Capital Markets Project

TRANSACTIONS AND PRACTICES THAT MAY AVOID PUBLIC JOINT COMPANY STATUS

A White Paper Including Issues and Recommendations

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I. Executive Summary and Recommendations

The Law of Ukraine on Joint Stock Companies (hereinafter - JSC Law) represents a major step forward in the organization, financing and governance of Ukrainian joint stock companies (hereinafter – JSCs or individually – JSC). In making a distinction in Article 5 of the JSC Law between public and private JSCs, the JSC Law correctly recognizes that private JSCs should not be subject to the same level or degree of regulation as public JSCs. Investor protection, regulatory oversight, corporate governance and accountability of management should be addressed more comprehensively with respect to public JSCs because there is a greater separation of ownership and control in public JSCs as well as a greater number of shareholders whose shares may be publicly traded.

It has now become evident that many JSCs that would be public JSCs under the JSC Law because they have more than 100 shareholders may wish to transform themselves to private JSCs which may have no more than 100 shareholders, or possibly to limited liability companies (hereinafter LLCs or individually LLC) which are not covered by the JSC Law and which currently may have no more than 10 members. This transformation process should not be discouraged or compromised.

However, for many of the JSCs that will undertake transformation to private JSCs or to LLCs, there are shareholders and shareholder value to be protected. It is essential that the transactions used to achieve such transformation should be conducted transparently and that shareholders receive information that is sufficient to enable them to make informed decisions. If the shareholders in the transformed companies are not treated fairly, Ukrainian capital market development may be seriously impeded because it will send the wrong message to domestic and foreign investors that Ukrainian authorities do not respect shareholder rights.

A number of articles of the JSC Law task the SSMSC with the responsibility for explaining procedures relating to application of the Law and adopting procedures to implement such articles. Unfortunately, the response to date of the SSMSC and other Ukrainian authorities to implementation and enforcement of the JSC Law has not been encouraging. They have issued a rather tenuous interpretation that unnecessarily defers applicability of the Law, and they have not addressed the need to change current regulations and adopt new implementing regulations. Moreover, instead of proactively recommending amendments that would improve protection of shareholders under the Law, particularly enforcement provisions, they appear to be searching for ways that would defer or weaken other provisions of the Law.

For example, despite the fact that a significant JSC transformation process is already well underway and will impact thousands of Ukrainian shareholders, the SSMSC and other governmental authorities have failed to recognize that current SSMSC regulations regarding determination of the price to be paid for the shares of shareholders that object to a transformation are woefully inadequate.

In summary, rather than seeking to defer or evade having to deal with the challenging regulatory issues raised by the JSC Law, the SSMSC and others within the GOU need to take steps to ensure that the Law is implemented expeditiously, transparently and fairly so that shareholder rights are respected.

The purposes of this White Paper are:

- to identify both the legitimate transactions and the manipulative practices that might be used by JSCs to achieve private JSC or LLC status;

- to identify the investor protection issues that are presented by such transactions and practices;
- to identify areas in which the JSC Law should be amended to provide greater shareholder protections and to make its provisions enforceable;
- to recommend valuation and other requirements that the SSMSC should apply to address the investor protection issues in connection with legitimate transactions; and
- to recommend regulations that the SSMSC should adopt to deter manipulative practices.[1]

Set forth below are recommendations regarding amendments that should be made to the JSC Law and changes that should be made in SSMSC regulations. Cross references are included to the Sections of the White Paper where the reasons for the recommended changes are explained.

Effectiveness of JSC Law. As explained in Section V, in order to establish a definitive date by which the provisions of the JSC Law will apply to all JSCs regardless of whether they adjust their charters and other bylaws, part 5 of Chapter XVII should be amended so that the text following the first paragraph of part 5 reads as follows:

> "All applicable provisions of this Law shall apply to joint stock company that has not adjusted its charter and other bylaws within the deadline specified in the preceding paragraph, and any provisions in such company's charter or other bylaws that conflict with the provisions of this Law shall be null and void.
>
> A company that has not specified in its charter whether it is a public or private joint stock company shall be deemed a public joint stock company subject to all provisions of this Law applicable to public joint stock companies."

SSMSC authority over private JSCs. As discussed in Section II, the BIT CJSC decision should be codified by adding the following at the end of indent 5) under part 3 of Chapter XVII:

> "Add new part 7 under the Final Provisions of Section VII to read:
>
> 'Effective May 1, 2011, Articles 39, 40 and 41 of this Law [the 2006 Law on Securities and the Stock Market] shall not apply to private joint stock companies.' "

Changes in SSMSC valuation regulations. As discussed in Section IV, the SSMSC should use its existing authority, including its authority under the new JSC Law, to prescribe improved valuation regulations that should apply to transactions related to transformation of JSCs before they become subject to the new JSC Law as well as all valuations required to be made under the JSC Law. The new regulations should be consistent with Article 8 of the JSC Law and should require an independent expert's opinion regarding whether the price involved in a transaction represents fair value. The regulations should require disclosure of:

- the professional qualifications and independence of the person who renders such opinion;
- any conflicts of interest that the person may have with respect to the transaction for which an opinion on fair value is being expressed;
- how such person is to be compensated and by whom; and

[1] This White Paper is not intended to address issues raised by the JSC Law's requirement that by October 29, 2010, all shares of joint stock companies are required to exist only in registered and non-documentary form. While the shortcomings of SSMSC and other governmental authorities' efforts toward implementation of this requirement are also evident, this is a subject that warrants separate analysis and recommendations.

- the factors and methodology used in rendering the valuation.

The first valuation method in the SSMSC's current valuation regulations should be abandoned. With respect to the second method in the current regulations, rather than limit the use of market prices for shares as a valuation factor, the regulation should require that to the extent market prices are used, information should be provided as to the timeliness of the prices and the depth and liquidity of the market. The regulations should not require use of a weighted average market price. They should permit the expert to use valuation methodologies that the expert deems appropriate in the particular circumstances of a transaction, including the asset-based and discounted cash flow methods, which are described in Appendix 1.

Open and closed JSCs with less than 100 shareholders that wish to become private JSCs. As explained in Section VII, the SSMSC should adopt a brief regulation that provides where shareholders of a JSC with no more than 100 shareholders are asked to vote upon becoming a private JSC, information made available to shareholders prior to the meeting at which the vote is taken must include a summary of all changes to be made in the amended charter of the JSC that have a material effect on shareholders' rights, including the right to freely dispose of their shares.

Open and closed JSC's with less than 100 shareholders that wish to become LLCs. As explained in Section VIII, the SSMSC should:

1. Advocate adoption of draft legislation currently registered in the Rada that would amend the Law on Business Associations to change the 10-member limit on LLC members to 100 members or, alternatively, advocate adoption of a new LLC Law that would permit not more than 100 members.

2. Pending adoption of this change in the number of LLC members, the SSMSC should have in place a brief regulation that provides where shareholders of such a JSC are asked to vote upon becoming an LLC and some of the shareholders will not continue as members of the LLC, the information made available to shareholders prior to the meeting at which the vote is taken must include a summary of all provisions of the LLC's governing instruments that affect a member's rights. In particular, the regulation should require that any restrictions on an LLC member's right to dispose of the member's stake in the LLC must be disclosed as well as any circumstances under which members of the LLC may cause a member to be removed from the LLC. The regulation also should require disclosure to shareholders of the material terms of any transaction that will cause their shareholding in the JSC to be acquired or eliminated, including:

    - the purpose of the transaction;
    - what consideration the shareholder will receive in exchange for his shares and how the value of such consideration was determined;
    - what vote of shareholders is required to approve the transaction; and
    - what appraisal or other rights are available to a shareholder who objects to the transaction.

Takeover bid and/or purchase of shares by a third person that enables a JSC to become a private JSC. For reasons explained in Section IX, Articles 64 and 65 of the JSC Law and SSMSC regulations should be amended as follows:

1. Article 64 should include a definition of "tender offer" based upon the definition of "takeover bid" in Article 2.1(a) of the EU Takeover Directive, as follows:

“Tender offer” shall mean a public offer (other than by the joint stock company whose securities are the subject of the offer) made to the holders of shares or other securities with voting rights of a public joint stock company, whether mandatory or voluntary, which follows or has as its objective the acquisition of control.

