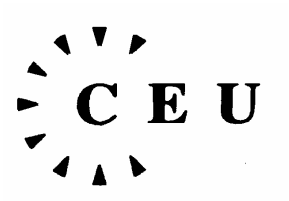

Protection of Members of Limited Liability Companies in Ukraine in Comparison with Germany

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Abstract

The research project explores the level of protection of Limited Liability Company's shareholders' rights in Germany and Ukraine and the ways of improvement of Ukrainian shareholders' protection. The first chapter focuses on the shareholder's protection during the expulsion prodecure. In this case the corporation denies the right of the shareholders to voice in company's affairs, which is considered a fundamental element of shareholding. It is stipulated that expulsion is a necessary remedy to cure corporate deadlocks. Under the Ukrainian law the question about the expulsion of the shareholder must be solved on the general meeting of the shareholders that give rise to more possibilities of sharehorders' abusement. On the grounds of comparative analysis of German and Ukrainian corporate laws the author of the thesis attempts to clarify the provision of the Ukrainian Act on Business Assosiations with a purpose to avoid a misuse of this right removing the authority to expel shareholders from the Shareholders' General Meeting to the court.

In the next chapter the research touches upon the origin of the notion of derivative suit, modern approach to the application of derivative suits in German legal system, its advantages and disadvantages. On the grounds on comparative analysis attention is called for the need to introduce the notion of derivative claim in Ukrainian legislation. Thus, the research seeks to improve the level of protection of LLC's shareholders' rights implementing the derivative suit in the legislation of Ukraine.

Introduction

Shareholders' disputes present one of the most difficult and potentially destructive issues which arise in the context of the close corporation.[1] Two remedies are available to shareholders to vindicate their interests in the corporation. Shareholders can sue in their own capacity to enforce their rights as shareholders (a direct action), and they can sue on behalf of the corporation to enforce corporate rights that affect them only indirectly (a derivative action).

Distinguishing between direct and derivative suits is especially difficult in Limited Liability Companies. It is important to draw the line between those two claims since it impacts the parties involved in the litigation, the type of possible relief, party which is entitled to the relief etc... The reason why this problem has appeared is that closely held corporation frequently does not have the same degree of separation between management and ownership. Case law and theoretical researches concerning the direct/derivative distinction are still overwhelming. So American scholars, e.g. Daniel S. Kleinberger, emphasize the need for courts and legislators to re-examine the important question of "direct versus derivative" in closely held business enterprises[2]. Unfortunately Ukrainian legislators do not pay enough attention to this issue since in current political environment the concerns of publicly held corporations are considered to be of the prime importance.

The thesis analyzes comparative protection of Limited Liability Company's shareholders under Ukrainian and German Corporate Laws in order to understand how Ukraine can better protect shareholders of LLC and attract foreign investors to small and medium Ukrainian business. It is worth mentioning that German Law on LLC has already been used by Ukrainian legislators as a model for Ukrainian Law on Business Associations. Germany presents a model of highly developed and influential legal system. The German Law on Limited Liability Companies of 1892 became a

[1] LEWIS D. SOLOMON, ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS, 194-195 (1990)
[2] Daniel S. Kleinberger, Direct vs Derivative, or "What's a lawsuit between friends in an 'incorporated partnership?'", William Mitch. L.R, (1996).

model not only to U.S. close corporation statutes but also Chinese, Japanese and Korean civil law acts were adopted on the basis of German Model.[3] Beside aforementioned German Corporate Law is a model for European Union Acts on Corporate Law. Besides it is useful for Ukraine to model its legislation on that of European state since Ukraine is currently seeking an admission to European Union. Therefore Germany was chosen as a comparator.

The thesis is divided into two major chapters. Chapter one will examine the direct claims in the law of Ukraine and Germany focusing in particular on shareholder's protection in case of her expulsion. In the first chapter the advantages and disadvantages of German and Ukrainian legislative acts concerning the expulsion of the shareholder will be analyzed. On the grounds of such comparison project of amendment to the Law on Business Associations of Ukraine will be proposed.

Chapter two will deal with the contemporary notion of derivative suit in Germany, historic development of this doctrine. The thesis will analyze the approach of the German commentators to the notion of the derivative suit, advantages and disadvantages of such type of the suits. The conclusion about the need of implementation of derivative claim into the corporate law of Ukraine will be made.

Currently in Ukraine there are three legislative acts regulating the existence of limited liability companies. They are Civil Code of Ukraine, Commercial Code of Ukraine and Law on Business associations (entered into force on October, 1, 1991). The most extensive of these with respect to the limited liability company is the Law on Business Associations which was adopted in 1991. The provisions of those acts are very controversial to each other, which creates particular impediments for the practitioners in creating and maintaining the business activity of Limited Liability Companies. Therefore there is a strong need to adopt new act which would respond to the needs of the market economy.

[3] Huge T. Scogine, Jr., Withdrawal and Expulsion in Germany: A Comparative Perspective on the "Close Corporation Problem", 15 Mich.J. Int'l L. 127 (1993)

In spite of the bulk of legislation no one of the aforementioned acts recognizes the notion of the derivative claim. In 2004 The Constitutional Court of Ukraine granted a decision according to which the shareholder of the stock company can not apply to the court in case the interests of the corporation were breached unless such possibility is provided by law[4]. Neither procedural law of Ukraine, nor corporate substantive laws provide such possibility. But the arisen quantity of corporate conflicts requires implementation of doctrine of derivative claim into Ukrainian legislation. The implementation of derivative claim doctrine would allow the shareholders of limited liability companies not only to recover damages caused by the misconduct of company's managers but also to provide a preventive function under the management. But in a row with positive features of this notion the legislative body should take into account some obstacles that can appear on a way of the shareholder of Limited Liability Company if she wants to bring derivative claim. Altogether, Ukrainian law, lacking a device like derivative suit gives shareholders little protection.

A direct claim may be asserted to vindicate some rights personal to shareholder. The shareholder suffers the harm directly rather than as a consequence of damage to the corporation. The corporation denies or abrogates the rights of the shareholder directly that gives rise to direct cause of action. This research focuses on the remedy in case of the expulsion of the shareholder. In this case the corporation denies the right of the shareholders to voice in company's affairs, which is considered a fundamental element of shareholding[5]. On the one hand the expulsion is the good remedy for the corporation in case of deadlocks at the shareholders meetings, on the other shareholders can abuse this right. Under the Ukrainian law the question about the expulsion of the shareholder must be solved on the general meeting of the shareholders that give rise to more

[4] Рішення Конституційного Суду України у справі за конституційним поданням 50 народних депутатів України щодо офіційного тлумачення окремих положень частини першої статті 4 Цивільного процесуального кодексу України (справа про охоронюваний законом інтерес), Справа # 1-10/2004 від 1 грудня 2004 року (Decision of Constitutional Court of Ukraine on official interpretation of the part one article 4 of the Code of Civil Procedure of Ukraine, December 2004.

[5] See SCOGINE *supra* note 3.

possibilities of shareholders'' abasement. Therefore the provision of the Ukrainian Act on Business Associations to avoid a misuse of this right must be will be clarified.

Therefore the thesis concerns such points as protection of Limited Liability Companies' shareholders' rights. The limitations of this paper necessitate, however, that only certain categories of legal disputes are examined. On the grounds of comparative analysis of Ukrainian and German corporate laws, the analysis of judicial practice the conclusion about the need of Ukrainian Corporate Law's modification will be made. As the result the paper will contain proposals as to improvement of Ukrainian law currently in force in the field of LLC' shareholders' rights' protection inter alia the project of amendments into Ukrainian Law on Business Associations. The proposed amendments make Ukrainian LLC more attractive to foreign investors, help to maintain economic stability of the company, promote market growth.

Chapter 1 – Protection of the shareholders' rights in the procedure of expulsion

1.1 General introduction

When shareholders of stock companies are not satisfied with management of the company or they can not continue business activity with each other, they may cease their relationships with the company by simple selling of their stock. In contrary the shareholder of limited liability companies (hereinafter - LLC) in case of the similar situation find it difficult to exit from the company. On practice the shareholders of LLC in which they have personal and financial stakes face internal quarrels very often. The majority shareholders that as a rule manage the company may behave opportunistically to the disadvantage of the minority members. In response minority participants may "revenge" to the majority shareholders putting company's welfare in jeopardy. One of the problems that shareholders of LLC may face is the situation of deadlock.

