

# EVOLUTION OF PRIVATE LAW

## NEW APPROACH

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Uniwersytet Śląski

WW

OFICyna WYDAWNICZA

Katowice 2016

Recenzent:  
Janusz Andrzej Strzępka

The publication of this book was supported by:

**SZiP**

ŚLĄZAK,  
ZAPIÓR  
I WSPÓLNICY



Fundacja Wydziału Prawa i Administracji US  
„Facultas Iuridica”

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**ISBN 978-83-60743-97-3**

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## REGULATION OF THE PROCEDURE OF ALIENATION OF A SHARE IN THE AUTHORIZED CAPITAL UNDER THE CONTRACT OF SALE IN LIMITED LIABILITY COMPANIES

Despite a long period of its establishment and development, corporate legislation of Ukraine requires further improvement and adjustment to high standards of European legislation. Currently, a matter of urgency is an issue of legal regulation of operation of limited liability companies (hereinafter – LLCs), since it is one of the most common legal forms of business companies that is chosen by both domestic and foreign investors for doing business in Ukraine, especially in the western region of the country. In particular, along with an opportunity to establish new LLCs or to inherit a share, one of the ways to acquire a share in the authorized capital of an LLC is to purchase corporate rights from LLCs that exist in the capital market for a certain period of time and have adequate business reputation.

The procedure of alienation of corporate rights from an LLC under a contract of sale is governed in accordance with Art. 147 of the Civil Code of Ukraine<sup>1</sup> (hereinafter – CC) and Art. 53 of the Law of Ukraine “On Business Associations”<sup>2</sup>. Pursuant to these norms, it is

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<sup>1</sup> Civil Code of Ukraine № 435-IV as of 16 January 2003, 40–44 *Bulletin of the Verkhovna Rada of Ukraine* 356 (2003). Retrieved June 15, 2016 from: <http://zakon2.rada.gov.ua/laws/show/435-15>.

<sup>2</sup> Law of Ukraine “On Business Associations” № 1576–XII as of 19 September 1991, 49 *Bulletin of the Verkhovna Rada of Ukraine* 682 (1991). Retrieved June 15, 2016 from: <http://zakon5.rada.gov.ua/laws/show/1576-12>.

provided that a member of a company may sell or otherwise cede his share (a part thereof) in the authorized capital. The given provision defines a share in the authorized capital of a company as a separate object of civil rights. When turning to grammatical interpretation of the phrase "a share in the authorized capital", literal understanding implies that a share is a part of the authorized capital. On this matter, I. V. Spasybo-Fatieieva notes that the authorized capital does not exist separately as an object of civil law. The authorized capital is a concept of accounting adopted by law for its purposes<sup>3</sup>.

If to refer to provisions of law, according to the Law of Ukraine "On Business Associations", the authorized capital of a company is formed of contributions that may take the form of money, securities, other tangibles, property rights or other alienable rights having monetary valuation (Part 1, Art. 13). The peculiarity of making such contributions to the authorized capital of a company is that they become the company's property and not that of its members (founders). When acquiring the status of a member of a company, a person becomes endowed with a set of rights and obligations with regard to the company that is defined by the size of his share in the authorized capital. The foregoing implies that the term "a share in the authorized capital" is identical to the concept of "corporate rights" conferred to a person acquiring the status of a member of a company. Therefore, as a subject matter of a contract, a share is a legal form that defines a set of property and non-property rights. Yet, in law enforcement practice, the concept of "a share in the authorized capital" is interpreted differently: in some cases, it is a set of property and non-property rights of a member (corporate rights); in other cases, it is property rights of a member. As a result, the subject matter of a contract of sale is defined as either corporate rights or a share in the authorized capital. Along with that, since the contract stands as an independent regulator of social relations, there appear differences in determining the mechanism for transition of corporate rights or a share in the authorized capital. Consider the procedure of alienation of a share in the authorized capital of LLCs under the contract of sale in more details.

