The role of legal capital rules in creditor protection: contrasting the demands of western market economies with Ukraine’s transitional economy

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Abstract

Rules regulating a company’s capital (legal capital rules) have traditionally been considered a creditor protection mechanism. More recently, however, commentators have suggested that legal capital rules are an ineffective and unnecessary form of creditor protection in developed economies, since the rules themselves are incapable of delivering the desired protection, and other strategies are available to provide what is necessary. These other strategies include directors’ duties (of the creditor-regarding variety) and contractual mechanisms (enabling creditors to protect themselves contractually). In developed economies, the existence of these alternative strategies diminishes the need for a strict legal capital regime. The position might be different in developing economies. Do legal capital rules have a role to play in creditor protection in a transitional economy, where a comparable framework of creditor protection mechanisms is missing or under-developed?

In light of the inadequacy of the ex post creditor protection framework in the transitional economy of Ukraine, the protection offered by the legal capital rules (however limited) emerges as a potentially useful collective guarantee against the opportunistic withdrawal of assets by corporate controllers. However, the practical effect of even such basic regimes is often compromised by the corporate environment in which the regime operates. Underdeveloped market mechanisms, non-transparent ownership structures and weak judicial credibility can adversely affect creditor protection. In such an environment, pressure to deliver functional convergence by way of voluntary corporate governance codes, international organisations’ initiatives, and training in international judicial standards can be effective in helping to move forward the necessary changes by bearing on the acceptance of best practices and ethics.
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Introduction

Subject matter

This thesis is a comparative study of creditor protection aspects in economies that differ in the levels of their market development. For the purposes of this thesis I will distinguish between developed and transitional economies – the former referring to Western market economies such as the UK and the US, and the latter to ex-Socialist countries in the process of transition from a command to a market economy.

In developed economies rules regulating a company's capital, or legal capital rules, have traditionally been considered a creditor protection mechanism, the rationale behind it being the rules' alleged ability to help safeguard creditors' equity cushion represented by shareholder contributions. More recently, however, it has been suggested that the creditor protection function of legal capital rules has become outdated and unnecessary in developed economies due to the existence of complex networks of other regulations and strategies capable of protecting creditors' interests. The question I ask here is whether legal capital rules have a role to play for creditor protection in a transitional economy, where a comparable framework of creditor protection mechanisms is missing or under-developed.

Methodology

In order to accomplish this task, I start by using the case of developed economies to establish the analytical framework, firstly to assess the ability of legal capital rules to safeguard a company's assets as a primary source for satisfying creditors' claims, and secondly, to consider the ability of ex post creditor protection mechanisms to safeguard a company's assets. I then proceed to apply this analytical framework to Ukraine as a model of a transitional economy. By adopting this approach, I attempt to assess the utility of legal capital rules for creditor protection in transition, whilst taking into account contextual considerations and peculiarities of a transitional economy. Furthermore, through analysing creditor protection aspects, I aim to provide an insight into wider issues of the corporate environment in transition, such as problems related to corporate ethics and the institutional persistence of historic, political and economic factors.
Chapters

This thesis is split into four chapters. Chapter One reviews the legal capital rules regime under the provisions of the Second EU Company Law Directive (on the formation of public limited liability companies and the maintenance and alteration of their capital), and its implementation at the national level, focusing on the UK as a paradigmatic example and using comparisons with Germany and the US to illustrate points of interest. The analysis centres around publicly traded companies as it is these companies that are the target of the Second EU Directive’s provisions. The chapter sets the scene for considering the utility of legal capital rules in the wider context of a creditor protection framework in both developed and transitional economies.

The aim of Chapter Two is two-fold. Firstly, the chapter aims to outline examples of ex post creditor protection mechanisms targeting opportunistic behaviour on the part of company controllers in the vicinity of insolvency and to assess the need for legal capital rules within a creditor protection framework in light of these mechanisms. Secondly, the chapter outlines the pros and cons of the contractual approach to creditor protection and considers whether the role of rules on capital in a creditor protection framework can also be affected by the availability of contractual mechanisms.

Chapter Three focuses on Ukraine as a model of a transitional economy. The choice of this jurisdiction was prompted by the possibility of access to primary sources in the original (Ukrainian) language, and it is on these sources that the chapter principally relies, both to ensure accuracy of analysis and due to the relative lack of current secondary sources. A further difficulty was the lack of official English language translations of the Ukrainian legislation. Rather than undertaking a literal translation exercise, the chosen approach is to deal with primary sources in the original language, whilst adopting the terminology in common usage in Anglo-American jurisprudence for explaining and analysing the law. Therefore, primary sources in the original language will be cited, with translations of relevant provisions appended.

Chapter Three aims to apply the analytical framework and conclusions of Chapters One and Two to Ukraine, assessing the utility of legal capital rules for creditor protection in

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1 This was the case at the time of writing. Some of the Ukrainian legislation is now available in English on the Verkhovna Rada of Ukraine (Parliament of Ukraine) website <http://portal.rada.gov.ua/control/en/index> (last accessed January 2009).
transition, whilst taking into account the state of the ex post creditor protection framework. Chapter Three thus analyses creditor protection in Ukraine from the 'law on the books' viewpoint.

Finally, Chapter Four puts forward the importance of considering the effectiveness of a creditor protection regime in the context of the corporate environment within which the regime is intended to operate. The chapter thus looks at the factors of the corporate environment that can impact on the effectiveness of creditor protection in a transitional economy.

Research issues

The process of transition from a planned economy to a market economy necessarily involves dynamic changes in the political and social landscapes of the countries concerned. On the other hand, due to the nature of the legislative process, legal transition may require a longer time to catch up with the changes. Delays in legal transition, particularly in the area of company law, can negatively affect economic growth and development which are driven by business activity. International concern with legal and economic issues associated with transitional economies is clearly evidenced by research and initiatives undertaken by international organisations such as the European Bank for Reconstruction and Development and the International Finance Corporation\(^2\), as well as scholarly research from both sides of the developed-transitional divide\(^3\). Nevertheless, research into the finer legal details and practical application of the law in transitional economies continues to be hampered by access difficulties, the lack of empirical evidence and the shortage of secondary sources. Whilst recognising and acknowledging these limitations, I do not attempt to carry out an empirical study; rather, I aim to outline issues and themes for further research into the corporate environment in transition.

\(^2\) For the European Bank for Reconstruction and Development projects, see <http://www.ebrd.com/> (last accessed January 2009); for the International Finance Corporation initiatives, see <http://www.ifc.org/> (last accessed October 2008).

Chapter One
Legal capital rules and creditor protection: analysis of selected developed jurisdictions

1.1 Introduction

Legal capital rules have traditionally been placed within the creditor protection field. These rules cover the issues of raising a company’s share capital; they also regulate the maintenance of the company’s capital by imposing constraints on companies transferring their assets to company shareholders in their capacity as members of the company. Such distributions can typically be in the form of dividends, but can also be accomplished through purchase or redemption by the company of its own shares or through the restructuring of the company’s capital combined with transfers of assets to shareholders.

Legal capital rules normally form a part of national company law and they are to be adhered to by the companies regardless of whether the company is a borrower. It can therefore be somewhat surprising at first glance that creditor protection is advanced as an important reason for the existence of these rules.

If company law is to protect creditors, then perhaps two questions need to be asked from the outset: what is it exactly that should be protected and what sort of conduct needs to be controlled.

The creditor protection functions of company law inevitably centre around safeguarding a company’s assets, and in particular those contributed by the company’s shareholders. This function can be fulfilled either by reliance on share capital rules, as is the case in the UK and in Germany, or through selective restrictions on distributions to shareholders, which is the focus of the US regime. In the former case, the aim is the preservation of the issued share capital; in the latter, the dominating objective is to ensure solvency of the company. In either case, however, the most important goal as far

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as creditors are concerned is to safeguard the company’s assets in order to minimise the risk of insolvency and to increase the chances of creditor claims being satisfied. Therefore, the answers to the questions posed above are as follows: if company law is to protect creditors, then it should concentrate on the protection of a company’s assets and it should aim to control the activities which may endanger a company’s solvency. Consequently, in order to assess the utility of legal capital rules as a creditor protection device, this chapter will consider the ability of the rules to safeguard a company’s assets.

In focusing on the rationale behind legal capital rules as a creditor protection device, the purpose of the chapter is two-fold: firstly, it will look at how company law rules on share capital can work to protect creditors’ interests in developed jurisdictions; secondly, it will attempt to draw conclusions as to the efficiency of these rules for the purposes of subsequent evaluation of creditor protection in a transitional economy.

In Parts 1.3 and 1.4, an evaluation of the provisions of the Second EU Directive (on the formation of public limited liability companies and the maintenance and alteration of their capital, further — Second EU Directive) and their implementation on the national level is undertaken, focusing on the UK as a paradigmatic example with references to Germany to illustrate particular points of interest; references are also made to the laws of the American states of Delaware and California in order to contrast the EU and the US approaches to matters relating to company’s capital.

Part 1.5 critically evaluates the creditor protection function of the legal capital regime.

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2 Second Council Directive 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, OJ 1977 L 26/1.


4 References are made to Title 8 (Corporations) of the Delaware Code and Title 1 (Corporations) of the California Corporations Code.
1.2 Legal capital rules – background

The background and origins behind the idea of legal capital rules serving a creditor protection function stem from general issues of concern for creditors of corporate entities. Arguably, the interests of all creditors essentially converge towards the same concern: all creditors want the debtor company to have sufficient funds to repay the debts owed. However, when a corporate borrower is provided with credit, a lender must necessarily undertake the risk of dealing with the limited liability of the company, whereby the liability of the company shareholders is at all times limited to the value they have agreed to contribute for the equity that they hold. The limited liability principle thus confines creditor claims to the assets of the company only and does not allow these claims to extend beyond the company’s assets to the personal assets of the company shareholders. Should the company become insolvent, the creditors’ claims will be satisfied only to the extent of what is left of a company’s assets.\(^5\)

From the operation of the limited liability principle stems the potential for conflicts of interest between creditors and shareholders throughout the lifetime of the company. Shareholders, being the equity claimants, are able to benefit from potential gains of the company. Creditors, on the other hand, are the company’s fixed claimants, and will therefore not receive more than they contractually agreed to in the event of a company’s increased prosperity; they instead will be expected to bear the downside of the risks undertaken by the company\(^6\).

Conflicts of interest between a company’s creditors and a company’s shareholders can become more acute at times when the company finds itself in financial difficulty or on the brink of insolvency. As shareholders’ equity claims diminish in value and the company is essentially left with assets that rightfully belong to the company’s creditors, shareholders, having very little or nothing to lose, can become increasingly willing to salvage their original investment through investing in risky projects or through transactions aimed at transferring assets to themselves.

\(^5\) For an overview of exceptions to this general rule, such as the possibility of ‘lifting the corporate veil’, see L. Sealy and S. Worthington, *Cases and Materials in Company Law, 8th Edition* (Oxford University Press 2008) pp. 51 – 71.

\(^6\) Subject to having first claim on the available assets ahead of the shareholders in insolvency.
Thus, as far as a company’s assets are concerned, there are two main scenarios in which creditors can lose out: (1) when investment decisions lead to losses; and (2) when assets are distributed to shareholders in the absence of distributable profits.

In the context of the first scenario, legal capital rules can arguably lessen the moral hazard resulting from the limited liability of the shareholders; however, in order to reduce it substantially, the rules would need to be capable of placing controls on a company’s trading decisions. In any case, even if that were possible, a company cannot be protected against unsuccessful business projects. Therefore, the creditor protection function of legal capital rules in the context of the first scenario is somewhat limited.

The rules can, however, address the problems associated with the second scenario by attempting to ensure that a designated part of the company’s assets, represented by shareholders’ equity investments, is not removed from the company through returns to shareholders. What follows is the analysis of the rules regulating capital in the context of protecting a company’s assets as a primary source for satisfying creditors’ claims.

Parts 1.3 and 1.4 look at *raising of capital* and *maintenance and distribution of capital* respectively. The former considers the ways in which legal capital ‘originates’, that is, at the initial raising of capital when the company is being formed. Capital raising is in turn subdivided into several aspects: minimum capital requirements, share regimes and non-cash contributions. Part 1.4 deals with maintenance of capital and incorporates dividend distributions, capital reductions and share repurchases.

### 1.3 Raising of capital

#### 1.3.1 Minimum capital requirements

In the process of raising equity capital, a public company is normally required to reach a certain minimum capital yardstick prior to commencing trading. Article 6 (1) of the Second EU Directive requires that a minimum capital amount of €25,000 must be subscribed; however, the systems of both the UK and Germany require public
companies to issue a minimum of £50,000 (or the prescribed euro equivalent)\(^7\) and €50,000\(^8\) worth of shares respectively. The Second EU Directive further specifies, in Article 9 (1), that the paid-up amount is to constitute at least 25% of the subscribed nominal value. Both the UK and Germany incorporate the 25% minimum requirement, and therefore, effectively the actual amount raised on incorporation can be as little as £12,500\(^9\) or €12,500\(^10\).

How then does this requirement aim to protect creditors? On one hand, a requirement for minimum capitalisation addresses the moral hazard problem posed by the limited liability principle, by attempting to ensure that at least some of the downside from pursuit of high risk strategies is borne by the shareholders.\(^11\) The minimum capital requirement thus imposes on the shareholders an ‘entrance fee’ for limited liability.\(^12\) In addition, the fact that minimum capital requirements are imposed on a company regardless of its contractual relationship with creditors and without the latter needing to take action can be seen as a positive feature with regard to protecting weaker creditors, who may lack the sophistication and bargaining power to negotiate with the company for their preferred terms.\(^13\)

On the other hand, a minimum capital requirement cannot safeguard a company’s assets, since the raised amount does not stay firmly in place throughout a company’s lifetime. Minimum capital requirements do not restrict a company’s trading decisions and cannot prevent a company from making decisions that can lead to losses, and therefore the levels of capital present at the beginning of trading may not necessarily be present at a

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\(^7\) Companies Act 2006, s. 763 (1).

\(^8\) Stock Corporation Act (Aktiengesetz), § 36.

\(^9\) Companies Act 2006, s. 586 (formerly s. 101(1) of Companies Act 1985).

\(^10\) Stock Corporation Act (Aktiengesetz), § 36 (a) (1).


\(^13\) This argument can also be applied in the context of protecting involuntary creditors. The latter are, however, outside the scope of this thesis.
later stage. Minimum capital requirements thus provide no guarantee that a particular level of assets will be available for the creditors at any particular point in time.

A possible way to give relevance to a minimum capital requirement in the context of creditor protection is to require a company to take appropriate action to salvage the assets when the level of the company's net assets is reduced to a certain proportion of the company's share capital. For example, Article 17 of the Second EU Directive requires a general meeting to be called in the event of a serious loss of subscribed capital; the Directive, however, leaves it to the discretion of the Member States to decide what measures are to be taken by the company. Consequently, the British version of this requirement plays only a very vague creditor protection function, if any. Section 656 of the Companies Act 200614 deals with the duty of directors in the event of serious loss of capital and requires them to convene a general meeting if the net assets of a company fall to half or less of its called-up share capital. The section, however, does not prescribe any specific steps to be undertaken and in fact there is no obligation for anything to be done.15 Furthermore, a general meeting requirement places the decision with the shareholders, whose interests are likely to be in conflict with those of creditors, particularly at the time of capital losses. A creditor is therefore left to rely on the directors' legal duties16 and statutory wrongful trading provisions.17

Another shortcoming of a European minimum capital requirement is that there is no meaningful link between the riskiness of the businesses that different companies may be undertaking and the amount of legal capital prescribed by statutory law.18 Setting the minimum capital requirement at a level that would reflect the relationship between the minimum capital and the riskiness of a company's activities is not an impossible task

14 Formerly Companies Act 1985, s. 142.

15 In the context of capital reductions, when the court confirms a reduction of a public company's capital that has the effect of bringing the amount of subscribed share capital below the authorised minimum, the company is to re-register as a private company - see s. 650 of the Companies Act 2006. Capital reductions are considered below. Similarly to s. 656 of the Companies Act 2006, § 92(1) of the Stock Corporation Act (Aktiengesetz) requires the management board to convene a shareholder meeting when one half of the company's legal capital is lost, but does not require the company to stop trading.

16 Developed as part of common law and codified by the Companies Act 2006.

17 Directors' duties to creditors and wrongful trading provisions are considered in Chapter Two of this thesis.

and this is certainly a common occurrence with banking or insurance industry regulations, when minimum capital requirements act as a safeguard. However, due to the nature of the latter industries, the systemic impact of a failure would be too significant for the economy, and therefore resources are invested into devising appropriate capital requirements.\(^9\) It should also be noted that due to the relative uniformity of these industries, too, their regulation is arguably easier to accomplish. With other companies, an arbitrary figure will normally be selected: there is an obvious difficulty, in terms of the necessary resources, in the attempt to link the two together and to establish what is in fact a proper amount of capital for a company.\(^{20}\) A higher amount may be preferable from the creditors’ perspective; however, if set at too high a level, a minimum capital requirement can over-protect creditors whilst having the effect of reducing competition by discouraging new companies from entering the market.\(^{21}\) The latter point is however largely theoretical – it is invariably the lower threshold that company laws adopt.

By way of contrast, US jurisdictions, such as that of Delaware, do not impose compulsory minimum capital rules in the way the UK and Germany do. § 152 of the Delaware Code provides that it is for the board of directors, unless the terms of the subscription provide otherwise, to determine when the payment for shares is to be made, and whether the shares are to be paid up in full or in instalments, the latter also being determined by the board. Furthermore, according to § 154 of the Delaware Code, the board of directors can decide that only part of the consideration received for shares shall constitute capital. The only qualification is that the amount designated to be capital must not fall below the aggregate value of shares, issued with a par value.\(^{22}\) If both par value shares and no par value shares are issued, then the amount designated to be capital must be in excess of the aggregate par value of shares issued as such.\(^{23}\) In other words, capital is represented by a sum of (1) consideration received upon issue of shares with a par value to the extent of the par value of such shares and (2) consideration received upon

\(^9\) This approach is certainly not foolproof. Financial industries regulation is, however, outside the scope of this thesis.


\(^{22}\) The Delaware Code, Title 8, § 154.

\(^{23}\) The Delaware Code, Title 8, § 154.
issue of shares without par value to the extent of the amount designated by the board of
directors to constitute part of capital. Under Delaware law, the amount of the
consideration determined to be capital in respect of no par value shares is 'stated capital' 
of such shares. Capital of the company can be increased at the discretion of the board,
by transferring all or part of the surplus – the net assets of the company in excess of the
amount of stated capital – to the capital account. The Corporations Code of
California, on the other hand, has no requirement as to the amount to be designated as
capital and since the Code provides that shares may be paid up in part, it would seem
that the shares may be wholly unpaid. However, if the company were to become
insolvent, the shareholders would be liable to pay the agreed share price, thus adding to
the pool available for distributions to the creditors.

Evidently, the rules on capital in the US jurisdictions are far more flexible than those in
the EU, with the decisions regarding the capital being largely entrusted to the directors’
board, rather than being prescribed by law. This seems to be in line with the idea that
each company has its own specific needs and the board is arguably in a better position
than the legislator to determine what the appropriate amount of capital for a company
might be at different stages of its lifetime, including the incorporation stage. The board
will be better equipped to take into account a company’s particular circumstances, such
as its current health and the current interests of both the creditors and the shareholders. It
can of course be argued that creditor interests can be served better if a minimum level of
‘risk’ capital is uniformly imposed on all companies. However, as the European
evidence outlined above suggests, it is unlikely that a uniform figure can serve as a
sufficient protective measure for creditors when this figure is not linked to the amount
and type of debt provided, and the companies under consideration may differ
substantially by size and industry. Furthermore, as has been said before, minimum
capital requirements do not prevent losses that can be incurred through trading. Thus
there is no guarantee that the minimum capital will be maintained within the company as

24 The Delaware Code, Title 8, § 154.
25 The Delaware Code, Title 8, § 154.
26 The Delaware Code, Title 8, § 154.
27 The Delaware Code, Title 8, § 154.
28 The California Corporations Code, Title 1, s. 409 (d).
29 The California Corporations Code, Title 1, s. 409 (d).
it trades. In other words, after incorporation minimum capital can no longer provide a reliable source of debt satisfaction.

It can be argued that, subject to the existence of well-developed corporate governance standards that would ensure proper conduct by directors, the US approach is perhaps more efficient for both the company's activities and for the protection of creditor interests. More flexibility to accommodate various circumstances means that the company can act quickly to salvage its assets, if necessary, and this can certainly be beneficial for company's creditors.

1.3.2 Subscribed capital and share regimes

When a company is formed, one way for it to raise capital is through issuance of shares. Company law rules can play a role in regulating the prices at which a company may allot its shares. Several approaches that can be adopted in this respect will be looked at in the context of the jurisdictions under consideration, before proceeding to evaluate the benefits and disadvantages of different share regimes for the purposes of creditor protection.

The Second EU Directive allows for (i) nominal or par value shares – when shares are denominated as having fixed values attached to them; and (ii) a no-par share alternative – a share value that can be represented by a fraction of a company's subscribed capital, known as a share's 'accountable par'.

The UK operates a par share value regime. Public companies must denominate each share as having a fixed amount to be subscribed in respect of it. The UK Companies Act 2006, section 580 (1) further stipulates that shares are not to be issued at a discount, that is at a price below their par value. No prohibition however exists on issuing shares

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30 Second EU Directive, Art. 3 (b).
31 Second EU Directive, Art. 3 (c).
32 Companies Act 2006, s. 542(1) (formerly s. 2(5)(a) of the Companies Act 1985).
33 Formerly s. 100 (1) of the Companies Act 1985. This is also a requirement contained in Art. 8(1) of the Second EU Directive. See also Ooregum Gold Mining Co v Roper [1892] AC 125.
for the amount that exceeds the par – this share premium amount is accounted for separately in the company’s balance sheet.\textsuperscript{34}

Prior to Companies Act 2006, section 2 (5) (a) of Companies Act 1985 used the concept of ‘authorised capital’ to refer to a figure which had to be divided into a number of shares of a fixed value. Authorised capital was defined as a ceiling upon the amount of capital that a company could raise through share issuance without further formalities.\textsuperscript{35}

The Second EU Directive does not in fact include a mandatory requirement for a company to have an authorised capital\textsuperscript{36} and therefore with the UK not bound by EU law in this regard, the Companies Act 2006 abolished the concept of authorised capital. Instead, the Companies Act 2006 now requires the statement of capital and initial shareholdings to contain a subscribed capital amount - the aggregate nominal value of the shares to be taken on formation by the subscribers to the memorandum of association.\textsuperscript{37}

Germany is an example of a jurisdiction that operates both par value and no par value share regimes. § 8 (1) of the Stock Corporation Act (Aktiengesetz) stipulates that shares can be issued as par value shares or as no par value shares. Par value shares must have a value of at least one euro\textsuperscript{38}, and in case of no par value shares, the proportionate amount of share capital attributable to a share must also not be below one euro\textsuperscript{39}. Both par value


\textsuperscript{35} Authorised capital primarily served a shareholder protection function by putting an upper limit on the number of shares that the company could issue, thus to an extent preventing the dilution of shares beyond the amount that shareholders agreed to when they first acquired their shares. However, the amount of authorised capital was not permanently entrenched and could be altered at a general meeting by an ordinary resolution. As far as creditor protection is concerned, the function of authorised capital requirement was even more questionable, since creditors would be more inclined to focus their attention on the subscribed share capital, rather than base their risk-assessment on essentially fictitious authorised capital amount. Moreover, if a company were to fix its authorised capital figure at a certain level, and then find itself in financial difficulty and needing to raise more equity finance than allowed by the memorandum, it would first need to go through the hurdle of convening a general meeting and amending the memorandum. As far as the creditors are concerned, there were at least two possible negative consequences for them in this situation: the company would not be able to act fast enough to improve its financial health, which would increase the threat of insolvency thus raising the chances of creditors’ claims not being satisfied; the company would also have to incur the costs of holding a meeting, which would deplete the company’s assets thus negatively affecting the creditors’ chances of repayment.

\textsuperscript{36} Second EU Directive, Art. 2 (c).

\textsuperscript{37} Companies Act 2006, s. 10 (2) (b).

\textsuperscript{38} Stock Corporation Act (Aktiengesetz), § 8 (2).

\textsuperscript{39} Stock Corporation Act (Aktiengesetz), § 8 (3).
shares and no par value shares are subject to a no discount rule: § 9 (1) requires that shares are not to be issued at a price lower than par value or than pro rata capital attributed to a no par value share. Unlike the British Companies Act 2006, the German Stock Corporation Act (Aktiengesetz) specifically states in § 9 (2) that shares can be issued at a price higher than their par or accountable par value.

