

## Legal Due Diligence in Ukraine: uncovering risks

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Investing in Ukrainian assets is much cheaper than in similar assets in most European countries. However, in business, a lower price usually means increased risks. Such risks are mostly due to regional and historical features.

#### 1. Privatized enterprises and property

At the beginning of the 90s of the last century, all production assets and the land belonged to the state. The process of transferring such assets to private ownership still goes on. The vast majority of Ukrainian companies own such assets in one way or another.

#### Possible violations during the privatization process

The complex and multi-stage process of privatization, which in most cases is not meticulous enough, is accompanied by lots of errors in documents and procedures, which make privatization invalid. As a result, all production facilities, equipment, infrastructure that have been privatized may be returned to the state, or it may lead to lengthy and costly litigation.

Example: LLC – a tenant of premises, has purchased these premises from the territorial community without an auction on the terms of redemption. The purchase of the premises was done without an auction, and the sale contract, the

decision of the relevant council, entries in the Register of ownership rights to immovable property, etc., were fully formalized. But at the conclusion of such a sale contract, LLC did not have sufficient evidence that during the time of lease it made integral improvements to the premises in the amount of not less than 25% of the premises' cost, and, accordingly, didn't have the right to purchase the premises without an auction. As a result, the local prosecutor filed a lawsuit in court, the sale contract was declared invalid, the entry in the Register of ownership rights to immovable property, and the decisions of the relevant council were cancelled.

### **Outstanding commitments imposed on the privatized enterprise during the privatization**

Example: extracts from the registers of property rights clearly show that industrial buildings and industrial equipment belong to the target asset. At the same time, the conditions of privatization provide for the preservation of the main activities of the privatized enterprise. By acquiring such a Ukrainian company, the investor will not be able to legally start, for example, car service in the production facilities of the bakery, or will find that he is obliged to build a sanatorium for retirees of the privatized enterprise. Such obligations are not reflected in any register or legal documents on property, but only in privatization documents.

### **How to identify risks?**

It is necessary to pay attention to the grounds for acquiring property rights in statutory or legal documents. If the ownership is acquired based on any of the privatization documents (decisions of the state body, a sale contract as a result of the privatization procedure, etc.), it's necessary to establish which procedure was used for privatization. It's necessary to check the privatization documentation and the compliance of the procedure with the legislation in force at the time of privatization. It is also worth carefully reviewing the privatization documentation for any privatization obligations (preservation of jobs, preservation of the main activity, etc.).

## **2. Corporate history**

The corporate history check of the target asset (if it is a company) is an even more important component of the legal audit of the Ukrainian target asset than establishing its current legal status.

### **Violations during the acquisition of the company by the current owner**

#### **What are the risks?**

Failure to comply with the law when acquiring shares or stocks of a Ukrainian company may result in a chain reaction – invalidation of agreements between the previous owner and the current owner, and, accordingly, invalidation of agreements on the acquisition of Ukrainian target assets by foreign investors and current owners. As a result, it may lead to lengthy and costly litigation.

Example: at the time of the current owner's acquisition of LLC's shares, the previous owners did not contribute their shares in full, or didn't obtain the consent of the spouses to sell their shares, or didn't follow the company's charter procedure for selling shares. The consequence is the invalidation of agreements, and, as a chain reaction, the invalidation of all decisions of the current owner, the

invalidation of the purchase agreement of a Ukrainian asset by a foreign investor, and the loss of such an asset.

### **How to identify risks?**

a) first, it is necessary to establish if such circumstances exist. For this purpose it is necessary to demand and check all editions of statutory documents from the moment of the Ukrainian target company foundation;

b) it is necessary to establish how the current owners became members of the Ukrainian target company if they were not its original founders. In this case, not only the availability, content, and form of agreements (other documents) based on which the current owners became members of the company must be checked. It is important to establish whether the parties have obtained all necessary approvals (consent of the spouses, the presence of powers of attorney, minutes, and decisions), whether they have followed the procedure and requirements established by the charter of the Ukrainian target company, and made a full settlement. It should be borne in mind that such an inspection should be carried out based on legislation and corporate documents in force at the time of the relevant agreements;

c) if the target asset is a joint-stock company, it is necessary to check not only the records from the registers but also the transactions based on which the current owner purchased the shares. It is also necessary to analyze compliance with the conditions for the acquisition of a significant block of shares (more than 5% of ordinary shares), compliance with the pre-emptive rights of other shareholders, and the form of securities established by law and the charter of the target asset.

### **"Ghosts" of former members**

#### **What are the risks?**

Special attention should be paid to a Ukrainian company, which in its corporate history had cases of members exclusion or their withdrawal.