For purposes of this definition, a tender offer shall be deemed to seek control of a public joint stock company if the offer is made to acquire more than 10% of the shares or more than 10% of any other class of securities with voting rights, of if the offer, taking into consideration shares and other equity securities already owned by the bidder, would give the bidder more than 50% ownership of the shares or more than 50% ownership or any other class of securities with voting rights.”

2. Article 64 should be amended to provide a <u>de minimus</u> exception for small acquisitions as follows:

   “No notification or other filing shall be required by a person that is a 10% or more owner of a public joint stock company’s shares or of another class of the joint stock company’s securities with voting rights if there is a subsequent acquisition of not more than one percent of the joint stock company’s shares or other equity securities during any twelve-month period.”

3. SSMSC regulations should be amended to require that once a person has acquired 10% or more ownership, notification should be given to the SSMSC and any material changes in such ownership should also be reported by amendment. Copies of such information should be required to be sent to the joint stock company and the stock exchange on which a public joint stock company’s shares are admitted to trading. In addition, to requiring disclosure of current ownership and ownership proposed to be acquired, and the proposed means of acquisition, the notification should require the information referred to under Problems, paragraph 3 in Section IX of this White Paper. For tender offers that would be covered by Article 64 as amended, the SSMSC regulations should require that the information referred to in part 2 of Article 65 as well as the additional information and conditions referred to under Problems, paragraph 8 in Section IX of this White Paper, should be included in and applicable to any such tender offer.

4. Part 2 of Article 64 should be revised to permit defensive actions authorized by a public joint stock company’s shareholders and to require the joint stock company to disclose its recommendation regarding a tender offer or why it is not making a recommendations. See discussion under Problems, paragraph 5 in Section IX of this White Paper.

5. The squeeze-out and sell-out procedures included in the EU Takeover Directive and discussed under Problems, paragraph 6 in Section IX of this White Paper should be added as amendments to Article 64.

6. Article 64 and paragraph 2 of part 1 of Article 65 should be amended to permit the additional methods of publishing a tender offer that are required for the notification now referred to in Article 64. See discussion under Problems, paragraph 7 in Section IX of this White Paper.

<u>Purchase of shares by a JSC that enables it to become a private JSC</u>. For reasons explained in Section X, Article 66 of the JSC Law should be amended as follows:

1. In the first sentence of part 1, delete “According to a decision of the general meeting,” and replace with “Except for redemptions referred to in part 5 of this Article, a decision of the general meeting shall be required so that”.

2. Delete paragraph 5 of part 1 and revise the first sentence of part 2 to read as follows:

> “If the number of shares offered for redemption by shareholders pursuant to an offer of redemption exceeds the maximum number of shares that the company has stated that it is willing to redeem and the company is not willing to waive the maximum limit, the shares redeemed by the company must be redeemed pro rata from all shareholders who have offered their shares for redemption.”

3. Delete the second sentence of the paragraph 2 of part 2 and replace with:

> “If shares are to be redeemed from a director, manager or 10 percent of more shareholder of the company or an affiliated person of such person other than in circumstances covered by part 5 of this Article, the redemption price paid for such shares may not exceed their market value determined in accordance with Article 8 of this Law.”

4. Delete paragraph 2 of part 3 since a correct reference to Article 8 is already included in paragraph 4 of part 1.

5. Add new part 5, reading as follows:

> “Notwithstanding part 1 of this Article, approval of a general meeting of shareholders shall not be required to redeem shares in the circumstances described in Article 7, part 2 of this Law.”

6. Add new part 6, reading as follows:

> “If the amount of shares proposed to be redeemed during a twelve-month period exceeds 10 percent of the issued shares and the circumstances described in paragraph 2 of part 2 of this Article do not apply, the company shall be required to comply with the tender offer provisions of Article 64:

[At this point, the information required by recommendations 5 and 6 under “Takeover bid and/or purchase of shares by a third person that enables a JSC to become a private JSC” should be set forth.]

Sale of all or substantially all of a JSC’s assets. For reasons explained in Section XI, a sale of all or substantially all of a JSC’s assets should be covered in a separate article under Chapter XVI of the JSC Law and protections comparable to those included in Article 81 should apply to a sale of all or substantially of a JSC’s assets. If more specificity is required regarding the meaning of “substantially all”, the following definition is recommended:

> “A sale of all or substantially all of a company’s assets takes place when the assets sold account for more than 75% of the value of the company’s assets indicated on its most recent annual balance sheet, or the assets sold leave the company with no operating assets.”

In addition, the recommendations made under "Changes in SSMSC Valuation Regulations" above regarding an independent expert's opinion should apply to the independent expert's opinion referred to under Article 81 of the JSC Law.

II. Background

The JSC Law represents a major step forward in the organization, financing and governance of Ukrainian JSCs. In making a distinction in Article 5 of the JSC Law between public and private JSCs, the JSC Law correctly recognizes that private JSCs should not be subject to the same level or degree of regulation as public JSCs. Investor protection, regulatory oversight, corporate governance and accountability of management should be addressed more comprehensively with respect to public JSCs because there is a greater separation of ownership and control in public JSCs as well as a greater number of shareholders whose shares may be publicly traded.

This is also true with respect to other laws affecting Ukraine's JSCs, including securities, depository, auditing and accounting laws, especially for those JSCs whose financial size would make it difficult to justify application of public JSC requirements on cost vs. benefits basis.[2] In this regard, the March 14, 2008 decision of the District Administrative Court of Kiev in Bit CJSC vs. Securities and Stock Market State Commission (SSMSC) that the SSMSC exceeded its authority in adopting and applying SSMSC Regulation #1591 to require annual reports by closed JSCs that have not made a public placement of their shares correctly recognizes that disclosure and financial reporting obligations should not be the same for public JSCs with publicly traded shares and private JSCs whose shares may not be traded on the stock exchange.

It is unfortunate in this regard that in making selective amendments to the securities legislation, the drafters of the JSC Law did not amend the 2006 Law of Ukraine on Securities and the Stock Market to make this distinction in SSMSC disclosure and reporting requirements. It is recommended that the JSC Law be amended to do so. Note in this regard that if the amendments recommended in Section V below were adopted, they would provide that any JSC that did not adjust its charter by April 29, 2011 to indicate whether it was a public or private JSC would automatically be deemed a public JSC.

The distinction between public and private JSC status is of critical importance for at least three reasons that affect Ukraine's capital market development. The first is that there are currently a number of JSCs in the Ukraine, including some whose shares are admitted to public trading, that are simply not financially viable as public companies. In some of these JSCs, there is no shareholder value and the enterprise may be dormant or insolvent. Ideally, these JSCs should not remain as public JSCs. In some cases, they should be dissolved. In many others, they should be encouraged to reorganize and become private JSCs or possibly LLCs. Permitting these JSCs to remain public companies results in an environment where their public shells might be used for illicit purposes, including money laundering and securities market manipulation.

The second reason relates to EU accession. If Ukraine expects to become an EU member or even to secure favorable foreign trade status predicated upon compliance with EU legislation,

[2] However, JSCs that provide financial services to a public constituency, such as banks, insurance companies, securities firms, asset managers, stock exchanges, self-regulatory organizations and other professional securities market participants, should be subject to substantially the same level of disclosure, reporting and regulatory oversight regardless of whether these entities are owned by a class of public investors or closely held. Substantially equivalent regulation in these circumstances is necessary to ensure fair dealing and accountability with respect to transactions involving other people's money.

Ukrainian public companies that are admitted to trading on a regulated securities market must be able to comply with a comprehensive set of disclosure and financial reporting requirements.[3] Among the Central and Eastern European countries recently admitted to the EU, none have more than 500 listed companies to which these requirements apply. Ukraine also should not expect to have more than 500 public JSCs that would be capable of meeting these EU requirements. Even Russia, which privatized more than 14,000 companies via public share ownership, had only 347 listed companies as of August 2009.

