Shareholders Agreement:

Alternative to Ukrainian Law or its Violation?

by Alexey A. KOT

Traditionally in Ukraine the relationship between shareholders/members of legal entities as well as between shareholders/members and a legal entity and its management are regulated by the provisions of Ukrainian legislation and charter documents of the respective company.

When foreign legal entities started to join Ukrainian companies the expected issue related to the possibility of shareholders agreements implementation an additional corporate relationship governing mechanism arose.

The grounds for shareholders agreements inducement are obvious. Entering into shareholders agreement enables companies to solve a lot of problems. Its flexibility makes it possible to adjust it to any commercial scheme and to document almost any agreements between shareholders. Moreover, shareholders agreements may help to reduce the negative impact of incomplete Ukrainian legislation on corporate relationship, to establish their own relationship mechanisms absent in Ukrainian legislation, to protect currently unprotected interests, etc.

But there have always been doubts on whether it is possible to implement shareholders agreements under Ukrainian law and whether or not the entities that conclude such agreements violate Ukrainian legislation. First of all such doubts were connected with a substantial difference in approaches related to understanding the legal status of legal entity, its shareholders/members as well as their legal capacity as to defining the norms of legal entities operating that are common for the law of Ukraine and countries using common law.

It is generally known that shareholders agreements institution comes from the countries of the common law system, such as England, USA and other countries of former British colonies. Some of them at different times used to be countries of offshore jurisdiction among Ukrainian and Russian businessmen. It is likely that the last fact significantly increased the necessity for implementation of shareholders agreements towards legal entities established according to Ukrainian legislation. Also, it is a well-known fact that the common law system includes understanding the legal essence of the legal entity (so called "fiction" concept), which differs fundamentally from continental law adopted in different countries including Ukraine ("realistic" concept).

Such difference in approaches related to understanding of legal essence of the legal entity determines the difference in principles of statutory regulation of relations as for establishment and operation of legal entities, management of their activities and relationship between their shareholders/members. Ukrainian legislation in the field of corporate relations is more violent. It contains mainly imperative norms and strives for a more detailed regulation of the most important issues and procedures of legal entities.

Late in 2007 the Higher Commercial Court of Ukraine proved the above-mentioned doubts as for concluding shareholders agreements in Ukraine, issuing Recommendation No.04-5/14 as of 28 December 2007 *On Practice of Legislation Application in the Disputes arising out of Corporate Relations.*

The Higher Commercial Court of Ukraine determined that in resolving corporate disputes commercial courts should assume that relations between shareholders, as well as between shareholders and a joint venture, on its governance are regulated by the laws of Ukraine, other legislative acts and the charter of such a joint venture. Issues related to corporate governance may be regulated by the agreement concluded between shareholders only in cases stipulated by the law of Ukraine. Since there were no references about shareholders agreements in the law of Ukraine such position meant no less than total prohibition for them.

According to the Higher Commercial Court of Ukraine agreements between shareholders (members of company) are unable to amend the provisions of law and charter of the company, to limit the rights of other shareholders (members) of the company. If such agreements are concluded on issues that are regulated by the law or charter of the company, such agreements may be considered by a court as null and void. The examples of such issues specified by the Higher Commercial Court of Ukraine are the establishment of a special voting procedure at gen-

Alexey A. KOT
is the managing partner with Antika Law Firm, PhD (Law)

eral meetings that require one or any shareholders to vote in a certain way, the responsibility of all shareholders to participate in all general meetings, the establishment of a special decision making procedure as well as voting in other authorities of the company, the responsibility of the shareholder to provide presence and voting of the members of the respective authorities of the company (directorate, board of directors, supervisory board), the establishment of the special procedure for a company's executive authority formation (including single executive) and supervisory board. Also, the agreement (transaction) of shareholders of the company registered in Ukraine is unable to subject the null and void conditions of the transaction (grounds, procedure, consequences) on corporate governance performed by shareholders and the company as well as between shareholders to foreign law because the provisions related to null and void transactions in Ukraine are binding.

The Higher Commercial Court of Ukraine emphasized the binding nature of Ukrainian legislation that regulates the procedure on formation of company governing bodies, the general meeting voting procedure, etc., as well as in the competency of shareholders to determine other regulations that differ from those stipulated by Ukrainian legislation.

Moreover, the Higher Commercial Court of Ukraine specified that the term of agreement between shareholders (members) of the company registered in Ukraine on subjection of relations related to company's governance to foreign law is null and void because the respective relations are regulated by the personal law of the company which, according to Article 25 of the *On International Private Law Act of Ukraine* is the Act of Ukraine as the law of the country where the company is located.

