деякі питання практики вирішення спорів, що виникають з корпоративних правовідносин”] of 25 February 2016, published in Visnyk hospodarskoho sudochynstva, 2016, No. 1, Stor. 72, 1.7.

[1783] Штим Т, 189; Khort YV, 181.

shareholders that had owned their shares for five years or longer before the transaction was concluded.

6.3.3.2. Other methods of protecting minority shareholders

Shareholders in public companies have the right to demand that the company repurchase their shares if they vote against transactions with interest at the general meeting of shareholders.[1784] This appraisal right of shareholders could be improved by granting minority shareholders the right to demand a repurchase of their shares if a supervisory board member appointed by the shareholder's quota or an independent director votes against approval of a transaction with interest. This amendment would expand the scope of the appraisal right of minority shareholders seeking to exit the company.

Shareholders in private companies who own less than 50 per cent of the company's share capital have an unconditional right to exit the company.[1785] The exit triggers an obligation for the company to pay the value of the shares within one year after the shareholder's exit.[1786] However, this arrangement does not take into account situations where a shareholder indirectly owns more than 50 per cent of the share capital, i.e. through other entities that the shareholder controls. Given the high risk of abuse of shareholder rights in these situations, the concept of 'indirect ownership' within the meaning of the JSC Law of Ukraine (Article 1(11-1)) should also apply to private companies. To introduce this concept, Article 24(1) of the LLC Law of Ukraine could be amended to state that an exit by one or more persons who directly or indirectly own 50 per cent or more of a company's share capital requires the other shareholders' consent, for which purposes 'indirect' ownership has the same meaning as given in Article 1(11-1) of the JSC Law of Ukraine.

Shareholders in public companies that own more than 10 per cent of shares (for private companies: 10 per cent or more) have the right to appoint a special auditor.[1787] By law, companies are obliged to provide these auditors with access to and copies of any requested documents.[1788] At the same time, the law provides no rules to regulate how the auditor's findings should be considered, or what should be done if the company refuses to give access. Instead, these matters are left entirely to internal regulation and to the courts, in their role of filling in gaps in the law. Compared with the rules on appointments of auditors in Germany[1789] and Poland,[1790] and compared with the sophisticated inquiry proceedings in the Netherlands,[1791] Ukraine provides for little statutory regulation of these independent audits. The suggestion is therefore to amend the regulation by providing more detailed rules for how these reports should be considered and what the procedure and terms of these audits should be, if they are not defined in the articles of association, and what the consequences are of a company's breach of its duty to provide access to and copies of requested documents. Furthermore, institutional improvement is crucial to ensure proper protection of these rights, together with the respective material safeguards. However, this largely goes beyond the scope of this study.

6.3.4. RPT-related strategies

[1784] JSC Law of Ukraine, Article 68(1).
[1785] LLC Law of Ukraine, Article 24(1).
[1786] Ibid, Article 24(7).
[1787] JSC Law of Ukraine, Article 75(5); LLC Law of Ukraine, Article 41(1).
[1788] JSC Law of Ukraine, Article 75(6); LLC Law of Ukraine, Article 41(3, 4).
[1789] AktG, Articles 142-146.
[1790] KSH, Articles 223-226.
[1791] BW, Articles 344-359.

6.3.4.1. *Procedural safeguards*

The optional nature of supervisory boards and procedural safeguards for RPTs of private companies seems unfair in some situations. In Poland, for instance, private companies with a share capital of more than PLN 500,000 and more than twenty-five shareholders are required to have either a supervisory board or an audit committee.[1792] In Ukraine, before the LLC Law of Ukraine came into effect, the number of shareholders that private companies could have was capped at 100.[1793] In addition, to encourage share transferability, if a public company has more than 100 shareholders, it is automatically prohibited from granting its shareholders a pre-emptive right to purchase the shares of other shareholders.

These arrangements show that 100 is already a familiar threshold in Ukrainian company law, in terms of numbers of shareholders. If a company has more than 100 shareholders, this points towards the presence of minority shareholders, and requires improved shareholder oversight. The suggestion is therefore to adopt a system similar to that in Poland, making supervisory boards mandatory for private companies with more than 100 shareholders and a share capital representing 1250 times the minimum wage or more (i.e., the same as for public companies[1794]). Similarly, for private companies that reach these thresholds, it would be fair to dictate a mandatory approval procedure for transactions with interest: Articles 38 and 45 of the LLC Law of Ukraine would of course need to be amended accordingly.