The German Stock Corporation Act (Aktiengesetz) also provides for the possibility of fixing authorised capital amounts at the stage of formation. §202 (1) of the German Act allows for the articles to give the power to the management board for a period not exceeding five years to increase share capital up to a specified par value amount by issuing new shares. The subscribed capital can be increased by up to half of the subscribed capital that existed at the time the authorised capital was fixed in the statutes. This provision is conditional on several safeguards, such as the requirement for the share issues to be approved by the supervisory board. While protecting shareholders against share dilution, these safeguards do not add to the protection of creditors, for whom issue of more shares is always beneficial, since it increases the issued share capital figure, thereby increasing the company’s total assets.

The corporations legislation of the US stands in contrast with both UK and Germany on this matter. For example, the Delaware Code contains no requirement to state the maximum amount of capital with which the company proposes to be registered. Instead, there is a requirement for the certificate of incorporation to state the aggregate number of shares which the corporation shall have the authority to issue; however, whilst arguably fulfilling a shareholder protection function, the statement as to the total number of shares that a company can issue does not provide any safeguards or protections for creditors, whose concern is with assets representing the shares, rather than the number of shares themselves.

The share regime adopted in Delaware also allows for both par value and no par value shares to be issued, but is significantly more liberal than the share regime of the

40 Stock Corporation Act (Aktiengesetz), § 202 (3).
41 Stock Corporation Act (Aktiengesetz), § 202 (3).
42 The Delaware Code, Title 8, § 102 (a) (4).
43 The Delaware Code, Title 8, § 151 (a). Alongside the statement of the aggregate number of shares which the corporation shall have the authority to issue, the certificate of incorporation must specify 'each
Second EU Directive. Share prices can be determined by the board of directors, albeit in the case of shares with par value, a no discount rule operates: consideration received or such shares must not be less than the par value\textsuperscript{44}. As for the shares without par value, these are to be issued for such consideration as may be fixed from time to time by the board of directors;\textsuperscript{45} the incorporation certificate can also reserve the right to fix the consideration for shares to the shareholders\textsuperscript{46}. The Corporations Code of California goes even further: it does not distinguish between par values and no par values and, in fact it does not contain any provision with respect to par values at all.

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How should these different share regimes be evaluated from a creditor protection perspective? In the context of par value share regimes, the following creditor protection rationale can be advanced: if a par value approach is adopted and the shares are subscribed for at fixed values, then arguably it results in an identifiable amount that can at any time be attributable to the shares, in line with the idea of an identifiable fund available to satisfy creditors’ claims.

However, even if creditors were to rely on this fund, it is questionable to what extent ascribing each share with a par value would add any extra safeguards to the maintenance of creditors’ share capital cushion. Regardless of whether share issues occur at par value, below or above it, the legal capital of the company will still be increased, and therefore creditors will benefit in any of the three scenarios\textsuperscript{47}.

Furthermore, restricting a company from issuing shares at a value below par may prevent it from increasing its share capital in a situation of financial distress. When the market value of a company’s shares is less than their par value, it is unlikely that any investor will be willing to acquire shares at par. Thus, as a result of a company being

\textsuperscript{44} The Delaware Code, Title 8, § 153 (a).

\textsuperscript{45} The Delaware Code, Title 8, § 153 (b).

\textsuperscript{46} The Delaware Code, Title 8, § 153 (b).

\textsuperscript{47} It is a separate matter that new share issues can potentially harm the interests of a company’s existing shareholders by diluting their claims on the company. Share issues below par in particular would bestow shareholder rights on those who provided less consideration than those who paid at par value or above it.
unable to replenish its share capital cushion, creditors will be likely to face increased chances of default. It therefore seems that the concept of ‘par’ or ‘nominal’ value of shares is of doubtful utility at least as far as it purports to protect the company’s creditors.

One way to tackle a no discount rule obstacle would be to fix par values at a very low level. However, the minimum capital requirement of £50,000 or €50,000, which relates to the nominal value of the shares issued, may act as an incentive for public companies not to attach very low values to the shares, in order to avoid having to issue a very large number of them. As a result, a company may not be inclined to fix par values at a very low price, hence bringing us back to the difficulty of raising equity capital in an event of restructuring or financial distress.

On the other hand, there is no rule against shares being issued at a premium, one of the reasons for this being the fact that in the event of an increase of share’s market price, the new set of shareholders could potentially join the company at a disproportionately low price, in effect obtaining capital gains without having contributed to the growth. In fact, in the British case of *Hilder v. Dexter* it has been said that even though the statute does not require directors to issue shares at a premium, it may constitute a breach of their fiduciary duties not to do so. On the face of it, it appears that this fiduciary duty can operate to protect creditors as well as shareholders: directors will ensure that shares are issued at a fair price, often above the par value, therefore enhancing the legal capital cushion for the creditors. However, it is often the case that for the purpose of a company’s accounts, share premiums are to be treated separately from consideration received for par values of shares. Furthermore, according to the Second EU Directive, it is only par values that are to be treated as a maintained capital fund for creditors to rely on. It can therefore be argued that given the potential low par values and the accompanying low minimum capital requirements, the Second EU Directive approach does not provide any real protection for the company’s creditors.

Although the UK’s company law does treat par value capital and premium capital accounts separately, fortunately for UK creditors the two are subject to largely similar rules. As a result, as far as creditors are concerned, when shares are sold at a premium, the legal capital on which creditors can rely as being maintained for their benefit is

48 [1902] AC 474.
increased by the full price of the share, rather than simply by its par value. Undoubtedly, therefore, the British approach is an improvement on the European requirement and is far more protective of creditors. Nevertheless, maintaining separate accounts for par values and for share premiums does not always enhance creditor protection, and indeed adds extra costs to the running of the company, which in turn impacts negatively on the company’s assets, which form the focus of creditor claims.

Accountable par values may seem like an alternative to a par value share. However, it is in effect merely a different way of fixing share values. Instead of having an actual monetary value attached to it, an accountable par share is represented by a fraction of a company’s issued capital. An accountable par value regime has similar rules to that of a par value regime, in that it operates the prohibition on issue of shares at below the proportionate amount of the subscribed capital and retains the distinction between par value and premium, and therefore the same arguments outlined above in the context of par values can be applied with regard to the usefulness of accountable par value shares for the protection of creditors.

On the other hand, the share regimes adopted in the US provide a true alternative to the European ones. As outlined above, due to the par value requirement, a company is faced with speculating on what the right price for the share might be, in terms of incorporating into the price any potential difficulties that a company may face in the future. With a regime that does not require share values to be fixed, the board of directors can determine the appropriate value for the shares at a given moment, taking into account current health and financial requirements of the company. Such a regime can thus accommodate particular circumstances, such as restructuring or financial distress, without resorting to amendment of incorporation documents and without having to engage in an exercise of guessing the optimum fixed value of the share on incorporation. The process of raising the necessary equity is therefore more efficient and timely, thus benefiting creditors through minimised risk of insolvency.

The introduction of no par value shares has been suggested in the UK. However, this would currently be possible only for private companies, since public companies are regulated by the Second EU Directive which requires that either par values or

accountable pars are attached to a company’s shares. As a result, until the appropriate legislation is enacted on a European level, public companies in the UK, as well as in Germany, will be obliged to fix their share values on incorporation.

1.3.3 Non-cash contributions for shares

When discussing share value issues in the creditor protection context, it is important to address the rules regulating the consideration received for shares, since these rules can play an important role in determining company’s total assets. Potentially, buyers of shares may want to pay for them in cash, or, in the absence of cash or for other reasons, they may want to contribute some other form of consideration. Since issued and paid-up share capital is meant to act as a cushion for creditors, it is important that values contributed in exchange for shares do in fact represent the figure stated in the company’s accounts.

When equity is raised in exchange for cash, whether through par value shares or no par value shares or both, then the process is relatively straightforward: the amounts received are entered into appropriate accounts. However, when the consideration received for shares takes a form other than cash, such as property or an undertaking to perform work or to supply services, then it is important that contributed assets are appropriately valued to ensure that issued share capital as stated in the company’s documents is a true reflection of the value of the contributions.

Article 10 of the Second EU Directive requires that a special report be drawn up by independent experts with respect to any non-cash consideration. The experts must be appointed or approved by an administrative or judicial authority, and they must state the methods of valuation used to appraise the assets in question. This requirement is qualified by an amendment introduced by EU Directive 2006/68/EC50, whereby the Member States have the option to relax the provisions concerning the valuation of non-cash considerations for an allotment of shares and to forego the expert report requirement. However, these relaxations have not been implemented in UK legislation.51

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Consequently, the UK requires a mandatory valuation of non-cash consideration received by public companies.52

In the US, on the other hand, the power to determine the value of non-cash consideration is vested in the management board. § 152 of the Delaware Code states that consideration can consist of ‘cash, any tangible or intangible property or any benefit to the corporation, or any combination thereof’; and that ‘in the absence of actual fraud in the transaction, the judgement of the directors as to the value of such consideration shall be conclusive.’53 As seen earlier, California has a no par values regime.54 With non-cash consideration, however, it takes a somewhat stricter approach than Delaware, in that it does not accept future services and promissory notes as payment or part payment for shares55. Notably, the future services prohibition is also a feature of the Second EU Directive56.

There are two main points to consider with respect to the issue of shares for non-cash consideration: the nature of the consideration received for shares, and the process for valuing these contributions. With respect to the former, EU and US requirements generally converge - except for the above mentioned Californian prohibitions on future services and promissory notes: in both cases contributions in the form of tangible property capable of economic assessment are allowed. The main difference between the EU and the US lies in the second aspect, namely that of the valuation process. A key feature of the European regime is that the person or body with the power to determine the value of non-cash contributions is appointed or approved by an outside authority, and not the company itself.57 By contrast, in the US the power is vested in the management board or shareholders.58


52 See Companies Act 2006, ss. 593, 596 and 597 (formerly ss. 103 and 108 of the Companies Act 1985). In Germany, corresponding provisions are found in the Stock Corporation Act (Aktiengesetz), §§ 27, 33 and 34.

53 The Delaware Code, Title 8, § 152.

54 See above, section 1.3.2 at p. 22.

55 The California Corporations Code, Title 1, s. 409 (a) (1).

56 Second EU Directive, Art. 7. Corresponding requirements under the English law are found in the Companies Act 2006, s. 585.

Arguably, the US approach imposes less of a burden on companies, in the sense of not requiring them to incur expenses for expert reports. The company can decide, in accordance with its individual needs, how it wants to proceed with respect to valuing equity contributions, and a possible way to do that may be through acquiring expert advice.

The EU rules clearly provide more protection if an assumption is made that the company, through its directors or shareholders, is likely to engage in fraudulent activity and intentional deception of its creditors. Another reason in favour of the European rules is that independent experts are using established methods of valuation. As a result, creditors can rely on the fact that if shareholder contributions are represented by non-cash assets, then common standards in the form of recognised valuation techniques have been applied during the process of evaluating these non-cash contributions. Requirements for the value of non-cash contributions to be verified by independent experts can thus help address the problems of information asymmetry in the corporate credit markets, by seeking to ensure the true value of the assets that shareholders put into the company.

On the other hand, evaluation techniques leave experts with a wide range of discretion and can therefore produce diverging outcomes for similar kinds of contributions. Furthermore, motivating professional interests will also be likely to influence the ‘independence’ of the experts. It therefore appears that requiring an expert report on contributions in kind is of a small benefit to creditors, particularly taking into account the minor significance of the initial capital requirements for creditor protection.

1.3.4 Summary

The raising of capital provisions highlight important issues with regard to the creditor protection function of the legal capital rules. Firstly, the one-size-fits-all nature of the minimum capital requirement bears no relation to the economic reality and financial circumstances of the debtor company. Secondly, par value and accountable par share regimes do not enhance creditor protection. In contrast, a no par value share regime can

58 The Delaware Code, Title 8, § 152; the California Corporations Code, Title 1, s. 409 (a) (1).

benefit creditors through facilitating the raising of equity finance. Thirdly, expert valuation requirements for non-cash shareholder contributions can mitigate the debt-equity conflict by helping address the information asymmetries in corporate credit markets.

1.4 Capital maintenance

Once a company has raised its share capital and is a going concern, the EU approach to providing continued protection of the company’s assets for creditors’ benefit is to require the raised share capital to be maintained during the company’s lifetime. The capital maintenance rules ‘replicate for the company when it is a going concern the principles which apply on an insolvency: shareholders are entitled to payments only if the creditors’ claims have been met’. Naturally, a company’s assets can also be eroded as a result of trading losses rather than distributions to shareholders, and therefore capital maintenance rules cannot be all-reaching in this respect.

Such rules can however play a role in ensuring that creditors’ claims are not downgraded in priority through restricting the ability of corporate insiders to move assets out of the company into the hands of shareholders. The two major ways in which these transactions can be carried out are through the payment of dividends and capital returns through share repurchases. The regulation of these, as well as that of capital reductions, is considered below.

1.4.1 Dividend distributions to shareholders

The importance that both the UK and Germany attribute to the concept of share capital on formation is maintained in provisions on distributions to shareholders, and stems from provisions found in the Second EU Directive.

The dividend distribution test imposed by the Second EU Directive takes the company’s accounts as its basis. Article 15 (1) (a) contains a balance sheet test, which allows distributions only in the event of net assets not being lower than the subscribed capital

plus undistributable reserves. Article 15 (1) (c) then limits profits available for
distribution to the amount of the current year’s profits plus any accumulated profits plus
sums available from reserves for this purpose, less any accumulated losses and sums
carried to reserves.

Accordingly, the UK distribution rules follow a similar pattern. Section 830 of
Companies Act 2006\(^6\) (applying to all companies) prohibits any form of distribution
made other than ‘out of profits available for the purpose’\(^7\). Such profits are then defined
as the company’s ‘accumulated realised profits, so far as not previously utilised by
distribution or capitalisation, less its accumulated, realised losses, so far as not
previously written off in a reduction or reorganisation of capital duly made’\(^8\).

Section 831 (applying to public companies only) then focuses on the company’s net
asset position prior to a distribution. According to the rule a distribution will only be
lawful ‘if at the time the amount of [company’s] net assets is not less than the aggregate
of its called-up share capital and undistributable reserves’\(^9\). To the extent that
undistributable reserves include ‘the amount by which the company’s accumulated
unrealised profit […] exceeds its accumulated unrealised losses’,\(^10\) the impact of this
section, over and above that of section 830, is to require public companies to take into
account unrealised losses in determining the amount that can be distributed to
shareholders\(^11\).

The German system adopts a more restrictive approach to distributions than the UK and
goes beyond the Second EU Directive requirements. In addition to dividends only being
payable out of distributable profits\(^12\), a company also needs to set up a legal reserve\(^13\).

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\(^6\) Formerly Companies Act 1985, s. 263.
\(^7\) Companies Act 2006, s. 830 (1).
\(^8\) Companies Act 2006, s. 830 (2).
\(^9\) Companies Act 2006, s. 831 (1) (a) (formerly s. 264 (1) (a) of the Companies Act 1985).
\(^10\) Companies Act 2006, s. 831 (4) (c) (formerly s. 264 (3) (c) of the Companies Act 1985).
Maxwell 2003) p. 278.
\(^12\) Stock Corporation Act (Aktiengesetz), § 57 (3).
\(^13\) Stock Corporation Act (Aktiengesetz), § 150 (1).
where 5% of annual net profit less any losses brought forward is to be transferred. Eventually, the aggregate amount of all the reserves must reach 10% of the subscribed share capital. The reserves are non-distributable. Until the aggregate amount of the legal reserve and the capital reserves reaches 10% of the share capital (or a higher percentage set by the articles), such reserves can only be used to offset losses. When the aggregate of the reserves exceeds the required percentage, the excess can be used to cover losses and for share capital increases. However, using the excess to cover losses is not permitted if simultaneously transfers are made from profit reserves for the purpose of payment of dividends.

The Delaware Code provides that, subject to any restrictions specified in the incorporation certificate, directors can declare and pay dividends in either of the following cases: out of surplus or, if surplus is not available, out of the ‘net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year’. However, no dividends can be paid out if the capital has been diminished to ‘less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having preference upon the distribution of assets’; the capital needs to be replenished prior to declaration and payment of dividends.

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69 Stock Corporation Act (Aktiengesetz), § 150 (2).

70 This includes the capital reserves required to be set up in accordance with the Commercial Code (HGB), § 272 (2) - Stock Corporation Act (Aktiengesetz), § 150 (2).

71 Or a higher percentage if the articles of incorporation so prescribe - Stock Corporation Act (Aktiengesetz), § 150 (2).

72 Stock Corporation Act (Aktiengesetz), § 150 (3).

73 Stock Corporation Act (Aktiengesetz), § 150 (4).

74 Stock Corporation Act (Aktiengesetz), § 150 (4).

75 ‘Surplus’ is defined in the Delaware Code, Title 8, § 154 as net assets of the company in excess of the amount of stated capital. See above, p. 18.

76 The Delaware Code, Title 8, § 170 (a).

77 The Delaware Code, Title 8, § 170 (a).

78 The Delaware Code, Title 8, § 170 (a).
1.4.2 Share buy-backs and repurchases

A company's assets can also be distributed to shareholders through the company buying back or redeeming its own shares. It is therefore no surprise that share repurchases are strictly regulated under the EU law. Article 18 (1) of the Second EU Directive generally prohibits repurchases, whereas Articles 19 - 21 and 39 provide for conditions when exemptions can apply, such as procedural aspects and limits for aggregate nominal value of shares to be repurchased. In particular, Article 19 (1) (b) of the Second EU Directive imposes a net asset distribution rule of Article 15 (1) (a) and (b) - as a result, the acquisitions must not reduce net assets below the sum of subscribed capital and undistributable reserves. To avoid the reduction of subscribed capital, the Directive requires corresponding reserve accounts to be established. Correspondingly, under the British provisions, companies are required to maintain their legal share capital at the pre-buy-back level. Section 733 of the Companies Act 2006 requires a company to create an undistributable 'capital redemption reserve' in order to offset the decrease in the stated capital caused by the purchase.

The Delaware Code treats repurchases and redemptions in a similar manner to distributions - the procedure is decided upon by the board, subject to capital not being impaired as a result of the repurchase or redemption. However, a corporation can purchase or redeem preference shares out of capital or, if there are no preference shares issued, shares that are to be retired.

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80 Second EU Directive, Art. 22.

81 Companies Act 2006, s. 692 (2) - purchase of own shares and s. 687 (2) - financing of redemption.

82 Formerly Companies Act 1985, s. 170.

83 In Germany, § 272 (4) of the Commercial Code (HGB) requires for a capital reserve to be established on the liabilities side of the balance sheet to correspond to the amount entered for company's own shares on the asset side.

84 The Delaware Code, Title 8, § 160 (a) (1).

85 The Delaware Code, Title 8, § 160 (a) (1).
1.4.3 Capital reductions

All capital reductions necessarily diminish the fund available to creditors for their repayment. By reducing the share capital yardstick and thus allowing for easier distribution hurdles, the reductions can help create distributable assets for potential return of capital to shareholders. Consequently, the Second EU Directive imposes procedural safeguards involving court approval coupled with an entitlement for objecting creditors to have their claims paid out or secured.

The Second EU Directive incorporates creditor protection requirements in relation to capital reductions in Article 32 (1). The Article gives creditors whose claims pre-date the decision to make a reduction a right to at least obtain security for their claims, and such right cannot be set aside by the Member States 'unless the creditor has adequate safeguards, or unless such safeguards are not necessary having regard to the assets of the company.' Article 32 (2) further stipulates that the reduction cannot be considered valid until creditors have been satisfied or 'a court has decided that their application should not be acceded to.' Although the Second EU Directive places an obligation on the Member States to ensure that 'the creditors are authorised to apply to the appropriate administrative or judicial authority for adequate safeguards', it also places an express burden on creditors to 'credibly demonstrate that due to the reduction in the subscribed capital the satisfaction of their claims is at stake'.

On the other hand, capital reductions which simply set off losses do not attract creditor protection, according to Article 33 (1). The Second EU Directive recognises compelling reasons for a company to reduce its capital yardstick in situations where there are no distributable profits. The reduction of capital can reflect a diminution in the company’s assets, due to trading losses or otherwise, and it is considered legitimate for a company to bring the capital figure in its accounts into line with its actual position.

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87 Second EU Directive, Art. 31 (1), as amended by EU Directive 2006/68/EC.

88 P.L Davies, *Gower and Davies’ Principles of Modern Company Law*, 7th edition (London, Sweet & Maxwell 2003) p. 90. Alternatively, a company may have surplus cash but no distributable profits according to the balance-sheet distribution test. Provided there are no viable projects to pursue, capital reduction would be economically efficient as it would free up assets for distribution. The money could then be returned to shareholders to be used for other investments, rather than be put into an underperforming project. See J. Armour, ‘Share Capital and Creditor Protection: Efficient Rules for a
In accordance with the EU requirements, under the UK legislation creditors are entitled to object to a capital reduction if their interests may be compromised through 'diminution of liability in respect of unpaid share capital' or 'the payment to a shareholder of any paid-up share capital' and if they 'can show that there is a real likelihood that the reduction would result in the company being unable to discharge his debt or claim when it fell due.' However, in its treatment of capital reductions, the UK provisions go beyond their EU counterparts, making it mandatory for the company resolution to reduce its capital to be confirmed by the court.

In contrast, under Delaware law, a board resolution is sufficient in order to reduce the capital of a corporation. The Delaware Code provides for a number of ways in which capital can be reduced, including the purchase or redemption of shares and a transfer of some of the capital to a surplus account. A reduction must satisfy a solvency test whereby company’s assets remaining ‘shall be sufficient to pay any debts of the corporation for which payment has not been otherwise provided.’

1.4.4 Summary

The above provisions on dividend distributions, share buy-backs and repurchases and capital reductions demonstrate that the concept of capital maintenance focuses on the preservation of the share capital as the creditors’ equity cushion, at least under the Second EU Directive regime. One function of capital maintenance rules thus lies in ensuring that shareholders are prevented from getting their equity back ahead of creditors’ claims being satisfied. The capital maintenance regime is however limited to regulating the losses of corporate assets through distributions. The next section will consider whether such protection is of value as a creditor protection mechanism.


89 Companies Act 2006, s. 645(2) (a).
90 Companies Act 2006, s. 645(2) (b).
91 Companies (Reduction of Capital) (Creditor Protection) Regulations 2008, No 719, s. 2 (b).
92 Companies Act 2006, s. 641(1) (b).
93 The Delaware Code, Title 8, § 244 (a).
94 The Delaware Code, Title 8, § 244.
95 The Delaware Code, Title 8, § 244 (b).
1.5   Legal capital and capital maintenance regime: critical overview

1.5.1   A dated notion

Historically, legal capital rules were first imposed on the assumption that the amounts contributed by the shareholders in exchange for equity were to remain as company assets throughout the company’s lifetime. Due to its permanent nature, this investment was referred to as the ‘equity cushion’ whose function was to provide a safety net for the creditors of the company by ensuring that the equity contributions were not diminished by distributions to shareholders.

Safeguarding a designated part of the company’s assets from distribution has been one mission of legal capital rules for a considerable period of time. The significance of capital for the creditors of a corporate entity was articulated in the 19th century in the English case of *Re Exchange Banking Co* by Jessel MR who put it in the following way:

> The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the corporation shall keep its capital and *not return it to the shareholders* [emphasis added], though it may be a right which he cannot enforce otherwise than by a winding-up order.96

Can the needs of modern company law justify the original creditor protection function of capital, as intended by the ‘founding fathers of company law’97? In the early days of company law, shares would be issued partly paid, so that a large part of the capital would remain uncalled.98 This reserve liability could thus be used in a winding up to

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96 *Re Exchange Banking Company (Flitcroft’s Case)* [1882] L. R. 21 Ch. D. 519 at pp. 533 - 534.
produce cash for creditors. In addition, a potential obligation to pay up the balance of unpaid capital with no possibility to recover any investment through increased share value or future dividend was likely to act as a deterrent to opportunistic shareholder behaviour. Since then, however, it has become the practice for shares to be issued as fully paid or for the full issue price to be payable soon after allotment. As a result, legal capital is no longer of the same significance to creditor protection as it was when the rule was first imposed. So how can creditors benefit from the existence of legal capital rules?

1.5.2 Legal capital: a collective offer to company’s creditors

The requirement for the incorporators to specify the legal capital of their company on incorporation can be seen as an ‘enabling rule’, whereby the incorporators ‘make a collective guarantee vis-à-vis present and future creditors’. This collective guarantee can indicate to the creditors that a certain amount of the shareholders’ own funds has been put together prior to borrowing. Legal capital can thus play a role both as an entry price for the advantages of limited liability and as a tool for companies to signal their initial credibility to potential creditors. Because the legal capital information is provided in the annual accounts, it can be seen as providing a minimum amount of security. For larger creditors, who are likely to contractually impose additional requirements, this can mean a reduction in transaction costs. For smaller and weaker creditors lacking market power to bargain for their preferred terms, legal capital requirements offer ‘standardised credit terms for [...] sparsely worded individual agreements’. By establishing a ‘first signal of credit-worthiness’, the legal capital requirement thus serves to ameliorate the informational disadvantages of the company’s creditors. Likewise, rules on share issues and requirements for the value of non-cash contributions to be verified by independent

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experts can also be interpreted as a response to problems of information asymmetry in
the corporate credit markets, as they 'publicise to investors the value of the assets that
shareholders put into the company, and seek to ensure that this information is
truthful'.