For the proper examination, first, the requisite terminology must be defined. In the thesis the term "closely held corporation" will be used to refer to German LLC. Closely held corporations present a special concern for any legal system. The term "closely held corporation" signifies that it is usually owned by a small number of shareholders (one or few persons)[6], is often characterized by personal and flexible management[7] and defined by illiquid shares' market[8]. As a result the actual functioning of such companies does not always fit nearly into the categories provided by the formal structure of business law.

Gesetz betreffend die Gesellschaften mit beschrankter Haftung (The German Law on Limited Liability Company – hereinafter the Law on GmbH) of 1892[9] provides for many attributes that later were adopted by U.S. close corporation statutes.[10] Taking into account the *sui generis* nature of the

[6] F. Hodge O'Neal & Robert Thompson, O'Neal's Close Corporations § 1.02 (3d ed.) (1990).
[7] Id.
[8] ROBERT W. HAMILTON, THE LAW OF THE CORPORATIONS, 286-287 (1996).
[9] Gesetz betreffend die Gesellschaften mit beschrankter Haftung (The German Law on Limited Liability Company), translated in Statutory Materials for the course Business Associations in Europe (part 1), CEU (2007).
[10] Henry P. DeVries, Friederich K. Juenger, Limited Liability Contract: The GmbH, 64 COLUM.L. REV. 866 (1964)

GmbH the question may arise whether it is appropriate to compare GmbH with closely held corporations rather than limited liability companies. According to Robert R Keatinge German GmbH is closer to closely held corporations since the U.S Limited Liability Companies resemble more the structure and operation of German limited partnerships.[11] Therefore, reference to closely held corporation implies German GmbH.

The next term to be defined is "deadlock". According to Black's Law Dictionary deadlock in closely held corporation arises when a control structure permits one or more factions of shareholders to block corporate action if they disagree with some aspect of corporate policy[12]. Deadlock can occur at either shareholder or board level and it paralyzes the corporation's business. The shareholder deadlock is worst scenario which can occur[13]. On a board level deadlock as a rule is a consequence of 50-50 shareholder split. Different jurisdictions provide the variety of remedies to "cure" the deadlock situation. They are court appointed custodians and provisional directors, court-appointed receivers, court supervision, court-ordered-involuntary dissolution[14], other court-ordered relieves such as withdrawals of the shareholders or buy-outs, expulsion of shareholder etc.

This chapter focuses on such corporate deadlocks' remedy as expulsion of the shareholder and protection of the rights of the shareholder during the procedure of expulsion under German and Ukrainian laws. The purpose of the comparison is to define the advantages and disadvantages of the expulsion procedure in both legal systems and to make the recommendations as to the improvement of the Ukrainian legislation on the shareholder's expulsion from LLC. The need of amendments is stipulated by the current situation in Ukraine when the majority shareholder uses the expulsion procedure to get rid of the "undesirable" shareholder. In this case the corporation denies the right of the shareholders to the voice in company's affairs, which is considered a fundamental element of

[11] Robert R. Keatinge, The Limited Liability Company: A Study of the Emerging Entity, 47 BUS. LAW. 375 (1992)
[12] BLACK'S LAW DICTIONARY 398 (6th ed. 1996)
[13] LARRY D. SODERQUIST, A.A. SOMMER, JR., PAT K. CHEW, LINDA O. SMIDDY, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS, 4th ed. (1997).

shareholding. The new mechanism of expulsion will provide the investors with more protections and will help to attract new foreign investors to small and medium Ukrainian business.

1.2 Doctrine of expulsion in German legal system

1.2.1 Germany: The Development of the Expulsion Doctrine

For the best understanding of the doctrine of expulsion it is better to analyze it trough historical context. Initially this doctrine has been expressed in so-called Weimar period (1919-1933) by the court in famous Albatros case[15] and it was viewed as an exception to the traditional dissolution remedy. The intermediate court made an analogy between GmbH and partnership. As a result it was held that provisions of Commercial Code on treatment of expelled partners were applicable in that case due to "partnership-like reality of company in question"[16]. In contrary Supreme Court rejected this approach and held that application of the same concepts to different business entities was "unthinkable" and that "such an expulsion of a shareholder is unknown in the GmbH. It knows only dissolution as the means for ending a legally constituted GmbH"[17]. Therefore, it can be concluded that in Weimar period German legal system was reluctant to draw an analogy between partnerships and GmbH and as a result to transpose the general concept of *wichtige Grund* from the partnership law to GmbH.

However the approach of Supreme Court did not eliminate the expulsion remedy completely. First, courts accepted the principle of *wichtige Grund* in the area of companies associated with cartels if the shareholder became unable to fulfill the required obligations. Later it was extended to cases that involved companies in which maintenance of the shareholder status required performance

[14] See LEWIS D. SOLOMON, ALAN R. PALMITER *supra* note 1, at 246-247.
[15] Judgement of Dec. 7, 1920, RGH, 101 RGZ Entscheidungen des Reichsgerichts in Zivilsachen (RGZ) 55 (Ger.) (as cited in Huge T. Scogine, Jr., *Withdrawal and Expulsion in Germany: A Comparative Perspective on the "Close Corporation Problem"*, 15 Mich.J. Int'l L. 127 (1993))
[16] Id.
[17] Id.

of services in addition to payment of money for shares[18]. According to Hugh T. Scogin these exceptions do not contradict to the principle established by the Albatros case but only extend it[19] i.e. the *wichtige Grund* principle was "adjusted" to GmbH reality.

Acceptance of this new remedy by the German legal system took place within next ten years, during the Third Reich period. In 1942 the Supreme Court recognized Jewishness to be the *wichtige Grund*. From this moment expulsion became an inherent right in GmbH[20]. German commentators i.e. Hugh T. Scogin argue that the Supreme Court based its decision on the theories of Franz Scholz and the court seemed to imply that despite the right was not statutory stated unwritten will of the corporation arose from the social fact of corporate relations[21]. Personhood became a concern of the scholars of that period since they saw in it the way of achieving justice[22].

Postwar period is characterized by the controversy in the development of the expulsion doctrine. Schilling and Buchwald argued that the expulsion remedy was tained by its Nazi origins and therefore could not be "the basis of a just doctrine"[23]. The Supreme Court's decision in April, 1953 brought clarity to the situation. The decision stipulated:

> The legal grounding for the ability to expel a shareholder from the GmbH because of a substantial basis is supplied by the principle, which governs the civil as well as commercial code, that a legal relationship heavily impinging on the life activities of a party can be terminated early if a substantial basis is present.[24]

[18] Judgement of Feb. 7, 1930, RGH, 128 RGZ 1 (Ger.) (as cited in Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem*", 30 Cornell Int'l L.J. 381 (1997))

[19] See Scogine, Jr., *supra* note 3.

[20] Judgement of August, 13, 1942, RGZ 169, 334 (F.R.G.) (as cited in Huge T. Scogine, Jr., *Withdrawal and Expulsion in Germany: A Comparative Perspective on the "Close Corporation Problem"*, 15 Mich.J. Int'l L. 127 (1993))

[21] See Scogine, Jr., *supra* note 3.

[22]. LARRY D. SODERQUIST, A.A. SOMMER, JR., PAT K. CHEW, LINDA O. SMIDDY, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS, 4th ed. (1997).

[23] See Scogine, Jr., *supra* note 3.

[24] Federal Court of Justice, decision of April 1, 1953, BGHZ 9, 157 (F.R.G.) (as cited in Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem*", 30 Cornell Int'l L.J. 381 (1997))

Thus, the Supreme Court upheld expulsion as a general remedy available to the shareholders of the GmbH on personal grounds. However, Court additionally set two conditions which must be accomplished: confirmation of the action by the court and providing the valuation of the expelled shareholder's equity share in the court's decision.