6.3.4.2. *Disclosure*

On 1 May 2016, a rule came into effect requiring public companies to disclose approved transactions with interest to the NSSMC and announce them on the public website www.smida.gov.ua. It would be preferable if transactions with interest were instead disclosed ex ante, i.e. before they are approved, to give stakeholders more opportunity to take measures. However, the current regulation is a positive achievement, as it offers a user-friendly method of sharing key information on approved transactions.

6.3.4.3. *Standards*

The standards strategy remains underdeveloped in Ukraine. Compared with the German regime, Ukrainian company law does not explicitly recognize a duty of loyalty for shareholders, and unlike Dutch law it does not place the same value on legal principles. Except for the Supreme Court, Ukrainian courts tend to apply statutory rules only, and largely ignore abstract legislative provisions. Even though it is possible under the CCU to draw on legal principles and moral grounds to assess the issues of a claim for invalidation of a transaction,[1795] it is very difficult to find any cases where these provisions have been applied in a systematic and consistent manner. The formal interpretation therefore prevails over the functional interpretation, as can be seen in how disputes

[1792] KSH, Article 213(2).
[1793] Law of Ukraine 'On Economic Companies' [Закон України 'Про господарські товариства'], Article 50.
[1794] JSC Law of Ukraine, Article 14(1).
[1795] CCU, Articles 3, 509, 203.

concerning RPTs are resolved. Courts primarily consider whether the approval procedure was followed, and if it was not, the consequence is invalidation of the RPT.[1796]

The amendments of 20 September 2019 might lead to more widespread use of standards in disputes regarding RPTs. However, the legislature's suggestions do not possess the power to override formality-based approach preferred by the courts. As such, and as has already been recommended in the present section, the legal grounds for the overly broad remedy of invalidation should be redressed, to allow invalidation only where an RPT is both in breach of procedural requirements and not concluded on normal market terms. This would also match the provisions of SRD II. Although Ukraine's courts might find it difficult to interpret normal market terms when resolving cases on the invalidation of RPTs, this regulation nonetheless seems preferable. The courts will need to gradually develop jurisprudence by interpreting nebulous and evaluative concepts. Of course, in a country with a developing legal system, immediately replacing rules and procedures by standards would have a destructive outcome. Ukraine's courts are currently weak institutions, and hardly capable of coping with sophisticated tasks. However, if standards are developed gradually, including legal principles and moral grounds, in the long term the outcome will be positive. From the perspective of RPTs, it should lead to more efficient and fewer detrimental and abusive transactions.

6.3.5. Conflicts of interest

If a related party enters into an RPT in order to extract wealth from the company, this gives rise to a conflict of interest. However, conflicts of interest take other forms besides abusive and harmful self-dealing only. Misappropriation of business opportunities and competition with the company are other detrimental events that companies face. In these situations, the company might not feel an immediate reduction in its material assets. Ultimately, however, the indirect impact can be even worse, potentially leaving the company without business partners or prospects for success. It is therefore reasonable to prohibit company officers from misappropriating business opportunities and competing with the company.

In Ukraine, abstract rules for the business opportunities doctrine and the non-compete obligation are set out in the Principles of Corporate Governance.[1797] The non-compete obligation also supplements the general duty of loyalty under the LLC Law of Ukraine.[1798] Conversely, neither the CCU[1799] nor the JSC Law of Ukraine[1800] provides any specific details in their clauses on the duty of loyalty of company officers. As such, it is recommended that provisions to redress this lack should be added directly in those two laws (in Article 92(3) of the CCU and Article 63(1) of the JSC Law of Ukraine), to help improve the understanding of the duty of loyalty.

For the concept of conflicts of interest, the recently adopted LLC Law of Ukraine defines what constitutes a company officer's conflict of interest;[1801] its effect covers even situations where the officer's affiliated persons are enriched by third parties in connection with the officer's performance of his or her duties.[1802] This broad understanding of the concept could place an unnecessary burden on company officers, who might be unaware of gains received by affiliated

[1796] JSC Law of Ukraine, Article 72.
[1797] Principles of Corporate Governance, approved by the Decision of the National Securities and Stock Market Commission of Ukraine of 22 July 2014, No. 955 [Принципи корпоративного управління, затверджені рішенням Національної комісії з цінних паперів та фондового ринку від 22 липня 2014 року № 955], section II, 3.3.
[1798] LLC Law of Ukraine, Article 40.
[1799] CCU, Article 92(3).
[1800] JSC Law of Ukraine, Article 63(1).
[1801] LLC Law of Ukraine, Article 42 (3).
[1802] Ibid, Article 42 (5).

persons. Moreover, the fact that an affiliated person enjoys this manner of income is not necessarily harmful to the company. As such, the broad interpretation of the concept of a conflict of interest under the LLC Law of Ukraine should be narrowed, by expanding the definition contained in Article 42(3) of the LLC Law of Ukraine to include a reference to a detrimental effect of the gain received by the affiliated person.