1.5.3 Distribution restrictions: addressing the conflict between creditor and
shareholder interests

Since its initial inception, the function of share capital has shifted from providing
creditors with assurance of funds on winding up to playing a central role within the
capital maintenance concept during a company's lifetime. As seen above, capital
maintenance rules prohibit returns of capital to shareholders with the aim to protect the
capital cushion for the creditors' benefit. The rules thus help address the conflict
between creditor and shareholder interests and preserve the priority rule by stopping
shareholders from getting back their equity ahead of creditors.

Provisions on capital reductions provide an example of how capital maintenance rules
can mitigate the debt-equity conflict. Prescribing conditions to be met and procedures to
go through prior to a capital reduction inevitably means additional costs for a company,
particularly when court confirmation is required. At the same time, in the absence of
these restrictions, a company without distributable profits could successfully resort to
opportunistic distribution strategies, sometimes referred to as 'milking the property'.

Having engaged in capital reduction, a company could then return capital to
shareholders using the freed up assets. It could do so by way of a dividends distribution;
it could also use the assets to purchase its own shares. Assuming that the shares would
then be cancelled and no new shares were issued, a company's issued share capital
would necessarily be further reduced. Moreover, the assets of the company would have
been diverted to the selling shareholder at the expense of the equity cushion of issued
share capital. In this light, restrictions on capital reductions can help address the issue of
capital returns to shareholders through 'milking the property' distribution strategies.

105 J. Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?', 63

p. 429.
By prohibiting any form of distribution of corporate assets to shareholders except out of distributable profits, capital maintenance rules can thus be seen as a protection mechanism for creditors against the risk of opportunistic withdrawals by the shareholders. A number of features, however, undermine this protective function. Firstly, there is little value in using historic contributions by shareholders rather than the state of the balance sheet at the time the loan is advanced to calibrate distribution restrictions. Furthermore, the balance-sheet information on which legal capital and capital maintenance rules rely bears no necessary connection to the company’s current financial position. Soon after a company has been formed, the share capital “becomes an arbitrary number, unrelated to economic facts that are relevant to a creditor.” Adjustments that occur for example through new share issues only reflect a company’s


ongoing performance and prospects in a remote way.\(^{111}\) The utility of share capital as a distribution yardstick will thus diminish over time.\(^{112}\)

Secondly, capital maintenance rules can only regulate the loss of corporate assets resulting from distributions. Since they do not affect the economic success or failure of the company, they cannot regulate the loss of assets incurred through trading losses. As a result, the role of capital maintenance rules when a debtor company is in financial distress is rather limited. Once the shareholders' equity has been wiped out, or reduced to a very low level, the shareholders will be increasingly keen to recover some of their investment. In a situation where shares were partly paid up, share capital would not be wiped out by financial distress, as shareholders would be liable to pay up the balance of unpaid capital on winding up.\(^{113}\) In contrast, when shares are fully paid up, net assets of the company can fall below the amount designated as the share capital due to losses incurred in the course of trading. Meanwhile, shareholders will be shielded from any further contributions by the limited liability.\(^{114}\) In this situation, capital maintenance rules will only be able to protect creditors to the extent of prohibiting shareholders from getting back what is left of their equity. They will not be able to deal with perverse incentives on the part of the company controllers to undertake risky projects or divert value from creditors in the vicinity of insolvency.\(^{115}\)


\(^{113}\) See above, section 1.5.1 at pp. 34 – 35.

\(^{114}\) As well as not being able to protect creditors' capital cushion against trading losses, strict adherence to capital maintenance doctrine in financial difficulties may also lead to anomalous consequences for shareholders. French illustrates this with an example of a steamship company with four boats, and well able to pay its debts. In a situation where three of the boats were sunk but one survived and continued to be profitable, '[t]he capital maintenance doctrine would require that these profits be retained by the company until such time as the value of the net assets again equalled the paid up share capital'. She argues that the resulting non-payment of dividends for a number of years 'would have a disastrous effect on the price of the company's shares, and on any shareholders who depended on its dividends for their daily means'. E. A. French, ‘The evolution of the dividend law of England’, in W. T. Baxter and S. Davidson, eds., *Studies in Accounting*, 3rd edition (London, ICAEW 1977) p. 315.

1.6 Conclusion

Legal capital and capital maintenance rules certainly have a role to play before a debtor company finds itself in a financial distress. For example, the raising of capital rules can be seen as a tool for companies to signal their initial credibility to potential creditors through the collective offer of legal capital. Furthermore, legal capital rules help address the problems of information asymmetry in corporate credit markets, by publicising to investors the value of the assets that were put by the shareholders into the company, and seeking to ensure that this information is true. In addition, distribution restrictions aimed at capital maintenance seek to address the conflict between creditor and shareholder interests by reinforcing the priority rule whereby a company’s creditors have first claim on its assets ahead of the shareholders.

However, the ability of legal capital and capital maintenance rules to safeguard a company’s assets is limited once insolvency looms and shareholders’ equity may potentially be wiped out. Since the rules can only regulate the loss of corporate assets through distributions and not through trading losses, they provide no guarantee that a certain level of assets will be maintained within the company throughout its trading activities. Furthermore, opportunistic conduct on the part of the company controllers in the vicinity of insolvency is outside the reach of rules on capital. It would thus be appropriate for a jurisdiction to supplement the ex ante legal capital and capital maintenance rules with ex post provisions designed to counteract the opportunistic incentives that may arise in the vicinity of insolvency.

In the next chapter, creditor protection offered by such ex post mechanisms will be considered and contrasted with the ex ante protection of legal capital rules. In addition, market mechanisms affecting the utility of legal capital rules within a creditor protection framework will be considered. Chapter Three will then aim to apply the analytical framework and conclusions of Chapters One and Two to Ukraine as a model of a

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116 This 're-assurance' function of legal capital rules is of course limited as the capital raised on incorporation does not stay firmly in place throughout a company’s lifetime. See above, pp. 15 – 16.


transitional economy, assessing the utility of legal capital rules for creditor protection in transition, whilst taking into account contextual considerations and peculiarities.
Chapter Two
Wider creditor protection framework: rules on capital vs. ex post and contractual mechanisms

2.1 Introduction

Legal capital and capital maintenance rules aim to address the conflict of interest between creditors and shareholders by restricting the removal of a company’s assets. However, the ability of the rules on capital to safeguard a company’s assets is limited to restricting shareholder distributions. The rules cannot regulate the loss of corporate assets through trading. As a result, they cannot guarantee that shareholder equity will not be wiped out in financial distress.

Indeed, in financial distress the shareholders’ equity investments will become increasingly depleted. A company will thus be operating on creditors’ funds. Safeguarding or swelling these funds will thus be among creditors’ primary concerns. At the same time, corporate controllers acting in shareholder interests will be incentivised to engage in excessively risky projects. Given that limited liability will restrict creditors’ claims to corporate assets, shareholders will be shielded against the downside of business decisions once their equity has been wiped out or reduced to a very low level. In a situation of financial distress a debtor may also be tempted to divert assets out of the company, thereby reducing the pool available to creditors in insolvency.

It is thus not uncommon for a jurisdiction to impose ‘creditor-regarding duties’ on company directors in the vicinity of insolvency. In this chapter, legal mechanisms directed at two types of opportunistic conduct by company controllers are considered using the UK creditor protection framework. Firstly, provisions aimed at overly risky projects in insolvency are looked at in Part 2.2; then provisions targeting transactions designed to move assets out of the company to divert value from creditors are considered in Part 2.3.

Parts 2.4 - 2.6 then proceed to place the rules on capital in the context of ex post and contractual creditor protection mechanisms. Part 2.4 considers the need for legal capital rules within a creditor protection framework in light of the ex post creditor protection mechanisms. Part 2.5 considers the pros and cons of the contractual approach to creditor protection and Part 2.6 assesses whether the role of rules on capital in a creditor protection framework can also be affected by the availability of contractual creditor protection mechanisms.

2.2 Risky projects in financial distress

2.2.1 Overview

While the company is a going concern, the duties of directors are owed to the shareholders, who hold equity stakes in the company. As the prospect of insolvency approaches, the chances of there being insufficient assets to pay creditors' claims when the company is wound up are increased. In this situation, winding up may be in the creditors' best interests. However, directors may choose to take steps to trade out of a company’s difficulties. If they succeed, they can save their jobs; if they fail, the doctrine of limited liability can step in. Another possibility is that in the vicinity of insolvency a company may carry on its business with the conscious intent to defraud creditors in anticipation of winding up. To address these scenarios, incentives are needed for the directors to give regard to the interests of creditors when trading in the vicinity of insolvency. In the UK, such incentives are primarily provided by two sources: creditor-regarding duties originally developed as part of common law and now falling under the remit of the Companies Act 2006²; and statutory provisions on wrongful and fraudulent trading found in the Insolvency Act 1986.

² Prior to the Companies Act 2006, directors' general duties, including the duties to consider creditors' interests in financial distress, existed as part of common law. They centred around a well-established equitable principle of a company's director owing a fiduciary duty to the company to act bona fide in the interests of the company. For an overview of directors' common law duties, see for example S. Copp, 'Corporate governance: change, consistency and evolution Part 2', 14 (3) International Company and Commercial Law Review (2003) p. 115 at pp. 122 – 123.

Companies Act 2006 codified common law and equitable duties applying to directors. The codified duties are found in sections 171 - 177 of the Companies Act 2006, and include a duty to act within powers, a duty to promote the success of the company, a duty to exercise independent judgment, a duty to exercise reasonable care, skill and diligence, a duty to avoid conflicts of interest, a duty not to
All of the above impose personal liability on the directors of the company to make such a contribution as the court thinks proper to the insolvent company’s assets, thereby swelling the pool available for distribution to creditors. Both insolvency provisions and creditor-regarding legal duties view financial distress as a trigger for managerial responsibilities towards creditors.

Under both the insolvency provisions and Companies Act 2006, creditor-regarding duties do not allow creditors to directly protect their interests and give no standing to the creditors to sue for a breach. Rather, creditor-regarding duties are a collective tool whereby creditors can be represented through a liquidator or an administrator acting on behalf of the company.

2.2.2 Wrongful and fraudulent trading

Section 214 of the Insolvency Act 1986 places personal liability on company directors (and shadow directors) who realised or ought to have realised that there was no reasonable prospect for a company to avoid insolvent liquidation and who fail to take all reasonable steps to minimise the potential loss to creditors.

accept benefits from third parties and a duty to declare interest in proposed transaction or arrangement.

With respect to directors’ obligations to creditors, Section 172 containing a duty to promote the success of the company for the benefit of its members, is subject to ‘any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.’

Companies Act 2006 explicitly requires the courts to interpret and apply the general statutory duties ‘in the same way as common law rules or equitable principles’ and to have regard ‘to the corresponding common law rules and equitable principles in interpreting and applying the general duties’ (see Companies Act 2006, s. 170 (4)) Therefore, despite the fact that statutory duties contained in Companies Act 2006 supersede the older case law and have effect ‘in place’ of common law rules and equitable principles from which they are derived (see Companies Act 2006, s. 170 (3)), the cases preceding the codification remain relevant to the interpretation of the new statutory provisions, which have been generally formulated to reflect the older case law. See L. Sealy and S. Worthington, Cases and Materials in Company Law, 8th Edition (Oxford University Press 2008) p.274.

3 Insolvency Act 1986, s. 214 (2) (c).
4 Insolvency Act 1986, s. 214 (7).
5 Insolvency Act 1986, s. 214 (2).
6 Insolvency Act 1986, s. 214(3).
Effectively, Section 214 exposes directors and shadow directors ‘to the downside of their decisions if they adopt excessively risky strategies.’

Whereas section 214 refers to objective standards of competence on the part of the company controllers, section 213 of the Insolvency Act 1986 requires proof of subjective moral blame. Section 213 provides that ‘if in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose’, the court can make a declaration that those who were ‘knowingly parties to the carrying on of the business in the manner above-mentioned’ should be liable to make such contributions to the company’s assets as the court thinks proper.

Arguably, due to its wide wording, section 214 makes it possible to punish directors who are not only incompetent, ignorant and indifferent, but also those who engage in conscious wrongdoing with fraudulent intent. Section 214 on wrongful trading can thus include the grounds covered by section 213 on fraudulent trading, whilst requiring a less onerous burden of proof. However, the utility of section 213 lies in the fact that the class of potentially liable persons is not confined to directors and shadow directors.

2.2.3 Creditor-regarding legal duty under the Companies Act 2006

Directors’ creditor-regarding duty as developed under the common law is an extension of a well established equitable principle of a director owing a fiduciary

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9 Insolvency Act 1986, s. 213(1).

10 Insolvency Act 1986, s. 213(2).

duty to the company to act bona fide in the interests of the company.\textsuperscript{12} When a company is solvent, the only directors' duty recognised by the law is that owed to the company.\textsuperscript{13} When a company is in the vicinity of insolvency or in fact insolvent, it is the creditors' position in the company's liquidation which will be affected by the directors' acts. Indeed, directors' duties can be seen as 'being owed to those who have the ultimate financial interest in the company: the shareholders when the company is a going concern and the creditors once the company's capital has been lost.'\textsuperscript{14}

In line with this reasoning, following a number of cases in which judges were asked to consider whether directors ought to take creditors' interests into account in certain circumstances\textsuperscript{15}, in the case of West Mercia Safetywear\textsuperscript{16} the duty to consider the interests of creditors when a company is nearing insolvency has been imported into English law. West Mercia confirmed that 'insolvency in some form is a pre-requisite to consideration of creditors' interests',\textsuperscript{17} with the Court of Appeal establishing that company directors are obliged to have regard to creditors' interests before winding up.\textsuperscript{18}

Since creditor-regarding duties identify creditors' interests in the vicinity of insolvency as constituting the company's interests, the directors are to have regard to the interests of creditors as a group, rather than to particular creditors. In the case of

\textsuperscript{12} 'The interests of the company' were traditionally interpreted as being the financial interests of its present and future shareholders. Eventually, a requirement for directors to consider the interests of a company's employees was introduced in Section 309 of the Companies Act 1985. This requirement is now found in Section 172 (1) (b) of the Companies Act 2006 as part of a director's duty to promote the success of the company.

\textsuperscript{13} As confirmed by Yukong Line Ltd of Korea v Rensburg Investments Corp of Liberia [1998] 2 BCLC 485.

\textsuperscript{14} P.L. Davies, Gower and Davies' Principles of Modern Company Law, 7\textsuperscript{th} edition (London, Sweet & Maxwell 2003) p. 373.


\textsuperscript{16} West Mercia Safetywear Ltd v Dodd [1988] B. C. L. C. 250 (CA).


\textsuperscript{18} For the analysis of West Mercia Safetywear, see V. Finch, 'Directors' Duties Towards Creditors', 10 (1) Company Lawyer (1989) p. 23 at pp. 23 - 25.
Re Pantone 485 Ltd\(^9\), it has been reiterated that when a company is insolvent, 'the human equivalent of the company for the purposes of the directors' fiduciary duties is the company's creditors as a whole, i.e. its general creditors'.\(^{20}\)

### 2.2.4 Triggering the duty

In this section, some of the ways in which the above mechanisms diverge are considered. The aim is to demonstrate how insolvency provisions and legal duties complement each other in their ability to catch opportunistic behaviour on the part of company controllers in financial distress.

Whilst some form of financial distress eventually leading to insolvency is a prerequisite to the consideration of creditors' interests under the common law developments, 'the point at which a prospect of insolvency becomes real enough to warrant the change of focus in the directors' attention\(^{21}\) is not clear.\(^{22}\) Due to the difficulties in defining the point at which duties to take creditors' interests into account should be triggered, the courts may continue to experiment with various definitions of the trigger point.\(^{23}\) A positive aspect of this uncertainty for creditor protection is that common law duty can potentially be invoked at an earlier stage than a statutory duty under section 214 of the Insolvency Act 1986.

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\(^{19}\) [2002] 1 BCLC 266.

\(^{20}\) Re Pantone reaffirmed that 'if the directors act consistently with the interests of the general creditors but inconsistently with the interest of a creditor or section of creditors with special rights in a winding up, they do not act in breach of duty to the company' – Re Pantone 485 Ltd [2002] 1BCLC 266, n.72. The duty thus permits the directors to exercise their discretion to make decisions that account for the interests of the company's creditors without being open to the accusation of not acting in the best interests of the members. See A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors', 66 (5) Modern Law Review (2003) p. 665 at p. 670.


Indeed, section 214 has been criticised for operating too late in the company's economic decline.\textsuperscript{24} Section 214 refers to the point of 'no reasonable prospect of avoiding insolvent liquidation'. In turn, insolvent liquidation is defined by reference to the balance sheet test. However, it is not the fact of insolvent liquidation that section 214 uses to trigger the imposition of liability; the duties arise prior to the company going into insolvent liquidation. Nevertheless, the courts seem to have adopted a cash flow test rather than a balance sheet test when determining whether the company had no reasonable prospect of avoiding insolvent liquidation.\textsuperscript{25} A company may thus be insolvent on a balance sheet basis before section 214 can trigger directors' responsibilities.\textsuperscript{26} In this respect, directors' duties under the Companies Act 2006 to consider creditors' interests in the vicinity of insolvency can play a useful supplementary role to section 214 in triggering an earlier duty.\textsuperscript{27} To the extent that the common law nature of the legal duty allows experimenting with the trigger point definitions, it can allow the courts to impose liability when section 214 of the Insolvency Act 1986 may not apply.

Another positive creditor protection aspect of the duty under the Companies Act 2006 is that it can be invoked in all insolvency proceedings, including liquidation and administration, whereas section 214 of the Insolvency Act 1986 does not apply if the insolvent company goes into administration rather than liquidation. This is an important point, as the legislature appears to favour administration over other ways of dealing with insolvent companies, in an attempt to increase the chances of saving the company's business.\textsuperscript{28} If the administration is successful in achieving the objective of rescuing the company as a going concern, the directors can then escape


\textsuperscript{25} See for example \textit{Re Purpoint} [1991] BCLA 491, \textit{Re Rod Gunner Organisation} [2004] 2 BCLC 110. See also \textit{Re Hawkes Hill Publishing Co Ltd (in liq.)}, Ward v. Perks [2007] BCC 937, where a distinction was made between the directors knowing that the company was insolvent and knowing that there was no reasonable prospect that the company would avoid an insolvent liquidation.


liability under section 214, regardless of the fact that it is due to their risky business decisions that the company reached the point of needing to be rescued.29

However, there is an important downside of the creditor-regarding duties under the Companies Act 2006 which relates to the proceeds of the recoveries. A contribution made by a director to the assets of the insolvent company is caught by security interests granted by the company prior to insolvency30, to the disadvantage of the unsecured creditors. In contrast, directors’ contributions made under section 214 of the Insolvency Act 1986 are made available mainly to the unsecured creditors.31 Recoveries under section 214 of Insolvency Act are not considered to represent the proceeds of an asset held by the company prior to insolvency, and therefore are not caught by security interests.32

2.3 ‘Clawing back’33 the property provisions

2.3.1 Overview

Opportunistic behaviour of corporate controllers in the vicinity of insolvency is not limited to undertaking excessively risky projects in an attempt to turn the company around.34 As insolvency approaches, the controllers may engage in moving the assets out of the company with the aim of putting them out of the creditors’ reach. As seen above, moving assets out of the company to the detriment of the creditors’ equity

cushion can to an extent be caught by capital maintenance provisions.\textsuperscript{35} However, capital maintenance rules operate on the basis of the availability of distributable profits. At the same time, certain transactions can have the economic effect of returning capital to shareholders, but not fall within the capital maintenance concept. An example of such a transaction is a remuneration fee to a director-shareholder, which need not be paid out of distributable profits. As a result, such a transaction will essentially represent a ‘dressed-up return of capital’.\textsuperscript{36} To counteract this and similar scenarios, the Insolvency Act 1986 offers mechanisms that can benefit creditors in terms of swelling the assets available to satisfy their claims. These mechanisms give the courts the power to restore the position to what it would have been had the company not entered into the transaction in question.

\textbf{2.3.2 Transactions at an undervalue: section 238 of the Insolvency Act 1986}

Section 238 of the Insolvency Act 1986 targets the depletion of a company’s assets by transactions at an undervalue with any person. Provisions of section 238 do not depend upon proof of fraud and dishonesty. They simply require that there be transactions under which the company entering into the transaction receives no consideration\textsuperscript{37} or a consideration the value of which, in money or money’s worth, is less than the liabilities the company incurs under the transaction\textsuperscript{38}. A court has the power to make an order to restore the position ‘to what it would have been if the company had not entered into that transaction’\textsuperscript{39}, if within two years of entering into the relevant transaction the company goes into liquidation\textsuperscript{40} and if at the time of entering into the transaction the company goes into liquidation\textsuperscript{41} or in consequence of the transaction\textsuperscript{42} the company is or becomes unable to pay its debts.

\textsuperscript{35} See Chapter One, section 1.4.

\textsuperscript{36} \textit{Re Halt Garage (1964) Ltd} [1982] 3 All ER 1016 (Chancery Division).

\textsuperscript{37} Insolvency Act 1986, s. 238 (4) (a).

\textsuperscript{38} Insolvency Act 1986, s. 238 (4) (b).

\textsuperscript{39} Insolvency Act 1986, s. 238 (3).

\textsuperscript{40} Insolvency Act 1986, s. 240 (1) (a).

\textsuperscript{41} Insolvency Act 1986, s. 240 (2) (a).

\textsuperscript{42} Insolvency Act 1986, s. 240 (2) (b).
2.3.3 Transactions defrauding creditors: section 423 of the Insolvency Act 1986

Section 423 of the Insolvency Act elaborates on section 238 by focusing on fraudulent intent with respect to transactions at an undervalue. Under section 423, the court has the power to make an order with effect of 'restoring the position to what it would have been if the transaction had not been entered into'\(^43\). Under section 423, however, the burden of proof is substantial in comparison with section 238. Under section 238, the court shall not make an order if the company entered into the transaction 'in good faith and for the purpose of carrying on its business'\(^44\) and 'at the time it did so there were reasonable grounds for believing that the transaction would benefit the company'\(^45\). Under section 423, it must be shown that the transaction was entered into for the purpose of placing assets outside the reach of a creditor or potential creditor or of prejudicing the interests of such a person.\(^46\) However, it is not necessary to establish that the debtor's only or 'dominant' purpose in entering into the transaction was to put assets beyond the reach of the creditors; it is sufficient to show that this was a 'substantial' purpose.\(^47\)

Nevertheless, section 423 can be a flexible tool for creditors in terms of 'clawing back' the assets of the company. Firstly, those who may apply for an order under section 423 include creditors themselves.\(^48\) Secondly, a company need not be in liquidation or insolvent for a creditor to apply to set aside the transaction; where the company is insolvent, however, the leave of the court is required\(^49\). Thirdly,

\(^43\) Insolvency Act 1986, s. 423 (2) (a).

\(^44\) Insolvency Act 1986, s. 238 (5) (a).

\(^45\) Insolvency Act 1986, s. 238 (5) (b).

\(^46\) Insolvency Act 1986, s. 423 (3) (a).


\(^48\) Under sections 213, 214 and 238 of the Insolvency Act 1986 only the liquidator has standing.

\(^49\) Insolvency Act 1986, s. 424 (1) (a), 1 (c). Once an application is made, it 'is to be treated as made on behalf of every victim of the transaction' (Insolvency Act 1986, s. 424 (2)).
applications under section 423 are subject to a generous limitation period.\textsuperscript{50} Fourthly, since it is the \textit{purpose} of the transaction as opposed to its \textit{result} that determines the outcome under section 423, the section can cover a wide range of debtor conduct. Indeed, the term 'transaction' can be widely construed, to include 'plan' or 'arrangement'.\textsuperscript{51} In addition, the scope of section 423 does not exclude transactions entered into on professional advice.\textsuperscript{52} Section 423 of the Insolvency Act 1986 thus constitutes an effective and flexible creditor protection mechanism as it provides an opportunity to invalidate schemes and arrangements intended to put assets beyond the reach of the company's creditors.