Therefore, the Law on GmbH provides that the company may be dissolved by a court decision in case it becomes impossible to accomplish the purpose of the company or when there are other substantial causes for the dissolution resulting from the condition of the company.[25] This remedy was widely criticed in Germany.[26] As a result the possibility of shareholder's expulsion (*AusschlieBung*) as additional remedy has been created by court. As it has been mentioned above the remedy of expulsion was developed in the legal practice since according to the court[27] such remedy as dissolution "leads to a loss of business and a loss of jobs". This remedy demontrates the importance of case law in Germany in spite the fact that Germany is a civil law country.

The Law on GmbH itself does not grant shareholders a right to exclude other shareholder from the company. However, such possibility may be provided in the articles of association of the company.[28] The articles cannot restrict or exclude the right of the shareholder to exclude the other shareholder (-s) for cause. Expulsion is available to any shareholder who establishes *wichtige Grund* (substantial basis). There two possible grounds providing wichtige Grund in an expulsion action: personal characteristics of the shareholder in question and the conduct of the shareholder.[29] Hugh T. Scogin defines following factors which can serve as basis to establish *wichtige Grund*: advanced age, extended illness, *inter alia* mental illness. Moreover, the aggrieved party may demonstrate that

[25] Gesetz betreffend die Gesellschaften mit beschrankter Haftung (The German Law on Limited Liability Company) §61(1), translated in Statutory Materials for the course Business Associations in Europe (part 1), CEU (2007).
[26] See Scogine, Jr., *supra* note 3.
[27] Federal Court of Justice, decision of April 1, 1953, BGHZ 9, 157 (F.R.G.) (as cited in Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem*", 30 Cornell Int'l L.J. 381 (1997))

[28] See Scogine, Jr., *supra* note 3.
[29] Id.

the shareholder in question has disorganized financial circumstances, lacks trustworthiness or creditworthiness, or has lost personal qualifications required by articles. An expulsion can be sought if the shareholder has been performing her duties for a long time or perform them badly, breaches trust, causes incurable dissension, or makes improper sexual advances.[30] The articles of association of GmbHs can stipulate that a manager who is also a shareholder may only be removed from his position for cause.[31] Furthermore, it is commonly accepted that shareholders of GmbH have a right to exclude another shareholder for cause. According to L. Enriques, self-dealing might constitute substantial ground for the purpose of each of these remedies under certain circumstances.[32] A. Baumbach and A. Hueck stipulate that fault and misbehavior are not necessary elements of expulsion.[33]

Thus, all described above justifies the broad scope of the application of the substantial basis' doctrine. Moreover, not only business conduct of the shareholder in question is scrutinized by the court but, as well as her character, her personal circumstances and personal relationships. Therefore, the personal obligations of shareholders towards each other take priority over the property interests of the latter. As a result the minority shareholders have been granted the right to expel majority shareholders.[34]

So, for instance, in the period of Third Reich Jewishness was considered to be a "substantial basis" for the expulsion. In its decision court concluded that "GmbH must have the opportunity to eliminate a partner if the character of the partner becomes intolerable. Therefore, the plaintiff's

[30] Id.
[31] GmbH Law art 38 (2).
[32] L. Enriques, Enforcing self-dealing Constraints on Dominanat Shareholders in Europe, Paper on Law and Economics Workshop, University of California, Berkley (2007) available on a site http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1178&context=berkeley_law_econ, date of last visit March, 15, 2007.
[33] ADOLF BAUMBACH & ALFRED HUECK, GMBH-GESETZ 362- 363 (14th ed. 1985)
[34] See Scogine, Jr., *supra* note 3.

affiliation with the Jewish race was intolerable".[35] Now Jewishness is no more considered a substantial basis, however, the courts continue to grant expulsion on the grounds that shareholder should not be trapped in an unbearable commercial relationships.

In 1953 in the other key German GmbH decision involving a dispute between two owners of a cabaret-dance bar, the defendant's extramarital affairs became a ground for her expulsion from the corporation.[36] Initially, the plaintiff sought to expel defendant because the defendant failed to credit the company with certain funds, and purchased a car without consulting the plaintiff. In this case in addition to evaluation of parties' business conduct the court, evaluated the character of both parties and found shareholder in question to be guilty of adultery. The defendant complained that he should be permitted to continue his business activity since his own behavior was negated by the behavior of the plaintiff, because the plaintiff had also committed adultery. At the end of the day the court found the plaintiff to be entitled for an expulsion.[37] Moreover in this case court justified possibility for the minority shareholder to expel the majority shareholder if a substantial basis is present.[38]

Therefore, it is possible to speak about the broad scope of the definition "substantial basis" which can lead to conflicts and uncertainty among shareholders. As Hugh T. Scogin comments "the extremely vague and open-ended language of the applicable German concepts has given judges wide discretion in resolving GmbH disputes"[39].

1.2.2 The procedure of the shareholder's expulsion.

[35] Judgement of August, 13, 1942, RGZ 169, 334 (F.R.G.) (as cited in Huge T. Scogine, Jr., *Withdrawal and Expulsion in Germany: A Comparative Perspective on the "Close Corporation Problem"*, 15 Mich.J. Int'l L. 127 (1993))
[36] Federal Court of Justice, decision of April 1, 1953, BGHZ 9, 157 (F.R.G.) (as cited in Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem*", 30 Cornell Int'l L.J. 381 (1997))
[37] Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem,"* 30 Cornall Int'l L.J. 381,382 (1997)
[38] Federal Court of Justice, decision of April 1, 1953, BGHZ 9, 157 (F.R.G.)

The procedure of the shareholder's expulsion begins with a vote by shareholders. The shareholder in question, however, may not vote on the matter. According to the German scholars such as A. Baumbach and A. Hueck the courts require a supermajority of votes. [40] The Federal Supreme Court of Germany in its Judgment of 13 January 2003 has established that LLC's shareholders can initiate the proceeding to expel the shareholder only if the resolution is adopted by the majority of three-quarters of the vote cast and the shareholder in question is not entitled to vote. According to the court section 60(1) of the Law on GmbH [41] must be applied in these circumstances.[42] If the required majority of vote is achieved, the court must order the expulsion as long as it is satisfied that there is *wichtige Grund*. The expelled shareholder then must be paid the value of her holding. [43]

In German legal system disputes often revolve around the problem of appraisal of the value of a departing shareholder's interest. The judgment on April, 1953 stipulated the "full worth" standard for the share of shareholder in question. However, this standard appeared to be so vague[44] that courts preferred instead of it the concept of market value. Therefore the German legal system always seeks to safeguard this value. Thus, in theory the basis for the valuation is the market value that incorporates going concern value. Howe ever, the application of the term "going concern value" is not common among accountants and economists[45].

In Germany it is up to the courts to decide on the issue of valuation since it is an important part of their decision-making. Basically it is seen logical since parties to commercial law cases have the possibility of dealing with a judicial panel which is consistent of lay judges who have business

[39] See Scogine, Jr., *supra* note 3.
[40] See BAUMBACH & HUECK *supra* note, at 364.
[41] GmbHG § 60 (1).
[42] Judgment of the German Federal Supreme Court, 13 January 2003, case no. II ZR 227/00 translation is available on a site http://crossborder.practicallaw.com/4-107-0957 (the date of visit March, 26, 2008).
[43] Carol L. Klin, *Protecting Minority Shareholders in Close Corporations: Modeling Czech Investor Protections on German and United States Law*, Boston College Int'l and Comparative Law Review (2000)
[44] See Scogine, Jr., *supra* note 3.
[45] Harry J. Haynsworth, *Valuation of Business Interests*, 33 MERCER L. REV. 457 (1982)

experience[46]. However, parties rarely use this approach waiving the participation of lay judges and agreeing their case to be heard by a single judge. Therefore parties can face the possibility to get unqualified decision of the single judge with little experience in financial accounting. The possible way out of the situation is the appeal procedure known as *Berufung*. Under this procedure the intermediate court can conduct a complete review of the facts as well as the law including the substance of valuation decision. Thus, all this procedure seems to be time and money-consuming that can significantly influence the company's welfare, can impede the business activity bringing monetary damages to the GmbH.