<sup>3</sup> I.V. Spasybo-Fatieieva, *Civil Law: Towards formation of Doctrines: Selected research papers*, Kharkiv 2012, p. 125.

In the letter of the State Committee of Ukraine for Regulatory Policy and Entrepreneurship № 5410 as of 24 April 2010 "Regarding Documents on Transition or Transfer of a Share in the Authorized Capital of a Limited Liability Company", it is stated that a share (a part thereof) in the authorized capital of an LLC can be transferred on the basis of a contract of sale, a contract of exchange, a deed of gift<sup>4</sup>. Members of an LLC bear corporate rights in it and may alienate a share in the authorized capital to other company's members and the company itself.

In addition, Art. 147 of the CC and Art. 53 the Law of Ukraine "On Business Associations" provide that a member of an LLC may sell his share (a part thereof) to third persons, unless otherwise is established by the charter of a company. That is, whether it is permitted or prohibited to alienate a share in the authorized capital to third persons may be determined by the charter of an LLC. "Third persons" should be understood as persons who are not members of an LLC whereof a share in the authorized capital is being alienated at the time of purchase of a share.

Also, the legislation in force contains a number of restrictions on the free movement of a share in the authorized capital of LLCs. When concluding a contract of sale, there is a rule on the priority right to purchase a share in the authorized capital. The substance of the priority right is that members of a company shall have a principal right to purchase a share if a member of an LLC intends to sell it to a third person. Should members of a company not exercise the priority right to purchase a share in the authorized capital, this right passes to the company and / or third persons. Along with that, the consent of company's members to alienate a share in the authorized capital is not required.

However, an LLC may insert into the charter a provision whereby third persons may or may not have the right to purchase a share even in case members of a company do not exercise the priority right to purchase this share, namely:

- 1) The charter of an LLC does not provide for prohibition to alienate a share in the authorized capital of a company. When concluding

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<sup>4</sup> Letter of the State Committee of Ukraine for Regulatory Policy and Entrepreneurship № 5410 as of 24 April 2010 "Regarding Documents on Transition or Transfer of a Share in the Authorized Capital of a Limited Liability Company". Retrieved June 15, 2016 from: [http://search.ligazakon.ua/l\\_doc2.nsf/link1/DP2888.html](http://search.ligazakon.ua/l_doc2.nsf/link1/DP2888.html).

a contract of sale, a member who intends to sell a share in the authorized capital has to comply with provisions of law on the priority right to purchase a share by other members. In this case, a company is guided by regulatory provisions defined in law.

2) The company's character provides for prohibition to alienate a share in the authorized capital of a company to third persons in certain instances, such as concluding a deed of gift, a contract of exchange, and so on. Still, in what relates to the right to sell a share in the authorized capital, an LLC is guided by Clause 2, Part 2, Art. 147 of the CC providing for the priority right of other members to purchase a share that is being alienated. Should members of a company not exercise their priority right to purchase a share, the right of purchase passes to third persons. However, in the event a member of a company sells a share in the authorized capital without notifying other LLC members thereof, the latter shall have the right to bring an action on transferring rights and obligations of the buyer on them, as per Part 4, Art. 362 of the CC.

3) The charter of an LLC provides for prohibition of alienation of a share in the authorized capital, including sale of this share to third persons. That is to say that prohibition applies to all ways of alienation. In this case, members of an LLC are entitled not to admit membership of third persons in a company altogether. Still, a member who intends to sell his share in the authorized capital may conclude a contract of sale with other members or the company. Should a share in the authorized capital be acquired by the company itself, the latter shall not be passed corporate rights of a member. The company is obliged within a year since acquiring a share in the authorized capital to sell it to other persons or reduce the authorized capital. Should neither members nor the company exercise their right to purchase a share in the authorized capital, a member may withdraw from the company. A member shall exercise this right by filing an application for withdrawal and send it to the company in a manner prescribed by law. In this case, the company's right to purchase a share in the authorized capital becomes the company's obligation to pay off a member who has exercised the right to withdraw from the company.