The third reason is that Ukraine faces serious capacity problems with respect to the legal and accounting skills that are necessary to enable its financially viable JSCs whose shares are admitted to trading on securities markets to comply with international best practices in disclosure and financial reporting. For example, there would be a shortage of qualified auditors and accountants if only Ukraine's 500 publicly traded JSCs were subject to EU requirements, including international auditing standards (IAS) and international financial reporting standards (IFRS). If Ukraine seeks to apply such requirements to a broader base of JSCs, many of whom are not viable candidates for admission to public trading on a regulated securities market, the ability of the viable JSCs to render timely and reliable financial information will be further impaired.

III. Purpose of this White Paper

The above background suggests why many JSCs that would be public JSCs under the JSC Law because they have more than 100 shareholders may wish to transform themselves to private JSCs which may have no more than 100 shareholders, or possibly to LLCs which are not covered by the JSC Law and which currently may have no more than 10 members.[4] For most of these JSCs, sufficient time has elapsed since privatization for their managements to conclude whether they are among the limited number of JSCs likely to benefit from having a public trading market in their shares or whether the burdens of being a public JSC (especially under the more robust requirements of the new JSC Law) outweigh the potential benefits. If the principles of a market economy are to be respected and the decision not to be a public JSC is approved by a requisite majority of the JSC's shareholders, this transformation process should not be discouraged or compromised.[5]

However, for many of the JSCs that will undertake transformation to private JSCs or to LLCs, there are shareholders and shareholder value to be protected. It is essential that the transactions used to achieve such transformation should be conducted transparently and that shareholders receive information that is sufficient to enable them to make informed decisions. If the shareholders in the transformed companies are not treated fairly, Ukrainian capital market

[3] The EU Transparency Directive, available at http://ec.europa.eu/internal_market/securities/index_en.htm, provides a very good example of comprehensive financial reporting requirements applicable to companies with securities admitted to trading on a regulated securities market.

[4] A draft law, registered in the Rada in December 2009, would amend the Law on Business Associations to raise the 10-member limit for LLCs to 100 members. However, another draft law on LLCs, also registered in December 2009, would retain the 10-member limit on LLCs and give LLCs that exceeded this limit one year in which to either register as JSCs or to liquidate.

[5] For example, a proposal included in draft amendments to the JSC Law being considered by an SSMSC working group would increase the public vs. private threshold from 100 to 1000 shareholders. This proposal is ill-advised. If adopted, it would result in a class of private JSCs with numbers of shareholders that are well above international norms for private JSCs. As a result, there is a very realistic possibility that illicit, non-transparent OTC trading might take place in the shares of these "private" JSCs, which would be precluded from stock exchange trading. At the same time, there would be less reliable information available regarding these "private JSCs" because they would not be subject to the JSC Law's requirement that public companies prepare financial statements in accordance with international accounting standards.

development may be seriously impeded because it will send the wrong message to domestic and foreign investors that Ukrainian authorities do not respect shareholder rights.

The transformation process will impact thousands of Ukrainian shareholders. There are approximately 10,000 open JSC's and 20,000 closed JSCs registered in Ukraine. However, according to SSMSC data, there are only about 14,000 JSCs that file reports with the SSMSC and that hold general meetings.[6] Of the 14,000 JSCs, it is estimated that 40-50% of them have more than 100 shareholders. This would suggest that Ukraine still has at least 5,600 to 7,000 JSCs with more than 100 shareholders. However, since the JSC Law was adopted, it appears that approximately 1,500 JSC's have transformed themselves into non-JSC entities; in most cases, LLCs. It is not known how many of these JSCs were open or closed JSCs.

The fact that the JSC transformation process is already well underway and that there are many remaining JSCs that should be and will be transformed indicates that there is a immediate need for the SSMSC and others to take steps to ensure that the process is conducted transparently and fairly so that shareholder rights are respected. In this regard that part 3 of Chapter XVII of the JSC Law amends the Article 7, item 23, part two of the 1996 Law of Ukraine on State Regulation of the Securities Market in Ukraine to task with the SSMSC with the responsibility for explaining procedures relating to application of the legislation on JSCs, and that a number of other articles in the JSC Law task the SSMSC with the responsibility of adopting procedures to implement such articles.

The purposes of this White Paper are:

- to identify both the legitimate transactions and the manipulative practices that might be used by JSCs to achieve private JSC or LLC status;
- to identify the investor protection issues that are presented by such transactions and practices;
- to identify areas in which the JSC Law might be amended to provide greater shareholder protections and to make its provisions enforceable;
- to recommend valuation and other requirements that the SSMSC should apply to address the investor protection issues in connection with legitimate transactions; and
- to recommend regulations that the SSMSC should adopt to deter manipulative practices.

IV. Adoption of fair valuation procedures is of critical importance

Inadequate business and asset valuation procedures with respect to transformation of JSCs is the most common, and arguably the most serious, problem that arises in connection with the various means that may be used to transform JSCs into closely held entities. Current SSMSC regulations are woefully inadequate and invite shareholder abuse.

Under current SSMSC regulations, there are essentially two methods governing the price to be paid to shareholders when their shares in a JSC are to be acquired in connection with a JSC transformation:

1. The price shall be defined as agreed by the parties but shall be no lower than the shares' nominal value;
2. If the JSC's shares are traded on the stock market, the current price on the market, which is defined as the weighted average price resulting from transactions during the

[6] This discrepancy suggests that many of the registered JSCs are dormant or inactive, an issue that should be addressed by cleaning up the JSC registers and voiding or revoking charters of such JSCs.

six months preceding the date of notice of a general shareholders' meeting that will vote upon the transformation, may be used, provided:

a. The number of transactions that occurred during this period is at least 100; and
b. The total value of transactions during this period is at least UAH 10,000,000.

The shortcomings of the first method are:

- It fails to take into consideration that without objective valuation requirements to protect their interests, individual shareholders have substantially less bargaining power than the JSC (for example, where the vote of a self-interested, controlling shareholder may bind all shareholders); and
- Nominal value, despite its use in allocating shares for privatization purposes, is not a relevant metric for valuation purposes and is an inadequate substitute for an objective and independent valuation of a share's value;

The shortcomings of the second method are:

- Very few JSC's will have listed share prices that permit the use of this method;
- The valuation period prescribed may not result in a price that reflects the current value of a share based upon a company's expected future performance; and
- Despite the number of transactions and total value requirements, the price derived from this method could be a manipulated price.

Recommendations. The SSMSC should use its existing authority, including its authority under the new JSC Law, to prescribe improved valuation regulations that should apply to transactions related to transformation of JSCs before they become subject to the new JSC Law as well as all valuations required to be made under the JSC Law. The new regulations should be consistent with Article 8 of the JSC Law and should require an independent expert's opinion regarding whether the price involved in a transaction represents fair value. The regulations should require disclosure of:

- the professional qualifications and independence of the person who renders such opinion;
- any conflicts of interest that the person may have with respect to the transaction for which an opinion on value is being expressed;
- how such person is to be compensated and by whom; and
- the factors and methodology used in rendering the valuation.

The first valuation method in the SSMSC's current valuation regulations should be abandoned. Nominal value has no relevance and the fact that parties may agree on a price does not obviate the need for a valuation for the benefit of shareholders. With respect to the second method in the current regulations, rather than limit the use of market prices for shares as a valuation factor, the regulations should require that to the extent market prices are used, information should be provided as to the timeliness of the prices and the depth and liquidity of the market. The regulation should not require use of a weighted average market price. Earlier prices may be rendered irrelevant by subsequent events, The regulation should permit the expert to use valuation methodologies that the expert deems appropriate in the particular circumstances of a transaction, including the asset-based and discounted cash flow methods, which are described in Appendix 1, which is intended illustrate the types of valuation techniques that should be used by independent valuation experts.

V. How the JSC Law affects existing open and closed JSCs

The SSMSC, the Ministry of Justice and the State Committee of Ukraine for Regulatory Policy and Entrepreneurship (SCRP) have interpreted the JSC Law so that applicability of all of the substantive provisions of the JSC Law to existing open and closed JSCs is deferred until such time as the JSCs amend their charters to indicate whether they are public or private JSCs and to otherwise conform such charters to the JSC Law. In most cases, JSCs have until April 30, 2011 to amend their charters.