Therefore, it is possible to conclude that procedure of shareholder's expulsion is a necessary remedy in the situation of deadlock. The substantial basis for the expulsion of shareholder in Germany is rather vague and ambiguous term which includes not only the business aspects but also the personal relations among the shareholders, however, the judicial mechanism of shareholder's expulsion guaranties the common approach to the understanding of whether the particular event can be seen as *wichtige Grund.*

1.3 Expulsion of the Shareholder under the Ukrainian Law on Business Associations

The following subchapter will discuss Ukrainian approach to the expulsion of the shareholder from the Ukrainian Tovaristovo z obmezhenoyu vidpovidalnistyu (Limited Liability Company – hereinafter LLC) in order to provide a framework for comparison and prepare recommendations

[46] See Baumbach & Hueck *supra* note 33, at 362.

about the amending of Ukrainian legislation on protection of the shareholders in LLC. The proposed amendments will make Ukrainian LLC more attractive to foreign investors, help to maintain economic stability of the company, promote market growth.

Among Ukrainian scholars who have undertaken a research on the protection of shareholders' rights, *inter alia* protection of shareholders' rights in LLC the following names should be mentioned: O. Kibenko, I. Spasibo-Fateeva, I. Tarasov, O. Vinnik, O. Kheda, etc.. However, no one of them has not provided the detailed examination of the issue on the shareholder's expulsion from LLC. So O. Kibenko suggests an idea about the need of amendments of this provision[47]. O. Kheda proposes to repeal article 64 of the Ukrainian Law on Business Associations on the expulsion of the shareholder[48]. This thesis aligns with the idea of the vital amendment of the provision on the expulsion of the shareholder. I can not agree with O. Kheda about the need of repeal of the article 64 since the shareholder's expulsion is a vital mechanism for the LLC to resolve the deadlock situation.

Nowadays the Civil[49] and Commercial[50] Codes of Ukraine contain provisions which provide remedies for the protection of the shareholders' rights in the LLC. Special place among the legislation is given to the Law on Business Associations[51] because it contains the most extensive provisions regulating the legal relations within LLC.

The litigations in the sphere of LLC's shareholder's expulsion take a particular place among other corporate litigations in Ukraine since the shareholders often use this possibility to get rid of "undesirable" shareholder. Civil and Commercial Codes passed by the Parliament in 2003 have not

[47] Кибенко О.Р. Научно – практический комментарий Закона Украины "О хозяйственных обществах" – Х.: фирма "Эспада" - 2000. – С. 316. (O.R. Kibenko, Academic commentary of the Law on Business Association, Kharkov, 2000, 316)

[48] Хєда С. Особливості правового положення товариства з обмеженою відповідальністю (порівняльно-правові аспекти)// Міжнародне приватне право. – 2003. - № 9 – С. 51 - 53. (S. Kheda, Particularities of the legal status of Limited Liability Companies (comparative analysis)// Int'l Private Law. – 2003. -# 9-p. 51)

[49] Цивільний Кодекс України, Відомості Верховної Ради (ВВР), 2003, №№ 40-44, ст.356 (Civil Code of Ukraine, Vidomosti Verkhovnoi Radi Ukraini, 2003, ## 40-44, st. 356)

[50] Господарський Кодекс України? *Відомості Верховної Ради (ВВР), 2003, № 18, № 19-20, № 21-22, st.144* (Commercial Code of Ukraine, Vidmosti Verkhovnoi Radi Ukraini, *2003, № 18, № 19-20, № 21-22, st.144*)

[51] Law on Business Associations, 1991, Закон України "Про господарські товариства", Відомості Верховної Ради № 49, ст. 682 (1991).

fulfilled the existing lacunas in the regulation of the expulsion procedure. Analysis of the legal practice demonstrates that usually LLC's shareholders simply do not notify the fellow shareholder about forthcoming General Meeting that gives them the possibility to claim "non performance of the duties by the shareholder or performance of the duties in the improper way"[52]. All this justifies the urgent need of amendments of the Ukrainian legislation.

Article 64 of Ukrainian Law on Business Associations[53] contains a provision that permits General Meeting of shareholders to expel the shareholder which systematically does not perform her duties or perform her duties in improper way, or by her actions hinders the accomplishment of the LLC's purpose. This type of General Meeting's decisions belongs to so-called an "exclusive" decision which means that it can be taken only by the General Meeting of the Shareholders. The decision can be reached if more than 50 % of common quantity of shareholders' votes has voted for this decision. Moreover, the quorum must be constituted. According to article 60 of Ukrainian Law on Business Associations, quorum is constituted when the shareholders who own more than 60 % of votes are present at the General Meeting. The expelling shareholder is barred the vote at this General Meeting. It should be commented that the shareholder in question can not take part only in voting. Therefore her presence on the shareholders meeting is not prohibited.

Thus, three independent grounds of the expulsion are stipulated in the Law. They are systematic non-performance of shareholder's duties or performance of duties in improper way, or if actions of shareholder hinder the accomplishment of the company's purpose. First, it must be mentioned that there is no legislative act containing the definition of the term "systematic". E. Uvarova argues that two and/or more infringements can be considered systematic[54]. Other scholars

[52] Рішення Алуштинського міського суду від 26.06.2001 р.
[53] See Law on Business Associations, *supra* note 51, at art. 64
[54] Uvarova E. Expulsion of shareholder: grounds, procedure and consequences. Taxes and accountancy – 2007-# 23, p 17 –19. Уварова Е. Исключение участника из ООО: основания, порядок и последствия. Налоги и бухгалтерский учет, 2007, №12, стр 17-19.

consider three or more infringements to be systematic[55]. Therefore, the common approach to the understanding of the legal terminology is needed.

Article 11 of the Law on Business Associations stipulates the list of the shareholder's duties: to comply with the provision of articles of association and execute the resolutions of the General shareholders meetings and other managing bodies of the company; to perform the shareholders' duties towards the company; do not disclose confidential information and commercial secrets about corporate activity; to perform other duties if it is stipulated in this law, in other legislative acts of Ukraine or in the articles of association. The same list can be found in Civil Code of Ukraine[56]. The list is not exclusive, thus, the article of associations may provide additional duties for the shareholders. However, neither Civil Law nor article 64 of the Law on Business Associations clarify whether shareholder must comply only with the duties provided by the law or she should take into account the duties provided in the company's articles of association.

Likewise, the definition of the term "improper way of duties' performance" is rather ambiguous. Since the decision on expulsion is adopted by the General Meeting the shareholders may apply own standards of "improper" way of duties' performance which can differ from company to company. In turn it leads to the misuse of the right on expulsion by interested in the expulsion shareholders.

Therefore, it can be recommended to clarify the provisions of law on the shareholder's duties with the clear procedure of establishing new duties. Second, the term "improper way of performance" requires the common approach to its interpretation which can not be done without legal intervention.

The scope of application of the third ground of expulsion is very broad. On practice non-participation in General Shareholders' Meetings is considered to be an obstacle that hinders the

[55] A. Smityukh, 50 to 50: in the search of compromise. Expell or you will be expelled, Yuridicheskaya praktika
[56] Civil Code (Ukr) art. 117.

accomplishment of company's purpose[57]. But the shareholder in question as a rule is simply not notified by other shareholder (-s) interested in her expulsion about the General Meetings. This situation has happened with British Company Himalita Limited which was the shareholder in the Ukrainian Limited Liability Company "Misto Slavi". The other shareholder is Ukrainian Private Company "Dasko". The British shareholder was expelled from the company on the grounds that Himalita Limited did not participate in Ukrainian Company's affairs that was leading to the block of the business activity. Himalita limited argued that it was not properly notified about the General Meetings[58]. It should be commented that such situations are typical for small and medium Ukrainian business[59].

Thus, in my opinion the grounds stipulated in the Law on Business Associations seem to be controversial and ambiguous. The scope of applicability is broad and uncertain that can lead to precarious and unpredictable business activity. Subjective understanding of the ground by each shareholder during the General Meetings and application of it to the potential practical situations foster the manipulations of the expulsion right by interested shareholders.