Thus, in order to conclude a contract of sale of a share in the authorized capital a member is obliged to notify the company and its members of selling a share. The procedure of notifying the company is

not envisaged by law, so relevant provisions are to be prescribed in the LLC charter. This can be done either by giving a written notice to each member of a company or announcing sale of a share at the general meeting of an LLC. In his notice, a member has to inform the size of a share that is being sold, the price and other terms. Normally, along with the notice of sale of a share in the authorized capital there is given a draft contract wherein terms of purchase of a share are proposed. Such contract terms are to be equal for both members who enjoy the priority right to purchase a share and third persons. The notice of sale of a share in the authorized capital is to be given one month prior to the actual sale.

According to Part 2, Art. 147 of the CC, should company members reveal the intention to exercise the priority right to purchase a share (a part thereof), they are entitled to acquire a share pro rata to amounts of their shares. At the same time, the charter or agreement between members may contain other terms for distribution of a share that is being alienated. They may alter proportionality of a share by increasing or reducing the size of the alienated share in the authorized capital to be distributed among them. However, members do not enjoy the priority right to purchase a share in the authorized capital in relation to each other. Should members of an LLC not exercise the priority right to purchase a share within a month since being notified of sale of a share, the right of purchase passes to the company and third persons. Along with that, the term during which members are entitled to exercise the priority right to purchase a share in the authorized capital may be altered in the charter or by agreement between members of an LLC. Therefore, under the legislation in force, the procedure of alienation of a share in the authorized capital of an LLC may be established by the company's charter or agreement between members.

Alienation of a share to the authorized capital is also conditioned upon its payment. A member of an LLC may sell a share (a part thereof) in the authorized capital only to the extent, to which it has been paid by the member (Part 3, Art. 147 of the CC). The foregoing provision reflects the rule that no one can transfer to another more rights than he has. After all, upon the size of a share in the authorized capital there depends the amount of corporate rights of a purchaser of a share. A member may sell either the whole share or a part thereof, in which case he remains the member of the company with a share



smaller in size. Yet, in law enforcement practice, there often arise situations when a member sells the paid part of a share in the authorized capital, while still owning the part that is unpaid.

In notarial practice, there is a rule that when concluding a contract on alienation of a share in the authorized capital of an LLC, a member is to present the certificate (Art. 52 of the Law of Ukraine "On Business Associations") that attests making a contribution to the company's authorized capital, as well as the corresponding extract from the Unified State Register of Legal Entities and Individual Entrepreneurs indicating a share of the member in the authorized capital. The latter requirement is not provided by the legislation in force, but is dictated by notaries' practice and is not thus mandatory<sup>5</sup>.

However, an issue of the most practical importance concerns determining the moment of transition of corporate rights from a company's member to other persons. Corporate legislation of Ukraine does not envisage since which moment corporate rights pass to a purchaser of a share. In the letter of the State Committee of Ukraine for Regulatory Policy and Entrepreneurship № 5410 as of 24 April 2010, it is stated that when a share is being transferred from one member to another, transition of ownership of the property shall be formalized in a document pursuant to requirements of Chapter 24 of the CC<sup>6</sup>. Art. 208 and Art. 209 of the CC provide for cases of conclusion of transactions in writing and prescribe that a transaction performed in writing shall be notarized only in cases established by law or parties' agreement. If to analyze provisions of Chapter 54 that defines general terms of sale, it follows that the CC does not envisage notarization of the contract of sale of a share in the authorized capital of a company. Therefore, as a general rule, the contract of sale of a share in the authorized capital may be concluded in a simple written form. Nota-

<sup>5</sup> O. Parkhomenko, *How to Sell a Share? – Practical Issues (The Example of Kharkiv Region)*, "Yurydychnyi Radnyk" 3(39) (June 2008). [the original title of paper: О. Пархоменко, *Як продати частку? – практичні питання (на прикладі Харківського регіону)*] Retrieved June 15, 2016 from: [http://www.ilf-ua.com/ua/publications/articles/yak\\_prodaty\\_doliu/](http://www.ilf-ua.com/ua/publications/articles/yak_prodaty_doliu/).