### 2.4 Creditor-regarding duties vs. legal capital rules

The above overview of insolvency provisions and creditor-regarding duties under the Companies Act 2006 demonstrates how ex post mechanisms can address creditor protection concerns when legal capital and capital maintenance rules can no longer be of help to the creditors. Sections 238 and 423 of the Insolvency Act 1986 reinforce the prohibition on the company to return assets to shareholders ahead of the creditors by targeting 'dressed-up' returns of capital. Wrongful and fraudulent trading provisions and directors' legal duties to take creditor interests into account in financial distress attempt to compensate creditors for the downside of overly risky projects in the vicinity of insolvency. In addition, by placing personal liability on the directors, these mechanisms provide strong incentives for directors to take creditors' interests into account in financial distress when the company is trading with creditors' money.

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\textsuperscript{50} The Court of Appeal in \textit{Re Nurkowski} [2006] BPIR 789 established that the limitation period applicable to Section 423 of the Insolvency Act 1986 is twelve years commencing with the date of the order of bankruptcy or winding up.

\textsuperscript{51} In \textit{Feakins v Defra} [2007] BCC 54 'arrangement' was held to constitute 'an agreement or understanding between parties, whether formal or informal, oral or in writing', per Jonathan Parker LJ.

\textsuperscript{52} \textit{National Westminster Bank Plc v. Jones} [2001] 1 BCLC 98, per Neuberger J. See also \textit{Arbuthnot Leasing International Ltd v. Havelet Leasing Ltd (No 2)} [1990] BCC 636, where the court ordered the reversal of the transaction where a company's business and assets had been transferred on legal advice to an off-the-shelf company shortly before it went into receivership.
As noted above, legal capital and capital maintenance rules are not designed to deal with the temptation on the part of the company controllers to engage in overly risky activities in the vicinity of insolvency. However, when combined with strict creditor-regarding duties, they can slow down or prevent the descent into insolvency.\(^5\) This is because strict creditor-regarding duties in the vicinity of insolvency can potentially discourage the incorporation of inadequately capitalised companies. In effect, therefore, imposing a liability on directors in the vicinity of insolvency 'may operate so as to reduce pressure to strengthen or introduce minimum capital rules.'\(^5^4\) By diminishing the necessity for strict legal capital rules, effective ex post mechanisms thus present a case for the rules' relaxation or perhaps abolition.

### 2.5 Contractual approach to creditor protection

#### 2.5.1 Overview

The role of legal capital and capital maintenance rules within the creditor protection framework can also be affected by the availability of contractual creditor protection mechanisms. The benefits of a contractual approach to creditor protection have been advanced as part of the criticisms of creditor protection in the form of legal capital rules. It has been argued that when making arrangements for the provision of debt, creditors can contractually agree with the company on the issues of concern.\(^5^5\) Indeed, creditors have better knowledge of their business needs and therefore it would arguably be more efficient if they bargained independently with the borrowing company on the basis of their specific preferences.

The most straightforward way for creditors to compensate themselves for the risks they face when lending to a corporate entity is to charge higher rates of interest for higher risk borrowers. In addition, they can insist on other contractual terms designed


to diminish the risk of default and improve the probability of repayment. The latter can take the form of loan covenants which may stipulate the limits on incurring further debt or regulate the ability of a company to engage in particular activities. Moreover, creditors may insist on some form of collateral as a condition of providing the financing, thus becoming secured creditors and ensuring a priority position for themselves on liquidation.

To further offset the risks associated with the operation of the limited liability, creditors can also negotiate for a condition whereby both the company and its shareholders will be liable on the debt obligations. Thus, personal assets of the shareholders can become available to the creditors if the assets of the company are insufficient to satisfy their debt claims. Similarly, in the case of a group of companies, a guarantee or a ‘letter of comfort’ may be sought from the parent company. Therefore, creditors can potentially bargain to extend the pool of assets available to satisfy their claims beyond the assets of the company, thus effectively insuring themselves against substantial reductions of a company’s net assets.

Furthermore, trade creditors who may be cautious about supplying goods before they are paid for can insert retention of title clauses into their supply contracts, thereby reserving to themselves the ownership of the property in question until the payment has been made or other specified conditions have been satisfied.

Despite the many advantages of a contractual approach to creditor protection, the argument that creditors can bargain for what they want through contractual negotiation raises important issues. Firstly, the non-homogenous nature of creditors as a group makes it impossible for all creditors to bargain equally for their preferred terms. Secondly, the process of drafting and implementing the contracts in question...

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can prove costly and/or impractical. These two issues are considered in more detail below.

2.5.2 Non-homogenous nature of creditors

Creditors may differ according to bargaining power, their levels of sophistication, and their opportunities for access to legal and other relevant information. Arguably, more sophisticated creditors, such as institutional providers of debt finance, hold the strongest bargaining power. They can negotiate for higher interest rates to compensate for the higher level of risk; they can insist on compliance with the covenants requiring companies to keep within particular financial ratios when making business decisions; they can also negotiate for collateral as a condition for extending debt. Similarly, larger trade creditors will also be in a position to bargain for their preferred conditions. However, less sophisticated creditors, such as smaller trade creditors, have less bargaining power. Certain suppliers of goods and services may find that they have a choice between supplying on credit or losing a customer. Furthermore, suppliers of customer-specific goods are often tied to a particular customer, especially where the market for their products is very limited. As a result, these weaker creditors may not be in a position to bargain for the conditions that would offset the risks associated with dealing with a corporate borrower.

As a group, creditors can also differ by their risk-pricing techniques and consequently the levels of risk that they may be willing to bear. Risk-preferring creditors will be willing to bear higher risks of default in exchange for the benefit of higher returns on their investment; their way of bearing the risks will necessarily involve setting the interest rates accordingly. As above, however, the type of creditor able to negotiate a higher return usually only includes larger creditors.


In terms of diversity of creditors and their needs, a special mention needs to be made of the issues that may be faced by creditors whose debtor belongs to a corporate group. Corporate groups consisting of a parent entity and subsidiary companies are widely used, not least for the opportunities that they provide as risk-shifting devices. Corporate groups therefore present a particular challenge for the creditor protection issue. The separate legal personality principle provides that companies in a group are treated as separate entities, subject to relevant statutory provisions and case law, and the limited liability principle ensures that shareholders of a subsidiary (and in particular the parent company) are liable only to the extent of their equity investment in the latter. Since a parent is not automatically liable for the debts of its subsidiary and at the same time in reality may play an active role in the decision-making processes within the subsidiary, this may give rise to possibilities for abuse on the part of the parent, and may ultimately result in increased risk of default for the creditors.

According to the separate entity doctrine as applied in the context of a corporate group, voluntary creditors of a subsidiary are in a contractual privity with the subsidiary alone and can therefore have no claim to recovery against other subsidiaries within the group, the parent, or the parent's shareholders. However, companies in a group can be said to represent a single economic unit. This is supported by such requirements as consolidation of financial statements, which emphasises the fact that the financial position of a corporate group cannot be properly assessed if each participant of a group is looked at separately. Behaviour of a particular subsidiary can at certain times be determined by the interests of a group as a whole; pursuing these interests may involve transactions which can result in diminishing the assets of a subsidiary. Consequently, the interests of a subsidiary's creditors can be compromised. This clearly presents a shortcoming for the contractual approach to creditor protection. It can be argued, however, that creditors of a company that is part of a group can bargain accordingly, to include the parent or

62 There is of course a possibility that the parent entity may in particular circumstances be regarded as a shadow director of a subsidiary and therefore potentially liable with the subsidiary's directors under appropriate law in a particular jurisdiction.

other subsidiaries to bear potential liability. Of course, as above, this approach is generally only available to more sophisticated, larger creditors.

Overall, stronger creditors will be able to limit a company’s behaviour in a number of different ways which are likely to mitigate the risks of limited liability and protect the company assets, thus improving the chances of debts being repaid. As a result, weaker creditors may benefit indirectly from the contracts negotiated by the more sophisticated creditors. For example, they will be able to take advantage of the likely restrictions on distributions to shareholders and of subsequent monitoring of the borrower by the sophisticated creditor to ensure compliance. It has been said that if a debtor company has at least one sophisticated creditor, then all creditors of the company in question are better protected from wrongdoing. However, the possibility of ‘free-riding’ on restrictions imposed by creditors with stronger bargaining powers and higher levels of sophistication cannot guarantee with certainty the debts of their weaker counterparts.

2.5.3 Problems of drafting and implementation

A second issue outlined above in relation to the desirability of contractual negotiation approach is the practical matter of creating and implementing the contracts in question. In order for a contractual arrangement to provide comprehensive protection for the creditor, the provisions of such a contract would have to be highly detailed and would need to cover most of the operating aspects of the borrowing company. Not surprisingly, a number of problems would present themselves in the process of attempting to draft such a document.

Firstly, it would not be possible to envisage all the possible contingencies of shareholder and director misconduct as far as creditors’ interests are concerned. Secondly, the costs involved in drafting such provisions would be high, since they are likely to involve the services of lawyers and accountants and possibly other specialists depending on the particular situation. Thirdly, the costs of enforcing the

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aforementioned provisions are likely to be substantial. In order to oversee the
decision-making process, a creditor would have to effectively assume a managerial
function\(^{66}\); and even if it is argued that creditors would want to do this, many would
simply not be in a position to do so.\(^{67}\)

Furthermore, there are a number of issues concerning the desirability of creditors
taking on an active role in the management of the company.\(^{68}\) Due to the fixed nature
of creditors' return, it does not make financial sense for a creditor to get significantly
involved in the company's decision-making.\(^{69}\) Also, realistically, creditors cannot
become involved in the management of every borrowing company and this is
especially likely to be the case with institutional lenders and most trade creditors.\(^{70}\)
In addition, there are legal risks that creditors may face if they are significantly
involved in the running of the company.\(^{71}\) These can include a potential to incur
liabilities as a director or a shadow director.

2.6 Contractual approach vs. legal capital rules

The drawbacks of unequal bargaining positions as well as drafting and enforcement
costs mean that leaving creditors to bargain individually for the conditions they
require will not provide a satisfactory level of protection across the range of
creditors. Does this mean that legal capital and capital maintenance rules can be seen

\(^{66}\) M.C. Jensen and W.H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and

\(^{67}\) Prentice gives an example of two groups of trade creditors, one with a long-term supply contract
and another being a short-term contracting team, the latter being in a better position to bargain for up-
to-date information. D.D. Prentice, 'Corporate Personality, Limited Liability and the Protection of
Creditors', in R. Grantham and C. Rickett, eds., Corporate Personality in the 20th Century (Oxford,

75-76.

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\(^{70}\) There can of course be situations where a particular product produced by a trade creditor will be
specifically manufactured for the company in question, which would in effect mean that the borrower
would be a trade creditor's sole customer.

276 - 277.
as helpful for creditor protection as they ‘provide a ready-made, off the rack, solution’?72

To answer this question, the extent to which contractual solutions and legal capital rules replicate each other must be considered. In other words, in the absence of legal capital and capital maintenance rules as part of the formal legal system, would creditors themselves nevertheless bargain to cover the matters regulated by the rules in their loan covenants?

Ferran73 notes that covenants directly restricting dividends are rare in UK and German debt contracts. In contrast, in the US covenants imposing such constraints are common. If the US practice is taken to demonstrate that distribution restrictions are important to creditors, then one explanation for this divergence is that European loan agreements rely on the general law and thus there is no need to include distribution restrictions.74 At the same time, British studies suggest a tendency for loan covenants to use the current data from profit and loss accounts and cash flow statements, rather than historical balance-sheet information, on the basis of which capital maintenance rules operate.75 Creditors’ assessment of the contractual terms on which they are willing to lend is thus based on financial ratios which are substantially different from the relationship between net assets and undistributable capital underlying the capital maintenance doctrine. This observation is in line with the limitations of the share capital yardstick outlined in Chapter One, namely the absence of links to the company’s on-going performance and economic prospects.

This section began by submitting that the role of legal capital and capital maintenance rules within the creditor protection framework can be affected by the availability of contractual creditor protection mechanisms. The shortcomings of legal capital rules as a creditor protection mechanism on one hand and the opportunity to

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contractually negotiate for preferred terms on the other, suggest that creditors would be unlikely to engage in the process of bargaining for and enforcing the requirements covered by the legal capital rules. It appears, therefore, that the availability of contractual creditor protection mechanisms can diminish the utility of legal capital rules within the creditor protection framework.

2.7 Conclusion

The availability of ex post creditor protection mechanisms targeting opportunistic behaviour on the part of company controllers in the vicinity of insolvency questions the utility of legal capital rules for creditor protection. Furthermore, contractual mechanisms allow creditors to bargain for their preferred terms, rather than rely on the pre-imposed rules on capital. Despite the inability of the contractual approach to provide protection for all types of creditors, this mechanism nevertheless remains a valuable tool for control of individual borrowers by creditors and provides an opportunity to reduce creditor risks through including financial ratios based on creditor needs. The existence of creditor-regarding duties on one hand and the availability of contractual mechanisms on the other thus diminish the need for strict legal capital regime.\textsuperscript{76}

It is important to note that the above conclusion is based on the legal provisions and evidence from a developed economy. How does it apply in the context of a transitional economy? Using Ukraine as a model of a transitional economy, the next chapter assesses the utility of both legal capital rules and ex post mechanisms for creditor protection in transition.

Chapter Three
Creditor protection in Ukraine: analysis of legal provisions

3.1 Introduction

Chapters One and Two established the analytical framework for evaluating creditor protection offered by ex ante legal capital rules and ex post mechanisms targeting opportunistic behaviour on the part of corporate controllers in the vicinity of insolvency. The limited ability of legal capital and capital maintenance rules to safeguard a company’s assets was found to be further diminished in value in light of directors’ creditor-regarding duties and the availability of contractual protection.

In this chapter the above conclusions are tested using Ukraine as a model of a transitional economy. Applying the analytical framework of Chapters One and Two, the aim is to assess a corresponding creditor protection framework in transition and to outline contextual issues and considerations that may have an impact on the effectiveness of either mode of creditor protection.

The chapter begins with a brief introduction to companies legislation in Ukraine (Part 3.2). Parts 3.4 and 3.5 then analyse the treatment of legal capital rules in Ukrainian law and draw comparisons with the EU regime, whilst considering whether and to what extent the rules on capital are capable of ensuring that a designated part of a company’s assets, represented by shareholders’ equity investments, is not removed from the company through returns to shareholders. Part 3.6 deals with ex post protection mechanisms available to creditors under insolvency legislation. Part 3.7 considers whether the limited creditor protection function of the rules on capital can be of benefit in the creditor protection framework of a transitional economy.
3.2 Companies legislation in Ukraine – background

The development of modern company law in Ukraine is still in its infancy. Following over 50 years of state-owned enterprises as the only permissible corporate form in the Soviet Union, Ukraine saw the revival of a privately-owned corporate form in the late-1980s as part of the Soviet legislation and only started developing its own company law framework in 1991, after the dissolution of the Soviet Union.¹

Ukraine’s transition from a command economy to a market economy has been characterised by short but intense periods of economic reform and political openness, and longer periods of policy inaction.² As a result, legal reform in general and company law reform in particular was not systematic.³ The first pieces of legislation addressing corporate governance issues in Ukraine were the Enterprise Act 1991 and the Business Associations Act 1991. Whilst these Acts established general basic principles, they were not sufficiently comprehensive to regulate large privatised corporations.⁴ The Civil and Commercial Codes which came into force in 2004 targeted important corporate governance issues, such as majority shareholders’ duties and liabilities and conflict of interest transactions⁵. However, identical company law rules were devised in both the Civil and Commercial Codes of Ukraine by groups of specialists working independently, without coordination. This resulted in conflicting provisions, leading to the need for complicated interpretation exercises.⁶


The Draft of a new Joint Stock Companies Act is expected to consolidate companies legislation under one enactment and bring it into line with international standards. The draft contains provisions aimed at improving corporate governance standards and is expected to increase transparency and strengthen the protection of shareholder rights. The current version of the draft introduces a number of progressive corporate governance practices for Ukraine. These include clarification of related-party transactions and conflicts of interest rules.

The Orange Revolution of 2004 appeared to be a turning point in the economic and political transformation of Ukraine. However, continuing uncertainties caused by frequent changes in government meant that policy articulation and implementation since 2004 has been inconsistent. As a result, a number of necessary improvements in the business environment have been delayed. In the EBRD Corporate Governance Sector Assessment 2004, the Ukrainian corporate governance legislation was found to be in ‘very low compliance’ with the principles developed by the OECD (the Organisation for Economic Cooperation and Development).

The draft of a new Joint Stock Companies Act is an example of an urgently needed piece of legislation. Its implementation is frequently cited by international experts as

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9 The most recent version of the Draft was submitted to the Parliament in February 2007.


11 The European Bank for Reconstruction and Development.

a priority action in improving regulatory corporate governance framework. The Ukrainian Parliament began working on a draft in the late 1990s. The most recent version of the Draft was submitted to Parliament in February 2007 and accepted as a basis for the final draft. The progress of the draft however has been repeatedly stifled by persistent political instability. Any delays may also be the result of concern about how the proposed new transparency rules might affect parliamentarians’ personal businesses. In addition, certain provisions of the Draft Law, such as the elimination of closed joint stock companies, are seen as too radical by lobbyists in the Ukrainian Parliament. Finally, as the draft currently stands, many of best practice rules would not apply to closed joint stock companies (while they continue to exist). This makes the draft law an uncomfortable compromise between the oligarchs who own many closed joint stock companies and more progressively oriented businessmen.

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14 See Verkhovna Rada of Ukraine (the Ukrainian Parliament), Draft Joint Stock Companies Act of Ukraine, Project No 3177 of 15 February 2007 (further – Draft Joint Stock Companies Act) <http://gska2.rada.gov.ua/pls/zweb_n/webproc4_l?id=&pf3511=29524> (last accessed October 2008). Given persistent political uncertainty and the parliament’s previous record, it is unclear when the law might be passed and no official date has been put forward.

15 An attempt to pass the Draft through in May 2007 was controversial, as at the time the President of Ukraine had disbanded Parliament, rendering it legally incapacitated. Further consideration of the draft is still pending. O. Martinenko and Y. Deyneko, Joint-stock companies in Ukraine: changes in the legislative framework, Law in transition 2008: securities markets, and legal reform in Ukraine, EBRD, May 2008, p. 92. See also Document of the European Bank for Reconstruction and Development, Strategy for Ukraine, 18 September 2007, pp. 16 – 17.


17 The current draft suggests cancelling the distinction between open and closed joint stock companies, allowing closed joint stock companies to exist for five more years after coming into force and then re-register either as an open joint stock company or another type of corporation. See below, pp. 65 – 66 n. 29.

18 See below, pp. 65 – 66 n. 29.

3.3 Legal capital rules in Ukraine – setting the scene

3.3.1 Relevant legislation

Due to political instability and the resulting lack of a systematic approach to legal reform, companies legislation in Ukraine is piecemeal in nature, with provisions relating to company matters scattered across several sources of legislation, including the Business Associations Act 1991, the Civil and Commercial Codes of Ukraine, the Securities and Stock Exchange Act 2006 and the Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999.

As noted above, the new Joint Stock Companies Act is expected to become an important consolidated piece of company legislation. In this chapter, references are made to the currently applicable legislation and to the current version of the Draft Joint Stock Companies Act.

The Business Associations Act 1991 is the main source of companies legislation regulating formation, functioning and termination of corporate entities. It introduces five kinds of incorporation (the preceding Soviet legislation allowed for only two types of companies), and covers aspects of capital formation and capital maintenance.

The Civil and Commercial Codes of Ukraine, which came into force in 2004, also contain provisions regarding company capital. The Codes cover the same company capital matters as does the Business Associations Act 1991. Some of their provisions however improve on those contained in the Business Associations Act 1991 – for example, the Civil Code clarifies procedures for share capital alterations and

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22 Relevant provisions in the Ukrainian Civil Code 2004 are found in Chapter 8, Part 3, Articles 152-162.
requirements for distributable reserves and dividend distributions.\(^{23}\) The Securities and Stock Exchange Act 2006\(^{24}\) contains provisions on share issuance and circulation.

Due to the lack of official English language translations at the time of writing of this thesis, the applicable legislation is cited with reference to primary sources in the original (Ukrainian) language. Translations\(^{25}\) of the relevant provisions are appended.

### 3.3.2 Type of company under consideration

When looking at legal capital rules in Ukraine, the discussion in this chapter will focus on the ‘Open Joint Stock Company’ type of corporation. A Joint Stock Company is defined in Article 24 of the Business Associations Act 1991 as a company with a stated capital subdivided into shares of equal nominal value.\(^{26}\) Article 25 of the Business Associations Act 1991 distinguishes between an Open Joint Stock Company – when shares can be offered for public subscription and/or traded on the stock exchange; and a Closed Joint Stock Company - when shares can be distributed between company’s incorporators only and cannot be openly traded.\(^{27}\) An Open Joint Stock Company most closely resembles the British public company limited by shares, which is covered by the Second EU Directive\(^{28}\) and is the focus of the discussion in Chapter One. An Open Joint Stock Company can therefore provide a relatively straightforward case for comparison.\(^{29}\)

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\(^{23}\) See below, sections 3.5.1 and 3.5.3.


\(^{25}\) Author's own.

\(^{26}\) The definition of a joint stock company is also found in the Civil Code 2003, Art. 152 (1).

\(^{27}\) One of the versions of the Draft Joint Stock Companies Act suggested replacing the terms with ‘public’ and ‘private’ companies, but this proposal was so far rejected.

\(^{28}\) Second EU Directive, Art. 1 (1).

\(^{29}\) The Draft Joint Stock Companies Act proposes the cancellation of the current distinction between open and closed joint stock companies and the creation of a single regime for all joint stock companies, whereby a joint stock company would be able to carry out both public and private placements of shares. This would effectively eliminate the concept of closed joint stock companies, which would be allowed a 5-year grace period to adjust their incorporation documents in accordance with the new joint stock companies legislation, or to convert into a different type of legal entity. The new joint stock company will be subject to the legal capital regime currently applicable to open joint stock companies. See Central Science and Expertise Office, *Conclusion on the Draft Joint Stock Companies Act of Ukraine (N 3177 of 15.02.2007)*, submitted by the Cabinet of Ministers of Ukraine,
3.4 Raising of capital

3.4.1 Minimum capital requirements

Under Ukrainian law, a joint stock company is required to raise capital which would form the asset base for its activities. The term used in the Business Associations Act 1991 to describe a company's capital can be literally translated as either 'memorandum (joint stock) capital' or 'stated share capital'. The concept under consideration most closely resembles that of 'stated share capital' found in English law and therefore for clarity will be referred to as such. There is no authorised capital requirement: the incorporation documents do not need to declare the maximum amount of capital that the company can raise without modifying its memorandum and articles.

Ukrainian law requires a certain minimum capital to be in place before a joint stock company can be registered and commence its business activities. The Business Associations Act 1991 prescribes a stated capital of a joint stock company to reach the minimum value of at least 1,250 statutory minimum monthly wages, using the value of minimum wage at the time of incorporation. This minimum capital requirement corresponds to approximately £72,000. Article 30 (7) of the Business Associations Act 1991 stipulates that shares of an open joint stock company must be...

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30 Business Associations Act 1991, Arts. 4 (2) and 24 (1) and 24 (4); Civil Code 2003, Art. 155 (1). See also E. Kibenko, Corporate Law of Ukraine (Kharkov, Espada 2001) p. 65.

31 'Memorandum capital' in the Civil Code 2003, Art. 155 (1).

32 Business Associations Act 1991, Arts. 4 (2) and 24 (1) and 24 (4).

33 The appended English translations of selected Business Associations Act 1991 provisions use the term 'stated share capital'.

34 This is also the case under the regime of the Second EU Directive. See Chapter One, section 1.3.2 at p. 20.

35 Business Associations Act, s. 24 (4). From 1 January 2009, the minimum salary in Ukraine is 605 hryvnas (UAH) per month (State Budget of Ukraine for the Year 2009 Act). 605 hryvnas constitute approximately £58 (calculation based on the exchange rate on 25 January 2009).

36 The UK minimum capital requirement is £50,000 – see Chapter One, section 1.3.1 at pp. 14 – 15.
at least 30% paid. Therefore, on incorporation, the founders of an open joint stock company in Ukraine must raise approximately £21,600 as a minimum. To put this into context, the initial minimum capital requirement (30% paid up) is approximately thirty times more than the minimum annual pay. In contrast, the UK minimum capital requirement of £12,500 is approximately half the average annual pay amount in the UK. Therefore, in Ukraine a minimum capital requirement for an open joint stock company constitutes a significantly greater barrier to entry than it does in the UK. The Draft Joint Companies Act aims to further raise the minimum capital yardstick, by setting it at 2,500 statutory minimum monthly wages. The fact that the minimum capital requirement for an open joint stock company is based on the minimum salary means that this requirement is subject to potential increases.

