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ON THE NEED TO EXAMINE THE REASONABILITY OF MAINTAINING A COMPLETE BAN ON FINANCIAL ASSISTANCE IN UKRAINIAN LAW IN THE CONTEXT OF EU AND POLISH LEGISLATION

1. Introduction

Pursuant to Article 23(5) of Ukrainian Joint-Stock Companies Law (Act of 17/09/2008 № 514-VI), joint-stock companies cannot provide financial assistance for the acquisition of their own shares to third parties. This pertains to financial assistance provided by companies in the form of loans and loan facilities and by providing a surety (or other type of security) for liabilities incurred by third parties to acquire shares of those companies (a so-called financial assistance ban).

The history of financial assistance bans dates back to the 1920s. It starts with the measures adopted in the United Kingdom following the financial crisis triggered by the takeover boom of 1919-1920. One of the causes of the crisis was the widespread use of a strategy that involved the financing of corporate buyouts using the assets of acquired companies. The British legislator concluded that "companies cannot be bought with their own money" and in Section 16 of the Companies Act 1928 explicitly banned companies from providing financial assistance for the acquisition of their own shares, in particular by way of making loans and providing security.

From that moment on, special regulations on the financing of acquisition of companies' own shares have not only made their way into the legislation of most European states, but have also spread to other continents. Their introduction was not limited to the legal systems that rely on the British Companies Act (such as Australia, New Zealand, India, Singapore, the Republic of South Africa, Nigeria or certain Canadian provinces) – they became a rule in states that follow the Roman, Portuguese (e.g. Angola, a former Portuguese colony), French, Spanish (e.g. Paraguay) or Italian (e.g. Venezuela) legal traditions. Meanwhile, no equivalent laws can be found in such states as the US, Switzerland, Russia, the Chinese People's Republic, Brazil and the United Arab Emirates [1; 2, p. 629-639; 3].

Over time, the approach to financial assistance has evolved. Many countries have gradually decided to ease their absolute bans on financial assistance. However, as evidenced by Article 23 of the Joint-Stock Companies Law, Ukraine has not decided to make a similar move. Ukrainian law still mandates a ban of financial assistance, which, interestingly, is exceptionally strict, as it does not allow for any exemptions for ordinary activity of banks and activities related to the acquisition of shares by employees or on employees' behalf (such exemptions are typical for most legal systems that have opted for the ban).

In 2008, Poland decided to relax its financial assistance ban. This paper sets out to discuss current Polish legislation, the EU model it is based upon and encourage Ukrainian legal scholars to examine the potential for easing the Ukrainian financial assistance ban. This topic is attracting more and more attention among foreign legal scholars [see e.g. 4; 5; 6; 7]. In this article I present selected outcomes obtained in research carried out by me within a project financed with the funds awarded by the Polish National Science Centre, decision No. DEC-2013/09/N/HS5/04309.

2. EU model

The diffusion of financial assistance regulations in Europe is largely attributable to the EU model. The first financial assistance ban made its way into EU law in 1976 following the adoption of the Second Directive of the Council No. 77/91/EEA of 13/12/1976 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 (EU OJ L 26 of 31/1/1977 p.1). Its provisions remained in force unchanged for nearly three decades. Pursuant to Article 23(1) of the Second Directive, a company could not advance funds, make loans, nor provide security with a view to the acquisition of its shares by a third party. The only exceptions from the ban on financial assistance were set forth in Article 23(2) and 23(3) of the Second Directive. They exempted the transactions concluded by banks and other financial institutions in the normal course of business and transactions effected with a view to the acquisition of shares by or for the company's employees or the employees of an associated company (on condition that they did not cause the reduction of company's net assets below a specified level) from that ban.