<sup>6</sup> Letter of the State Committee of Ukraine for Regulatory Policy and Entrepreneurship № 5410 as of 24 April 2010 "Regarding Documents on Transition or Transfer of a Share in the Authorized Capital of a Limited Liability Company". Retrieved June 15, 2016 from: [http://search.ligazakon.ua/l\\_doc2.nsf/link1/DP2888.html](http://search.ligazakon.ua/l_doc2.nsf/link1/DP2888.html).

rization of the contract may be performed by agreement of contracting parties, but is not mandatory.

At the same time, Art. 334 of the CC establishes that the moment when ownership is acquired under the contract may be either the moment of transfer of the property or notarization or state registration of the contract. Since special rules of law do not provide for the form of the contract of sale of a share in the authorized capital and the moment of transition of corporate rights under the contract of sale, one should pay attention to the following. Part 1, Art. 87 of the CC stipulates that a legal entity of private law may be established and operate on the basis of a model charter. The Resolution of the Cabinet of Ministers of Ukraine № 1182 as of 16 November 2011 has adopted the model charter of a limited liability company wherein Clause 20 prescribes that along with transfer of a share (a part thereof) to a third person, the latter is passed all rights and obligations held by a company member who has ceded a share in whole or in part<sup>7</sup>. The cited provision effectively duplicates Art. 53 of the Law of Ukraine "On Business Associations" before amended by the Law № 997-V as of 27 April 2007 and determines the moment of transition of corporate rights to a new member, which is the moment of signing the contract.

In addition, according to provisions of the Resolution of the Plenary Supreme Court of Ukraine as of 24 October 2008<sup>8</sup>, in order to become a member, it suffices to conclude a contract of sale of a share in the authorized capital. Amendments to the charter and state register do not affect deciding the matter of joining the company by a new member.

On the one hand, one may agree with such conclusions, since the legislation in force does not contain a mandatory rule that would prohibit alienating corporate rights to third persons under the contract. Moreover, the law entitles members (founders) to prohibit alienation of a share in the authorized capital in rules of a local nature, in particular the company's charter. Therefore, should members of a com-

<sup>7</sup> Resolution of the Cabinet of Ministers of Ukraine № 1182 as of 16 November 2011 "On Adoption of the Model Charter of a Limited Liability Company". Retrieved June 15, 2016 from: <http://zakon5.rada.gov.ua/laws/show/1182-2011-%D0%BF>.

<sup>8</sup> Resolution of the Plenary Supreme Court of Ukraine as of 24 October 2008 "On Judicial Practice in Corporate Disputes", 11 *Bulletin of the Supreme Court of Ukraine* (2008), Retrieved June 15, 2016 from: <http://zakon5.rada.gov.ua/laws/show/v0013700-08>.

pany not exercise their priority right and the company's charter not contain prohibition to alienate a share, the moment when ownership of a share is acquired under the contract may be the moment of acquisition of corporate rights. In this case, the company has no objection against accepting a new member.

On the other hand, acquiring of a share in the authorized capital under the contract is just one of legal facts of acquiring corporate rights in a company, which is followed by amendments to the charter and state register. Pursuant to Part 1, Art. 51 of the Law of Ukraine "On Business Associations", Part 1, Art. 88 and Part 1, Art. 143 of the CC, the constituent documents of an LLC are to contain information on the composition of founders and members, the size of shares of each of the members, as well as the procedure of joining the company and the procedure of transition of a share in the authorized capital. Furthermore, as per Part 5, Art. 89 of the CC, amendments to the constituent documents of a legal entity shall come into force for third persons on the date of state registration. Should information on the new member not be entered into the state register, he shall not be able to dispose of his share and perform its alienation.