A significant minimum capital requirement, as well as a one year time limit for paying-up the stated capital and a higher interest rate on non-payment can all be seen as measures that discipline shareholders and benefit creditors. Having to fully pay-up

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37 The remaining amount must be paid up in accordance with the terms stated in incorporation documents, but in any case no later than 1 year after the registration of the company (Business Associations Act 1991, Art. 33). Failure to do so leads to annual fines of 10% of the unpaid amount (Business Associations Act 1991, Art. 33). A company is free to stipulate a higher penalty fine in its incorporation documents. In the event of non-payment within 3 months of the agreed payment date, a company has the right to dispose of the shares in question in accordance with the memorandum (Business Associations Act 1991, Art. 33). In contrast, Companies Act 2006 (UK) quotes a lower 5% per annum as interest rate (Companies Act 2006 (UK), s. 592 (1)).

Despite the fact that the Business Associations Act 1991 created two different regimes for incorporating joint stock companies – where shares of an open joint stock company can be distributed through open subscription and shares of a closed joint stock company are distributed among the incorporators only - Civil Code 2003 qualified this provision in an important way: Article 155(2) provides a single regime for all joint stock companies whereby on incorporation shares can be divided between the incorporators only and cannot be offered for public subscription. Article 155 of the Civil Code 2003 further stipulates that public subscription cannot take place until after the share capital has been fully paid-up. This is one example of legislative inconsistency, where two clearly conflicting provisions in the Civil Code 2003 and the Business Associations Act 1991 continue to co-exist.

38 Based on the minimum monthly wage of 605 hryvnas (UAH) per month, minimum annual salary in Ukraine amounts to approximately 7,260 hryvnas (UAH), which constitutes approximately £690.53 (calculation based on the exchange rate on 25 January 2009).

39 According to the 2008 Annual Survey of Hours and Earnings (Office for National Statistics), the average annual pay in the UK in the year to April 2008 was approximately £23,000. See <http://www.statistics.gov.uk/cci/nugget.asp?id=285> (last accessed January 2009).


41 In fact, according to the State Budget of Ukraine for the Year 2009 Act, the minimum monthly salary will increase to 625 hryvnas from 1 April 2009, to 630 hryvnas from 1 July 2009, to 650 hryvnas from 1 October 2009 and to 669 hryvnas from 1 December 2009. Thus throughout 2009, the initial (30% paid up) minimum capital requirement for an open joint stock company would have increased from £ 21,600 to £ 22,300 (calculation based on the exchange rate on 25 January 2009).
their shares may restrain shareholders from undertaking risky activities that could jeopardise their investment, since in the event of insolvency their claims will be residual to those of creditors, and less risky behaviour prompted by this requirement can in turn benefit creditors. Furthermore, due to the one-year time limit for paying up, creditors can be assured that at most after a year a company’s capital will reach the amount stated in the incorporation documents.\footnote{Provided that the company hasn’t traded unprofitably and lost assets.}

Although the Ukrainian provisions are stricter and therefore in theory more protective of creditors, a similar conclusion to that in Chapter One can be reached: since minimum capital requirements do not restrict a company’s trading decisions, the capital amount raised at the outset will not stay in place throughout a company’s lifetime.\footnote{Indeed, academic commentators suggests that minimum capital under Ukrainian company law is not meant to reflect the available amount of assets, but rather the source of the assets. See E. Kibenko, \textit{Corporate Law of Ukraine} (Kharkov, Espada 2001) p. 114.} Therefore, minimum capital requirements provide no guarantee that a particular level of assets will be available to creditors at any particular time. However, as suggested in Chapter One, a possible way to give relevance to a minimum capital requirement in the context of creditor protection is to require a company to take appropriate action when net assets are reduced to a certain proportion of share capital or fall below minimum capital\footnote{Chapter One, section 1.3.1 at p. 16.}. It was observed that the Second EU Directive requires for a general meeting to be called and leaves it to the discretion of the Member States to decide on the measures to be taken. Consequently, the Companies Act 2006 (UK) for example contains no obligation beyond calling a general meeting.\footnote{Chapter One, section 1.3.1 at p. 16.}

By contrast, Article 155 (3) of the Ukrainian Civil Code 2003 places strict requirements on a joint stock company with regard to the value of its net assets. Starting from the end of the second financial year, should the net assets fall below the stated capital, a company must carry out a capital reduction. If net assets fall below the minimum capital, the company becomes subject to mandatory liquidation. Following the introduction of the Civil Code 2003, the Business Associations Act
1991 was amended to mirror the above Civil Code provision in Article 39 (6).\textsuperscript{46} Although the Business Associations Act 1991 is silent on the subject of the relationship between share capital and creditors, the Civil Code 2003 expressly states that stated capital represents company's minimum assets, which guarantee creditors' interests.\textsuperscript{47} Furthermore, the requirements regarding the relationship between stated capital and net assets of the company are echoed in Article 13 (3) of the Draft Joint Stock Companies Act, however with added opportunity for a company to replenish the value of its net assets prior to proceeding to capital reduction or liquidation. Allowing companies the opportunity to bring their equity back to the statutory minimum capital threshold prior to liquidation arguably carries more of an economic rationale than a mandatory liquidation rule, since the latter runs the risk of being too drastic for many start-up joint stock companies and particularly those joint stock companies involved in businesses with high initial costs and delayed returns.\textsuperscript{48}

The minimum capital requirement under Ukrainian law is arguably more meaningful in terms of creditor protection value than its British or American counterparts, due to the requirement for mandatory liquidation in the event of net assets falling below the minimum capital amount. A mandatory liquidation requirement thus makes the minimum capital amount a yardstick that the management of a company needs to consider. However, as said earlier, a minimum capital requirement cannot prevent losses that may be incurred through trading and therefore cannot guarantee that a particular level of assets will remain in place.

\subsection*{3.4.2 Share regime}

Chapter One concluded that whilst the 'par' and 'accountable par' approaches of the UK and Germany are consistent with the idea of an identifiable fund available to satisfy creditors' claims, the 'no par value' share regimes in the US allow for

\begin{itemize}
\item \textsuperscript{46} Amendments were introduced by the Amendments and Repealing of Certain Legislative Acts of Ukraine in Connection with the Civil Code of Ukraine Coming into Force Act 2007. However, legislation does not provide for any control mechanisms with regard to these requirements. See E. Kharenko, 'Legal regulation of corporate relationships in joint stock companies', \textit{7 Ukrainian Commercial Law Journal} (2006) p. 15 at p. 17.
\item \textsuperscript{47} Civil Code 2003, Art. 155 (1).
\end{itemize}
flexibility on the part of the company to efficiently adapt to changing circumstances, speeding up the raising of necessary equity and thus benefiting creditors through minimised risk of insolvency.\textsuperscript{49}

Ukrainian company law operates a ‘nominal’ or ‘par’ value regime. The stated capital of a joint stock company must be divided into a certain number of shares of equal nominal value\textsuperscript{50}. This nominal (or par) value is determined by the incorporators of the company: however, the nominal value of a share cannot be fixed at less than 1 kopeika\textsuperscript{51}. Unlike Section 580 (1) of the Companies Act 2006 (UK), there is no express prohibition on shares being issued at a discount, i.e. at a price below their nominal value.\textsuperscript{52} Likewise, there is no specific prohibition on issuing shares for the amount exceeding a share’s nominal value, nor is there an express statement that shares can be issued at a price higher than their par value.\textsuperscript{53}

The Ukrainian regime of par value shares falls within the ‘identifiable fund’ creditor protection rationale put forward in Chapter One: if shares are subscribed for at fixed values, then there is an identifiable amount that can at any time be attributable to the shares.\textsuperscript{54} On the other hand, as was pointed out in Chapter One, even if creditors were to rely on this identifiable fund, ascribing each share with a par value would not add any extra safeguards to maintaining creditors’ share capital cushion, because issuing shares at any value will increase the share capital, thus benefiting creditors.\textsuperscript{55}

As far as a ‘no discount’ rule is concerned, this can have a detrimental effect on a

\textsuperscript{49} See Chapter One, section 1.3.2 at pp. 22 – 24.


\textsuperscript{51} Securities and Stock Exchange Act 2006, Art. 6 (3). Kopeika – a coin unit in Ukraine, 100 kopeikas = 1 UAH. A kopeika translates to less than one penny.

\textsuperscript{52} However, in the context of capital increases, Article 38 (1) of the Business Associations Act 1991 stipulates that a joint stock company can increase its stated share capital if all the previously issued shares have been fully paid up at a price not less than the nominal value. Article 21 (2) of the Draft Joint Stock Company Act contains an express ‘no discount’ rule with regard to share issuance.

\textsuperscript{53} Similarly to the UK, however, a joint stock company has the right to alter the nominal share value, in the event of capital alterations, redenomination of share capital or subdivision or consolidation of shares, subject to prescribed procedures.

\textsuperscript{54} See Chapter One, section 1.3.2 at p. 22.

\textsuperscript{55} See Chapter One, section 1.3.2 at p. 22.
company's ability to raise equity capital in financial distress, thus increasing the chances of default.\textsuperscript{56}

Chapter One advanced the no par value share regimes in the US as a more flexible alternative to the European par value and accountable par share regimes with regard to creditor protection, since with a no par value regime the board of directors can determine what the appropriate value for the share is at a given point in time, taking into account current health and financial requirements of the company.\textsuperscript{57} Particular circumstances, such as restructuring or financial distress can thus be accommodated without amending the incorporation documents. The resulting timely and efficient process of raising the necessary equity thus benefits creditors through minimising the risk of insolvency. However, a no par value regime relies on the board discretion to issue shares at a fair price and therefore calls for strict fiduciary duties and high corporate governance standards. Careful thought must therefore be given to whether a no par value share regime would be a desirable alternative to a par/nominal share value regime in the context of transitional economies.

\textbf{3.4.3 Non-cash contributions for shares}

When shares are issued in exchange for cash, the monetary amounts are entered into appropriate accounts. On the other hand, when consideration takes forms other than cash, then contributed assets need to be appropriately valued to ensure that issued share capital as stated in the company's documents is a true reflection of the value of the contributions.\textsuperscript{58}

In Chapter One a distinction was drawn between the nature of the consideration received for shares and the process of evaluating those contributions.\textsuperscript{59} With respect to the former, Article 13 of the Business Associations Act 1991 stipulates that, in addition to cash, shareholder contributions can take the form of buildings, equipment, securities, property rights, rights for use of land and other natural

\textsuperscript{56} See Chapter One, section 1.3.2 at pp. 22 – 23.

\textsuperscript{57} See Chapter One, section 1.3.2 at p. 24.

\textsuperscript{58} See Chapter One, section 1.3.3 at p. 25.

\textsuperscript{59} See Chapter One, section 1.3.3 at p. 26.
resources, as well as intellectual property rights. The law does not expressly prohibit contributions in the form of future services, and in theory shareholders can allow for such contributions. However, in practice contributions by way of future services do not normally feature in incorporation documents as shareholder contributions to stated capital 60.

As for the valuation process, the Business Associations Act 1991 does not require a mandatory independent expert assessment of non-cash contributions except in cases prescribed by the law. 61 The process of evaluating non-cash contributions is thus similar to the US approach 62 — their value is left to be determined in accordance with the procedure specified in the incorporation documents. 63

Chapter One suggested that the approach where the power to determine the value of non-cash contributions is vested in the management or shareholders, as is currently the case in Ukraine, is less burdensome on the companies by not imposing expert report requirements and hence extra expenditure. 64 However, as with the no par value regimes above, this approach presupposes high corporate governance standards. As seen in the beginning of this chapter, the corporate governance framework in Ukraine is underdeveloped and in low compliance with international standards. 65 Therefore, the independent expert valuation approach is likely to provide a more suitable alternative for a transitional economy, where corporate governance standards are at

60 See E. Kibenko, Corporate Law of Ukraine (Kharkov, Espada 2001) p. 66. Article 22 of the Draft Joint Stock Companies Act expressly prohibits contributions in the form of an undertaking to carry out work or provide services. Article 22 (1) mentions a company's obligations towards the shareholder arising prior to share allocation as an acceptable contribution; however, current amendments suggest that this form of contribution should only be allowed if approved by the general meeting. It remains to be seen how this issue will be resolved.

61 Article 13 (2) of the Business Associations Act 1991 states that an independent expert valuation is mandatory in specific cases, prescribed by the law. Article 7 of the Property Valuation, Property Rights and Professional Valuation Activity in Ukraine Act 2001 further stipulates that valuation is mandatory when non-cash contributions in question include state-owned property. This is in contrast to a generally applicable (to public companies) requirement for an expert report to be drawn up under the Companies Act 2006 (UK). See Chapter One, section 1.3.3 at p. 26.

62 See Chapter One, section 1.3.3 at p. 26.

63 Business Associations Act 1991, Art. 13 (2). Article 7 (1) of the Draft Joint Stock Companies Act attempts to introduce an express requirement for an independent expert valuation, but runs into inconsistencies when it also gives the supervisory board the power to approve the independent valuation in Articles 7 (3) and 9 (2).

64 See Chapter One, section 1.3.3 at p. 27.

65 See above, section 3.2 at pp. 61 – 63.
an early stage of development. Furthermore, with an independent expert requirement, creditors would be able to rely on the fact that common standards in the form of recognised valuation techniques were applied when evaluating non-cash contributions to the company’s capital.

3.5 Capital maintenance

Ukrainian law places a similar emphasis on the preservation of stated capital as does the Second EU Directive. Below, the treatment of dividend distributions, share repurchases and capital reductions in the Ukrainian law is considered.

3.5.1 Dividend distributions to shareholders

Ukrainian law distinguishes between a balance sheet profit and a net profit. Balance sheet profit is the amount by which gross revenue exceeds gross expenses and amortisation.\(^6\)\(^6\) Once loan payments, taxes and other contributions to the state budget have been paid out of the balance sheet profit, the resulting net profit can then be put to the uses stipulated by the incorporation documents of the company.\(^6\)\(^7\) The only mandatory requirement is for at least 5% of the net profit to be transferred to the reserve fund, which the company is under an obligation to create according to Article 14 of the Business Associations Act 1991. The size of the reserve fund can be determined by incorporation documents, but in any case must not be less than 25% of stated capital amount.\(^6\)\(^8\) In contrast, in Germany the lower threshold of the reserve fund is 10% of the share capital.\(^6\)\(^9\) Annual contributions must be transferred to the reserve fund until its size reaches a statutory minimum or the amount established by the incorporation documents.\(^7\)\(^0\)

\(^{6\) Business Associations Act 1991, Art. 15.\(^6\)

\(^{6\) Business Associations Act 1991, Art. 15.\(^6\)

\(^{6\) Business Associations Act 1991, Art. 15.\(^6\)

\(^{6\) Business Associations Act 1991, Art. 14 (1).\(^6\)

\(^{6\) See Chapter One, section 1.4.1 at p. 30.\(^6\)

\(^{7\) Article 18 of the Draft Joint Stock Companies Act renames ‘reserve fund’ into ‘reserve capital’ and proposes that the reserve fund be lowered to 15% of stated capital figure, keeping annual contributions at 5% of net profit.\(^7\)
Once the reserve fund contribution has been made, a company is free to use its net profit in accordance with the terms set out in the incorporation documents. Directors normally submit proposals to the general meeting concerning the uses and distribution of the net profit and shareholders confirm what part of the net profit will be distributed in dividends. Prior to the Civil Code coming into force in 2004, the law did not prescribe any formula for dividend distribution. Article 158 (3) of the Civil Code introduced share capital as a yardstick for distributions by stipulating that a joint stock company has no right to announce and pay out the dividends until (a) the stated capital has been fully paid-up and (b) net assets are greater than the aggregate amount of stated capital and reserve fund.

The fact that provisions on distributions to shareholders in the Civil Code contain a direct reference to share capital maintenance suggests that Ukraine places similar significance on share capital to the UK and Germany. Furthermore, while the Business Associations Act 1991 lacks express mention of dividend distribution, the Draft Joint Stock Companies Act remedies that. It devotes two articles to the subject: Article 29 of the Draft Act deals with the procedural aspects of dividend distribution and Article 30 lists limitations on dividend distribution. More specifically, Article 30 (3) reinforces the stated capital yardstick for dividend distributions established in Article 158 (3) of the Civil Code by prohibiting a joint stock company from distributing dividends to ordinary shareholders when net assets are less than the aggregate of stated share capital, reserve capital and the amount by which liquidation value of preference shares exceeds these shares' nominal value.

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72 Article 158 (3) (b) of the Civil Code 2003 essentially contains a balance sheet test found in Article 15 (1) (a) of the Second EU Directive.

73 See Chapter One, section 1.4.1.

74 For example, Article 29 (2) of the Draft Joint Stock Companies Act states that dividends must be paid out of the net profit in the amount, approved by the general meeting within a maximum of six months from the end of a given accounting year.
3.5.2 Share buy-backs and repurchases

Ukrainian law distinguishes between voluntary and compulsory share repurchases. Voluntary repurchase involves the company buying back shares from those shareholders who consent to a repurchase. A company has no right to determine which shareholder will receive the offer to have their shares bought back – it must, subject to the prescribed procedures, announce the repurchase decision to the shareholders and accept all shareholders' offers to buy their shares back. Compulsory repurchase can take place on shareholders' demand, under conditions prescribed by the law, for instance when a shareholder is trying to protect his/her property interests in situations of significant alteration by the company of conditions under which he/she made the investment in the first place – this right is often referred to as 'right of disagreement'.

The law prescribes that the repurchase can only be financed out of the sum over and above stated capital amount, similarly to the requirement found in the Second EU Directive to maintain the legal capital of the company at the pre-buy-back level. Furthermore, the law prescribes that the repurchased shares be realised or annulled within a year of repurchase and during the year in question the repurchased shares must not be taken into account for profit distribution purposes. Once the shares are annulled, the share capital figure is reduced.

3.5.3 Capital reductions

Article 157 (1) of the Civil Code and Article 39 of the Business Associations Act 1991 stipulate that capital reductions must be agreed by the general meeting. Until the Civil Code 2003 came into force, the Business Associations Act 1991 only briefly mentioned creditors in the context of capital reduction: Article 16 stated that

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78 See Chapter One, section 1.4.2.
capital reductions were prohibited in the event of any creditor objections. Article 157 (1) of the Civil Code expressly states that a joint stock company is only allowed to reduce its capital after informing all its creditors in accordance with the law. Creditors then have the right to demand the termination of the loan agreement or for their claims to be satisfied. Under the Ukrainian system, there is no requirement for court approval, unlike Article 32 of the Second EU Directive. Following Article 157 (1) of the Civil Code, Article 39 (3) of the Business Associations Act 1991 eventually incorporated the provision on creditors' rights, thus stating that capital reduction by a joint stock company is only allowed after all the creditors have been informed, and that creditors can demand to either have the loan agreement terminated or the company's obligations under the agreement fulfilled.

Article 39 (3) of the Business Associations Act 1991 overrides the older provision in Article 16 (3) of the Business Associations Act 1991 that capital reductions are prohibited in the event of creditor objections, although Article 16 (3) still exists in its original wording. Kharenko suggests that the new provisions are more effective in terms of creditor protection because, although creditors cannot object to capital reductions, they have the right to have their claims satisfied. As stated in Chapter One, capital reduction can affect a company's creditors through diminishing the amount of the stated share capital hence leading to less strict distribution tests. In this respect, Article 157 (3) of the Civil Code prescribes that in the event of capital reduction below the level of minimum legal capital, a company becomes subject to liquidation. This provision reinforces the mandatory liquidation requirement in Article 155 (3) of the Civil Code and Article 39 (6) of the Business Associations Act 1991.

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80 No further guidance as to the type of objections was given in the Act.
81 Civil Code 2003, Art. 157 (1).
82 Amendments were introduced by the Amendments and Repealing of Certain Legislative Acts of Ukraine in Connection with the Civil Code of Ukraine Coming into Force Act 2007.
84 See Chapter One, section 1.4.3 at p. 32.
85 See above, section 3.4.1 at pp. 68 - 69.
Article 15 of the Draft Joint Stock Companies Act attempts to remedy the piecemeal state of the capital reduction provisions by consolidating the procedure under a single enactment. Article 15 (2) states that following the decision to reduce capital, a joint stock company must inform every creditor in writing of this decision within 30 days. Upon receipt of the notification, unsecured creditors have 30 days to submit their demands to the company. The company then has 45 days to take one of the following measures: to secure creditors' claims, or to either terminate the loan agreement or fulfil its obligations under the agreement.

3.6 Ex post mechanisms – creditors in insolvency

3.6.1 Background

Insolvency law in Ukraine is in the early stages of its development. During the Soviet era, when state-owned enterprises were the only permissible corporate form, insolvency issues were resolved through appropriate administrative channels. Following the collapse of the Soviet Union, this legacy ensured that insolvency legislation was rarely used. Very few bankruptcy cases were initiated under the Bankruptcy Act 1992, which was adopted less than a year after the collapse of the Soviet Union. The Bankruptcy Act 1992 focused on the mechanism of bankruptcy and liquidation of enterprises in debt, and the only remedy under the insolvency legislation was liquidation, with no option of a reorganisation to restore solvency.

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86 Draft Joint Stock Companies Act, Art. 15 (3).

87 The latest ministerial comments on this article propose that the option to secure creditors' claims be removed, as Article 157 (1) of the Civil Code 2003 does not cover this option (see above, section 3.5.3 at p. 76). It remains to be seen how this issue will be resolved.

88 Draft Joint Stock Companies Act, Art. 15 (3).


Bankruptcy was seen as a punishment for debtors, rather than thought of by businesses as a way of tackling financial difficulties.\textsuperscript{91}

Following a review of the Bankruptcy Act 1992 in 1999, amendments were made in an attempt to take into account changes in Ukraine’s economic development and to reflect the economic need to preserve jobs, production and the pool of qualified labour.\textsuperscript{92} The amended version of the Bankruptcy Act 1992, renamed the Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act\textsuperscript{93}, allows the management of a company to take measures to avoid liquidation.\textsuperscript{94} The Act introduces the option of corporate rescue, thus shifting the emphasis from liquidation to the restoration of solvency.\textsuperscript{95} Under this law, once the court accepts a bankruptcy petition, it then has the option either to commence the restoration of solvency procedure or to declare a company bankrupt and move to a liquidation procedure.\textsuperscript{96} A restoration of solvency procedure aims to satisfy creditors’ claims in part or in full through restructuring the debtor’s finances and/or activities\textsuperscript{97}. If the corporate rescue attempt is unsuccessful, the court can declare a debtor insolvent and commence the liquidation procedure.

Ukrainian bankruptcy legislation allows creditors to elect a Creditors’ Committee: a body envisaged to represent creditors’ interests throughout the bankruptcy proceedings.\textsuperscript{98} After the court has considered all claims submitted by creditors and announced the approved creditor claims and amounts, a meeting of creditors is


\textsuperscript{93} English translations of the relevant provisions of the Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999 are appended.

\textsuperscript{94} Changes were introduced by the Amendments to the Bankruptcy Act of Ukraine Act 1999.

\textsuperscript{95} For more on the general overview of the Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999, see A. Biryukov, ‘Ukraine’s recent bankruptcy reform’, Global Insolvency and Restructuring Review (March/April 2001) p. 26 at pp. 26-28.

\textsuperscript{96} The court can also approve a settlement agreement that can reschedule or cancel the debtor’s obligations.

\textsuperscript{97} Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999, Article 1. According to Article 17 (1) of the Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999, solvency restoration process can last no longer than 18 months.

\textsuperscript{98} Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 16 (1).
called. Only creditors whose claims were approved by the commercial court have the right to vote at the creditors' meeting to elect a Creditors' Committee. Among the competencies of the Creditors' Committee is the right to petition the court with a request for reorganisation (restoration of solvency) or liquidation. In the event of a petition to restore solvency, and subject to the court's decision, the Creditors' Committee has the right to approve the restoration of solvency plan. The Creditors' Committee monitors the progress of the reorganisation programme through the restoration of solvency manager's reports.

The Creditors Committee makes its decisions by a majority vote, with each member holding a block of votes proportionate to the claim amount. The fact that creditors are allowed to consolidate their claims can help to ensure that smaller creditors can be in a position to initiate bankruptcy proceedings, if they join forces. As a result, they can also have an increased say in the Creditors' Committee. On the other hand, this approach assumes that creditors share a common interest. In reality, however, a conflict of interests is likely to arise, as some creditors may be in favour of immediate liquidation, while others may be more interested in corporate rescue procedures. Nevertheless, participation in the Creditors' Committee, whether in a direct or an indirect way, allows creditors a potential opportunity to remain in control of the situation throughout the bankruptcy proceedings.

Despite the availability of the Creditors Committee mechanism, vague legislative provisions can allow debtors to evade their obligations to creditors under the bankruptcy procedure. Examples of such occurrences are considered below.

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99 Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 16 (8).

100 Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 17 (2).

101 Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 16 (4).

102 Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 7 (9).