The unfortunate effect of this interpretation is to provide JSCs with a "two-year window period" within which the JSCs that have more than 100 shareholders and wish to become private JSC's with no more than 100 shareholders or LLCs may engage in transactions to eliminate excess shareholders without applicability of the safeguards in the JSC Law and related amendments. For example:

- The market value of property safeguards of Article 8 of the JSC Law will not apply during the two-year window period when many JSCs are likely to engage in transactions to reduce the number of their shareholders.
- The amendments to Article 40 of the Law of Ukraine on Securities and Stock Market made by Chapter XVII of the JSC Law, which require public JSCs to prepare their financial statements in accordance with international accounting standards according to SSMSC procedures will not apply during the two-year window period.

Instead, such transactions will be governed by the currently applicable provisions of the Law of Ukraine on Business Associations, the Civil Code of Ukraine, the Commercial Code of Ukraine and several securities laws, none of which contain adequate safeguards to prevent abuse of shareholder rights.

Prior to the adoption of the JSC Law, there were approximately 10,000 open JSCs and 20,000 closed JSCs. These are the two types of JSCs recognized under the Law on Business Associations. The JSC Law (Article 5.1) now provides that JSCs must be public JSCs or private JSCs, and that private JSCs may not have more than 100 shareholders.

Part 1 of Chapter XVII of the JSC Law provides:

> "This Law shall come into force 6 months after the date of its publication, other than part 2 of Article 20, which comes into effect two years after the date of publication of this Law."

Part 1 seems to indicate that the effective date of all provisions of the JSC Law except Article 20.2 is six months after publication, which is April 30, 2009. However, part 2 of Chapter XVII provides that effective on April 30, 2011 Articles 1-49 of the Law on Business Partnerships "shall cease to be in force in the part related to open JSCs. And, part 5 of Chapter XVII provides that:

> "Charters and other bylaws of joint stock companies prepared before the enactment of this Law shall be adjusted to comply with this Law no later than within two years from the day this Law comes into effect." [7]

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[7] However, part 6 of Chapter XVII provides that if following the enactment of the JSC Law, a JSC established before the enactment of the JSC Law holds a general meeting at which it decides to change its statutory capital

As a result of these provisions, both open and closed JSCs must decide by not later than April 30, 2011 whether they wish to become public or private JSCs, and amend their charters to reflect their status and to conform to other applicable provisions of the JSC Law.

Notwithstanding part 1 of Chapter XVII, the SSMSC, the Ministry of Justice and SCRP each have issued interpretations indicating that existing open and closed JSCs do not have to comply with **any** of the JSC's Law's provisions until they amend their charters.[8] The interpretations appear to be premised upon the reasoning that if the JSC Law only recognizes public and private JSCs, it is necessary to provide in a JSC's charter whether it is a public or a private JSC before other provisions of the JSC Law are applicable.

On their face, it seems clear that the JSC provisions were intended to apply automatically to all JSCs effective April 30, 2009. This more logical construction regarding automatic effectiveness is also supported by the fact that, as explained below, the only two remedies for failure to comply with the Law relate to failure to take affirmative action required to adjust a company's charter to comply with the JSC Law. If all other provisions of the JSC Law are interpreted as being dependent upon adjustment of charter provisions as a pre-condition, then if a JSC fails to submit adjustment of charter provisions for a shareholder vote or fails to obtain a three-fourths vote required under the Civil Code to amend the JSC's charter, the JSC Law fails to provide any independent remedy for a JSC's failure to comply with the other provisions of the JSC Law.

Moreover, despite the requirement in part 5 of Chapter XVII of the JSC Law that an existing JSC must adjust its charter to comply with the requirements of the JSC Law not later than April 30, 2011, the JSC Law provides only two limited remedies designed to enforce this requirement. The first is second paragraph of part 5 of Chapter XVII, which permits a shareholder of a JSC whose charter is not adjusted to appeal to a court for adjusting the JSC's charter to comply with the JSC Law. The second remedy is the second paragraph of part 6 of Chapter XVII, which directs that the failure to introduce amendments in the charter or other bylaws of a JSC in order to comply with the JSC Law shall serve as a ground for refusal of securities issue registration for such JSC.

Neither of these remedies is adequate. Most shareholders, especially persons who became shareholders via privatization, are passive investors. Recourse to the courts requires a plaintiff that is willing to undertake the time and expense of litigation. There may be no such shareholder-plaintiffs, especially in closed JSCs. Moreover, the remedy available to shareholders is circuitous. While part 5 of Chapter XVII refers to appealing to a court "for adjusting company charter to comply with this Law," in reality it appears that the court would simply issue an order directing the delinquent JSC to hold a general meeting and vote of shareholders to amend the charter.

This highlights a broader problem with the procedure for charter amendments. The Civil Code requires a three-quarters vote of shareholders represented at a general meeting in order to amend a charter. Therefore, even if a company proceeds in good faith without a court order to

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amount, denominate shares or issue securities, the JSC must adjust its operations in line with the JSC Law and amend its charter and bylaws.

[8] SSMSC Clarification No. 8 of July 14, 2009 as amended in line with SSMSC Resolution 712 dated July 21, 2009; Ministry of Justice Interpretation dated October 5, 2009; and SCRP Letter No. 5224 of July 5, 2009. Somewhat ironically, an earlier letter of the SCRP, discussing the JSC transformation process, includes both citations to the JSC Law and Law on Business Associations as applicable to such transactions. *See* SCRP Letter No. 523 of May 7, 2009.

amend its charter, there appears to be a significant risk that there may be an insufficient number of shareholder votes in order to do so.

The second remedy in part 6 of Chapter XVII appears to permit the SSMSC to cancel a JSC's securities issue registration if it fails to adjust it charter to conform to the JSC Law's requirements. It appears that this remedy may be used to invalidate a registration previously approved by SSMSC. However, if a JSC were to refuse to voluntarily comply with the SSMSC's direction to adjust its charter or face these consequences, it would be necessary for the SSMSC to go to court to invalidate the prior registration.

With a universe of more than 25,000 existing JSC's, it is quite possible that a great deal of the SSMSC's time may be taken up in dealing with recalcitrant JSCs and that it might be well beyond two years before all existing JSC's are brought into compliance with the JSC Law. Indeed, there is no assurance under recourse to the Ukrainian court system that JSC shareholders or the SSMSC will prevail in all of these cases. The effects of recourse to this remedy also are uncertain. If a JSC's prior share registration by the SSMSC is voided, what does this do to the validity of shares held by the JSC's shareholders?

It has taken over ten years for Ukraine to adopt a new JSC Law. Interpreting the new JSC Law provisions as inapplicable to existing JSCs for up to two additional years (and possibly longer) is a clear disservice to JSC shareholders. Rather than interpreting the Law's applicability to JSCs to depend on events that may never take place, the effectiveness provisions of the Law should be amended so that there is closure with respect to the status of all JSCs not later than April 29, 2011.

Recommendations. There are two provisions that should have been added to Chapter XVII of the JSC Law to avoid these problems:

1. Including by amendment a more logical construction that the effectiveness of the vast majority of the JSC Law's provisions are not dependent on a charter amendment and become automatically effective as of a specified date. Consistent with part 1 of Chapter XVII, that date should have been April 30, 2009. However, in order to avoid *ex posto facto* applicability of an amendment, the date might now be specified by amendment as April 30, 2011.
2. Providing that after April 30, 2011, any provision in a JSC's charter or other bylaws that is in conflict with the JSC's requirements is automatically deemed null and void and that a JSC that has not adjusted its charter by this deadline to indicate whether it is a public or private JSC shall be deemed a public JSC subject to all provisions of the JSC Law applicable to public JSCs.

If these changes were made, the second paragraph under part 5, which is unlikely to be an effective remedy, might be deleted.