Particular problems arise in the company established by two investors with equal shares. They are the quorum can not be constituted when one of the shareholders is absent on the General Meeting and neither of shareholders has the required 50 % +1 votes to take a decision of the expulsion. Thus, the shareholders of such companies are deprived of expulsion right. The Supreme Court of Ukraine in its decision on October 17, 2002 explicitly stated that "according to the analysis

[57] Martinov M., Unnderground war –: trial without the participation of defendant (микола мартинов, Підземна війна – 2: суд без участі відповідача), available at the site http://www.zn.kiev.ua/nn/show/587/52753/ , last visited on March, 4, 2008.
[58] Id
[59] A. Smityukh, 50 to 50: in the search of compromise. Expell or you will be expelled, Yuridicheskaya praktika

of the articles 59 and 64 of the Law on Business Associations expulsion of the shareholder from the Limited Liability Company is impossible"[60].

Thus, according to Ukrainian law, it is impossible for the minority shareholder to expel the majority shareholder; moreover, the shareholders of the company with equal 50/50 shareholding are completely deprived of the right on expulsion. As a result the possibility to face the situation of minority's oppression is high that gives rise to additional conflicts. Therefore it is possible to speak about low level or minority shareholders' protection. The existing regulation does not solve the problem of equal shareholding in case the Limited Liability Company has been established and run by two people with equal share and the situation of deadlock is arisen. It often can be often burdened by the familial or other personal relations in addition to the business dealing[61].

Thus, as we see the article 64 of the Law on Business association is outmoded provision that does not respond to the demands of market economy. It foster the misuse of the right on expulsion by the shareholders interested in the concentration of their ownership.

1.4 Solutions

The expulsion remedy is common to Ukraine and Germany. German law provides highly discretionary system of remedies in case of the shareholders' conflicts. In contrary, in Ukraine the range of remedies is established statutory *inter alia* Civil and Commercial Codes of Ukraine, the Law on Business Associations. However, Ukrainian corporate legislation is outmoded and it requires substantial amendments.

Review of the expulsion remedy in Ukraine and Germany demonstrates that vague standards of the shareholder's conduct are familiar to both legal systems. German "inability to accomplish

[60] Smirnov S. Divorce in "ukrainian style", Legal newspaper "Precedent", 2007 # 5 p. 8-11. Смирнов С. Развод «по-украински» // Правовая газета «Прецедент» 2007.

company's purpose", "improper performance of shareholder's duties" are the concepts familiar to Ukrainian corporate law. However, Ukrainian law is more focused on the conduct of the shareholder in the framework of her business activity rather than on shareholder's personal circumstances as it is established in Germany.

The scope of grounds for the expulsion is broad in both countries; however the judicial mechanism of expulsion in Germany gives the common approach to the understanding of ambiguous standards of conduct of LLC's participants. In its turn in Ukraine the General Meeting of shareholders can adopt the resolution about the shareholder's expulsion on the grounds of subjective understanding of the legal terminology. As a result it leads to the misuse of the right on expulsion by the interested shareholder in case she wants to get rid of "undesirable" shareholder.

Thus the common mechanism of control of the deadlock situation must be worked out. Therefore in my opinion it is better to change the procedure of shareholder's expulsion transmitting the decision-making power on this question to the judicial body *inter alia* court. This solution would help to lessen the quantity of situations when one of the shareholders can misuse her right and expel undesirable fellow. Likewise, it would assist in avoiding the situation when such remedy as expulsion is not available to the companies with 50-50 split of shareholding. Moreover, the transmission of the decision-making power on the issue of expulsion would bring some clarity and common understanding of the legal terminology of the expulsion grounds. Besides that transmission of the power to the court would help to prevent some shareholders interested in the expulsion of "undesirable" shareholder from the suing on this cause of action taking into account high cost of judicial procedure and its time-consuming. The proposed amendment will protect the minority shareholder in the situation when the majority shareholder wishes to concentrate her ownership.

[61]EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF THE CORPORATE LAW 228-229 (1991)

According to German legal practice minority shareholder can expel majority shareholder. Ukrainian legislation does not provide minority participants with such an opportunity. It is seen desirable to provide the minority shareholder with the expulsion remedy to improve the level of minorities' protection however it is better to define the minimal amount of shareholding for the person that wishes to initiate the expulsion procedure. That would prevent minority shareholders from impeding the business activity of the company by initiating the trial against majority shareholder which as a rule are the managers of the LLC.

The proposed procedure of shareholders expulsion does not make the resolution of this question conditional on the presence of shareholders on General Meeting and on the required by law quorum. Moreover, controversial terminology of article 64 of the Law on Business Associations requisites common approach to its understanding. That can be achieved by the judicial interpretation of the expulsion grounds. With this purpose author of the thesis proposes to amend the article 64 of the Law on Business Association and stipulates next text of proposal:

"Shareholders of Limited Liability Company with aggregated shareholding of no less than 10 % of the share capital have the right to file the motion to the court with request about the expulsion of the shareholder which systematically does not perform (or perform in improper way) her duties stipulated by the law or by the articles of association, or by her actions hinders the accomplishment of the company's purpose".

Chapter 2 – The Doctrine of Derivative suit: the need of its implementation into the Ukrainian Corporate Law

2.1 Doctrine of Derivative Suit under the Common Law

All jurisdictions must protect shareholders against opportunistic behavior of those whether corporate managers or controlling shareholders. Last ten years such device of shareholder's protection as derivative suit has gained lot of attention of the scholars around the world[62]. However, very long time the right of the shareholder to bring derivative suits was not accepted by legal scholars. So O. Siroedova in her book "The Law of Stock Companies in USA and Russian Federation"[63] mentions that David Rene did not accept the possibility of the shareholder to claim damages from the members of the managing board on behalf of the company. He explained that through non-existence of relationships among the shareholders and managers.

Derivative suit is "derivative" in the sense that the shareholder's suit derives from a right of the company to claim in respect of a wrong done to it. In the United Kingdom the possibility of the shareholder to bring derivative suit has arisen under common law as an exception to the rule in *Foss v Harbottle*.[64]

The judgment of this case established the following rule. First, in case if the company suffered the wrong done by the managing organ of the company the proper claimant is the company itself. Second, the court does not interfere with the internal management of a company acting within its power. *Foss v Harbottle* identifies that the will of the majority of a company's shareholders is the will of the company itself. This "majority rule" prevails i. e. in a situation if the activity that caused

[62] Pearlie Koh Ming Choo, *The Statutory Derivative Action in Singapore – a Critical and Comparative Examination*, 13 BOND L. R. (2001).
[63] Сыродоева О.Н. Акционерное право США и России. – М., 1996. – С. 73. (Siroedova O.N. The Law of Stock Companies in U.S. and Russian Federation. –M., 1996. – p. 73)
[64] *Foss v Harbottle [1843] 2 Hare 461*

wrong to the company was ratified by the majority of the shareholders, neither minority nor individual shareholder can not sue derivatively.

However, there is an exception to this rule. The person may bring derivative claim if "this when the person against whom the relief is sought holds and controls the majority of the shares in the company and where that person will not permit an action to be brought in the name of the company, and the acts complained of are of a fraudulent character or are beyond the powers of the company, a shareholder may bring a derivative claim in order to prevent fraud on the minority".[65] So first under the common law the scope of derivative suit's application was narrow. As S.J. Berwin argues situation has changed with the adoption of the Companies Act in 2006. The Act did not follow the common law approach but has accepted the recommendations of the Law commission about new modern approach to the derivative procedure with flexible and more accessible criteria for the shareholders to sue the directors.[66] Therefore, UK law has passed a long way till accept the derivative suit as an effective remedy against the malfeasance of the managing organ or majority shareholders.

American law has permitted derivative suits since the middle of 19th century.[67] In the United States, the derivative action is seen as very much as a regulator of corporate management[68] and one of the most effective means of enforcing the management's duties and obligations under the law.