The Recommendations of the Higher Commercial Court of Ukraine caused broad resonance among the legal society. The views of experts are divided. Some experts shared the court's arguments and agreed with the fact that concluding shareholders agreements is illegal within Ukrainian jurisdiction. Other insisted on the binding principle of freedom of agreement stipulated by Article 6 of the *Civil Code of Ukraine* and confirmed the groundlessness of the Higher Commercial Court of Ukraine's position and possibility to ignore it.

From the practical point of view the Supreme Court of Ukraine upended the issue related to the legal status of the shareholders agreements in Ukraine, the Plenum of which as of 24 October 2008 adopted Decision No.13 *On Court Practice of the Corporate Disputes Consideration*.

In practice, the Supreme Court of Ukraine proved the Recommendations of the Higher Commercial Court of Ukraine. In particular, it remarked that the conclusion of an agreement (transaction) by shareholders (foreign legal entities or private person) on subjection of relations between shareholders as well as between shareholders and a joint stock company as for its activity to foreign law, is considered as null and void due to Article 10 of the *On International Private Law Act of Ukraine* (i.e. the one that is aimed at avoiding law).

In the same way, the agreement of shareholders of the company registered in Ukraine is unable to subject the null and void conditions of the transaction (grounds, procedure, consequences) on corporate governance carried out by shareholders and the company as well as between shareholders and to subject to international commercial arbitration consideration of corporate disputes related to the activity of the company registered in Ukraine, particularly those that arise from corporate governance.

In addition, the Supreme Court of Ukraine considered violation of provisions of legislative acts of Ukraine on formation of the company authorities, determining their competence, calling of general meetings and decision making procedures as violation of public policy.

In this way, the *Supreme Code of Ukraine* consequently proved the norms of Ukrainian law that govern corporate relations to be binding and objected to the right of the shareholders (members) to amend them by concluding shareholders agreements. So, the Supreme Court of Ukraine implemented an approach according to which the norms of company governance belong to the field of legal capacity of the legal entity that is determined by legislation binding norms. Taking all these things into account, it can be concluded that binding norms of legislation are not applied to company governance and that's why the reference to the principle of the freedom of agreements is out of common sense.

It should be mentioned that the position of the Supreme Court of Ukraine is the same as the approaches of private law in Ukraine. Understanding such a circumstance brings less hope that the Supreme Court of Ukraine will change its position related to shareholders agreements at least in the near future.

There are certain grounds to consider that categorical recommendations of the Higher Commercial Court of Ukraine and the conclusions of the Supreme Court of Ukraine were based on the Provisions of the Article 29 of the *On Joint Stock Companies Act of Ukraine* ac-

BINDING NORMS of LEGISLATION are NOT APPLIED to COMPANY GOVERNANCE and that's why the REFERENCE to the PRINCIPLE of the FREEDOM of AGREEMENTS is OUT OF common SENSE

Ukrainian LEGISLATION in the field of CORPORATE RELATIONS is STRIVING for DETAILED REGULATION of companies

cording to which the charter of the company may include the possibility to conclude agreements between shareholders according to which the shareholders are charged with additional obligations, including an obligation to participate in the general meeting and the liability in case of failure to fulfill it. In other words, the legislation of Ukraine accepts the possibility of conclusion of an agreement by the shareholders of the company. Such agreement shall regulate certain relations between them.

But, the impact of the stated norm should not be underestimated on concluding shareholders agreements in general. First of all, this norm is too general and vague. There are no other references to agreements between shareholders in Ukrainian legislation. Secondly, such a norm does not mitigate the binding norms that regulate company governance. That is why such norms shall be complied with while concluding an agreement between shareholders, but it makes no sense to conclude this particular agreement. Thirdly, the *On Joint Stock Companies Act of Ukraine* was adopted prior to the Decision *On Court Practice of the Corporate Disputes Consideration* of the Plenum of the Supreme Court of Ukraine. So, it is impossible to state that the Supreme Court of Ukraine did not take into account the provisions of this Act, and that's why such provisions are unable to change the court position related to concluding shareholders agreements.

That is to say, the shareholders or the members of the companies established under the legislation of Ukraine that consider it necessary to agree the rules of its governance and determine the principles of their relations, that differ from the established ones stipulated by Ukrainian legislation have the only one possible way of reaching their aim. This way provides establishing a legal entity in foreign jurisdiction and transferring 100% of shares of the Ukrainian company to this entity. In this case, the members shall enjoy the right and possibility to conclude shareholders agreement which shall be subject to the law of the country that is the most suitable for the parties.

Other ways are too unsafe if one takes into account Ukrainian legislation and court practice.

END