The above changes should be made by amending part 5 of Chapter XVII so that the text following the first paragraph of part 5 reads as follows:

> "All applicable provisions of this Law shall apply to joint stock company that has not adjusted its charter and other bylaws within the deadline specified in the preceding paragraph, and any provisions in such company's charter or other bylaws that conflict with the provisions of this Law shall be null and void.

A company that has not specified in its charter whether it is a public or private joint stock company shall be deemed a public joint stock company subject to all provisions of this Law applicable to public joint stock companies."

VI. Framework for analysis

The remainder of this White Paper addresses issues raised by the JSC Law's provisions affecting JSCs that seek to avoid public JSC status. These JSCs may be placed in one of the following three categories:

1. Open and closed JSCs that do not have more than 100 shareholders and wish to become private JSCs;
2. Open and closed JSCs that have more than 10 but less 100 shareholders and wish to become LLCs;
3. Open and closed JSCs that have more than 100 shareholders and wish to avoid public JSC status by transforming themselves to private JSCs or possibly LLCs.

For purposes of the analysis and recommendations that follow, it is important to bear in mind the following distinctions among these three categories of JSCs:

- Categories 1 and 2 represent JSCs where the 100 shareholder limitation makes it very unlikely that there is now or ever will be a public trading market for their shares; so if these JSCs become private JSCs or LLCs where public trading is unlikely or precluded, respectively, their shareholders are not losing the right to a public trading market in the companies' shares.[9]
- If a category 3 JSC with more than 100 shareholders seeks to avoid public JSC status, there is a significant possibility that its shareholders will lose an existing or future public trading market for their shares. In addition to the greater number of shareholders, if the category 3 JSC is a public JSC, its shares are required by the JSC Law to be listed. If it becomes a private JSC or LLC, a public trading market in its shares would be unlikely or precluded, respectively.
- Category 1 JSCs differ from category 3 JSCs. Because a category 1 JSC already has no more than 100 shareholders, it is not necessary to eliminate shareholders through a separate transaction in order to become a private JSC.
- More emphasis should be placed on category 3 JSCs becoming private JSCs than on category 2 JSCs becoming LLCs. The reasons are that category 2 JSC conversions do not involve shareholders' loss of a public trading market and the maximum number of shareholders that could be eliminated in a category 2 JSC's conversion to LLC status is 99 shareholders.[10] Category 3 JSC conversions involve both a loss of a public trading market and transactions that are likely to result in the elimination of substantially greater numbers of shareholders.

As a result of these distinctions, issues and recommendations relating to category 1 JSCs becoming private JSCs may be addressed in Section VIII below. Issues and recommendations relating to category 2 JSCs becoming LLCs may be addressed succinctly in Section VII below.

[9] Article 24.2 of the JSC Law prohibits exchange trading of a private JSC's shares. While this does not preclude the possibility of OTC trading, the 100 shareholder limitation on private JSC's makes such trading unlikely. Moreover, if a private JSC's charter were to provide a preemptive right of first refusal for other shareholders and/or the company to purchase the shares of a shareholder wishing to sell them (as permitted by Article 7.2 of the JSC Law), such restrictions would preclude effective OTC trading. In the case of LLCs, the ten member limitation effectively precludes a trading market for members' shares.

[10] *But see* note 4 *supra*.

However, because there are a number of different transactions that may be used by category 3 JSCs to eliminate shareholders and each of these transactions raises somewhat different shareholder protection issues, it is necessary to address issues and recommendations separately in with respect to each type of transaction in subsequent sections of this White Paper.

VII. Conversion of a category 1 JSC to a private JSC when a separate transaction is not necessary to accomplish the conversion

Since a category 1 JSC already has no more than 100 shareholders, all that is necessary for the JSC to become a private JSC is a more than 75% shareholder vote to amend its charter. The only significant shareholder protection question that arises in these circumstances is what information should be made available to shareholders regarding the effects of becoming a private JSC on their rights as shareholders.

Recommendation. The SSMSC should adopt a brief regulation that provides where shareholders of a JSC that meets the conditions of category 1 (no more than 100 shareholders) are asked to vote upon becoming a private JSC, information made available to shareholders prior to the meeting at which the vote is taken must include a summary of all changes to be made in the amended charter of the JSC that have a material effect on shareholders' rights. In this regard, the most significant change, if proposed by the JSC's management, would be inclusion in the charter of the preemptive right in favor of the JSC and other shareholders to purchase any shares that a shareholder may offer for sale to third parties (Article 7.2 of the JSC Law). Even though there is no public trading market in the category 1 JSC's shares, the presence of such a preemptive right constitutes a significant limitation on a shareholder's right to freely sell his shares to third parties. The SSMSC regulation should require that a specific explanation of this limitation be made available to the JSC's shareholders, including how the limitation is implemented in accordance with Articles 7.3 through 7.6 of the JSC Law.

VIII. Conversion of a category 2 JSC to an LLC

The only two differences between category 1 and 2 JSCs is that category 2 JSCs will be converted to LLCs instead of private JSCs, and because of the 10-member limitation for LLCs, it will be necessary for a transaction to take place which eliminates a number of the category 2 JSC's shareholders. However, as noted above, because a category 2 JSC has no more than 100 shareholders, the maximum number of shareholders that could be eliminated in these circumstances is 99 shareholders.

Recommendation.

The easiest way to address the concern that a JSC's shareholders may be eliminated in a conversion to an LLC is for the SSMSC to advocate adoption of legislation currently pending in the Rada that permit LLCs to have up to 100 members. This threshold is used in a number of countries and its use in Ukraine would remove the need for category 2 JSCs to eliminate shareholders prior to transformation to an LLC.

Until the above legislative change can be made, the SSMSC should have in place a brief regulation that provides where shareholders of a JSC that meets the conditions of category 2 (no more than 100 shareholders) are asked to vote upon becoming an LLC and some of the shareholders will continue as members of the LLC, the information made available to shareholders prior to the meeting at which the vote is taken must include a summary of all provisions of the LLC's governing instruments that affect a member's rights. In particular, the regulation should require that any restrictions on an LLC member's right to dispose of the member's stake in the LLC must be disclosed as well as any circumstances under which members of the LLC may cause a member to be removed from the LLC. The SSMSC regulation also should require disclosure to the category 2 JSC's shareholders of the material terms of any transaction that will cause their shareholding in the JSC to be acquired or eliminated, including disclosure of:

- the purpose of the transaction;
- what consideration the shareholder will receive in exchange for his shares and how the value of such consideration was determined;
- what vote of shareholders is required to approve the transaction; and
- what appraisal or other rights are available to a shareholder who objects to the transaction.

IX. Takeover bid and/or purchase of shares by a third person that enables a JSC to become a private JSC

Each of the transactions discussed in Sections IX – XI of this White Paper assume a category 3 JSC, which is defined for these purposes as a JSC with more than 100 shareholders.

In order to make a JSC eligible for private JSC status, a third person may seek to reduce the number of the JSC's shareholders to no more than 100 shareholders. The third person may be someone previously unrelated to the JSC who decides that the JSC is worth acquiring and wishes to operate it as a private JSC, possibly becoming the sole shareholder. Alternatively, the third person may already be a controlling or significant shareholder or a manager or director of the JSC who would prefer to retain control or increase his ownership and convert the JSC to a private JSC to further these objectives.

Article 64 of the JSC Law addresses the above circumstances.[11] It provides that any person (or persons acting jointly) who intends to acquire shares of a JSC, which together with the shares already owned by such person (and affiliated persons) equals 10% of more of the JSC's shares, must give not less than 30 days written notice to the JSC. The notice is required to be made public by providing it to the SSMSC and each stock exchange on which the JSC's shares are listed, and by publishing it in an official press addition. The notice must indicate the number of shares owned and the number of shares intended to be acquired.