103 B. Poliakov, 'Legal regulation of restoring a debtor's solvency or declaring a debtor bankrupt', in V. Mamutov, ed., Commercial Law (Kiev, Jurincom Inter 2002) p. 532.
3.6.2 Initiating bankruptcy proceedings and registering creditor claims

Creditors are entitled to initiate bankruptcy proceedings through an application to a commercial court if their claims against a debtor amount to at least 300 statutory minimum monthly wages. A creditor has to submit evidence that the claims were not satisfied within three months of the date set for their settlement. The law allows creditors to consolidate their claims and to submit a single joint petition.

In accordance with Article 11 (5) of the Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, the judge must require the debtor company to announce the start of bankruptcy proceedings at its own expense in the official printed mass media within ten days of the hearing, in order to inform all creditors. Creditors have to submit their written financial claims with supporting documentation within 30 days of the said publication. Late submissions are not reviewed in court and the claims contained in them are considered void. The 30-day requirement is particularly onerous in view of the fact that the Act allows for bankruptcy announcements to be published in either the national or regional media, making it difficult for creditors to monitor. Publications in the regional media can be motivated by the desire of a debtor-applicant to both save on the costs of the publication and conceal the announcement from creditors, thus making it possible for the debtor to legally deny the demands of those creditors who missed the 30-day deadline.

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104 300 statutory minimum monthly wages in Ukraine amount to approximately £16,000 (calculation based on the exchange rate on 25 January 2009). See above, section 3.4.1 at p. 66 n. 35.

105 Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 7 (7).

106 Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 7 (9). Creditors whose claims are fully secured cannot submit a bankruptcy petition. Bankruptcy proceedings can also be initiated by a debtor — Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 7.

107 Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 14 (1).

108 Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 14 (2). The literal translation of the wording used in the article is that claims contained in late submissions are 'deemed settled'.

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3.6.3 Moratorium on creditors' claims - using bankruptcy proceedings to evade obligations to creditors

Upon accepting the bankruptcy application, the court declares a 'moratorium' on creditors' claims\textsuperscript{109}. Article 1 of the Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999 defines 'moratorium on creditors' claims' as a suspension on the borrower's obligations to settle creditors' claims that have matured prior to the moratorium's commencement date.\textsuperscript{110} One of the purposes of the moratorium is to protect the interests of the creditors who have not yet been identified\textsuperscript{111}. The moratorium remains in place until the debtor is reorganised, liquidated or has entered into a settlement agreement.\textsuperscript{112} The moratorium on creditors' claims thus essentially prohibits creditor claims being satisfied outside bankruptcy proceedings.

When the moratorium provision was first introduced by the Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, it was seen as a positive feature, helping to ensure that the final outcome was reached fairly by prohibiting creditor collection activity during the bankruptcy proceedings. Without the protection of the moratorium, 'creditors could ignore the bankruptcy process and simply devour the moribund debtor'.\textsuperscript{113}

In reality, however, the moratorium can work in the debtor's favour and to creditors' detriment\textsuperscript{114}. Ukrainian legal practitioners commonly cite examples of the ways in which debtor companies try to evade their obligations through having the moratorium imposed on the creditors' claims as part of the bankruptcy proceedings.

\textsuperscript{109} Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 12.

\textsuperscript{110} The suspension includes interest that would normally accrue. The moratorium does not apply to payments of wages, personal injury or other damages claims.


\textsuperscript{112} In reality, moratoriums imposed as part of bankruptcy proceedings can stay in place for a number of years - at least five, but normally 10 to 15 years (interview with K. A. Ludvik, Director of Corporate Clients Department, Kievskaya Rus Bank, Kiev, Ukraine, 29 May 2007).


\textsuperscript{114} B. Poliakov, 'Legal regulation of restoring a debtor's solvency or declaring a debtor bankrupt', in V. Mamutov, ed., Commercial Law (Kiev, Jurincom Inter 2002) pp. 537 - 538.
Since a bankruptcy application can be made by the debtor company itself\(^{115}\), the debtor may initiate bankruptcy proceedings for the purpose of having creditors' claims suspended by the moratorium. Alternatively, a debtor wishing to escape from its liabilities can initiate a bankruptcy procedure indirectly through 'close' or controllable creditor companies\(^{116}\). A debtor may then fraudulently increase creditor claims in favour of companies under its control\(^{117}\) and challenge the claims of other creditors.\(^{118}\) As a result, the debtor is provided with the backing of the majority in the Creditors' Committee. This can help to ensure that decisions on re-structuring, the writing off or pardoning of debts are biased in favour of the debtor.

Creditors cannot appeal against the court's decision to accept a bankruptcy application by a debtor company until a notice of initiation of bankruptcy proceedings has been printed in the official printed mass media in accordance with Article 11 (5) of the Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999.\(^{119}\) As said above, the responsibility to announce the start of bankruptcy proceedings lies with the debtor and the publication must take place within ten days of the bankruptcy application hearing.\(^{120}\) However, a weak enforcement of the 10-day requirement to publicise the start of bankruptcy proceedings means that the debtor-company often does not abide by the law and no announcement is made for an indefinite amount of time.\(^{121}\) Furthermore, as mentioned before, a debtor may choose to place the announcement in an official regional newspaper of a remote part

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\(^{115}\) Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 7.

\(^{116}\) Ukrainian Law Firms: A Handbook for Foreign Clients (Yuridicheskaya Practika Publishing 2002 - 2008), <www.ukrainianlawfirms.com/areas/bankruptcy/> (last accessed November 2008). While Article 218 of the Ukrainian Criminal Code establishes responsibility on the debtor for initiating a fictitious bankruptcy, it provides that in order for the Article to apply, the initiator itself has to be a debtor. Therefore, when bankruptcy is initiated through so-called 'friendly' companies, Article 218 cannot be of any value in terms of creditor protection.

\(^{117}\) This is referred to by the commentators as 'producing 'fake' creditors'. See Ukrainian Law Firms: A Handbook for Foreign Clients (Yuridicheskaya Practika Publishing 2002 - 2008) <www.ukrainianlawfirms.com/areas/bankruptcy/> (last accessed November 2008).

\(^{118}\) For example, a similar scenario took place in the case of Agroeksport No 10/171/06 (State Register of Court Decisions of Ukraine <http://reestr.court.gov.ua/pls/apex/f?p=200:1:1046546051982759> (last accessed October 2008); High Commercial Court of Ukraine <www.arbitr.gov.ua> (last accessed October 2008).

\(^{119}\) See above, section 3.6.2 at p. 80.

\(^{120}\) See above, section 3.6.2 at p. 80.

of the country, and as a result, certain creditors will be unaware of the start of the proceedings during their 30-days opportunity to submit claims to the court. As a result, creditors can find themselves with no standing to have their claims satisfied. On the one hand, a creditor cannot submit its monetary claims against a debtor until after bankruptcy publication. On the other hand, the moratorium declared following the initiation of bankruptcy proceedings makes it impossible for creditors to enforce their claims individually.

3.6.4 Avoidable pre-insolvency transactions

As seen above, a number of legislative loopholes can allow debtors to evade their obligations to creditors through the initiation of the bankruptcy procedure. A question needs to be asked: does financial distress in the vicinity of insolvency trigger any managerial responsibilities towards creditors, in a similar vein to the UK legal mechanisms? To what extent does the Ukrainian creditor protection framework reflect the fact that with the onset of insolvency, a company is essentially operating with creditors’ funds, and therefore a company’s interests become equivalent to those of the creditors? It appears that the extent to which the Ukrainian law targets managerial actions that may potentially harm or have harmed creditors’ interests in the vicinity of insolvency is very limited.

The only provision dealing with voidable pre-insolvency transactions is Article 17 (11) of the Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999. According to this provision, a manager appointed to oversee the restoration of solvency procedure can petition the court to invalidate certain transactions entered into by a debtor prior to a court’s decision to commence the corporate rescue.\textsuperscript{122}

Article 17 (11) defines two types of voidable transactions. The first type covers agreements concluded between the debtor and interested persons which resulted or may result in creditors’ losses. The second type deals with agreements concluded between the debtor and a particular creditor or another person six months prior to the restoration of solvency ruling and which give advantage to one creditor over other

\textsuperscript{122} Under Article 17 (11) of the Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999 only the restoration of solvency manager can petition the court to invalidate the transactions, although presumably they can influence restoration of solvency manager to do so.
creditors or are connected to the return of a capital contribution to a shareholder. The law does not use 'wrongful' or 'fraudulent' terminology; however, the provisions appear to cover preferential transfers with and without a fraudulent intent. The remedy under Article 17 (11) is the restoration of the position to what it would have been if the company had not entered into a transaction.

The first type of voidable transactions under Article 17 (11) does not specifically refer to fraudulent intent, but it does not account for the possibility that the transaction was entered into in good faith, either. As a result, a debtor can argue that a transaction was entered into for the purpose of carrying on its business and that there were grounds for believing that the transaction would benefit the company. In addition, an agreement which can be set aside on the grounds of having resulted or having the potential to result in creditors’ losses can only take place between a debtor and interested persons. The concept of ‘interested persons with regard to the debtor’ as defined by the Act, includes legal entities created with debtor’s participation, debtor’s management and accountant, as well as family members of the above. By limiting the list of interested persons in this way, the Act can potentially overlook transactions to the detriment of creditors concluded with entities outside the definition of interested persons under Article 17 (11). As a result, certain transactions which resulted or may result in creditor losses can appear as transactions entered into in the ordinary course of business.

The latter shortcoming is partially rectified in the second type of transaction, where the transaction in question can be concluded with a particular creditor or another person. The second type of voidable transactions under Article 17 (11) also appears to cover fraudulent intent, as it refers to advantage being given to one creditor over other creditors. Arguably, creating a preference would necessarily pre-suppose fraudulent intent. However, an important drawback of Article 17 (11) is a short limitation period applicable to transactions that give preference to one creditor over others or are connected to the return of capital to a shareholder. These transactions

123 As do ss. 213 and 423 of the Insolvency Act 1986 (UK).
124 In contrast to s. 238 of the Insolvency Act 1986 (UK).
125 Including those who changed employment within a year of initiation of bankruptcy proceedings.
126 Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999, Art. 1.
ought to have taken place within six months prior to the day of the restoration of solvency ruling. The use of the restoration of solvency ruling as a benchmark, rather than the initiation of bankruptcy proceedings can work to the detriment of creditors in a situation where there is a considerable time lag between the initiation of bankruptcy and the restoration of solvency ruling. For example, if the transaction in question takes place two months prior to the initiation of bankruptcy proceedings, it would fall outside the provision in Article 17 (11) if the restoration of solvency ruling occurred five months after the initiation of bankruptcy.

The vague wording of Article 17 (11) thus leads to a number of important limitations with regard to protecting a company’s assets for the benefit of creditors. Firstly, Article 17 (11) makes no reference to the point of financial distress when the company would be expected to realise that it was in the vicinity of insolvency; nor does the Article make any reference to the conduct of the company in the vicinity of insolvency, such as taking steps to minimise potential losses to the company’s creditors. As a result, a company is free to argue that a transaction was entered into as part of the ordinary course of business and for the benefit of the company. Secondly, the ‘interested persons’ limitation overlooks transactions to the detriment of creditors with entities outside the ‘interested persons’ definition. Thirdly, the value of the 2nd provision concerning transactions on preferential treatment of creditors and returns of capital to shareholders is diminished by a limitation period fixed by reference to the restoration of solvency ruling rather than to the initiation of bankruptcy proceedings. Article 17 (11) thus offers a rather limited recourse for creditors in terms of invalidating pre-insolvency transactions.

3.7 The role of legal capital rules in the Ukrainian creditor protection framework

The foregoing analysis of Ukrainian legal provisions highlighted a number of important issues in the Ukrainian creditor protection framework. Legal capital rules proved not to be significantly different from the legal capital regime of the UK, looked at in Chapter One. In certain respects, however, the Ukrainian treatment of legal capital rules.

127 In contrast, ss. 213 and 214 of the Insolvency Act 1986 (UK) do not specify a time limit and s. 238 of the Insolvency Act 1986 (UK) defines the relevant time as 2 years ending with the onset of insolvency.
legal capital rules was found to be stricter, for instance by requiring mandatory liquidation in the event of net assets falling below the minimum capital. Taking contextual considerations into account, the minimum capital requirement was also found to represent a significantly higher barrier to entry.

The Ukrainian legal capital regime focuses on the preservation of the issued share capital, in a similar vein to the European regimes of the UK and Germany. This is evidenced by the increased emphasis on regulating shareholder distributions and capital reductions by reference to a share capital yardstick in the provisions of the Civil Code 2003, the Business Associations Act 1991 and the Draft Joint Stock Companies Act. References to a company's capital being a guarantee of creditors' interests acknowledge the conflict between creditor and shareholder interests. They also suggest the legislature's concern with restricting the ability of corporate insiders to move assets out of the company into the hands of shareholders and with ensuring the priority of creditors' claims over those of shareholders.

However, as seen earlier, creditor protection offered by legal capital and capital maintenance rules has important limitations. The rules do not guarantee that a particular level of assets will be maintained within the company as it trades, since the rules only regulate the loss of corporate assets through distributions, not through trading losses. It is thus important for legal capital and capital maintenance rules to be supplemented by ex post mechanisms capable of targeting opportunistic behaviour on the part of corporate controllers when trading with creditors' money in the vicinity of insolvency. As seen above, Ukrainian legislation lacks sophisticated ex post mechanisms and does not provide for the 'effective avoidance of suspicious pre-bankruptcy transactions'. Creditors only have a limited recourse through the provision on voidable pre-insolvency transactions in Article 17 (11) of the Restoring a Debtor's Solvency or Declaring a Debtor Bankrupt Act 1999. In addition, the Ukrainian bankruptcy framework contains a number of legislative loopholes that allow debtors to evade their obligations to creditors. For example, debtors may

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128 Chapter One generally.


130 According to the EBRD's 2004 sector assessment survey, Ukrainian insolvency legislation scored 'very low compliance' with international standards, when compared with other transition economies. See V. Tsekhanovych and A. Yegupova, 'Recent changes in the commercial laws of Ukraine', Law in
initiate bankruptcy proceedings to ensure a moratorium on creditors’ claims, or conceal the announcement of the start of bankruptcy proceedings by calculated choice of media outlet.\textsuperscript{131}

In Chapter Two it was suggested that effective ex post creditor protection mechanisms diminish the necessity for legal capital and capital maintenance rules.\textsuperscript{132}

In view of the inadequate ex post creditor protection framework in Ukraine, can a limited creditor protection function of legal capital rules be of benefit as a ready-made collective offer to the company’s creditors? Or does the rules’ utility within the creditor protection framework diminish due to the availability of contractual protection mechanisms, regardless of the ex post provisions’ inadequacy?

To answer this question, an important drawback of the contractual approach to creditor protection must be revisited: the inability to adequately protect weaker creditors.\textsuperscript{133} Effective contractual protection pre-supposes the ability of corporate creditors to bargain for their preferred terms, by negotiating for higher interest rates and/or insisting on compliance with financial ratios when making business decisions.\textsuperscript{134} However, not all creditors have the same bargaining power. Less sophisticated creditors, such as smaller trade creditors, may not be in a position to

\begin{footnotesize}
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\item \textsuperscript{131} It should be noted that when insolvency law fails to protect creditors, legal practitioners suggest considering the general provisions found in the Civil, Commercial and Criminal Codes of Ukraine. Article 220 of the Commercial Code 2003 (Part V, Chapter 24) covers default by a debtor in general. Similarly, Articles 610 - 625 of the Civil Code 2004 (Part I, Chapter 51) cover liability for breach of obligations in general. Presumably, the latter provision could in theory be extended to cover breach of obligations of the kind that directors owe to a company’s creditors when making management decisions in financial distress, i.e. when the loan payment is overdue and the company is in the insolvency territory. It is however unlikely that this provision would be used in this way by Ukrainian courts, given that judicial practice in the field of corporate duties and obligations is still largely underdeveloped. It has also been suggested above (p. 81, n. 115) that the Criminal Code of Ukraine can be of some, albeit very limited, assistance. While Article 218 of the Criminal Code places responsibility on the debtor for initiating a fictitious bankruptcy, it provides that in order for the Article to apply, the initiator itself has to be a debtor. In practice however, bankruptcy is often conveniently initiated through so-called 'friendly' companies and as a result the aforementioned article cannot be of any value in terms of creditor protection. Although all of the above provisions can arguably apply to creditor-debtor relations in the corporate context, they are not specific to corporate relationships.
\item \textsuperscript{132} See Chapter Two, section 2.4.
\item \textsuperscript{133} See Chapter Two, section 2.5.2.
\item \textsuperscript{134} See Chapter Two, section 2.5.2.
\end{itemize}
\end{footnotesize}
negotiate the conditions that would offset the risks associated with lending to a
corporate borrower.\textsuperscript{135} In this context, legal capital and capital maintenance rules can
be seen as a useful mechanism providing collective, albeit limited, protection from
which weaker creditors can benefit without having to take any action. Indeed, in the
context of developed economies, legal capital rules are sometimes advocated as
being necessary to protect weak creditors who do not have the bargaining power to
adequately protect themselves through contractual covenants.\textsuperscript{136} However, the legal
capital rules’ value of offering a collective protection to weaker creditors is
diminished by the limitations of capital maintenance regime. Although the regime
can provide initial collective protection to the creditors, it does not safeguard against
trading losses and provides no guarantee that cash flow will be maintained at a level
adequate to pay debts as they fall due.\textsuperscript{137} These shortcomings can potentially be
captured by ex post creditor protection mechanisms aimed at pre-insolvency
transactions harmful to creditors’ interests.

As seen earlier, the ex post creditor protection framework in Ukraine is not equipped
to handle debtors’ opportunistic behaviour in financial distress and to adequately
protect creditors’ interests in bankruptcy proceedings. In addition, failure to provide
for the effective avoidance of suspicious pre-insolvency transactions means that
corporate controllers have no incentive to consider creditors’ interests when the
company is in financial distress. Furthermore, the lack of strict creditor-regarding
duties in the vicinity of insolvency will also fail to prevent the incorporation of
inadequately capitalised companies, unless a certain level of legal capital is required
by law.\textsuperscript{138} As seen above, legal capital and capital maintenance rules provide a
‘modest collective protection […] against a limited category of value diminishing
actions’.\textsuperscript{139} Nevertheless, given the inadequacy of ex post creditor protection

\textsuperscript{135} See Chapter Two, section 2.5.2.

\textsuperscript{136} See, for example, W. Schöen, ‘The Future of Legal Capital’, 5 European Business Organization
protection – or: A high-level framework for corporate creditor protection, ECGI Law Working Paper

\textsuperscript{137} E. Ferran, The Place for Creditor Protection on the Agenda for Modernisation of Company Law in

\textsuperscript{138} P.L. Davies, ‘Directors’ Creditor-Regarding Duties in Respect of Trading Decisions Taken in the

\textsuperscript{139} E. Ferran, The Place for Creditor Protection on the Agenda for Modernisation of Company Law in
framework, the limited protection offered by the rules on capital emerges as a useful collective guarantee, at least for the weaker contractual creditors, against the opportunistic withdrawal of assets by corporate controllers. Of course, the rules on capital were not designed to substitute the provisions directly addressing perverse incentives on the part of company controllers in the vicinity of insolvency. Nevertheless, if the availability of effective ex post mechanisms can diminish the need for strict rules on capital, then the lack of adequate ex post creditor protection framework certainly raises the utility of these rules, despite the limited extent of their protection.

3.8 Conclusion

The legal analysis in this chapter has highlighted a number of important differences between the creditor protection frameworks of Ukraine and of the UK. In certain respects, the Ukrainian treatment of legal capital rules was found to be stricter, for instance by requiring mandatory liquidation in the event of net assets falling below the minimum capital. In contrast, the analysis of the Ukrainian ex post creditor protection framework exposed a number of important shortcomings, such as the failure to provide for the effective avoidance of pre-insolvency transactions. In this light, the limited protection offered by the rules on capital emerged as a useful collective guarantee, at least for the weaker contractual creditors, against the opportunistic withdrawal of assets by corporate controllers.

In view of the inadequacy of the ex post creditor protection in Ukraine, legislative reforms certainly have to be on the agenda. However, alongside the quality of law on the books, the effectiveness of a creditor protection regime also needs to be considered in the context of the corporate environment within which the regime is intended to operate. The next chapter thus proceeds to consider the factors of the corporate environment that can impact on the effectiveness of creditor protection in a transitional economy.
Chapter Four
Creditor protection in a transitional economy: aspects of corporate environment

4.1 Introduction

Discussions relating to the merits of various creditor protection strategies in developed jurisdictions often take as a given the existence of a business culture with strong informal norms of honest business practices. However, the way corporate relationships are perceived and whether the rule of law is respected is likely to have a bearing on the extent to which the available legal provisions are able to protect the creditors. Indeed, evidence from transitional economies suggests that the quality of the law on the books is not an exclusive or even a dominant factor in credit market development or, in other words, a determinant in creditors’ willingness to lend.¹

For example, in the previous chapter the limited protection against opportunistic withdrawals of assets by corporate controllers was outlined as a useful creditor protection feature of legal capital rules, given the inadequacy of the ex post creditor protection framework in Ukraine. However, the ability of the rules to fulfil their protective function will depend on whether the rules are followed in the first place. This in turn is likely to be affected by the strength of the compliance culture in the corporate environment. The likelihood of voluntary compliance with creditor protection provisions is thus an important factor in the effectiveness of a creditor protection regime.

What are the factors that can affect the likelihood of compliance? On the one hand, compliance is positively correlated with the ability of the business culture to conduce best practices.² At the same time, the degree of compliance is also determined by whether there is a credible threat that defection will be sanctioned. Effective law enforcement is thus an important element in making such a threat viable.

A strong business culture and the credibility of the judicial establishment thus emerge as the necessary pre-conditions for effective creditor protection. Using these pre-conditions as a starting point, this chapter aims to provide an insight into the wider issues of the corporate environment in transition. Path dependence factors that can have an impact on the state of business culture with regard to creditor protection are considered in Part 4.2. Factors affecting the institutional credibility of the judicial establishment in the context of transition are looked at in Part 4.3. Part 4.5 then proceeds to suggest ways to improve the business culture and corporate ethics through strategies that can bear on the acceptance of best practices and corporate ethics by the company's insiders. Part 4.6 considers the role of international judicial standards for improving judicial credibility in transition.

4.2 Path dependence factors affecting business culture in transition

4.2.1 The ability of market forces to influence corporate behaviour

Hall and Soskice argue that in any national economy companies will gravitate towards the mode of coordination for which there is institutional support. In developed market economies, companies coordinate their activities primarily via competitive market arrangements. As a result, developed markets can act as

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4 P. A. Hall and D. Soskice, 'An Introduction to Varieties of Capitalism', in P.A. Hall and D. Soskice, eds., Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (Oxford, Oxford University Press 2001) p. 9. This observation is part of the 'varieties of capitalism' approach as developed by Hall and Soskice. The 'varieties of capitalism' framework focuses on institutional variations within comparative capitalism. Placing the company at the centre of the analysis, the framework examines strategic interactions between economic actors. Hall and Soskice differentiate between two basic types of political economies, namely liberal market economies and coordinated market economies, as idealised types at the ends of a spectrum along which countries can be placed, depending on their degree of reliance on market mechanisms. See P. A. Hall and D. Soskice, 'An Introduction to Varieties of Capitalism', in P.A. Hall and D. Soskice, eds., Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (Oxford, Oxford University Press 2001) pp. 6 - 21.

institutions that support relationships, marked by arm’s-length relations and high levels of competition for corporate valuation and control.\textsuperscript{6}

In developed economies opportunistic behaviour on the part of company controllers is likely to be mitigated by market forces as there are sufficient market and contractual mechanisms available to restrain directors from misconduct towards creditors.\textsuperscript{7} The ability of markets to influence corporate behaviour in developed economies is strengthened by the constant development of corporate governance standards, with measures such as strict disclosure requirements\textsuperscript{8}, Sarbanes-Oxley-type regulations and constantly evolving codes of corporate behaviour\textsuperscript{9}, further contributing to the improvement of the corporate climate.\textsuperscript{10} Indeed, developed market mechanisms dominated by professional and sophisticated investors can be capable of influencing corporate behaviour and encouraging financial discipline.\textsuperscript{11} For example, directors’ behaviour is likely to be influenced by institutional investor guidelines and corporate governance codes to which companies tend to adhere for reputational reasons.\textsuperscript{12} Despite these guidance provisions not being directly enforceable by court-based legal mechanisms, companies that do not comply with

\begin{itemize}
\item \textsuperscript{8} For example, the EU Market Abuse Directive (Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), OJ 2003 L 96/16).
\end{itemize}
market-driven codes of conduct run the risk of investor dissatisfaction. The image of 'bad' governance is likely to undermine the market's confidence in a company, leading to a drop in share prices. In addition, non-compliant companies may find it more difficult to raise new capital.