In modern U.S. law a shareholder's derivative suit is an action brought by a shareholder not on its own behalf, but on behalf of the corporation. The shareholder brings an action in the name of the corporation against the parties allegedly causing harm to the corporation, i.e. an action against directors or officers of the corporation itself when their conduct is in violation of a fiduciary duty

[65] S.J. Berwin, Derivative claims under the Companies Act 2006, (2007), available on a site http://www.legal500.com/index.php?option=com_content&task=view&id=2806 date of last visit March 15, 2008.
[66] Id.
[67] B. Singhof, O. Seiler, *Shareholder Participation in Corporate Decisionmaking under German Law: a Comparative Analysis*, 24 Brook. J. Int'l L. 493 (1998).
[68] Cohen v Beneficial Industrial Loan Corp 337 US 541, 548 (1949).

owed to the shareholders, vis-à-vis the corporation. As a result of the litigation any proceeds of the action go to the corporation.

If shareholder decides to file a derivative action, she will go through the particular stages. First stage is the stage of notification to the company about the intentions of the shareholder to apply to the court. At this stage a shareholder wishing to sue the corporate managers/officers must notify the board of directors demanding it to sue prior the shareholder will pursue the derivative litigation by herself. If directors affirm the decision the shareholder's derivative is precluded. However, as a rule managers are reluctant to initiate the proceedings against themselves. Moreover, in most U.S. jurisdictions, demand is excused when it is futile to expect the directors to make a reasoned and unbiased decision on the matter, as where the directors are themselves interested in the challenged transaction. So in New York State shareholder may avoid this stage if she can prove that such demand is "futile"[69]. The judgment on Marx v Akers case contains the situations when the demand is futile:

> 1) when either the board's majority is directly interested in the challenged transactions or the alleged wrongdoers control a majority of the directors or 2) when the board members did not adequately inform themselves about the transactions in question; or 3) when the challenged transaction was so egregious that it could not have been the product of sound business judgment.[70]

Therefore the shareholder-plaintiff must prove particular fact that demonstrates alleged misbehavior of the board or its interest in the transactions. In majority of cases the shareholders try to convince judge the demand rule is not applicable. It is explained by the reason that after the shareholder notified the board about her wish to commence the litigation and the board refused to initiate the proceengs, the board is protected by the "business judgement rule".[71]

[69] Marx v Akers, 88 N.Y. 2d 189, 189-200, 666 N.E.2d 1034, 1040-1041 (1996).
[70] Id.
[71] See Singhof & Seiler *supra* note 67.

In its turn the board is entitled to create a special litigation committee to establish whether corporation should pursue the litigation.[72] The committee is nothing more than the shareholders that permitted to decide whether corporation should pursue the derivative litigation.[73] The decision of the committee will be supported by the court it is determined that "committee was independent and unbiased, and its decision was reasonable and principled".[74] It must be commented that commencing the derivative litigation shareholder must act in a good faith. This requirement is necessary to preclude shareholders from personal vendettas.

In some states the contemporary ownership rule is stipulated as additional procedural requirement. According to this rule plaintiff who complains of past wrongs must have been already the shareholder at the time of the wrongs of which he complains. It prevents a person that pursues selfish ends from buying shares with the very purpose of complaining about them, and benefiting on settlement from the corporation and its officers.[75] I agree with A. Connard that this rule prevents the misuse of the right not only by blackmailers but also by innocent purchasers who discover that they have bought "into a disaster area".[76]

When plaintiff has complied with procedural requirements and proved the wrong to the corporation she will be entitled to the relief. She can get the equitable remedies (injunction, rescission or cancellation of illegal transactions etc.) as well as she can get common-law damages. However, recovery in a derivative suit is the right of the company, not the litigant shareholder.[77] Except the issue or required relief the court decides who bears the costs of the litigation. As it was determined in Coggins v New England Patriots Football Club, Inc. "attorney's fees may be awarded,

[72] Thomas P. Billing, *Remedies for Aggrieved Shareholder in a Close Corporation*, 81 Mass. L. Rev. 3 (1996).
[73] Id.
[74] Houle v.Low, 407 Mass. 810,821 (1990).
[75] ALFRED F. CONARD, CORPORATIONS IN PERSPECTIVE 400-401 (1991).
[76] Id, at 400.
[77] See Ming Choo *supra* note 62.

in the judge's discretion, to a party who has successfully brought a derivative action on behalf of the corporation".[78]

Therefore, despite of the strict procedural requirements to enforcement mechanism, shareholder's derivative suit in the United States is still one of the most "striking and threatening" way of shareholders control over the management of the company.

2.2 Application of Derivative Suit Doctrine in Germany

German GmbH is a separate legal entity.[79] This leads to the prohibition of individual shareholders' rights enforcement against GmbH's organs i.e. the German law does not give to an individual shareholder the possibility to compel company's organs to act in accordance with their duties.

Another question whether the shareholder may bring the suit on behalf of the corporation for the harm caused by the organ of the corporation *inter alia* management or other shareholders, ff they have violated their duties towards company, because the dual role played by majority shareholders of the small-medium companies as both owner and managing board member creates environment for self-interested conduct[80].

At the beginning it should be discussed what kind of duties corporate organs and shareholders have towards the company. Since manager acts as an agent of the shareholders, agency relationships creates fiduciary obligations of the managers towards the shareholders. Fiduciary duty of the managing organ to shareholders consists of two elements: duty of care and duty of loyalty.[81]

[78] Coggons v. New England Patriots Football Club, Inc., 406 Mass. 666, 669 (1990).
[79] BERND TREMML, BERNARD BUECKER, KEY ASPECTS OF GERMAN BUSINESS LAW: A PRACTICAL MANUAL (2nd ed.) 2002
[80] See Miller *supra* note 37.
[81] See EASTERBROOK & FISCHEL *supra* note 61, at 228.

Regarding of duty of care the Law on GmbH explicitly establishes that "managing directors shall employ the diligence of an orderly businessman in the matters of the company" [82] i.e. . . . the standard of diligence is the one of an orderly businessman.

German Law has interpreted duty of care trough the so-called business judgment rule. Initially managing board lacked the traditional U.S. approach of "business judgment rule". However, German courts, according to German commentators, judicially created the version of business judgment rule with the purpose "not to discourage risk-taking and entrepreneurial activity of the directors."[83]

Managing directors have fiduciary duties toward the company. Duty of loyalty is not established under the Law on GmbH but it has been developed by the courts. [84] In contrast to the German Stock Companies the relationships between shareholders and managers of GmbH are characterized by the great degree of co-operation and personal trust. According to the opinion of German Federal Supreme Court (Bundesgerichtshof):

> The possibility for the majority of shareholders to exercise influence on the management and therefore to interfere with the business interests of the other shareholders requires as a counterpart the legal obligation to consider this interests.[85]

In other words majority shareholders taking decisions on company's affairs must take into account interests of minority shareholders. Likewise, the courts held that directors owe their company a duty of loyalty that requires them to disregard or even oppose dominant shareholders' attempts to self-deal. [86] Principle of equal treatment must to be obeyed and discrimination of

[82] GmbHG, § 43 (1).
[83] L. Enriques, Enforcing self-dealing Constraints on Dominanat Shareholders in Europe, Paper on Law and Economics Workshop, University of California, Berkley (2007) available on a site http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1178&context=berkeley_law_econ, date of last visit March, 15, 2007.
[84] Detlef Kleindiek, *Protection of Minority Shareholders under German Law*, I.C.C.L.R. 138-147 (1993).
[85] ITT (1975) 65 BGHZ 15, at 19.
[86] See Enriques supra note 83.

minorities is not permitted.[87] Moreover, managers of GmbH can not use corporate business opportunities for their personal benefit.[88] So it is possible to speak that German Law is familiar with the doctrine of corporate opportunity.[89] Managing directors who violate their obligations are jointly and severally liable to the company for the resulting damage.[90]

In the GmbH the right of the shareholder to bring the action on behalf of the corporation (*action pro societate*) exists under certain conditions. First of all § 46 (8) states that it is up to shareholders meeting to decide on assertion of the damage claims against managing directors or shareholders.[91] And individual shareholder may bring an action for damages only if majority of shareholders have decided not to bring claims for damages and, in particular circumstances of the case, such rejection constitutes a breach of the duty of loyalty of the shareholder.[92]

