# Related party transactions and corporate groups : when Eastern Europe meets the West

Romashchenko, I.

**Author**: Romashchenko, I.
**Title**: Related party transactions and corporate groups : when Eastern Europe meets the West
**Issue Date**: 2020-04-01

# 7. CONCLUSIONS AND RECOMMENDATIONS

The main goal of the present research, as envisaged in Chapter 1, was to understand what solutions the legal systems of Germany, Poland, the Netherlands and the EU can offer to help overcome the problems of RPTs within and outside corporate groups in Ukraine and improve the efficiency of regulation in Ukraine. The emphasis was on the need for a meticulous study of Ukrainian company law, its statutes and their implementation, compared with the Polish, German and Dutch company law regimes, against the background of their implementation of relevant instruments of EU law. An inter-jurisdictional comparison of existing doctrines, strategies and statutory and judicial approaches, as well as the economic and legal situations in the countries studied, would allow for a better understanding of Ukraine's laws and create the possibility to suggest solutions that, if implemented properly, might help to balance the interests of the various groups of stakeholders in RPTs and improve the efficiency of regulation from the perspective of its costs and benefits for Ukraine. These solutions are described in section 6.3, and can be summarized as follows.

1 - *Implementation of SRD II*

Shareholders with 20 per cent or more of a company's share capital, rather than 25 per cent or more, should be viewed as interested persons under the JSC Law of Ukraine.

For the purposes of legal certainty and predictability of procedural safeguards, it is important to avoid broad interpretations of 'control' and 'significant influence' for defining what constitutes an interested person under the JSC Law of Ukraine. For the same reason, domestic partners, their children and dependents should also be left out of the concept of an interested person under the JSC Law of Ukraine.

To close the gap in RPT-related strategies, a new paragraph should be introduced in Article 71 of the JSC Law of Ukraine, obliging companies to publicly announce transactions between their subsidiaries and their interested persons, accompanied by 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 be subject to the same exemptions and thresholds as transactions with interest.

Another suggestion is to introduce a rule in Article 71 of the JSC Law of Ukraine governing aggregation of transactions concluded with the same interested person within a given 12-month period or during a single financial year but were not subject to the disclosure and procedural requirements.

It is also advisable to make invalidation of transactions with interest available if, besides being in breach of procedure, the transactions were not conducted on normal market terms. The approach introduced by the amendments of 20 September 2019 should be tweaked, by introducing a single ground for invalidating transactions: a breach of procedural requirements coupled with inconsistency with market price.

*2- Implementation of the Second Council Directive and improvement of other capital maintenance rules*

The German doctrine of hidden (or concealed, or disguised) distributions is capable of implementation in Ukraine, as long as it is balanced by a range of necessary exemptions and is made conditional on proper enforcement by the courts.

The net profits test should be improved for public companies, by amending Article 30(2) of the JSC Law of Ukraine to require that carry-forward losses and additions to reserves be taken into account for the purposes of calculating the dividends that can be paid to shareholders. The asset-based (or balance-sheet) test for public companies should also be improved, by modifying Article 31(1) of the JSC Law of Ukraine, which sets out the restrictions on dividend payments, to include another condition that will prevent dividend payments: if the dividend *would cause* the net assets as presented in the company's financial statements to drop below the company's subscribed capital plus non-distributable reserves.

Looking beyond the Second Council Directive, the liquidity test should be introduced for public companies, by adding further conditions that will prevent dividend payments to Article 31(1) of the JSC Law of Ukraine: '*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*'. For private companies, the asset-based (or balance-sheet) test should be introduced, by adding a further condition that will prevent dividend payments to Article 27(1) of the LLC Law of Ukraine: '*if on the closing date of the previous financial year, the net assets as presented in the company's financial statements are less than, or as a result of the dividend distribution would drop below, the amount of the subscribed capital*'.

*3- Recognition of the notion of a group interest*

A further recommendation is to establish a system, similar to the arrangement in the Netherlands, for both public and private companies that the company's articles of association may state that management must conduct itself in accordance with the instructions of a company body in respect of the general policy to be pursued in the areas specified in the articles. That provision may be introduced in combination with the possibility of parental liability for loss or damage caused to the subsidiary as a result of detrimental instructions, by expanding Article 118 to include new paragraphs:

*'(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'.*

*4- Intra-group loans*

A suggestion for protecting the interests of creditors is to implement the doctrine of hidden distributions, by extrapolating the use of the asset-based, net profits and liquidity tests, which at present apply only to dividends, to various other transactions. However, distributions that are made in the group's interests should be excluded from the strict capital maintenance rules. The doctrine of hidden distributions and the associated exemption can be introduced by adding an Article 31-1 to the JSC Law of Ukraine and an Article 27-1 to the LLC Law of Ukraine, stipulating the following:

*'(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.'*

Besides the introduction of the hidden distributions doctrine, the notion of a control-based group as used in the Accounting Directive (‘*a parent undertaking and all its subsidiary undertakings*’) can also be added to the JSC Law of Ukraine and the LLC Law of Ukraine.