In contrast to developed market economies, in transition economies, both competitive labour and capital markets are under-developed. For example, in the former Soviet Union, under the central planning system of corporate control, state-owned enterprises were the only corporate form in existence until 1985. Financing was provided by the state, removing the necessity of raising external finance. The concepts of financial discipline and accountability were thus virtually non-existent in a socialist firm. When a central planning system ceased to exist, market mechanisms were missing. Companies in transitional economies are thus more accustomed to depend on non-market interactions to coordinate their relationships with other economic actors. They tend to employ relational or incomplete contracting and place greater reliance on collaborative, as opposed to competitive, relationships to build the competencies of the company. In addition, in transition economies loopholes and inconsistencies in company legislation, combined with


weak institutional credibility of the judicial establishment\textsuperscript{21}, mean that courts cannot be relied upon by the business community to resolve disputes fairly. Consequently, a company's choice of business partners can often become limited to those with whom it already has longstanding ties or family/kinship relations.\textsuperscript{22} As a result, equilibrium outcomes of company behaviour are conditioned less by demand and supply, as is the case in competitive markets, but are more often the result of strategic interaction and relational contracting between companies and other economic actors.

In the absence of a competitive market for corporate valuation and control, managerial misbehaviour and bad corporate governance cannot be efficiently detected by market forces and corrected by outside stockholders\textsuperscript{23}, for example through the refusal of credit in the future or increased interest rates. Managers will thus be less likely to be susceptible to discipline and consequently even their eventual replacement will not lead to a significant improvement.\textsuperscript{24}

Why is the ability of market forces to exert controls on corporate behaviour important for creditor protection in a transitional economy such as Ukraine? As seen earlier, the rules on capital only regulate distributions and are not designed to address perverse incentives on the part of the company controllers in financial distress. Gaps in the ex post creditor protection framework of Ukraine mean that creditors are left to rely on other mechanisms to mitigate opportunistic behaviour in the vicinity of insolvency. By disciplining corporate controllers, market forces could thus provide a mechanism to counteract the lack of adequate ex post creditor protection provisions. Instead, weak market forces contribute to a business culture characterised by a low degree of compliance, thus undermining the effectiveness of the available creditor protection provisions.

\textsuperscript{21} See below, section 4.3.


4.2.2 Ownership concentration

Another important factor affecting the state of business culture in transitional economies relates to patterns of ownership concentration and control. The process of transition from a planned economy to a market economy necessarily involves dynamic changes in the economic landscape. Economic reform had a significant impact on the structure of ownership rights through the process of privatisation in transition.25 Under the central planning system, state monitoring of enterprises was weak.26 As a result, incumbent managers had accumulated de facto control rights. Due to non-competitive privatisation methods which favoured insiders, privatisation led to a de jure allocation of ownership rights to managers who already held de facto control.27 Consequently, insider control can be mirrored in boards and shareholder meetings dominated by management. It was a common occurrence in the course of insider privatisation for the managers to buy out the workers’ shares. As a result, concentrated insider ownership became a major corporate governance feature in transition economies.28 Due to the lack of effective mechanisms for legal protection of shareholder rights, and minority shareholder rights in particular, in an ownership structure where controlling packages are concentrated in the hands of block-holders, the corporate governance system is transparent only to a limited number of large shareholders.29 Privatisation in transition has thus created one of the classic problems

of corporate governance: protection of minority shareholders against strong block-holder interests.\textsuperscript{30}

What is the significance of concentrated insider ownership for business culture and creditor protection? In a concentrated ownership structure, there is an increased risk of management being directed by the controlling majority. However, when ownership and control of a corporate entity are separate, directors' interests may not necessarily coincide with shareholder interests. Thus, in financial difficulty, shareholders might be tempted to engage in risky transactions to salvage their investment or to undertake dressed-up returns of capital\textsuperscript{31}, whilst directors may be discouraged from opportunistic behaviour to the creditors' detriment by the existence of potential liabilities and/or as a result of reputational concerns. However, when the directors are also the shareholders, in financial distress their interests as shareholders are likely to prevail over their duties as directors to take creditor interests into account. Naturally, this problem is further magnified when adequate provisions targeting managerial misconduct in the vicinity of insolvency are lacking, as is the case in Ukraine. As a result, insider ownership may negatively affect the willingness of the management to abide by the existing creditor protection provisions.


\textsuperscript{31} See Chapter Two, sections 2.2 and 2.3.
Concentrated insider ownership can thus affect the way the conflict of shareholder and creditor interests is perceived by the company controllers.

4.3 Institutional credibility of the judiciary in transition

4.3.1 Overview

In addition to factors of the corporate environment outlined above, business culture and corporate mentality can be reinforced or weakened by the credibility of the judicial establishment. Compliance with legal provisions requires a viable threat that defection will be sanctioned by the legal institutions charged with enforcing the law. If the institutional credibility of the judiciary is weak, the courts will not be trusted by the corporate community to enforce legal provisions. As a result, legal rules will not be taken seriously, thus undermining the effectiveness of a legal regime.

In a transitional legal environment, the quality of the law enforcement is at least as important as the extensiveness of the law itself.\(^3\)\(^2\) Legislative reforms are unlikely to produce the desired effect if reforms to legal institutions and the judicial process are lacking.\(^3\)\(^3\) Effective legal institutions in transition have been found to have a far more significant effect on the level of equity and credit market development than the quality of the law on the books.\(^3\)\(^4\) Indeed, even if basic creditor protection mechanisms are in place on the books, they will be of little value to creditors if the available legal provisions cannot be enforced. Institutional credibility of the judiciary can thus play a vital role in the operation and effectiveness of a creditor protection regime.\(^3\)\(^5\)


Can the judiciary in a transitional economy be seen as a credible institution for the application and enforcement of the law? Evidence suggests that judicial credibility in transition is weak. Findings by the EBRD indicate that in CIS countries as many as 75% of enterprises do not trust the legal system to protect their rights.\(^{36}\) Taking a particular example, courts in Ukraine were judged to be considerably less fair and honest than courts in both advanced transition countries and mature market economies according to 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey.\(^{37}\) This is echoed in the EBRD’s ‘Life in Transition’ survey, where 70% of the Ukrainian population voiced complete or at least some distrust towards courts as public institutions.\(^{38}\) Below, possible reasons behind weak judicial credibility in the context of a transitional economy are considered.

### 4.3.2 Legal transition implications

The poor quality of the judiciary in transition can be partially explained by factors linked to the transition from a socialist to a market economy, and to the legal transition in particular. Legal change may negatively affect law enforcement by presenting legal practitioners with a new and unfamiliar body of law.\(^{39}\) A lack of technical skills can become an issue with regard to judges trained under the old socialist system, who need to adapt to market economy principles\(^{40}\). This problem is exacerbated when, as is the case in Ukraine, there is no requirement for judges to attend professional development courses.\(^{41}\)


Scarce financial resources can also play a role in the quality of the judiciary: low salaries might drive away the profession’s best members and are not likely to attract qualified lawyers. Furthermore, judges in transition countries do not generally enjoy the same prestige as their colleagues in Western Europe or the US, which results in the judicial career’s unattractiveness for legal professionals.

Although the implementation of the law is at least as important as the law on the books, an effectively functioning system needs to be founded within an adequate legal framework. If the adequate law is lacking, implementation will be more likely to suffer. Weak legislative framework is thus another important factor affecting judicial credibility in transition. Judicial decision-making is vital for promoting predictability in the system through consistent and uniform interpretation and application of the law. However, the lack of a systematic approach to legal reform in transition can lead to related laws being developed independently and without coordination. Furthermore, the introduction of a new law or an amendment to an existing act are not necessarily accompanied by changes to related laws to ensure the smooth functioning of the new provisions within the legal framework. As a result, conflicting laws covering the same issue contribute to the high levels of uncertainty and low levels of predictability with regard to court disputes. When the application of the law is filled with uncertainties, judicial credibility will be negatively affected.

In addition, low salaries make the members of the judiciary vulnerable to bribery.


This was the case with the Civil and Commercial Codes of Ukraine – see Chapter Three, section 3.2.

V. Tsekhanovych and A. Yegupova, ‘Recent changes in the commercial laws of Ukraine’, Law in transition 2008: securities markets, and legal reform in Ukraine, EBRD, May 2008, p.52. Legislative inconsistencies and the resulting application issues can also prevent judges from publishing comprehensive legal analyses as guidance to the corporate community, thus negatively affecting predictability in the system. Worse still, the application of conflicting provisions on the same subject can become ‘a breeding ground for corruption’ - V. Tsekhanovych and A. Yegupova, ‘Recent changes in the commercial laws of Ukraine’, Law in transition 2008: securities markets, and legal reform in Ukraine, EBRD, May 2008, p. 52. See also M. Onyschuk-Morozov and V. Ryabota, ‘Promoting
4.3.3 Judicial ethics

Institutional credibility of the judiciary in transition can be undermined as a result of the challenges that make it particularly difficult for the judges to maintain high standards of ethics and integrity. Among the key issues affecting the application of the law is the vulnerability of the judiciary to political or other influences. Where a close association between business and politics is still a strong feature of the political system (as is the case in Ukraine), judges can be faced with attempted infringements of their independence and integrity when instructed by government officials on how to decide on a particular case.

Legal provisions do not appear to be a decisive factor in the outcome of a court dispute. In Ukrainian insolvency disputes, for example, it is not uncommon for certain creditors' claims to be disregarded with the aid of the implicit or explicit cooperation of the judges. As a result, there can be no confidence on the part of the business community that the court will rule in favour of the party with the strongest legal position. Even if basic creditor protection mechanisms are in place on the books, they will be of little value to creditors if there is a perception on the part of the business community that the courts cannot be trusted to enforce the available legal provisions. If enforcement of the legal rules is not seen as effective, it may in turn

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51 An incumbent liquidator may work with the debtor to ensure that the available pool of money goes to their preferred creditor. Meanwhile, other creditors' claims may be rejected by the court, despite having been filed in the correct legal order. After the debtor's preferred creditor is approved by the court, the funds received by this creditor are then promptly channeled to a connected company. Other creditors are thus left with very little or no chance of being repaid. See the case of Agroeksport No 10/171/06 for an example of a similar scenario (State Register of Court Decisions of Ukraine <http://revestr.court.gov.ua/pls/apex/f?p=200:1:1046546051982759> (last accessed October 2008); High Commercial Court of Ukraine <www.arbitr.gov.ua> (last accessed October 2008)).

encourage unethical corporate practices and outright violations of the law. Weak institutional credibility of the judiciary will thus weaken the business culture by lowering the likelihood of the corporate controllers to be compelled to abide by the creditor protection provisions.

4.4 Summary to parts 4.2 and 4.3

The above discussion highlights a number of issues relating to the effectiveness of a creditor protection regime in transition. Firstly, underdeveloped market mechanisms mean that market forces are weak in their ability to influence corporate behaviour and to act as a deterrent for managerial misconduct towards creditors. Secondly, concentrated insider ownership structures dominated by non-transparent corporate governance systems affect the perception of the conflict between shareholder and creditor interests. Thirdly, the weak institutional credibility of the judiciary can encourage the persistence of unethical corporate practices as part of the business culture. This can in turn reinforce the perceived ineffectiveness of the available creditor protection provisions. The combination of these factors thus adversely affects the state of the business culture and corporate mentality, in turn creating an environment characterised by a weak culture of compliance.

Improving creditor protection on the books in such an environment can at best be a partial solution. The corporate environment in general needs to be improved. In particular, alternative strategies are necessary in order for the business culture to become conducive to the company insiders’ acceptance of best practices and corporate ethics.

4.5 Functional convergence: improving business culture in transition

In an environment in which the institutional persistence of path dependence features is strong and in which the necessary legal reforms might be slowed down by political uncertainties53, certain changes in the business culture can be achieved through

53 See Chapter Three, section 3.2.
functional convergence. Functional convergence implies the ability of existing corporate governance institutions to react to changed circumstances without altering their formal characteristics. The question is therefore whether the business culture and corporate ethics in transition can be improved through functional convergence and what are the influences necessary to achieve this goal?

4.5.1 The role of market-driven codes of conduct in promoting best practices in a transitional economy

Voluntary codes of corporate conduct provide a useful example of an attempt to improve the business culture through suggesting good corporate governance standards. In a corporate environment where legal rules are not seen as a constraint due to low judicial credibility and weak market forces, codes of practice can at least raise awareness of the generally accepted principles of corporate culture, such as integrity, transparency, openness and accountability.

In Ukraine, for example, "Principles of Corporate Governance in Ukraine", adopted in 2004, introduced for the first time in Ukrainian corporate culture the concepts of the 'independent director', the 'corporate secretary' and 'conflict of interest'. It is

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54 See R.J. Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function', 49 The American Journal of Comparative Law (2001) p. 329 at p. 356. In contrast, formal convergence is defined as requiring legislation in order to change the structure of existing corporate governance institutions. Coffee uses the process of transition towards dispersed ownership in the US and the UK as an example to illustrate functional convergence. In the case of the US, Coffee suggests that as a debtor nation dependent on foreign capital and in need of developing such capital-intensive industries as electrical power and railways, the country made an effort to minimise the risks of dispersed ownership by developing self-regulatory standards in an attempt to convince remote foreign investors of the adequacy of the safeguards taken to protect their investments. In the UK, on the other hand, from as early as the 1860s, securities markets were regulated by the law to a greater extent than in the US, and therefore less effort was needed for self-regulation. For example, whilst Britain enacted a mandatory law regulating disclosure well ahead of similar developments in the US, US institutions were under pressure to progress more quickly towards self-regulatory standards in this area. The US was therefore moving towards increased protection by self-regulation, while the UK did so by legislation. Coffee's conclusion in relation to the above is that even though the two economies might not have had equivalent investor protections during the same periods, they both reached the minimum standards that needed to be in place in order for dispersed ownership to develop, in line with the idea of functional convergence, whereby functional substitutes for formal legal requirements will develop in the absence of law on the books. See J. C. Coffee (Jr), 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', in K. Hopt and E. Wymeersch, eds., Capital Markets and Company Law (Oxford University Press 2003) pp. 669 - 702.

55 State Commission on Securities and Stock Market, Principles of Corporate Governance in Ukraine, Kiev, 2004, part 3. "Principles of Corporate Governance in Ukraine" outlined good corporate governance practices for open joint stock companies traded on the stock exchange. Along with the Principles, a sample charter and by-laws as guidance to companies on incorporating the Principles were also adopted. The document was based on the OECD Principles of Corporate Governance 2004 <www.oecd.org/daf/corporate/principles> (last accessed January 2009) and is the product of a
difficult to determine the practical extent to which implementation of the principles improves corporate governance, due to the lack of empirical data. Nevertheless, evidence suggests that many open joint stock companies in Ukraine have revised their corporate documents to include aspects of the Principles, despite the code being of a voluntary nature. These numbers are likely to rise as the number of listed companies increases. This development can be seen as part of a growing trend of voluntary improvements in corporate governance practices ahead of companies' plans to raise capital through IPOs on foreign stock exchanges.

However, the extent to which corporate governance culture in transition can be improved through corporate governance codes can be limited. Drafting the codes may prove difficult due to the resistance of powerful groups of private benefit seekers interested in preserving the status quo. In markets dominated by large block holders, stock exchanges may in large part rely on the fees from corporations controlled by these block holders. Consequently, should higher corporate governance standards limit the private benefits in question, the stockholders may be


In more developed jurisdictions, there are sophisticated data on the formal implementation of voluntary codes' provisions, for example the number of companies with designated independent directors. Wymeersch notes, however, that it can be difficult to ascertain whether the directors are effectively independent. E. Wymeersch, 'Corporate governance codes and their implementation', in *Law in transition 2006: Strengthening corporate practices*, EBRD, May 2006, p. 61.


Interview with L. N. Pravdivaya, Head of the Banking Regulation Department and Corporate Secretary (Compliance), International Mortgage Bank, Kiev, Ukraine, 30 May 2007.


encouraged to de-list, thus affecting stock exchange revenues. As a result, code drafters may choose to steer clear of tackling the real weaknesses in corporate governance practices in order to avoid this situation. Cankar adds that voluntary codes of a self-regulatory nature are unlikely to have a major impact in transition economies where the corporate environment is characterised by the dominant influence of strong block-holders, and a weak culture of compliance.

4.5.2 The role of the demonstration effect in improving business culture in a transitional economy

How can the companies be encouraged to adopt more responsible corporate practices of their own accord? Gilson suggests that the development of corporate governance institutions is likely to be influenced by the behaviour of differently organised competitors in order to survive in the market. Existing corporate governance institutions can therefore be influenced by what Gilson refers to as 'environmental selection mechanisms' – by situations in which 'the demands of current circumstances grind against the influence of initial conditions' and encourage functional convergence to a more efficient structure. In other words, if companies can see the benefits of improving corporate governance and compliance with the rules, their willingness to observe the rules will increase.

International organisations' initiatives can play an important role in creating a demonstration effect in the market by promoting the benefits of improving corporate governance practices. As a result, these initiatives can help strengthen the business culture, thus strengthening one of the necessary pre-conditions for effective creditor


protection. An example of a strategy that can bear on the acceptance of best practices and corporate ethics by the company controllers is considered below.

As part of an ongoing initiative to raise public awareness of the importance of good corporate governance and to improve the level of corporate governance practices, the International Finance Corporation (IFC)\(^6\) carried out a 'Pilot Programme' within its 'Ukraine Corporate Development Project'.\(^6\) A competitively selected group of joint stock companies first had their corporate governance practices assessed.\(^6\) IFC staff then worked with directors and managers to develop an improvement plan and assisted in implementing it.\(^6\) An important benefit reported by the participating companies as a result of improvements to corporate governance practices was an improvement in the ability to obtain financing.\(^7\) Successful outcomes of these exercises were made public in order to make an example of the benefits of improved

\(\text{\footnotesize 6 The International Finance Corporation (IFC) is a member of the World Bank Group and specialises in helping to build the private sector in developing countries. In particular, the IFC aims to promote sustainable growth by financing private sector investment and providing advisory services to businesses and government institutions on improving corporate governance practices and policy reform (see <www.ifc.org/about> (last accessed October 2008)). For more on the IFC activities in Ukraine, see M. Onyschuk-Morozov and V. Ryabota, 'Promoting Corporate Governance in Ukraine: Adding value to the private sector through advisory services', Law in transition 2008: securities markets, and legal reform in Ukraine, EBRD, May 2008, pp. 85 - 88.}\)


\(\text{\footnotesize 8 M. Onyschuk-Morozov and V. Ryabota, 'Promoting Corporate Governance in Ukraine: Adding value to the private sector through advisory services', Law in transition 2008: securities markets, and legal reform in Ukraine, EBRD, May 2008, p. 86.}\)


\(\text{\footnotesize 10 During 2002 – 2007, participants in the pilot programme are reported to have attracted over USD 950 million of investment as a result of improving their corporate governance practices. See M. Onyschuk-Morozov and V. Ryabota, 'Promoting Corporate Governance in Ukraine: Adding value to the private sector through advisory services', Law in transition 2008: securities markets, and legal reform in Ukraine, EBRD, May 2008, p. 87, also for an example of a case study of a Ukrainian company Galnaftogaz that attracted international financing for its expansion plans following its participation in the pilot programme. The participating companies also reported improved company reputation, improved decision-making and reduced conflicts among the benefits of improved corporate governance (M. Onyschuk-Morozov and V. Ryabota, 'Promoting Corporate Governance in Ukraine: Adding value to the private sector through advisory services', Law in transition 2008: securities markets, and legal reform in Ukraine, EBRD, May 2008, pp. 87 - 88).}\)
corporate governance to other companies. Indeed, according to the surveys undertaken by the IFC in Ukraine, the demonstration effect proved a powerful force, with companies indicating that the practices of other corporations were among their top motivators in improving corporate governance.71

Through publicising the link between good corporate governance and access to finance, a strong message was thus sent to the market that 'a very real payoff' can be gained from establishing credible corporate governance by the companies themselves.72 It appears therefore that corporate governance can potentially be improved at the company level as part of creating a positive corporate image with a view to improving access to finance. This supports Coffee’s submission that market changes are likely to precede legal reform.73 In the context of functional substitutes that will develop to supplement and/or substitute formal laws, Coffee points to the value of ‘reputational capital’, which companies will be willing to develop by observing requirements far stricter that those required under the local laws.74 Collectively, these individual changes can promote bigger changes in the market in terms of improving the business culture and corporate ethics.75


75 It has been observed, however, that companies may not find it worthwhile to improve corporate governance practices of their own will due to low levels of financial and economic development in their respective countries. Doidge, Karolyi and Stulz developed a model that looked at companies' behaviour and governance choices in more developed and less developed economies in terms of the companies' willingness to adopt investor protection measures of their own accord, as a functional substitute for investor protection provided by the state through legislation. Doidge, Karolyi and Stulz's findings suggest that, given low levels of financial and economic development, companies will be more reluctant to improve corporate governance strategies of their own accord as doing so will be unlikely to provide them with a greater access to global finance. On the other hand, the authors find that the incentives to adopt better governance mechanisms at the company level will increase with a country's financial and economic development. See C. Doidge, G. A. Karolyi and R. M. Stulz, Why Do Countries Matter So Much for Corporate Governance, Finance Working Paper No 50 (2004).
4.6 Improving judicial credibility in a transitional economy

4.6.1 The role of international judicial standards

In line with the idea of functional adaptability explored earlier in the context of improving business culture, corporate ethics and corporate governance, international judicial standards can be seen as a functional convergence tool and a guide for judges to drive forward domestic judicial reform. While applying international standards in a domestic context can be difficult and politically risky for judges, it can also provide a springboard for a reform movement.

For example, following training in international judicial standards provided by the American Bar Association Central European and Eurasian Law Initiative (ABA/CEELI), a group of judges from Serbia and Montenegro have taken the initiative to create a code of ethics for judges based on international standards and to reproduce the course materials in order to further educate a broader cross-section of judges in the country. The training has thus contributed to empowering the judges to take steps in advocating reform from within.

Furthermore, the impact of training in international judicial standards is not limited to collective action, and can be manifested at an individual level. For example, one of the participants in the ABA/CEELI course on 'Judging in a democratic society', a

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80 For more on the course, see J. Broome and M. Inman, 'Using international standards as tools for judicial reform', Law in Transition 2005: Courts and Judges, EBRD, May 2005, p. 94.
judge from Bosnia-Herzegovina, reported that he was contacted by another judge
two courts above him with a request to take 'special consideration' in a case.\textsuperscript{81} The
participant judge 'had the courage to explain to the [other] judge why his call was
inappropriate.'\textsuperscript{82} The participant judge attributed his confidence to the result of the
training he had received on international standards and ethics.\textsuperscript{83} Training in the
practical application of international judicial standards can thus provide judges with
confidence and support in making ethical decisions.\textsuperscript{84}

4.6.2 A Ukrainian example: the Academy of Judges

In Ukraine, an important step in terms of promoting judicial ethics has been the
initiative to set up the Academy of Judges of Ukraine in 2002.\textsuperscript{85} When the Academy
was first established, the idea of creating a specialist educational institution for
judges was met with mistrust at the national level, being seen by some members of
the profession as a threat to their independence.\textsuperscript{86} This made it more difficult for the
Academy to realise its potential in its early days. The resistance can however be viewed retrospectively as a positive sign with regard to judicial ethics in Ukraine, as
it arguably indicated the importance of independence from state/political influences
to at least some members of the profession. Nevertheless, the Academy has since
managed to demonstrate its usefulness to the legal community. As well as providing
training courses to judges and court officials, the Academy has been active in forging
links with international organisations, educational institutions and international
technical assistance projects with the aim of obtaining international legal expertise on

\textsuperscript{81} J. Broome and M. Inman, 'Using international standards as tools for judicial reform', \textit{Law in

\textsuperscript{82} J. Broome and M. Inman, 'Using international standards as tools for judicial reform', \textit{Law in

\textsuperscript{83} J. Broome and M. Inman, 'Using international standards as tools for judicial reform', \textit{Law in

\textsuperscript{84} J. Broome and M. Inman, 'Using international standards as tools for judicial reform', \textit{Law in

\textsuperscript{85} Judicial System Act of Ukraine and a Presidential Decree established the academy as a specialist
higher education institution attached to the State Judicial Administration of Ukraine. See I. Voytyuk,
'Developing the Academy of Judges of Ukraine', \textit{Law in transition 2008: securities markets, and

\textsuperscript{86} I. Voytyuk, 'Developing the Academy of Judges of Ukraine', \textit{Law in transition 2008: securities
issues relating to democratic transformations in judicial training and reform in Ukraine.\textsuperscript{87}

Another important initiative of the Academy in terms of promoting judicial ethics has been the creation of a framework for a national training system for judges, which incorporates the long-term goals of implementing the principle of the rule of law and preparing the judicial system for Ukraine's possible integration into the EU\textsuperscript{88}, thus necessarily involving training in international judicial standards of ethics.