The corporate legislation of Ukraine requires the payment to a member withdrawn from the company of his share in the authorized capital. In some cases, it's a question of property returning to such member, which he brought in kind. If a participant has been excluded from the company, then the procedure for such exclusion must be strictly followed. It is important to take into account the legislation and the wording of the statute, which were in force at the time of such withdrawal or exclusion. In case of violation of the relevant legislation, the former member may demand the restoration of his membership, the implementation of payments in his favor, or the return of property. If he manages to do that, the consequences are even worse – there will be grounds to declare all decisions invalid, including the decision to sell the Ukrainian company to a foreign investor that will lead to the loss of the asset.

Example: an investor bought a Ukrainian company. A few years after such an acquisition, a conflict arose between the former owner of the company and the investor. The former owner found a member of the company, which was excluded a few years before the sale of the asset to the investor (at that time the exclusion was peaceful, only for formality), agreed with him and filed a lawsuit on his behalf to cancel the decision of exclusion and restore rights of the member. The reason

was non-compliance with the term of the member's exclusion notice under the charter of the Company.

### **How to identify risks?**

- a) request and check all editions of the statutory documents of the Ukrainian target company since its inception;
- b) request and check all minutes (decisions) of the authorized body of the Ukrainian company, paying attention to the continuity of their numbering;
- c) investigate all cases of withdrawal and exclusion of a Ukrainian company's members for compliance with the requirements established by the legislation and the charter in force at that time (minutes, notices, postal receipts, notes on notices' receipt, payment orders, or cash orders for payments to the member, acts of acceptance and transfer of property that was contributed by the member in-kind, etc.).

### **Payment of dividends**

Payment of dividends by Ukrainian companies is a rather rare phenomenon. Therefore, this issue is often overlooked during a legal audit.

### **What are the risks?**

The decision to pay dividends is the prerogative of the company's governing bodies. In joint-stock companies and limited liability companies, this prerogative is implemented in different ways. If the company has a net accounting profit or retained earnings of previous years, it can be distributed or used for other purposes. A member of the company is entitled to receive dividends at the time of the correspondent decision to pay them. Failure to pay dividends within the time limits specified by law or the constituent documents of the legal entity is a violation of the monetary obligation. Non-payment of dividends entitles a member to demand recovery of the debt amount from the company, taking into account the established inflation index for the entire period of delay, as well as penalties related to overdue debt.

Example: one year after the sale of a company to an investor, the former owner, citing a general meeting decision made shortly before the sale of the company, claims the new owner to pay the dividends he was entitled to.

### **How to identify risks?**

- a) establish the availability of profits from which dividends can (could) be paid;
- b) request and check all minutes (decisions) of the authorized body of the Ukrainian company (paying attention to the continuity of their numbering), for decisions on the distribution and payment (or non-payment and use for other purposes) of dividends;
- c) in case the financial documentation shows the presence of retained earnings establish confirmation of dividends payment (payment orders, cash orders, etc.) if there are minutes on their payment.

### 3. Property of collective ownership

The peculiarity of the legal audit of property rights in Ukraine is associated with frequent changes in legislation and a difficult transition period from the Soviet economy to the market economy. The vast majority of production capacity, even small ones, and all land belonged to the state and since the early '90s were transferred to private ownership in various ways—through privatization, shareholding, the creation of leased enterprises, etc. As a result, there are amazing legal constructions in Ukraine that are not even properly regulated. Nevertheless, such property participates in the production and commercial turnover.

#### Share property

Most Soviet agricultural enterprises (collective farms) were divided between their members. As a result of this process, hundreds of thousands of people received property and land certificates certifying their right to receive a share of property and land. It was impossible to do anything with land certificates (so-called "shares"), except for lease, but the situation with property certificates was different – they could be contributed to the authorized capital of companies, bought and sold. In addition, based on such property certificates, it is possible to allocate property in kind and carry out its proper legal registration.

#### What are the risks?

The current legislation practically doesn't regulate the procedure for registration of property ownership (both for individuals and legal entities) that is allocated to the property share. A large number of procedural errors in the procedures of redemption and allocation of property in kind under property certificates causes risks of challenging decisions and documents based on which the ownership of the property is issued, and it may lead to the loss of such property.

Example: a Ukrainian agricultural company owns a granary. The real estate ownership is duly registered based on the act of acceptance and transfer of the property allocated in kind. At the same time, no general meeting of the property shares co-owners was held before the allocation of property in kind, and consequently, no agreement was reached on the share property division. Based on this one of the former co-owners of the share property filed a lawsuit to declare the registration of real estate ownership invalid.