So according to the German commentators there is no statutory basis for derivative suits in GmbHs, although their possibility is generally recognized.[93] Other scholars consider the shareholder's possibility to bring suit against directors who acted dishonestly almost impossible.[94] As a consequence, in Germany liability suits against directors have always been rare. Most often, they were brought by the company after a change in control or by the bankruptcy trustee after the company had gone bankrupt.[95] Therefore, Germany devotes numerous statutory provisions to the regulation of related party transactions, but it also gives individual shareholder almost no tools to enforce these provisions.[96]

[87] Id
[88] id
[89] Black's Law Dictionary defines corporate opportunity doctrine as the doctrine that precludes corporate fiduciaries from diverting to themselves business opportunities in which the corporation has an expectancy, property interest or right, or which in fairness should otherwise belong to corporation (Black's Law Dictionary, 6th ed., 1996)
[90] GmbHG, § 43 (2).
[91] Id, § 46(8).
[92] See Kleindiek *supra* note 84.
[93] HOLGER ALTMEPPEN, GESETZ BETREFFEND DIE GESELLSCHAFTEN MIT BESCHRÄNKTER HAFTUNG § 13, cmt. 15 (5th ed. Günther H. Roth & Holger Altmeppen 2005).
[94] KRAAKMAN R., DAVIS P., HANSMANN H., HERTIG G., HOPT K., KANDA H., ROCK E, THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, 128-130 (2004).
[95] See Enriques *supra* note 86.
[96] F. DORNSEIFER, CORPORATE BUSINESS FORMS IN EUROPE, 262 – 270 (2005).

One of significant reasons why German legal system was reluctant to adopt the doctrine of derivative suit is the cost of litigation. Like one of the civil law countries the German Code of Civil Procedure (*Zivilprogrezessordung*) states that party lost the litigation bears the costs of the litigation, i.e. contingency fees are not recognized by the German law. They are considered unethical and against public policy.[97]

It is important to mention that Germany liberalized the procedure for shareholder- initiated litigation against managers in Stock Companies. Now shareholders that own 1 % of the share capital or shares with a par value of € 100, 000 can bring derivative suit.[98] Special "lawsuit admission procedure" (*Klaugezulassungsverfahren*) was introduced to avoid the abuse of the right on derivative action. Therefore, it seems that with the purpose not to deter the foreign investors German legislator has chosen the right trend of amending of the German Corporate law.

2.3 Implementation of derivative suit doctrine in the corporate legislation of Ukraine

Specific nature of corporate law fosters legislators to look for particular remedies which can protect participants of corporate relations. Doctrine of derivative suite is unique phenomena of procedural law that allows one person to sue the other person with the purpose of third party's rights protection without participation of the latter in the process.

Unfortunately, modern Ukrainian corporate law is not familiar with the notion of derivative suit. The idea of impossibility to mix the interests of the corporation with the interests of its

[97] Susan-Jacqueline *Butler, Models of Modern Corporations: a Comparative Analysis of German and U.S. Corporate Structures*, Arizona J. Int'l and Comparative Law (2000)

[98] AktG § 148(1), as amended by the Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), of September 22, 2005, BGBl. I 2005, No. 60., p. 2802 (Sept. 27, 2005).

shareholders or to equal them was supported by the Soviet Union scholars. I. Tarasova and P. Gusakovski argued that "such remedy as derivative suit can not be used by the shareholder since she has no authority for that".[99] They concluded that shareholder can impose liability on the managers of the corporation only requesting this question be announced for the passing of a resolution on the General Meeting since exactly this organ has the authority to represent the corporate interests.[100] Currently in Ukraine shareholders in LLC can not bring the derivative suits; however, such possibility is not explicitly prohibited by law. On practice derivative suits are concealed by the complainants that claim not only the grievance towards the third party (corporation) but towards themselves either.[101] Adoption of new Civil and Commercial Codes in 2003 does not change the situation.

Special attention in the examination of this issue must be given to the Decision of the Constitutional Court of Ukraine № 18-рп/20041 adopted on December, 1, 2004. this was the case initiated by 50 parliamentarians on the official interpretation of provisions of article 4(1) of the Code of Civil Procedure (case about protected interest).[102] In this case on the grounds on the Law on Constitutional Court[103] parliamentarians applied to the Constitutional Court with the motion to obtain an official interpretation of the term containing in the article 4 (1) of the Code of Civil Procedure "protected interest". The article 4(1) stipulates that "every person has the right to apply to the court for the protection of the breached or moot rights or for the safeguard of protected by the law interests".[104] In addition they asked to explain "whether this term can be applicable to the

[99] Чугунова Е. И. Производные иски в России и за рубежом // Арбитражный и гражданский процесс. – 2003. - № 3. - С. 41-43.(Chugunova E.I. Derivative suits in Russia and abroad // Commercial and Civil Procedure. –2003.- #3.- p.p. 41-43.)
[100] Id.
[101] Попов Ю. Толкование "косвенных" исков // Юридическая практика. – 2002. -№ 50(260) – С. – А7. (Popov Y. Interpretation of derivative suits// Yuridicheskaya praktika. –2002. - # 50 (260)- p. A7.)
[102] See Constitutional Court Decision *supra* note 4.
[103] Закон України "Про Конституційний Суд України" *Відомості Верховної Ради (ВВР), 1996, № 49, ст.272,* (Law on Constitutional Court of Ukraine, Vidomosti Verkhovnoi Radi Ukraini, 1996, # 49, st. 272)
[104] Цивільний процесуальний кодекс України Затверджений Законом від 18.07.63 *ВВР, 1963, N 30, ст. 464 (*Code of Civil Procedure (Ukr.), art. 4 (1).

interest of the natural person – shareholder of the stock company to bring the suit to the court for the protection of the interests of the stock company in what he/she has shares taking into account that as a consequence of the grievance of the corporation's rights, the legal rights of the shareholders are breached."

Constitutional Court decided that the term "protected by the law interest" in logical connection with the term "rights" must be understood as an aspiration to the use of material[105] and nonmaterial benefits, as a simple legitimate permition that is an object of the judicial protection per se with the purpose of satisfaction of individual and collective needs which do not contradict to the Constitution and other legislation of Ukraine, to common interests, to the principles of fairness and just, to the principles of good faith and reasonableness.

In the light of the question set in the constitutional motion the provisions of the article 4 (1) of the Code of Civil Procedure must be understood in the following way:

> "shareholder is entitled to protect her rights and protected interests in a court in case of the breach of the rights or the interests, their non-recognition by the stock company, by its bodies or by other shareholders. The legal procedure of 1) protection of the rights breached by somebody *inter alia* by the third person, 2) protection of the rights and interests of the stock company, that can not be the same as simple amount of individual protected by the law interests of its shareholder, is established by the law"[106].

In addition, in the decision the Constitutional Court commented on the term of minority shareholder. It argued that minority shareholders have no right to sue the executives of the corporation since the interests of minorities do not constitute the interests of the corporation per se. Therefore it is only up to majority shareholders to sue the executive bodies of the corporation if such a possibility explicitly established by the law.

Thus, according to the decision of the Constitutional Court of Ukraine only the majority shareholders can be entitled to bring derivative suits in case such possibility will be established by law. So using the reasoning by analogy it is possible to assume that the majority shareholders of the

[105] Here the word "material" is used in its sense as "physical" or "having to do with matter"

Limited Liability Companies can bring derivative suit only in case this possibility is provided by the Law on Business Associations.