The above initiatives show the willingness on the part of members of the profession to move away from the current corrupt and unreliable image of the judicial system towards a system based on democratic and ethical principles. This progress is of course highly susceptible to political pressures both in terms of carrying out the necessary law reform\textsuperscript{89} and the application of international judicial standards on an individual level. Nonetheless, in terms of providing 'a basis upon which judges can act appropriately and provide justification for their refusal to engage in unethical behaviour in an environment in which such behaviour may be the norm'\textsuperscript{90}, the introduction of international standards into the judicial training system can be a valuable step towards improving judicial ethics, creating a more positive image of the court system and restoring institutional credibility of courts in the country.

4.7 Conclusion

Having outlined a strong business culture and the credibility of the judicial establishment as the necessary pre-conditions for effective creditor protection, this chapter provided an insight into the corporate environment in transition.


\textsuperscript{89} In order for the national training system to become mandatory for all future judges, appropriate legislation (Judicial Status Act and Judicial System Act) needs to be amended. See I. Voytyuk, 'Developing the Academy of Judges of Ukraine', \textit{Law in transition 2008: securities markets, and legal reform in Ukraine}, EBRD, May 2008, p. 79.

Underdeveloped market mechanisms, non-transparent ownership structures and weak judicial credibility emerged as factors adversely affecting creditor protection through undermining the business culture. In such an environment, functional convergence measures such as voluntary corporate governance codes, international organisations' initiatives and training in international judicial standards can be effective in helping to move forward the necessary changes. By bearing on the acceptance of best practices and ethics, these strategies can help strengthen business culture and restore judicial credibility, thus improving the necessary pre-conditions for effective creditor protection.
Concluding remarks

This thesis has sought to undertake a comparative study of creditor protection aspects in order to contrast the demands of western market economies with the transitional economy of Ukraine. As a starting point in the analysis, legal capital rules were evaluated from a creditor protection standpoint. Whilst a number of positive creditor protection features with respect to the rules, such as the 'collective offer' or the informational functions of legal capital, can be identified, the ability of legal capital and capital maintenance rules to safeguard a company’s assets is limited in situations when a company is on the brink of insolvency and when the shareholders’ equity may potentially be wiped out.

It is thus important that legal capital and capital maintenance rules are supplemented by ex post mechanisms designed to target opportunistic conduct on the part of the company controllers when trading with creditors’ money in the vicinity of insolvency. When contrasted with the protection offered by ex post mechanisms, ex ante protection of legal capital rules appears unnecessary. In addition, the role of legal capital and capital maintenance rules within the creditor protection framework is further diminished in light of the availability of contractual creditor protection mechanisms enabling creditors to protect themselves through bargaining for their preferred terms. Effective ex post mechanisms imposing directors’ duties of the creditor-regarding variety coupled with mechanisms allowing creditors to protect themselves contractually thus question the utility of legal capital rules for creditor protection in the context of developed economies.

When tested against the legal provisions and contextual considerations of a transitional economy, however, this submission cannot be readily sustained. On the one hand, the legal analysis of the rules regulating a company’s capital in Ukraine suggests that the creditor protection offered by the Ukrainian legal capital regime possesses similar limitations to those found in the context of developed economies. Since the rules only regulate the loss of corporate assets through distributions and not through trading losses, they do not guarantee that a particular level of assets will be maintained within the company as it trades. On the other hand, in view of the inadequacy of the ex post creditor protection framework in Ukraine, the limited creditor protection offered by legal capital rules emerges as a potentially useful
collective guarantee against the opportunistic withdrawal of assets by the company controllers.

However, whilst the quality of the law on the books is important for creditor protection, the practical effect of even the most basic regimes can be compromised by the corporate environment in which the regimes are intended to operate and in particular by the contextual factors of market development, ownership structure and enforcement. Indeed, the theoretical conclusions with regard to the utility of legal capital rules for creditor protection need to be qualified by references to the realities of the corporate environment. The effectiveness of a creditor protection regime can be adversely affected by underdeveloped market mechanisms, non-transparent ownership structures and weak judicial credibility. In such an environment, strengthening the business culture and raising the credibility of the judicial establishment can be partially achieved through functional convergence by way of voluntary corporate governance codes, international organisations’ initiatives, and training in international judicial standards. By bearing on the acceptance of best practices and ethics, these strategies can thus help to improve the necessary pre-conditions for effective creditor protection.
Appendix

English translations of selected Ukrainian legal provisions

Business Associations Act 1991

Part I

General provisions

Article 4. Incorporation documents of a company

(1) A joint stock company, a limited liability company and an additional liability company shall be established and shall operate on the basis of a memorandum. […]

(2) Incorporation documents must contain information on the type of the company, objects and purposes of a company's activity, a list of founders and members, name and location, stated share capital amount and capital raising procedure, profit and loss distribution procedures, composition and competencies of a company's governing bodies and decision-making procedure, including a list of matters requiring qualified majority voting, procedure for altering incorporation documents and liquidation and reorganisation procedures.

Article 13. Contributions of the founders and members of the company

(1) Contributions to stated share capital of a company may include cash, bonds and securities, other items or property (or other) rights, that have monetary value, if the law does not state otherwise.

(2) The valuation of members' contributions is carried out in accordance with an agreement between the members of the company; in cases, prescribed by the
Article 14. Funds of a company

(1) A company must establish a reserve (insurance) fund in the amount stated in the incorporation documents, but in any event it cannot be less than 25% of the stated share capital. [...] 

(2) The amount of annual contributions to the reserve (insurance) fund is to be determined in the incorporation documents, but in any event cannot be less than 5% of net profit.

Article 15. Profit of a company

The profit of a company is formed of the proceeds of a business activity after the monetary and related expenses, including wages, have been covered. Interest on bank loans and securities, as well as taxes and other contributions to the budget, stipulated by the Ukrainian legislation, are to be paid out of the balance sheet profit of a company. After all of the above payments have been made, the resulting net profit shall be entirely at the company’s disposal, and the company shall determine its uses in accordance with the incorporation documents.

Article 16. Alterations of the stated share capital

(1) A company has a right to alter (increase or reduce) the amount of the stated share capital.

(2) An increase in the amount of the stated share capital can be carried out only after all of the company’s members have fully paid up their shares, except when this Act stipulates otherwise.

(3) A reduction in the amount of the stated share capital is prohibited in the event of objections by the company’s creditors.

(4) A company’s decision to alter the amount of the stated share capital comes
into force from the date the changes are entered into the state register.

Section II. Types of companies

Chapter 1. A Joint Stock Company

Article 24. Definition of a joint stock company

(1) A joint stock company is a company whose stated share capital is divided into a specified number of shares of equal nominal value, and whose liabilities are limited to the assets of the company.

(2) Liability of the shareholders of a joint stock company for a company’s obligations is limited to their shares.

(3) In cases, stipulated by the memorandum, shareholders whose shares are not fully paid up, are also liable for a company’s obligations to the extent of the unpaid amount.

(4) The total nominal value of the issued shares constitutes the stated share capital of a joint stock company, which cannot be less than the sum of 1,250 minimum wages’ amounts, based on the minimum wage rate at the time of incorporation of a joint stock company.

Article 25. Types of joint stock companies

(1) Joint stock companies include: an open joint stock company, the shares of which can be distributed through public subscription and trading on a stock exchange; and a closed joint stock company, the shares of which are divided between the founding members and cannot be distributed through subscription or traded on a stock exchange.

(2) A closed joint stock company may be re-registered as an open joint stock company through the registration of its shares in accordance with the procedure, stipulated by the securities and stock market legislation, and
through a subsequent amendment of the company memorandum.

**Article 30. Open subscription for shares**

(1) Open subscription for shares on incorporation of a joint stock company shall be organized by the founding members. The founding members shall in any case hold shares in the amount of at least 25% of the stated share capital for a term of at least two years.

(4) Persons who wish to purchase the shares must transfer to the founding members' account at least 10% of the price of the shares for which they subscribed, after which the founding members shall issue these persons with a written undertaking to sell a corresponding number of shares.

(7) Prior to calling the initial incorporation meeting, persons who subscribed for the shares must pay up at least 30% of the nominal value of the shares, inclusive of the initial deposit. The founding members shall issue temporary certificates to confirm the payment.

**Article 32. Repurchase of own shares by a joint stock company**

A joint stock company shall have the right to redeem its own paid-up shares from a shareholder only out of the sums which exceed the stated share capital amount, for the purpose of the subsequent re-sale, distribution among the company's employees or annulment of the shares. The aforementioned shares must be realised or annulled within a term not exceeding one year. During this term, decisions on the distribution of profits, as well as voting and quorum determination procedures at the general meeting must not take into account the shares redeemed by a joint stock company.

**Article 33. Payment for shares**

(1) Within a period, determined by the initial incorporation meeting, but in any event not later than one year after the registration of a joint stock company, a shareholder shall pay up the shares in full.
(2) In the event of non-payment within the stipulated period, a shareholder shall be liable to pay a 10% annual interest on the unpaid sum, unless a company’s memorandum stipulates otherwise.

(3) In the event of non-payment within three months of the agreed payment date, a joint stock company has the right to realise the shares in question in accordance with the memorandum.

**Article 38. Procedure for increasing the stated share capital of a joint stock company**

(1) Subject to approval by the general meeting, a joint stock company has a right to increase its stated share capital, if all the shares issued previously are fully paid up at a price which is not less than the nominal value.

**Article 39. Procedure for a reduction of the stated share capital of a joint stock company.**

(3) A reduction in the stated share capital of a joint stock company is allowed after all of the company’s creditors have been informed in accordance with the procedure, stipulated by the law. At the same time, creditors of the company have the right to demand a premature termination of the credit agreement or for a company to fulfill its obligations and cover any losses.

(6) If, after the end of the second and every consecutive financial year, the value of net assets of a joint stock company is found to be less than the stated share capital amount, a company must announce the reduction of its stated share capital and amend the company’s memorandum accordingly. If the value of net assets becomes less than the minimum capital amount, stipulated by the law, a company becomes subject to a liquidation.
Article 152. Definition of a joint stock company

(1) A joint stock company is a company with stated share capital divided into a specified number of shares of equal nominal value.

[...]

Article 155. Stated capital of a joint stock company

(1) Stated capital of a joint stock company shall be formed from shareholder contributions in return for purchased shares.

Stated capital of a company shall represent the minimum amount of a company's assets, guaranteeing the interests of the company's creditors. It cannot be less than the statutory minimum capital amount.

(2) On incorporation of a joint stock company, all of its shares must be distributed among the founding members. Open subscription for shares of a joint stock company shall not take place until the stated share capital has been fully paid up. The process for open subscription shall be stipulated by the law.

(3) If, at the end of the second and every consecutive financial year, the value of net assets of a joint stock company is found to be less than the stated share capital, a company must announce the reduction of its stated capital and amend a company's memorandum accordingly. If the value of net assets of the company becomes less than the statutory minimum stated share capital amount, a company becomes subject to liquidation.
Article 157. Reducing the stated capital of a joint stock company

(1) A joint stock company shall have the right, subject to a decision by the general meeting of shareholders, to reduce its stated capital by reducing the nominal value of the shares or by buying back part of the issued shares with the aim of reducing the total number of shares.

Reducing the stated capital of a joint stock company shall be allowed after all of the company’s creditors have been informed in accordance with the procedure, stipulated by the law. The company’s creditors shall have the right to demand an early termination of the credit agreement or the fulfillment by the company of its obligations and compensation for any losses.

(2) A reduction of the stated capital of a joint stock company by repurchasing and annulling of part of the shares is allowed, if the company’s memorandum so allows.

(3) The consequence of reducing the stated capital of a joint stock company below a statutory minimum is liquidation.

Article 158. Limitations with regard to the issue of securities and the payment of dividends

[...]

(3) A joint stock company shall not have the right to announce and pay out dividends:

1) until the stated capital has been fully paid up;
2) if the value of the net assets of a joint stock company falls below the amount of stated capital and reserve capital fund;
3) in other circumstances, stipulated by the law.
Securities and Stock Exchange Act 2006

Part II

Types of securities

Article 6. Shares

(3) A share shall have a nominal value, denominated in the national currency. A minimum nominal value of a share cannot be less than 1 kopeika.

Draft Joint Stock Companies Act

Part I. General provisions

Article 7. Determining market value of the assets

(1) Market value of the assets, in the event of their valuation in accordance with this Act, other acts or the memorandum of a joint stock company, shall be determined on the basis of an independent valuation, carried out in accordance with legislation governing asset valuation, property rights and professional valuation activity.

A decision on the entity that will carry out the valuation shall be taken by the supervisory board of a joint stock company (during incorporation – by the initial incorporation meeting).

(3) A supervisory board of a joint stock company (during incorporation – the initial incorporation meeting) shall approve the market value of the assets (securities).
Part II. Formation of a joint stock company

Article 9. The incorporation meeting of a joint stock company

(1) The incorporation meeting of a joint stock company shall take decisions with regard to:

(2) approving the valuation of the assets, contributed by the founding members as payment for the shares of the company;

Part III. Capital of a joint stock company

Article 13. Stated share capital and balance sheet capital of a joint stock company

(1) The minimum amount of the stated share capital of a joint stock company shall constitute the sum of 2,500 minimum monthly salaries. The stated share capital of the company shall represent the minimum amount of a company’s assets, guaranteeing the interests of the company’s creditors.

(2) The amount of balance sheet capital (the value of net assets) of a joint stock company is the difference between the total amount of the company’s assets and the amount of its obligations to third parties, and is determined in accordance with accounting standards.

(3) If, after the end of the second and every consecutive financial year, the value of net assets of a joint stock company is found to be less than the stated share capital amount, a company must announce the reduction of its stated share capital and amend the company’s memorandum accordingly. If the value of net assets of a company becomes less than the statutory minimum stated share capital amount, a company must, within the period and according to the
procedure stipulated by the State Commission on Securities and Stock Market, correct this irregularity or take a decision on liquidation.

**Article 15. Reducing the stated share capital amount**

[...]

(2) After taking the decision to reduce the stated share capital of a joint stock company, the executive organ of the company must inform every creditor of such a decision in writing within thirty days.

(3) A creditor, whose claims towards a joint stock company are not secured by a pledge or security, within thirty days of receiving a notification specified in Part 2 of this Article, can submit a written request to the company, following which a company must, within forty five days, choose and carry out one of the following measures: to secure creditors' claims through a pledge or security agreement; or to either terminate the loan agreement or fulfil the company's obligations to creditors, covering any losses, provided that the loan agreement between the company and the creditor does not stipulate otherwise.

**Article 18. Capital reserve fund**

(1) A joint stock company must establish a reserve capital fund in the amount not less than 15% of the stated share capital amount. Capital reserve fund is formed from undistributable profits by way of annual contributions from the net profit of a company. Until the capital reserve fund reaches the statutory requirement, the amount of annual contributions must not be less than 5% of annual net profit.

[...]
Part IV. Securities of a joint stock company

Article 21. Share price

[...]

(2) A joint stock company must not issue shares at a price below their nominal value.

Article 22. Payment for securities

(1) In the event of securities allocation by a joint stock company, payment for securities shall take monetary form or, based on the agreement between the company and the investor, the form of tangible property rights, intangible property rights, which have monetary value, securities (except bonds issued by the buyer, and bills of exchange), other assets or by way of taking into account company’s obligations towards the buyer, which arose prior to securities allocation.

Payment for securities in the form of an undertaking to carry out work or provide services for the company is prohibited.

[...]

Part VI. Dividends of a joint stock company

Article 29. Dividend distribution procedure

[...]

(2) Dividend distribution shall be made out of the net profit in a given accounting year in the amount, determined by the decision of the general meeting of a joint stock company within a maximum of six months of the end of the accounting year.
Article 30. Limitations on dividend distribution

(1) A joint stock company has no right to carry out a dividend distribution with respect to the ordinary shares when:

[...]

3) balance sheet capital (the value of net assets) of the company is below the combined sum of stated share capital, reserve capital fund and the amount by which liquidation value of preference shares exceeds their nominal value.

[...]

Property Valuation, Property Rights and Professional Valuation Activity in Ukraine Act 2001

Part II

Foundations of property valuation

Article 7. Occurrences of property valuation

Property valuation shall take place in circumstances, stipulated by the Ukrainian legislation, international agreements, on the basis of a contract, as well as at a request of one of the parties to the agreement and upon consent by the parties.

Property valuation is mandatory in the following circumstances:

the formation of an enterprise (company) on the basis of state property or property which is communally owned;

the re-organisation, bankruptcy, liquidation of state and communal enterprises and
enterprises (companies) part-owned by the state;

[...]

determination of the value of the company members’ and company founders’ contributions, if the contributions include property of companies part-owned by the state, and in the event of a member’s or founder’s exit from a company;

[...]

Independent property valuation is mandatory in the event of pledging state property as security, [...].

Restoring a Debtor’s Solvency or Declaring a Debtor Bankrupt Act 1999

Part I

General provisions

Article 1. Definitions

[...]

Restoration of solvency – a framework of measures, undertaken in the course of bankruptcy proceedings, seeking to prevent the debtor being declared bankrupt and the debtor’s liquidation, aimed at the rehobilitating the debtor’s financial and economic situation, as well as at satisfying creditors’ claims in full or in part through credit, restructuring of the enterprise, its debts and capital structure, and (or) changing the legal status and production structure of the debtor;

[...]
Interested persons with regard to the debtor — a legal entity formed with the debtor’s participation, debtor’s manager, members of the debtor’s managing organs, the debtor’s chief accountant (accountant), including those persons who were made redundant within a year of the start of the bankruptcy proceedings, as well as persons who have family connections with the aforementioned persons […], specifically, spouses and children, parents, brothers, sisters and grandchildren. For the purposes of this Act, interested persons with regard to the restoration of solvency manager or the creditors are subject to the same list as interested persons with regard to the debtor.

Moratorium on satisfying creditors’ claims — a suspension on the borrower’s monetary obligations and obligations with regard to the payment of taxes and duties (mandatory payments), which became due prior to the date of the introduction of the moratorium, and suspension on the measures aimed at securing the fulfilment of the said obligations and obligations as to the payment of taxes and duties (mandatory payments), initiated prior to the decision to introduce the moratorium.

[...]

Part II

Bankruptcy proceedings

Article 7. Application initiating the bankruptcy proceedings

(1) An application to initiate bankruptcy proceedings is made by the borrower or the creditor in written form, […].

(7) An application by a creditor must contain, in addition to the information required by part (1) of this Article, the following:

the amount of the creditor’s claim against the debtor indicating the amount of any fines and penalties to be paid;

evidence confirming debtor’s obligation towards the creditor that gave rise to the claim, as well as the obligation’s due date;
proof that the amount of the confirmed claims exceeds the sum of three hundred (300) statutory minimum wages' amounts, unless otherwise stipulated by this Act;

proof that the creditors' claims are justified;

other evidence in support of the creditor's application.

(9) An application by a creditor can be based on the debtor's consolidated debt under the debtor's various obligations to this creditor.

Creditors have the right to consolidate their claims against the debtor and apply to the court with a single petition. Such an application is signed by all creditors, who have consolidated their claims.

In the course of bankruptcy proceedings, interests of all the creditors are represented by the creditors' committee, established in accordance with this Act.

Article 11. Initiation of the bankruptcy proceedings

(5) With the aim to identify all creditors and persons willing to take part in the restoration of the debtor's solvency procedure, the judge shall make a ruling at the preliminary hearing obliging the applicant to place an announcement of the start of the bankruptcy proceedings in an official publication within ten days of the hearing at its own expense. The newspaper announcement shall contain full name of the debtor, the debtor's postal address, its bank details, name and address of the commercial court, case number and information on the property administrator.
Article 12. Securing creditors' claims and a moratorium on satisfying creditors' claims

(4) A moratorium on satisfying creditors' claims shall be introduced at the same time as the initiation of the bankruptcy proceedings, and this shall be indicated in the commercial court's ruling.

Whilst the moratorium on satisfying creditors' claims is in force:

- debt collection on the basis of executive instruments and other documents that allow for lawful debt collection is prohibited;
- fines and penalties, and other sanctions for failure to fulfill or improper fulfillment of monetary obligations and obligations as to the payment of state pension contributions and taxes and duties (mandatory payments) are not applied.

(6) A moratorium on satisfying creditors' claims does not apply to the payment of wages, alimony, compensation for personal injury claims and royalties.

(7) The moratorium is terminated from the date of the termination of the bankruptcy proceedings.

Article 14. Identifying creditors and persons willing to participate in the restoration of debtor's solvency procedure

(1) Unsecured creditors whose claims arose prior to the date of the initiation of the bankruptcy proceedings, must submit written applications with claims against the debtor, as well as supporting documentation, to the commercial court within thirty days of the date of the announcement of the start of the bankruptcy proceedings in the official publication.

[...]

Copies of the aforementioned applications and accompanying documentation
shall be sent by the creditors to the debtor and the property administrator.

(2) Unsecured creditors' claims, which are submitted after the expiration of the stipulated term or are not submitted at all, shall not be considered and shall be deemed settled, and this shall be indicated by the commercial court in the ruling approving the register of creditors' claims. The stipulated term is final and is not subject to renewal.

(6) Creditors' claims, which are accepted by the debtor or approved by the commercial court, shall be included in the register of creditors' claims by the property administrator.

Article 16. Holding a creditors' meeting and establishing a creditors' committee

(1) Within ten days of the ruling made by the commercial court at the preliminary hearing, the property administrator shall inform the creditors included in the register of creditors' claims and the person with the power of attorney appointed by the shareholders or members of a limited or additional liability company of the time and place of the creditors' meeting, and shall organise the meeting.

The participants of the creditors' meeting with the right to vote shall be the creditors whose claims have been included in the register of creditors' claims. A representative of the debtor's employees, a person with the power of attorney appointed by the shareholders or members of a limited or additional liability company and the arbitration manager can take part in the meeting with an advisory vote.

(4) Creditors [...] at the creditors' meeting shall have the number of votes proportional to the total sum of creditors' claims, included in the register of creditors' claims, and divisible by UAH 1,000.

(5) The competencies of a creditors' meeting shall include making decisions with regard to:
electing members of the creditors' committee;

determining the number of members in the creditors' committee, determining its powers and early termination of the powers of the creditors' committee or of its individual members;

other issues, stipulated by this Act.

(6) The creditors' meeting shall elect a creditors' committee for the duration of the bankruptcy proceedings, with the membership of the committee not exceeding seven persons.

The creditors' committee shall be elected in accordance with the list by creditors, present at the meeting, by an open majority, with the number of votes determined according to part 4 of this Article.

(8) The competencies of a creditors' committee shall include making decisions with regard to:

electing a chairman of the committee;

calling a creditors' meeting;

preparing and concluding a settlement agreement;

submitting proposals to the commercial court with regard to the extension or reduction of the term for administration of the debtor's property procedure or restoration of the debtor's solvency procedure;

petitioning the commercial court to commence a restoration of solvency procedure, to declare debtor a bankrupt and open a liquidation procedure, to terminate the powers of the arbitration manager (property administrator, restoration of solvency manager, liquidator), [...];

other issues, stipulated by this Act.
The arbitration manager, a representative of the debtor's employees, a person with the power of attorney appointed by the shareholders or members of a limited or additional liability company and, if necessary, a representative of an organ, authorised to manage the debtor's property, and a representative of the local government, shall have the right to take part in the work of the committee with the right of an advisory vote.

(9) A decision by a creditors' meeting (creditors' committee) is deemed approved by the majority of creditors' votes, if the creditors present at the meeting (committee) voted in its favour, with the number of votes having been determined in accordance with part 4 of this Article.

Article 17. Approving the restoration of debtor's solvency plan, appointing the restoration of solvency manager and his/her powers

(1) At the request of a creditors' committee, the commercial court, within a period that does not exceed the term stipulated by this Act for property administration procedure, shall have the right to approve the plan of the restoration of the debtor's solvency and the appointment of the restoration of solvency manager.

The restoration of solvency is introduced for a period of no more than twelve months.

At the request of a creditors' committee or the restoration of solvency manager or the investors, this period can be extended by six months or reduced.

(2) The creditors' committee shall make a decision on the approval of the candidate for the position of the restoration of solvency manager, on the choice of investor (investors), on the approval of the restoration of solvency plan.

[...]
An agreement, concluded by the debtor, including an agreement concluded prior to the restoration of solvency ruling by the commercial court, can be found void by the commercial court following an application by the restoration of solvency manager in accordance with the civil law, if:

an agreement was concluded by the debtor with the interested persons and as a result of which creditors suffered or may suffer losses;

an agreement was concluded by the debtor with a particular creditor or another person within six months preceding the date of the restoration of solvency ruling, and gives preference to one creditor over other creditors, or is related to the return of a part of the debtor’s assets in connection with a member’s exit from the debtor company.

All the proceeds under such an agreement shall be returned to the parties concerned.

Applications by the restoration of solvency manager seeking to invalidate the agreements and return all the proceeds under such an agreement shall be considered by the commercial court as part of the bankruptcy proceedings.
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