#### How to identify risks?

- a) verify the grounds for acquiring the property ownership, and if such property was registered based on the property certificates and acts of acceptance and transfer of property allocated in kind, to request and verify contracts of the property shares sale, copies of property certificates issued based on the contracts of sale to the new owner, minutes of the general meeting of the property shares co-owners, lists of share property, lists of co-owners;
- b) verify the competence of the general meeting of the property shares co-owners.

### 4. Property purchased at auctions

A feature of the legal status of property acquired at auction is the complex procedure before such acquisition.

### **What are the risks?**

Any violation of the auction procedure may be the ground for appealing its results, recognizing the purchase and sale of property invalid, and may result in loss of such property.

Example: a Ukrainian company owns production premises purchased at an auction in the enforcement proceedings. At the lawsuit of one of the auction's participants, the results of such an auction were declared invalid due to violations committed during the auction and the inconsistency of the proposed price to the auction procedure. Therefore, the invalidation of the auction results resulted in the invalidation of the premises sale contract concluded with the winner.

### **How to identify risks?**

- a) verify the ground for the property ownership. Usually, for this purpose the contracts of the property purchase and sale are requested and analyzed;
- b) if such a contract was concluded as a result of the auction (open bidding), it is necessary to analyze the minutes of the auction for its compliance with the rules of the auction and the legislation in force at the time of the auction as a whole.

## **5. Features of infrastructure objects using**

The legal audit of a Ukrainian company should also take into account the production characteristics of the target asset, in particular, the infrastructure that provides the asset's operation. These include energy supply, access conditions for access roads, railway lines, etc.

### **What are the risks?**

Loss of control over infrastructure capacity can completely stop operations and devalue an asset.

Example: The access road to the elevator gate passes through the territory of another enterprise. The transfer of the entry point to the elevator entails significant costs – the transfer of car scales, control post, change of internal logistics. If the right to use such a road is not properly executed, then in case of acquisition of the enterprise through the territory of which the access road passes by a competitor, the elevator's operation may be blocked.

### **How to identify risks?**

- a) when conducting a legal audit, it is necessary to request a list of communications that are used in the production cycle or provide its operation (access roads, gas pipelines, connections to power grids, power substations, etc.);
- b) establish the availability and compliance of permits related to the operation of these facilities with the legislation;
- c) establish the legal grounds for the location of such facilities and the communications between them.

## **6. Agricultural land assets**

Land used by Ukrainian companies in production processes in agricultural business has a special status and regulation. Historically, all such land belonged to the state, but after Ukraine gained independence, it was largely privatized and divided into small plots among millions of Ukrainians. The moratorium on the sale of such land lasted till July 2021, and legal entities still can't buy it. Therefore, Ukrainian companies are forced to use agricultural land based on thousands of lease agreements with citizens.

### **What are the risks?**

The conclusion of even one land lease agreement is a specific procedure, which includes the preparation of technical documentation, signing lease agreements with the owner, and state registration of the land lease agreement. At the same time, landowners are mostly elderly people who die due to objective circumstances, and land plots are divided to heirs into even smaller plots.

A company that uses 10,000 hectares of land should oversee transactions with approximately 3,000-5,000 people. In addition, land lease contracts are usually concluded for different terms – for 3, 5, 10 years, and each expiration of such a term requires almost the same procedure as the primary conclusion of the contract. As a result, a company that claims to use (and actually uses) 10,000 hectares of land can actually evidence the use right for only 50-70% of that area. Often companies are not able to properly control the timely and proper implementation of land lease procedures.

### **How to identify risks?**

- a) request and verify registers of land lease contracts;
- b) carry out a thorough audit of land lease contracts;
- c) carry out a selective audit of lease extension contracts with a presentation of results in a table.

## **7. Unscrupulous use of legal audit results**

If the above was mainly about a legal audit in the case of acquisition of a Ukrainian asset by a foreign investor, then in this case it is about a sale by a foreign investor of his Ukrainian asset.

Example: a foreign investor, by prior agreement with a potential buyer, ordered a legal audit of a Ukrainian company that he intended to sell. The legal audit revealed some shortcomings in the corporate structure of the target asset. The customer (foreign investor) acquainted the potential buyer with the legal audit report. The potential buyer refused to buy the asset, but later, using information about the weaknesses of the target company, began unfriendly processes that almost led to the seizure of a company owned by a foreign investor.

Recommendations: to conduct a preliminary legal audit, if there is an intention for one purpose or another (sale of the asset, obtaining financing) to acquaint third parties with its features. Identification of any shortcomings, in this case, will be the basis for their correction, and not a threat to the company.