Article 65 of the JSC Law provides that if a person (or persons acting jointly) has acquired more than 50% of a JSC's shares, within 20 days after reaching that threshold, the person must make an offer to acquire the shares of all other shareholders. The supervisory board (or if there is none), the executive body of the JSC must send the written offer to each shareholder listed on the register of the JSC's shareholders within 10 days of receipt of the offering documents from the bidder. The offer must indicate the name and residence of the person[s] making the offer, their holdings of the JSC's shares, the acquisition price being offered and how it was calculated, the period during which shareholders may accept the offer, which may be no less than 30 or more than 60 days, and the procedure for payment of shares acquired, which must be

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[11] The only circumstances in which Article 64 of the JSC Law would not apply is where an acquirer with less than 10% ownership of the JSC acquired shares from other shareholders of the JSC so that the number of shareholders of the JSC was reduced to no more than 100 and the acquisition still did not make the acquirer a 10% or greater shareholder of the JSC. This exclusion appears warranted and consistent with what is done in many countries' joint stock company or takeover laws. If, however, a JSC or principal shareholder were to attempt to avoid application of Articles 64 or 65 of the JSC Law by setting up and funding a third person to make the share acquisitions, it appears that the "persons acting jointly" language in these articles should be sufficient to prohibit this evasion technique.

within 30 days after the deadline for acceptance of the offer. The acquisition price for the shares must be not less than the market price calculated in accordance with part three of Article 8 of the JSC Law.

This last reference is somewhat confusing because part three is not the part of Article 8 that prescribes how market value is calculated. Part three requires that "the market value of property (securities) shall be approved by the supervisory board of a JSC". Presumably this means the supervisory board of the persons making the acquisition, assuming that such person is a JSC with a supervisory board. Approval by the target JSC's supervisory board would seem inconsistent with part two of Article 64, which prevents a target JSC from taking measures to prevent acquisition of shares pursuant to Article 64. Once more than 50% ownership has been acquired, giving the acquiring persons control of the target JSC, it hardly seems logical to provide that the target JSC's supervisory board, whether it is the pre-control board or a newly reconstituted board including the bidder's representatives, should be required to pass upon the acquisition price for the mandatory bid made to remaining shareholders of the target JSC.

Problems. Articles 64 and 65 raise the following shareholder protection issues:

1. It seems clear that the language of Article 64 requires the notice and information to be provided with respect to any acquisition that will result in an acquiring person becoming a 10% or more shareholder, or increasing an acquiring person's 10% or more ownership. However, Article 64 does not require that the acquisitions must be made by tender offer. It would appear possible for the acquirer to acquire shares constituting control of the JSC by purchases in the securities market or possibly private purchases. Accordingly, Article 64 does not ensure in the case of an acquisition for control that all shareholders of the JSC will receive a tender offer or that all shareholders selling shares to the acquirer will receive the same price for their shares. Indeed, the notice required by Article 64 does not even require the acquiring person to indicate how the person proposes to acquire the shares.

2. On the other hand, Article 64, which is described as an acquisition of a significant block of shares, does not appear to be limited to acquisition of significant blocks. For example, a person who already owns 9.9% of a JSC's shares and proposes to acquire an additional one percent of the shares would be subject to Article 64 as would a person who owns 10.1% of the JSC's shares and proposes to acquire an additional one percent. Therefore, a tender offer requirement should be set forth in an amendment of Article 64 and there should be an exception for de minimus purchases not being considered a tender offer. There also should be a public reporting protocol which requires a 10% or more shareholder to timely report any material changes in ownership.

3. The background information required of the person making the acquisition is inadequate. Once a person's ownership of a public JSC's shares exceeds a certain threshold (usually prescribed as 5% or 10%), best practice is to require the person to indicate whether his acquisition and proposed acquisition of shares is for control or investment purposes, whether the person proposes any changes or transactions with respect to the JSC or its management (for example, conversion to a private JSC), what the person's source of funds is for any acquisition of a significant block of shares, and what has been the person's experience and background during the past five years. For example,
    a. What is the person's occupation or principal business and the person's title with the business?
    b. Is the person an officer or director or principal shareholder of any other open (public) JSCs?

c. If the person is a legal entity, who are its principal (10 percent or more shareholders), directors and managers?
d. Has the person, and if it is legal entity, also the persons in (c) above been a party to any bankruptcy or insolvency or committed a felony or violations of securities or other financial services laws?

4. If an acquisition of additional shares is to be made by tender offer pursuant to Article 64, the safeguards provided by part 2 of Article 65 as well as the additional safeguards we recommend below with respect to Article 65 offers are not included.

5. Part 2 of Article 64, which prevents a JSC from taking measures to prevent an acquisition, has some basis in the EU Takeover Directive.[12] However, it overlooks the fact the EU Directive (Article 9.2) permits a board of a target company to seek alternative bids and with the approval of the general meeting of shareholders it permits the target company to take other defensive measures. Also, Article 9.5 of the Takeover Directive requires the board of the target company to state its position regarding the takeover bid. The rationale for these two provisions is that if the board of a target company believes a tender offer is not in the best interests of its shareholders, it has a duty to advise shareholders and act accordingly.

6. Neither Articles 64 or 65, nor other provisions of the JSC Law adequately address the circumstances where a tender offer is sufficiently successful (for example, more than 90% of the shares are acquired by the bidder) that a right of squeeze-out of other shareholders may be exercised by the acquirer and a right of sell-out may be exercised by the minority shareholders.[13]

   In this regard, Article 84.4, which permits a short-form takeover without approval of the shareholders when there is more than 90% ownership, is not helpful because Article 84 requires shares to be issued in exchange for shares instead of cash for shares. In such circumstances, issuance of shares makes no sense since there is not likely to be a liquid trading market for shares when the JSC is more than 90% owned by one shareholder. Indeed, it is likely that if the less than 10% of the minority shareholders are seeking a higher cash value for their shares and they would not want new shares that are likely to be illiquid. Therefore, at least some of these minority shareholders should be permitted to object to receipt of shares in an Article 84.4 short-form takeover, exercise their rights of appraisal under Article 68 of the JSC Law and seek a higher cash payment of their shares.

7. It is not clear whether Article 65's requirement that the supervisory board of the target JSC shall distribute a mandatory bid is intended to be the exclusive means of publishing the mandatory bid. It should not be. Simply because an acquirer has acquired more than 50% of a target JSC, it cannot be assumed that within the 20 days after achieving more than 50% ownership that it is required to make a mandatory bid that the acquirer will have obtained control of the target JSC's supervisory board. If it has not, it cannot be assumed that the target JSC's supervisory board will cooperate in distributing the mandatory bid. The acquirer should be permitted to publish its mandatory bid independently in addition to Article 65's requirement for supervisory board distribution.

8. While part 2 of Article 65 provides certain shareholder safeguards with respect to mandatory bids, which also should apply to tender offers for control under Article 64, there

[12] Directive 2004/25/EC (21, April 2004) available at http://ec.europa.eu/internal_market/securities/index_en.htm.
[13] *See* Articles 15 and 16 of the EU Takeover Directive.

are other safeguards that should be added to apply both to tender offers under Article 64 and mandatory bids under Article 65. These include:

a. The purpose and effects of the transaction should be clearly disclosed.
b. The requirement that all shareholders receive the same price for their shares regardless of when the shares are tendered; for example, if the acquisition price is raised to induce greater acceptance of the offer or to exceed the price of a competing tender offer.
c. The requirement that shareholders be permitted to withdraw shares that they have tendered at any time in the event there is a competing tender offer, or if they have not been paid within [3] days after the deadline for payment of their shares in accordance with part 5 of Article 65 (and a deadline that should be established for tender offers under Article 64).[14]
d. The information recommended under paragraph 3(a)-(d) above.
e. Information regarding the financing for any tender offer.[15]
f. The bidder's intentions with respect to the future business of the target JSC and, in so far as it is affected by the tender offer or mandatory bid, the bidder company and with regard to safeguarding of the jobs of their employees and management, including any material change in the conditions of employment, and in particular the bidder's strategic plans for the two companies and the likely repercussions on employment and the companies places of business.[16]
g. All other conditions to which a tender offer is subject.

Recommendations.