Under the JSC Law of Ukraine, indirect conflicts of interest should be regarded through the lens of the procedural and disclosure safeguards for RPTs.[1803] It would be unrealistic to neglect the risk of tunnelling by persons close to or controlled by shareholders or company officers, and indirect conflicts should be covered by the legal regulation. However, the problem with this concept lies in the degree of clarity. A non-exhaustive list of related parties could produce unfair results, bearing in mind the risks of judicial errors and abuse. The more specific the definition of a related party (or interested person) is under the JSC Law of Ukraine, the more easily the rules can be enforced. However, once Ukraine's courts reach the proper level of development, it would be reasonable to start applying (as a tool for interpretation) the features of indirect conflicts of interest used by the courts in the Netherlands (as expressed in the celebrated *Bruil/Kombex* case[1804]).

6.3.6. RPTs in CGCs

A special feature of corporate governance in Ukraine is that the Principles of Corporate Governance, the national analogue to a CGC, were designed and adopted by a governmental authority, the NSSMC. This peculiarity does not mean that the Principles constitute hard law, however. Listed public companies must apply the comply-or-explain principle when they choose a compliance strategy. Given Ukraine's weak institutional development, this reduces the effect of the Principles of Corporate Governance. Research shows that courts are reluctant to draw on the Principles as a source of law, as is natural for a country with a developing legal system and underdeveloped institutions.[1805] Considering the soft nature of the Principles of Corporate Governance and their limited practical impact, the possibility of abusive application by enforcement actors is of little concern. With this in mind, their phrasing could be more abstract and restrictive, without creating much fear of misinterpretation.

Firstly, RPTs should be governed more according to their substance, similarly to the approach adopted in the Dutch CGC.[1806] The following clause is suggested for inclusion in the Principles of Corporate Governance: *'Loans and fundamental transactions with related parties should be conducted in the normal course of business only, on terms that apply to the whole workforce, and with no possibility for remission.'*

Secondly, the concept of a related party should be broadened. Unlike the Dutch CGC and the WSE Best Practice in Poland, Ukraine's Principles of Corporate Governance do not treat shareholders as related parties. Only company officers and their affiliated persons have a duty of loyalty.[1807] However, given the extent of ownership concentration in Ukrainian companies and the

[1803] JSC Law of Ukraine, Article 71.
[1804] *Bruil/Kombex* 29 June 2007, JOR 2007/169 (Supreme Court of the Netherlands).
[1805] Cuomo F, Mallin C and Zattoni A, 234; *Corporate Governance Codes for the 21st Century* (Du Plessis JJ and Low CK eds, Springer 2017), 111; Aguilera RV, Cuervo-Cazurra A and Kim S, 'Taking Stock of Research on Codes of Good Governance'. Available at SSRN: https://ssrncom/abstract=1773087 <<Go to ISI>://WOS:000271128400001>, accessed on 18 November 2018, 18.
[1806] Dutch CGC, section 2.7.6.
[1807] Principles of Corporate Governance, approved by the Decision of the National Securities and Stock Market Commission of Ukraine of 22 July 2014, No. 955 [Принципи корпоративного управління, затверджені рішенням Національної комісії з цінних паперів та фондового ринку від 22 липня 2014 року № 955], section II, 3.3.1.

associated risk of abuse, it would be reasonable to impose restrictive regulations on transactions between companies and their shareholders. It is also justifiable to look beyond shareholders as related parties, since control and significant influence can be exercised through other vehicles too. It is therefore suggested that the definition of related parties under the Principles of Corporate Governance should match the meaning under IAS 24.

6.3.7. Final notes

In Ukraine, and under the conditions that prevail there, minority shareholders as a class remain underrepresented. Amendments to company law and corporate governance can therefore not be justified by the need to protect minority shareholders only. Given this situation in Ukraine, the need to reinforce the capital maintenance rules derives more from respect for other stakeholders, including creditors. The prevalence of corporate groups also necessitates implementation of the notion of a group interest, and greater focus on the corporate opportunities doctrine, to expand the scope of conflicts of interest and the duty of loyalty. While the procedural requirements for RPTs under Ukraine’s company law regime are already detailed, the country’s poorly functioning court system means that the standards strategy remains underdeveloped.