Over time the ban on financial assistance, whose economic reasonability has not been supported with evidence, has come under growing criticism. On

the one hand, the ban was shown to fail in preventing abuse it was meant to eliminate, while blocking economically reasonable *bona fide* transactions on the other. In consequence, in 2006, the EU legislator amended the Second Directive and replaced a general ban on financial assistance with a general approval of such practices, conditional only upon satisfying the premises laid down in Article 23(1)(2)-(5) of the amended directive. Pursuant to those provisions, such transactions take place under the responsibility of the administrative or management body at fair market conditions, and require thorough investigation of the credit standing of the third party, or each counterparty in the case of multilateral transactions. The transaction requires prior approval of the general meeting granted by a qualified majority of 2/3 of votes (or, potentially, ordinary majority of votes if at least a half of subscribed share capital is represented at the meeting). The administrative or management body must present a written report to the general meeting, indicating the reasons for the transaction, the interest of the company in entering into such a transaction, the conditions on which the transaction is entered into, the risks involved in the transaction for the liquidity and solvency of the company and the price at which the third party is to acquire the shares. The report must be submitted to the register for publication. The aggregate financial assistance granted to third parties cannot result in the reduction of the net assets below the specified amount (as a rule the subscribed share capital plus provisions that cannot be disbursed under law or corporate statutes). The company must include, among the liabilities in the balance sheet, a reserve, unavailable for distribution, of the amount of the aggregate financial assistance. Where a third party by means of financial assistance from a company acquires that company's own shares issued in the course of an increase in the subscribed capital, such acquisition or subscription must be made at a fair price.

Apart from amending Article 23(1) of the Second Directive, the EU legislator added new Article 23a aimed at preventing the conflicts of interests in transactions with company's affiliates. It mandates that member states introduce appropriate safeguards ensuring that financing transactions between company and members of the company's or its parent's administrative or management body, the parent or individuals acting in their own name, but on behalf of the members of such bodies or on behalf of such undertaking, do not conflict with company's own interests.

The Second Directive was repealed by Directive 2012/30/EU of the European Parliament and the Council of 25/10/2012 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 54 of the Treaty on the Functioning of the European Union, 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 (EU OJ L 315 of 14/11/2012, p.74), which contained analogous rules to those included in the Second Directive (in its wording of 2006). Subsequently, in 2017, Directive 2012/30/EU was repealed by Directive of the European Parliament and the Council (EU) 2017/1132 of 14/06/2017 relating to certain aspects of company law.

3. Polish regulation

Polish legislation has followed the developments in EU law. In 2000, the newly adopted Polish Code of Commercial Companies (CCC) of 15/09/2000 (OJ 2017.1577 as amended), introduced a ban on financial assistance to Polish law. Article 345(1) CCC provided that "Company cannot make any loans, provide security, advance funds or directly or indirectly finance in any other way the acquisition or subscription of its own shares". The only exceptions from this rule involved performances delivered within ordinary activity of financial institutions and performances to the employees of the company or its affiliate, made in order to facilitate the acquisition of or subscription for shares issued by the company.

In 2008, in the wake of the amendment to the Second Directive, the general ban on financial assistance was waived. The recast Article 345(1) now reads: "company may, as a rule, either directly or indirectly, finance the acquisition or the subscription of shares it issues, in particular by extending a loan, disbursing an advance payment or establishing a collateral". The legislator introduced a general approval of financial assistance, but made its validity dependent on compliance with certain procedural requirements laid down in Article 345(2)-(7) CCC. Those provisions require, among other things, that financial assistance be extended on arm's length terms and following an investigation of debtor's solvency (Article 345(2)). Additionally, to provide financial assistance it is necessary to: establish a reserve capital allotted to financing (Article 345(4)); prepare company's management board's report on financing (Article 345(6)) to be submitted to registry court and published (Article 345(7)); adopt a general meeting's resolution on financing (Article 345(5)); and acquire or subscribe for the shares issued by company for a fair price (Article 345(3)).

4. A potential relaxation of the Ukrainian ban on financial assistance in the context of Polish experiences

Many European Union member states have decided not to ease their financial assistance bans. Of 28 EU members, a small minority chose to

implement the latest European regulation on financial assistance. This group includes: Belgium, Croatia, the Czech Republic, Denmark, Greece, the Netherlands, Luxembourg, Poland, Hungary and Italy [1; 8, p. 11]. Also outside the European Union (for instance in Ukraine), bans on financial assistance are still quite frequent. Was Poland right then to relax the ban on financial assistance for the acquisition or subscription of shares issued by joint-stock companies? In my view – it was. As a rule, the amendment to Article 345 CCC of 2008 should be seen as a positive development. My empirical research (involving an analysis of announcements on financial assistance published in the official journal entitled Monitor Sądowy i Gospodarczy) has shown that the rules governing financial assistance are being practically applied in Poland, and companies do provide financial assistance for the acquisition or subscription of their own shares [5, p.337-338]. Had the Polish legislator failed to ease the ban on financial assistance, some of the transactions that we have observed over the recent years could not have gone through. Business operations would have been affected by unnecessary restrictions.