1. Article 64 should be amended to include a definition of "tender offer" based upon the definition of "takeover bid" in Article 2.1(a) of the EU Takeover Directive, as follows:

   "Tender offer" shall mean a public offer (other than by the joint stock company whose securities are the subject of the offer) made to the holders of shares or other securities with voting rights of a public joint stock company, whether mandatory or voluntary, which follows or has as its objective the acquisition of control."[17]

   This definition should apply only to shares and other equity securities with voting rights in public JSCs. This approach is consistent with the second Whereas clause in the EU Directive and Article 4 of the Directive, which make clear that the intent is to apply the Directive to securities admitted to trading on a regulated market, and with Article 2.1(e) of the Directive, which makes clear that the Directive is intended to apply only to transferable securities with voting rights.

   Ukrainian authorities may wish to refine the definition of tender offer further to indicate more specifically what constitutes control. Clearly, any offer, if successful, and taking into consideration shares already owned by the bidder, which would give the bidder more than 50% ownership, should be considered control. On the other hand, an acquisition now covered by Article 64, such as acquisition by an 11% shareholder of an additional 2% of the

[14] In this regard, allowing the acquirer up to 30 days following an offer to pay for the shares tendered seems unnecessarily long. A more realistic deadline would be [3] days following expiration of the mandatory bid (or a tender offer under Article 64).
[15] *See* Article 6.3(l) of the EU Takeover Directive.
[16] *See* Article 6.3(i) of the EU Takeover Directive.
[17] This language taken from the EU Directive has been modified to refer to "tender offer" instead of "takeover bid" because Article 84 of the JSC Law already uses the concept of "takeover" to describe a merger of two JSCs. The term "target JSC" has been used in lieu of "offeree company".

shares, should not be considered seeking control. Addition of the following sentence is recommended:

> "For purposes of this definition, a tender offer shall be deemed to seek control of a joint stock company if the offer is made to acquire more than 10% of the shares or more than 10% of any other class of securities with voting rights, of if the offer if successful, and taking into consideration shares and other equity securities already owned by the bidder, would give the bidder more than 50% ownership of the shares or more than 50% ownership or any other class of securities with voting rights."

2. Article 64 should be amended to provide a de minimus exception for small acquisitions as follows:

   > No notification or other filing shall be required by a person that is a 10% or more owner of a public joint stock company's shares or 10% or more owner of another class of the public joint stock company's securities with voting rights with respect to a subsequent acquisition of not more than one percent of the joint stock company's shares or other equity securities during any twelve-month period.

3. SSMSC regulations should be amended to require that once a person has acquired 10% or more ownership, notification should be given to the SSMSC and any material changes in such ownership should also be reported by amendment. Copies of such information should be required to be sent to the public joint stock company and the stock exchange on which the public joint stock company's shares are admitted to trading. In addition, to disclosing current ownership and ownership proposed to be acquired, and the proposed means of acquisition, the notification should require the information referred to under Problems, paragraph 3 above. For tender offers that would now be covered by Article 64, the information required by part 2 of Article 65 as well as the additional information and conditions referred to above under Problems, paragraph 8 should be included in and applicable to any such tender offer.

4. Part 2 of Article 64 should be revised to permit defensive actions authorized by a public joint stock company's shareholders and to require the joint stock company to disclose its recommendation regarding a tender offer or why it is not making a recommendations. See discussion under Problems, paragraph 5 above.

5. The squeeze-out and sell-out procedures included in the EU Takeover Directive and discussed under Problems, paragraph 6 above should be added as amendments to the JSC Law.

6. Article 64 and paragraph 2 of part one of Article 65 should be amended to permit the additional methods of publishing a tender offer that are required for the notification now referred to in Article 64. See discussion under Problems, paragraph 7 above.

X. Purchase of shares by a JSC that enables it to become a private JSC

It would also be possible in accordance with Articles 66 and 67 of the JSC Law for a JSC to reduce the number of its shareholders below 100 by acquisition of its own shares.[18] However,

[18] The JSC Law refers to such a transaction as a "redemption" whereas in most countries it would be considered a "repurchase". Although this section of the memorandum uses "repurchase," in making our recommendations in this section, we have respected the JSC Law's choice of terminology.

two conditions apply to a JSC's repurchase of its own securities that do not apply to third party purchases under Articles 64 and 65.

First, Article 66, part 1 requires that a JSC's repurchase or its shares must be approved by shareholders. Article 42 requires a majority vote of the shares represented at a general meeting in order to authorize repurchases, provided that a 60% quorum requirement is satisfied.[19] Such approval is sufficient to authorize repurchases for a maximum period of one year.

Second, Article 67 imposes a number of prohibitions on repurchase of shares if the repurchase of shares would impair capital, render the JSC insolvent or take place without prior satisfaction of outstanding appraisal rights pursuant to Article 68 or without respecting prior dividend and liquidation rights of preferred shareholders.

Problems. Article 66 regarding share repurchases by a JSC raises some of same issues as Articles 64 and 65 because a repurchase of shares by a JSC at a fixed price is the equivalent of an issuer tender offer and should be subject to essentially the same shareholder protections recommended above for third party tender offers. In addition, three new problems are present.

1. Paragraph five or part 1 of Article 66 requires that a JSC must acquire shares from every shareholder accepting the offer for redemption of shares at the price given in the general meeting decision. However, item 1 of paragraph one, part 1 of Article 66 permits the JSC to decide the maximum number of shares to be repurchased. Therefore, the only possible manner in which paragraph five's requirement may be satisfied when more shares are offered for repurchase than the JSC has agreed to purchase is to require the same percentage of shares offered for repurchase by each shareholder to be taken up pro rata. In referring to pro-rata redemption, part 2 of Article 66 appears to recognize that this is intended, but part 2 is flawed because the first sentence thereof assumes incorrectly that the JSC will be able to specify in advance of receipt of shareholder offers what is the amount of shares to be repurchased from each shareholder. In fact, this amount will not be known until the expiration of the repurchase offer when the JSC learns how many shares have been offered for repurchase. Only at this time is it possible to divide the maximum number of shares the JSC has agreed to purchase by the total number of share offered for repurchase in order to determine the percentage of shares to be repurchased from each shareholder.

2. Paragraph two of part 2 of Article 66 "recognizes the possibility of a JSC repurchasing a "specific number of shares of a certain type and/or class from individual shareholders with their consent." There are both advantages and disadvantages in including this type of provision in the JSC Law and there are also flaws in the manner in which the provision is worded. The advantages are that if a JSC has a number of small shareholders as a result of the privatization process, it may be to the mutual advantage of the JSC and these shareholders for the JSC to make a repurchase offer to eliminate these shareholders. For example, the JSC might offer to purchase all the shares of each shareholder who, as of a specified record date, owned 99 or fewer shares. The advantages to the JSC are that it reduces the number of shareholders; possibly enabling it to become a private JSC, and it reduces the costs of having to provide information to a group of shareholders where the costs may be disproportionate to the value of the shares held. The advantages to the shareholders are that it may provide a means to sell their shares that does not otherwise exist and it avoids payment of brokerage commissions which also may be disproportionate

[19] Even though a repurchase of shares results in a reduction of statutory capital, the higher more than 75% share vote that part 5 of Article 42 requires for most capital decreases does not apply in these circumstances because Article 17 of the JSC Law provides an exception for redeemed shares.

to the value of their shares. Indeed, some of these small shareholders may not even have brokerage accounts.

On the other hand, the possibility of a selective purchase of shares may be abusive in some circumstances. For example, a person may acquire a significant number of shares in a JSC and then threaten to make trouble for the JSC and its management unless the person's shares are repurchased by the JSC at a price above their market value. This practice is usually referred to as "greenmail".

3. While the requirement of shareholder approval of share repurchases is a good safeguard that should apply in the case of significant of selective repurchases of shares, it seems unnecessary and cumbersome to apply the requirement with respect to all repurchases. For example, if the charter of a private JSC gives the JSC the preemptive right under Article 7.2 of the JSC Law to purchase shares before a shareholder may sell the shares to a third party, shareholder approval should not be required in these circumstances.

<u>Recommendations</u>. To address the above problems, the following changes are recommended in Article 66:

1. In the first sentence of part 1, delete "According to a decision of the general meeting," and replace with "Except for redemptions referred to in part 5 of this Article, a decision of the general meeting shall be required so that".

