Squeeze-Out of Minorities: More General Action Needed

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There was a short period of time in the history of Ukraine's corporations when corporate ownership was dispersed and control over the recently privatized companies was held by company management. The percentage of shares controlled by the managers was modest, the companies were open to takeovers and the country desperately needed proper takeover rules to protect minorities and to curb the powers of the directors.

These rules, stripped of much of their meaning and potential, were introduced in 2009, when the *Joint Stock Company Act* came into effect. Had this Act come about 15 years ago, the takeover rules, as imperfect as they were, could have played a positive role.

By 2009 all major corporations had become private by nature and saw control over them heavily concentrated. Yet most of these companies retained public form. Thousands, sometimes tens of thousands, of shareholders in many such companies were diluted. Their aggregate shareholdings were reduced to less than 0,01% shares, pursuant to the regulator.[1]

Late introduction of the rules governing public companies was initially simply useless as there were no companies left to enjoy them. With time, it has become harmful. The law imposes a public form on all corporations where the number of shareholders exceeds 100. The vast majority of these companies have never had their shares listed on a stock exchange. Yet they must carry the burden of a public form wasting money and efficiency to obtain zero benefits in return for themselves, and for the markets. Thousands of privately owned companies, trapped in the public form by the mere reason of having a significant number of their shareholders, have become hostages of the belated *JSC Act*.

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According to the data of one of the leading stock exchanges,[2] by the end of 2013 less than 130 companies (out of more than 7,000) maintained a listing of their shares. The remaining thousands desperately need the law helping them to become private. A law, which would allow them to repurchase the ballast of hundreds and thousands of shareholders representing in aggregate a negligible fraction, sometimes less than 0,01% of the entire share capital of the company. As the regulator explains, these shares have produced nothing but losses for their shareholders. The losses come from the cost of maintaining securities accounts in the depositary system and from complying with formalities of attending the general meeting. A cost, which has never been off-set against any gains.[3]

So, why don't the companies or their majority shareholders repurchase these shareholders if they prevent the companies from becoming private, a goal which they allegedly crave for?

Many of the previously public companies have done precisely this. Indeed, in many cases the companies were successful in reducing the number of their shareholders to less than 100 and subsequently got rid of their public status. But many still struggle.

There are two reasons for this. First, the high transaction cost which may be many times higher than the price of the shares in question. Second, and more importantly, the shareholders are not easily reachable for striking a deal with the company's controllers. Their whereabouts are unknown, or they are known to have left the city, or the country, or just died with no heirs willing or able to inherit the useless legacy. The scale of the problem is surprisingly big.

The solution is as evident as it is simple. The companies or their controlling shareholders must be allowed to repurchase these remaining shareholders mandatorily, with no formal contracts signed with them and with money deposited on an escrow account. The repurchased shareholders, if still existent and willing to extract at least some benefits from their shares, may collect the money within a reasonable time.

This solution was implemented in Russia back in 2006. Ukraine followed suit in 2010 when a similar law was passed by the Parliament in 3 readings but fell short of presidential approval. The law allowed a shareholder controlling 95% of the company's shares to mandatorily repurchase the remaining shareholders provided that the company in question is not listed on a stock exchange. The president vetoed the law claim-

[1] Explanatory Note to Draft Act No.4534a.

[2] Stock Exchange Perspektiva, Annual Report 2013.

[3] Explanatory Note to Draft No.4534a.

[4] The Russian Constitutional Court earlier rejected a similar claim.

[5] Draft No. 3441 did not find its way to the legislative agenda of the parliament and hence is deemed withdrawn upon resignation of the M. Azarov government.

[6] EBA Letter to the Prime Minister Arseniy Yatsenyuk dated 21 August 2014 No.869

ing, surprisingly to many, that the law violates a constitutional right to own property.[4]

This veto interrupted the development of Ukraine's corporate law for three more years. In 2013 the government made yet another attempt (Draft Act No. 3441) to adjust the form of Ukraine's corporations to their nature.

We call this attempt awkward and largely irrelevant. The vetoed law was to apply to thousands of companies whose shares are not traded on a stock exchange. It offered a remedy for the disease. The government's fresh attempt targeted only listed companies, the few healthy ones, and removed from its reach all others. The explanatory note says that, in doing so, the government approximates the Ukrainian corporate law to the EU Directive on take-over bids.

This is only remotely true. The Directive does indeed apply only to listed companies and allows a bidder to squeeze-out the remaining shareholders, provided that the bidder acquires more than 90% of shares in a public bid process. The emphasis here is on the "public bid", i.e., a public offer to all shareholders made by the purchaser pursuant to a strict set of rules. The squeeze-out rights are attached to a public bid and do not exist beyond it. If the government wishes to approximate Ukrainian law to the Directive, it should start with implementing the provisions governing public bids. Yet, rules governing public bids are non-existent in Ukrainian law and, logically enough, the government does not propose to implement them because they will be absolutely irrelevant to the nature of control over Ukrainian corporations.

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The government is cherry-picking the rules from the EU law trying to find a solution for Ukraine — specific problems. The prestige of the law from which it is borrowing must, in the opinion of the government, secure the success of the proposed solution. This is a bad strategy. Ukraine needs domestically designed rules to help its companies become more efficient.

Sadly, the new government is repeating the mistake of its predecessor. In August 2014, it submitted to Parliament its Draft No.4534a, which is a full copy of the previous Draft No. 3441[5].

The European Business Association was quick to express its cautious optimism in response to this initiative.[6] It rightly pointed out that the proposed Draft will be applicable to a handful of listed companies while the action is needed more generally.

We fully agree. We also believe that the shareholders in listed companies should be left in peace until the rules on public bids are fully implemented.

While approximation of the Ukrainian law to the *acquis* is important, the government should care first of all about its domestic problems. In the absence of a functioning stock market in Ukraine, the solutions developed within the EU to deal with the challenges of developed stock markets is a far cry from what is relevant to Ukraine. In the best casescenario, these solutions could supplement what is needed locally, not replace it.

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