Ukrainian contemporary scholars have an opposite to the Constitutional Court opinion. So N. Glus argues that non-matching of the shareholders' and corporation's interests is a natural. She states the any interest that legally belongs to the person must be protected, however, the peculiarity of the corporate rights make the decision of the question conditional upon the ratio among the will of the majority shareholder and the interests of minority. Therefore these peculiarities of the corporate rights' protection must encourage the legislator to adopt new not traditional remedies.[107]

Those ideas are supported by other famous scholars (O. Kibenko, O. Vinnik) that see the derivative suit as "a necessary protective mechanism of the rights that belong to the shareholders of business associations".[108] They speak about minimal set of mechanisms that must be established statutory among those mechanisms it is possible to find the derivative suit.[109] Moreover, all these doctrines are stipulated in the Directives of European Union on the law of companies. And Ukraine has undertaken to adopt its internal legislation with the legislation of European Union.[110]

It is important to comment that recently Russian Federation implemented the doctrine of derivative suit into its legislation. So according to the Law of Russian Federation on Limited Liability Companies[111] the shareholder of the LLC can bring the derivative suit not on behalf of the company but protecting the rights of the latter i.e. safeguarding the rights of the company the shareholder indirectly protects her own interests. Russian legal scholars consider this innovation to

[106] See Constitutional Court Decision *supra* note 4.
[107] Глусь Н.С. Корпорації та корпоративне право: поняття, основні ознаки та особливості захисту: дисертація … канд. юрид. наук за спеціальністю 12.00.03. – Цивільне право, цивільний процес, сімейне право та міжнародне приватне право / Київський національний університет імені Тараса Шевченка. – Київ, 2000. – с.20. .(Glus N.S., Corporations and corporate law: definition, main features and particularities of protection, Kiev National University. – Kyiv, 2000, p. 20)
[108] Вінник О.М. Деякі питання вдосконалення організаційно-правових форм господарювання в Україні // Право України. – 2000. - № 9. - С. 39-42. (O.M. Vinnik, On the question about the improvement of the business associations in Ukraine, Pravo Ukraini, # 9 (2000))
[109] Id, at 39.
[110] See Vinnik *supra* note 108

be “rather reasonable” because it substantially strengthened the responsibility of the managing organs and gave to the shareholders real possibility to impact the managing activity and control it. However, this doctrine requires further improvements in the framework of Russian reality.[112]

2.4 Solutions

Ukrainian system has lot of in common with the German legal system. Both systems are reluctant to implementation of derivative suit’s doctrine into the national legislation. However, according to the conducted analysis it is possible to conclude that the level of shareholders’ protection under the German law is better. Germany devotes numerous statutory provisions to the regulation of related party transactions; however it gives individual shareholder almost no tools to enforce these provisions[113]. The current trend of Germany is to improve the level of the shareholders’ protection with the purpose to make the German economy more attractive to foreign investors.

As it has been already mentioned modern Ukrainian corporate law is not familiar with the notion of derivative suit. However, lot of legal scholars conferre the idea about the need of implementation of this device into the legislation of Ukraine.

The doctrine of derivative claim contains a range of procedural requirements to be complied by the shareholder who wishes to initiate the derivative litigation. However, this type of suit can not only reimburse the damages caused to the corporation but also can perform preventive function over the management. Moreover, the legislator must encourage a certain level of shareholder activism since it can influence the whole state economy.

[111] Law of Russian Federation on Limited Liability Companies, art. 44 (5) avaliable on a site http://www.consultant.ru/popular/ooo/ last visited on March, 1, 2008

[112] Петникова О.В. Права участников корпоративных отношений по праву Великобритании: Автореферат дисс. … канд. юрид. наук: 12.00.03 – Гражданское право; предпринимательское право; семейное право; международное частное право. – М., 2007. – 22 с. (O.V. Petnikova, Rights of corporate relations’ participants under the law on Great Britain, Dissertaziya kandidata yuridicheskikh nauk, Moscow, 2007, p. 22)

[113] F. DORNSEIFER, CORPORATE BUSINESS FORMS IN EUROPE, 262 – 270 (2005).

Therefore on basis of the previous research the author of thesis aligns with the position of the Ukrainian scholars that the Law of Ukraine must adopt the doctrine of derivative suit i.e. suit brought by the shareholder of the company on behalf of the corporation against the parties allegedly causing harm to the corporation. With the purpose to improve the level of shareholders' protection stipulated in the corporate legislation of Ukraine, with the purpose of motivation of directors and/or officers of the corporation to the due exercise of their duties it is proposed to amend the Law on Business Association adding to it the provision which would entitle the LLC's shareholder to bring derivative suit on behalf of the LLC.

Conclusion

The shareholder's rights' protection is the issue that is widely discussed in the academic literature. This research has been concentrated on two remedies available to shareholders for the protection of their rights in the corporation. First remedy is so-called direct suit, which allows the shareholders to sue in their own capacity to enforce their rights as shareholders. Second remedy is derivative suit. Derivative suit is a suit which shareholder can bring on behalf of the corporation to enforce corporate rights that affect her only indirectly.

The thesis analyzed comparative protection of Limited Liability Company's shareholders under Ukrainian and German Corporate Laws in order to propose the amendments to current Ukrainian law with purpose to improve the level of shareholders' protection. The findings of the author of the thesis have had also policy implications because amending the corporate law Ukraine considers the possibility to attract new investors to such Ukrainian business entity as Limited Liability Company.

The thesis has been divided into two major chapters. Chapter one has examined the direct suits in the law of Ukraine and Germany focusing in particular on shareholder's protection in case of her expulsion. In the first chapter I have analyzed the advantages and disadvantages of German and Ukrainian legislative acts concerning the expulsion of the shareholder. The result of the research has shown that the expulsion remedy is common to Ukraine and Germany. However, German law provides highly discretionary system of remedies in case of the shareholders' conflicts. In contrary, in Ukraine the range of remedies is established statutory *inter alia* in Civil and Commercial Codes of Ukraine, in the Law on Business Associations. The conclusion about the outmoded character of Ukrainian corporate legislation has been made. Therefore the contention about the need of substantial amendments has been affirmed. On the grounds of such comparison project of

amendment to the Law on Business Associations of Ukraine has been proposed. Moreover, author has affirmed the general contention that expulsion is a necessary remedy in Limited Liability Company to cure the deadlock situation.

Chapter two has dealt with historic development of the derivative suit doctrine, the contemporary notion of derivative suit in Germany. The thesis has analyzed the approach of the German commentators to the notion of the derivative suit, the scope of its applicability, advantages and disadvantages of such type of the suits.

I examined three legislative acts regulating the existence of Ukrainian limited liability companies. They are Civil Code of Ukraine, Commercial Code of Ukraine and Law on Business associations (entered into force on October, 1, 1991). The provisions of those acts are very controversial to each other, which creates particular impediments for the practitioners in creating and maintaining the business activity of Limited Liability Companies. In spite of the bulk of legislation no one of the aforementioned acts recognizes the notion of the derivative suit. Moreover, the decision of the Constitutional Court of Ukraine on protection of the shareholders' interests has been examined. According to this decision the shareholder of the stock company can not apply to the court in case the interests of the corporation were breached unless such possibility is provided by law. Thus, currently neither procedural law of Ukraine, nor corporate substantive law provides the possibility to commence derivative action. But the arisen quantity of corporate conflicts requires implementation of doctrine of derivative claim into Ukrainian legislation. It has been stipulated that implementation of derivative suit would allow the shareholders of limited liability companies not only to recover damages caused by the misconduct of company's managers but also to provide a preventive function under the management. But in a row with positive features of this notion the author has argued that the legislative body should take into account some obstacles that can appear on a way of the shareholder of Limited Liability Company if she wants to bring derivative claim. Altogether, the research has demonstrated that Ukrainian law, lacking a device like derivative suit

gives shareholders little protection. On the grounds of the comparative analysis the conclusion about the need of implementation of derivative suit into the corporate law of Ukraine has been made.

Therefore the thesis has concerned protection of Limited Liability Companies' shareholders' rights. However, due to limitations of the thesis only certain categories of legal disputes have been examined. On the grounds of comparative analysis of Ukrainian and German corporate laws, the analysis of judicial practice the conclusion about the need of Ukrainian Corporate Law's modification has been made. As the result the paper contains proposals as to improvement of Ukrainian law currently in force in the field of LLC' shareholders' rights' protection *inter alia* the project of amendments into Ukrainian Law on Business Associations. The proposed amendments make Ukrainian LLC more attractive to foreign investors, help to maintain economic stability of the company, promote market growth. The obtained result can be used for the further research on the protection of LLC's shareholders' rights.

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