It seems that the Ukrainian legislator could consider the potential relaxation of the financial assistance ban as well. Inspiration can be drawn both from UE law and national legislation in those countries where specific solutions that go beyond the model laid down in Directive 2017/1132 were adopted (such as Italy and the Czech Republic). Additionally, the Ukrainian legislator enjoys more freedom in this respect, as it is not bound by the EU law and is not required to transpose those provisions of Directive 2017/1132 that it finds too far-reaching. This pertains, in particular, to the rules that determine premises for legality of financial assistance. It is precisely due to the difficulties with complying with certain of those criteria that many EU member states have rejected the new European financial assistance regime. For instance, Polish regulation regarding financial assistance is particularly burdensome when it comes to the requirement to establish reserve capital for that purpose from funds that, pursuant to Article 348(1) CCC, could be allocated to distribution among shareholders (Article 345(4) CCC). Importantly, companies with large cash provisions (which could establish reserve capital to finance the acquisition on their own) are not typically the ones being acquired. Rather, buyouts concern companies of weaker financial and organisational standing (but with a major growth potential). Such companies are unable to meet the condition referred to in Article 345(4) CCC. It is equally troublesome that Article 345(2) CCC mandates the investigation of the solvency of the debtor, namely the acquiring party, while (in the case of leveraged transactions), such solvency ratios in typical circumstances are not very high.

Importantly, the Ukrainian legislator should be weary of defining the catalogue of financial assistance forms too broadly. Polish lawmakers fell into this trap and constructed a catalogue of financial assistance forms which is completely open. Article 345(1) CCC provides that: "company may, as a rule (...) finance the acquisition or the subscription of shares it issues, **in particular** [boldfaced by JJ] by extending a loan, disbursing an advance payment or establishing a collateral". This approach is exceptional when compared to regulations in other countries, which typically list specific forms of financial assistance. At first glance to open the catalogue of financial assistance forms could seem to be the right move, as a way of preventing the evasion of law. However, this assumption has not been confirmed in practice. An open catalogue of financial assistance forms turned out to be a source of major interpretative problems. They mostly concern the so-called MLBOs (merger leveraged buyouts) – the dominant form of corporate buyouts in the market. In an MLBO, a party intending to go ahead with a buyout incorporates a special purpose vehicle that obtains debt financing and then acquires shares in the company being bought out. Subsequently, both companies merge, and the acquiring or newly incorporated company repays the liabilities incurred by the special purpose vehicle using, among other things, assets of the acquired company to repay the debt. Should such transactions be classified as a form of financial assistance within the meaning of Article 345 CCC, it would be necessary to make their legality dependent on compliance with the criteria laid down in Article 345(2)-(7) CCC. Those criteria are, however, completely inadequate as far as MLBOs are concerned [5, p. 118-129]. In fact, it would be most appropriate to exempt MLBO transactions from financial assistance rules and introduce a separate regulation in the Code. Preferably, the regulation should find its place in the section on corporate mergers and should require that the documentation developed during the merger process specify the manner of repayment of liabilities incurred to effect the buyout by the surviving company [5, p. 155-158]. Article 2501-bis of the Italian Codice Civile can serve as an inspiration for potential amendments in this field (Codice Civile of 16/3/1942, Gazzetta Ufficiale No. 79 of 4/4/1942, Serie Generale as amended). Furthermore, it would be recommendable to prevent excessively leveraged companies from participating in MLBOs, in order to prevent subsequent bankruptcies of companies involved in such transactions. In this respect, interesting solutions can be found in Czech law. One of the criteria which determine the admissibility of financial assistance in the Czech Commercial Code is that it cannot cause the financing company to go bankrupt (§ 161f (1)(h) of the Obchodní zákoník Act No. 513/1991).