*5- Derivative suits*

A further recommendation is to provide shareholders owning 10 per cent or more of a company’s share capital with standing to file claims on the company’s behalf to seek invalidation of transactions with interest and fundamental transactions concluded in violation of the procedure and not on normal market terms, and compensation for loss or damage caused by interested persons. These changes can be introduced by amending Article 54-1 of the Economic Procedural Code of Ukraine, and can be combined with safeguards to ensure that the right to file these derivative suits vests only with shareholders that held their shares for five years or longer before the transaction was concluded.

*6- Other methods of protecting minority shareholders*

The appraisal right of shareholders in public companies can be improved by granting minority shareholders the right to demand that the company repurchase 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.

For private companies, one recommendation is to introduce the concept of ‘indirect ownership’ within the meaning of the JSC Law of Ukraine (Article 1(11-1)), by amending Article 24(1) of the LLC Law of Ukraine 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.

Another suggestion is to amend the regulation governing the appointment of special auditors, by providing more detailed rules on how the auditor’s report should be considered and what the procedure and terms of these audits should be, if they are not defined in the company’s 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. Institutional improvement is crucial to ensure proper protection of these rights, together with the respective material safeguards.

*7- Procedural safeguards*

The suggestion here is to adopt a system similar to the arrangements under Polish law, making supervisory boards mandatory for private companies with more than 100 shareholders and a share capital representing 1250 times the minimum wage or more. 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 need to be amended accordingly.

*8- Standards*

As recommended above, the legal grounds for the overly broad remedy of invalidation should be redressed, to match SRD II, to allow invalidation only where an RPT is both in breach of procedural requirements and not concluded on normal market terms. The amendments of 20 September 2019, under which breach of procedural requirements and non-market prices could be adopted as separate grounds for invalidating an RPT, do not possess the power to override the formality-based approach preferred by the courts. In general terms, standards should be developed gradually, including legal principles and moral grounds, to achieve a positive outcome in the long term.

*9- Conflicts of interest*

The recommendation here is that prohibition on misappropriating business opportunities and competing with the company should be added directly to 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.

The broad interpretation of the concept of a conflict of interest under Article 42(3) of the LLC Law of Ukraine should be narrowed, by expanding the definition contained there to include a reference to a detrimental effect of the gain received by the affiliated person.

The issue of indirect conflict of interest needs to be addressed. 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 as articulated in the celebrated *Bruil/Kombex* case that was decided by the Supreme Court of the Netherlands.

*10- RPTs in CGCs*

RPTs should be addressed more substantially in the Ukrainian Principles of Corporate Governance, similar to how the Dutch CGC approaches this issue, by inserting the following clause: '*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.'*

The concept of a related party should also be given a broader interpretation in the Ukrainian Principles of Corporate Governance. It is therefore suggested that the definition of related parties under the Principles of Corporate Governance should match the meaning under IAS 24.

These said recommendations are based on and inspired by the study of RPT-related strategies and other safeguards that are in place in Germany, Poland, the Netherlands and the EU. How successful these changes will be in practice depends on numerous factors, as discussed in section 6.1.3. Factors that will benefit the chances of these legal transplants from their jurisdictions to Ukraine succeeding include the fact they belong to the same legal family (the Continental (i.e. civil) law), the concentrated ownership of companies and their successful implementation under EU law, which is also relevant for Ukraine. Factors that could hinder the success of legal transplants from their jurisdictions to Ukraine are that the economies, capital markets and standards in those jurisdictions are more developed. Still, each of those objections can be countered with other arguments. Firstly, the changes suggested here have largely been modified to reflect Ukraine's legal system, rather than simply carrying over foreign provisions in their original and unchanged form. Secondly, although the standards strategy is poorly developed in Ukraine, this does not mean that the situation will remain the same forever. Ukraine's economy and legal system are gradually developing, giving hope that the use of standards will become more widespread in the future. It would be pointless to deny the present weakness of Ukraine's courts and enforcement institutions, and the nebulous concepts described above, including hidden distributions, normal market terms, the group concept, and loss or damage caused by a parent's instructions, will need to be discussed among scholars and practitioners before they are introduced. Additionally, if these suggestions become hard law, courts and practitioners should be afforded time to adjust their mindsets. The application of legal principles in corporate relationships and moral grounds as a basis for invalidating transactions will also need to be discussed in greater detail. This is where the concept of the indirect conflicts of interest, as described in Dutch jurisprudence, can be useful, although again it will need to be subjected to careful study and analysis.

Even though this research has focused on the German, Polish and Dutch jurisdictions as a means to understand how Ukrainian company law could be improved, it nevertheless shows that, at least as far as RPTs are concerned, Ukraine has the more detailed and nuanced procedural strategies. This might be connected to the relatively underdeveloped nature of the standards strategy in Ukraine, and the use of other means instead. Still, even if considered separately from Ukrainian company law, the laws of the EU Member States analysed here seem to be lacking in terms of procedural and disclosure instruments for tackling RPT-related issues. It appears that this gap will be filled by SRD II, whose development is described in section 5.5, by requiring Member States to implement the announcement, report and approval obligations for listed companies. Moreover, despite the argument that approval and disclosure strategies for RPTs are more developed in Ukraine, it would be far from accurate to conclude that Ukraine's RPT-related strategies reflect the pinnacle of regulation. Although these obligations have been in place for RPTs by Ukrainian public companies since 2009, much room for improvement remains in the current regime of safeguards under the JSC Law of Ukraine – as evidenced by the recommendations suggested above, including implementing SRD II.