If to refer to judicial practice of the Supreme Economic Court of Ukraine, in the Resolution № 4 as of 25 February 2016<sup>9</sup>, it is stated that ownership of a share in the authorized capital of an LLC arises with a third person since the moment of contract conclusion, unless otherwise is agreed by the parties (Art. 363 of the CC). Still, the right to participate in a company is a personal non-property right acquired by a third person only upon joining the company, which is to be confirmed by the corresponding decision of the general meeting of company members.

However, as practice shows, there quite often arise situations when there is a considerable period of time between the moment of acquiring ownership of a share and the moment of acquiring the legal status of a company's member. This may be due to abuse of the law on the part of other company members who do not intend to admit a purchaser of a share to management of the company. In this case, the person,

<sup>9</sup> Resolution of the Supreme Economic Court of Ukraine № 4 as of 25 February 2016 "On Certain Issues of Practice of Resolution of Disputes that Arise out of Corporate Relations". Retrieved June 15, 2016 from: <http://zakon5.rada.gov.ua/laws/show/v0004600-16>

although owning a share in the authorized capital, is unable either to participate in managing the company, since no amendments on the composition of members are introduced into the constituent documents, or to dispose of his share, since information on him as a new member is not entered into the state register so far.

This is due to the fact that the legislation in force does not contain a provision on the obligation to notify persons who have acquired a share in the authorized capital of the general meeting, which often leads to ignoring the new purchaser of a share. Thereby, there arise situations when a person acquires a share under the contract of sale, whereas at the general meeting, members vote not for accepting the purchaser of a share as a new member, but dilute a share sold by increasing the authorized capital and increasing the size of their shares in it. As a result, amendments on the composition of members are introduced into the charter at the subsequent general meeting, and the person who becomes a company's member acquires a share in the authorized capital, but the scope of corporate rights diminishes, since there diminishes a share of the member joining the company. Along with that, the decision of the general meeting held by the time a person has acquired the status of a member, shall not be subject to appeal, since at the time of holding the general meeting, a purchaser of a share had not yet been a member of the company.

Hence, due to ambiguity of statutory, charter and contract regulation in both law enforcement practice and scholarly literature, they distinguish three approaches to determining the moment of acquisition of corporate rights under the contract. These approaches are the following: 1) rights and obligations of a company member arise since the moment of state registration of amendments to the constituent documents; 2) the moment of taking a decision on amending the constituent documents at the general meeting of a company is the moment of acquiring corporate rights in the company; 3) the moment of concluding a contract on alienation of a share in the authorized capital of a company is the moment of emergence of corporate rights.

If to analyze the given approaches, one should note the following. Provisions of the legislation in force providing for state registration of amendments to the constituent documents prescribe that these data is primarily a guarantee of reliability of information on a company for third persons. However, when acquiring a share in the authorized

capital, a person gains corporate rights with regard to a company and not other (third) persons, which does not reflect the need to bring the moment of acquiring corporate rights to the moment of state registration of amendments to the constituent documents.

In case taking a decision by the general meeting on joining a company by a person is considered as the moment of acquiring corporate rights, there arises a question on whether it is expedient to introduce in the legislation such restrictions as priority rights of members to purchase a share in the authorized capital, the possibility to secure in the charter prohibition to alienate a share in the authorized capital to third persons. Thus, as a general rule, members themselves are those who introduce amendments to the constituent documents. Therefore, the amendment on the member composition takes effect for the members since the moment of taking a decision on amending the constituent documents (the charter). Yet, this condition serves as another restraint to a purchaser of a share in the authorized capital and actually stands as a negative factor that violates rights of third persons who have acquired a share under the contract in good faith.

Thus and so, it would be reasonable to prescribe in corporate legislation that the moment of concluding a contract on alienation of a share is the moment of acquisition of corporate rights. Furthermore, it is necessary to introduce provisions that amend the procedure of alienation of corporate rights under the contract. After all, an LLC is a legal entity that is founded by bringing together first of all property, not persons. Therefore, it seems reasonable to minimize the possibility to restrict the movement of corporate rights provided by a company to its members. Considering this, the contract should be the only ground for acquiring corporate rights, while introducing amendments to the charter and state register should be actions aimed to confirm this fact.