Insofar as other issues that deserve Ukrainian legislator's attention are concerned, when drafting a new financial assistance regulation it would be useful to refer to the matters of conflict of interest inherent in the transactions with affiliates, management in particular. Directive 2017/1132 contains relevant rules to this effect (Article 65), but they are implemented into Polish law only to a small extent. Particular problems appear in the case of MBO transactions, as conflict of interest is inherent to them and affects every single stage of the process. On the one hand, the managers – as representatives of the company – must act in the best interest of the company and aim at maximising the benefits of its shareholders (sellers of shares). Failure to meet this duty exposes them to risk of penal and civil liability. On the other hand, however, as the buyers (or subscribers) of the shares of that company they are personally interested in ensuring that the MBO transaction be carried out on the best terms and conditions for themselves. Importantly, managers have a major advantage when compared to the sellers of shares due to the asymmetry in the access to information. In the end, board members, and not shareholders, have the best knowledge of the company's situation, including its corporate opportunities, and the actual value of the company's shares. Furthermore, they can influence the share price.

However, despite the clear mandate laid down in Article 65 of Directive 2017/1132, the Polish legislator failed to introduce "appropriate safeguards" to ensure that the financing is not in conflict with the best interest of the financing company when the other party to the financing transaction is an affiliate – managers of the company, its parent, the parent itself and individuals acting in their own name but on behalf of such entities. Lawmakers concluded that other commonly binding regulations of Polish company law (Article371(1), Article 15(2), Article 344 and Article 20 CCC in particular) guarantee a sufficient level of protection in transactions with affiliates. I do not share this view. In my opinion, Article 65 of Directive 2017/1132 requires broader transposition into Polish law. Polish legislator is right to point out to a number of general safeguards in the Code of Commercial Companies, but the effectiveness of those measures in MLBOs is low. They do not ensure appropriate protection required by Article 54 of Directive 2017/1132 when the counterparty is company's affiliate.

Similar remarks apply to the general rules governing liability established by Polish provisions on financial assistance. The effectiveness of claims for damages, compensation or organisational claims that can be submitted to persons liable for breach is illusory, since in practice there are either no entities interested in pursuing the claims (the manager who has become the owner of

the company will not submit a claim against himself) or even if such entities do exist (minority shareholders) they lack sufficient determination to engage in disputes, or to initiate actio pro socio litigation, which is simply financially unreasonable to them. This problem requires Polish legislator's interference as well. It is necessary to fully implement Article 65 of Directive 2017/1132 in Polish law. I believe that the most appropriate way of implementing EU provisions would involve ensuring – in cases referred to in Article 65 of Directive 2017/1132 – that shareholders have more reliable and fuller access to information on financing before they vote to adopt a relevant resolution. This objective can be achieved by extending the required content of management board's report on financing drafted as a part of a process to provide company's financial support to its affiliates and mandating the audit of the report by a certified auditor. What is more, it is advisable to introduce a requirement that transactions with affiliates be compliant with the best interest of the company. When drafting the potential new financial assistance solutions, the Ukrainian legislator should take these matters into account as well.

Conclusions

As the results of empirical research have shown, to prohibit financial assistance completely is no longer a reasonable choice. To examine the ban on financial assistance in Ukrainian law seems a worthwhile task for Ukrainian legal scholars and the national legislator, as it could contribute to increasing the number of transactions in the Ukrainian capital market. When drafting the new law, it is recommendable that the Ukrainian lawmakers rely on the experiences of the states that have already eased their financial assistance bans (e.g. Poland, Italy, the Czech Republic). As far as the Polish case is concerned, it is useful to consider the following (1) the catalogue of financial assistance forms should not be too broad, to avoid the inclusion of such transactions that cannot comply with financial assistance legality criteria; (2) the drafted regulation should explicitly govern the admissibility of MLBO transactions and prevent mergers of excessively leveraged companies on their basis; and (3) it is particularly important to establish effective mechanisms preventing the conflict of interest in transactions when financial assistance is provided to an affiliate.

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