2. Delete paragraph 5 of part 1 and revise the first sentence of part 2 to read as follows:

   > "If the number of shares offered for redemption by shareholders pursuant to an offer of redemption exceeds the maximum number of shares that the company has stated that it is willing to redeem and the company is not willing to waive the maximum limit, the shares redeemed by the company must be redeemed pro rata from all shareholders who have offered their shares for redemption."

3. Delete the second sentence of paragraph of part 2 and replace it with the following:

   > "If shares are to be redeemed from a director, manager or 10 percent of more shareholder of the company or an affiliated person of such person other than in circumstances covered by part 5 of this Article, the redemption price paid for such shares may not exceed their market value determined in accordance with Article 8 of this Law."

The recommended prohibition on selective purchase of affiliated persons' shares at a price in excess of market value is intended to prevent payment of a premium for such shares.[20]

4. Delete paragraph 2 of part 3 since a correct reference to Article 8 is already included in paragraph 4 of part 1.

5. Add new part 5, reading as follows:

[20] Even if a controlling block of shares were repurchased by the JSC, because the issuer rather than a third person is purchasing the shares, there is no justification for payment of a control premium by the JSC.

"Notwithstanding part 1 of this Article, approval of a general meeting of shareholders shall not be required to redeem shares in the circumstances described in Article 7, part 2 of this Law

6. Add new part 6, reading as follows:

> "If the amount of shares proposed to be redeemed during a twelve-month period exceeds 10 percent of the issued shares and the circumstances described in paragraph 2 of part 2 of this Article do not apply, the company shall be required to comply with the tender offer provisions of [Article 65]:

[At this point, the information required by recommendations 5 and 6 under Section IX above should be set forth.]

XI. Sale of all or substantially of JSC's assets

The JSC Law does not include a separate Article dealing with this topic. However, a sale of all or substantially all of a JSC's assets would be deemed a major legal transaction covered by Article 70 of the JSC. The JSC Law includes two significant safeguards if a JSC were to propose to sell all or substantially all of it assets. Paragraph three of part 2 of Article 70 requires that a more than 75% shareholder vote is required to approve a major legal transaction that involves assets whose value if more than 50% of the value of assets reported in the JSC's latest annual financial statements, and Article 68 provides that shareholders' rights of appraisal are available with respect to any major legal transaction.

Problem. Notwithstanding the above safeguards, the possibility exists that principal shareholders, directors or managers of a JSC or their affiliated persons may establish a new private JSC that they control and then cause the JSC's shareholders to authorize a sale of all or substantially all of its assets at an inadequate price to the private JSC for cash or other non-equity consideration. The JSC then might be liquidated by distributing the inadequate consideration received to its creditors and shareholders, or it might simply be abandoned. This form of "asset stripping" would enable the insiders to obtain sole ownership of the category 3 JSC's assets through the new private JSC.

The critical question that needs to be addressed when any sale of all or substantially all of a JSC's assets is involved is the fairness of the consideration to be received by the JSC. This is the same type of question that arises in connection with mergers, takeovers and other transactions covered by Article 81 of the JSC Law. Unfortunately, however, because the sale of assets transaction falls under Article 70 instead of Article 81, the following important safeguards in Article 81 are not applicable to the sale of assets transaction:

- Information on the terms of the transaction, as is required for transactions covered by part 2 of Article 81;
- An opinion of an independent expert regarding the transaction, as is required for transactions covered by part 3 of Article 81;
- Information equivalent to what would be required to sent to shareholders for a transaction covered by part 4 of Article 81, including:
    - A draft agreement for sale of assets;
    - An opinion of an independent auditor on the terms of the transaction;
    - Annual financial information of the JSC for the last three years.

Indeed, the need for these protections is arguably greater in the case of a sale of all or substantially all of a company's assets because, as explained in Section XIII below with respect to other articles of the JSC Law that apply to the transactions covered by Article 81, all of these transactions envision that shareholders of a JSC involved in such transactions will maintain a proportionate equity interest in legal entities that survive or arise from such transactions. In a sale of assets transaction for cash, the JSC shareholders lose all of their ownership interest if the JSC is subsequently liquidated, which is usually the case.

Recommendations. A sale of all or substantially all of a JSC's assets should be covered in a separate article under Chapter XVI of the JSC Law and protections comparable to those cited above in Article 81 should apply to a sale of all or substantially of a JSC's assets. If more specificity is required regarding the meaning of "substantially all", the following definition should is recommended:

> "A sale of all or substantially all of a company's assets takes place when the assets sold account for more than 75% of the value of the company's assets indicated on its most recent annual balance sheet, or the assets sold leave the company with no operating assets."

In addition, the recommendations made in Section IX above regarding an independent expert's opinions should apply to the independent expert's opinion referred to under Article 81 of the JSC Law.

XII. False bankruptcy proceeding intended to facilitate sale of assets to JSC insiders

Once a bankruptcy proceeding is initiated with respect to a JSC and accepted by a bankruptcy court, the liquidation or reorganization of the JSC becomes subject to the jurisdiction of the bankruptcy court. This situation is distinguishable from a voluntary liquidation and termination of the JSC, which must be authorized by its shareholders and governed by the provisions of the JSC Law.

In some developing economies, the bankruptcy legislation and/or the integrity of the courts responsible for bankruptcy is insufficient to prevent false bankruptcy proceedings where management or controlling persons (or in some cases, creditors) may place a JSC that is not insolvent into bankruptcy subject to the jurisdiction of a cooperative bankruptcy judge. A typical practice in such circumstances is to distribute the assets of the JSC to these persons for a consideration that is substantially below fair value, usually leaving inadequate or no value available for distribution to the JSC's shareholders.

Whether and to what extent false bankruptcies are a problem in the Ukraine is outside the scope of this White Paper and would require a review of Ukrainian bankruptcy laws and procedures as well as the integrity of the court system responsible for administration of bankruptcies.

XIII. Abandoned shares

It is possible that because of the substantial number of Ukrainian JSCs and the fact that most of them are products of a less than optimal privatization process, the JSCs will discover that in their efforts to reduce their ownership to no more than 100 shareholders, there are a number of shareholders who cannot be found; e.g. the shareholder no longer lives at the last known address in the register of shareholders and efforts to find the shareholder through other indicia of identity in the register are unsuccessful. In these circumstances, while there may be little more that can be done to find the shareholders, it will be important to ensure that JSCs faced with these problems do not resort to self-help and respect Ukraine's legal procedures for dealing with abandoned property.

XIV. Conclusion

The shareholder protection issues pointed out in this White Paper require both amendments to the JSC Law and changes in SSMSC regulations. In addition to the amendments and changes recommended in this White Paper, Ukrainian authorities indicate specifically what criminal and administrative sanctions and remedies are available when JSCs, their directors, officers and controlling shareholders fail to comply with the Law.

APPENDIX 1

BUSINESS AND ASSET VALUATION

Selling or buying a all or part of a business requires both parties to determine the estimated value. The asset constituting a business interest can take many forms such as a controlling or minority interest in company shares, all or part of the business assets, with or without assumption of related indebtedness, or individual business assets, such plant and equipment or a division comprising a business unit.

While it is quite easy to determine the value of commodities that are bought and sold in the market place every day, estimating business value requires more effort since each business is complex and different. Although modern day business valuation has become more scientific, it always judgment and well grounded guesswork, even when conducted by experts. The process of arriving at fair value requires a detailed, comprehensive analysis which takes into account a range of factors.

Some business owners often believe that the valuation is an appraisal of the real estate, the equipment, the furniture and so forth. A company may say that it has equipment that is on the books for only $1 million, but it is really worth $2 million. That may be true, but what really matters is the cash the company can generate.

Purpose of valuation. In the context of transformation of JSCs to closely held entities, the purpose of a valuation may include:

a. Determining whether the price offered for shares of a JSC represents fair value, especially where there is no reliable market price, and depending upon whether the shares represent:
    i. a controlling block;
    ii. a minority holding.
b. Determining a fair price to be paid to JSC shareholders who vote against a fundamental corporate transaction and are entitled to exercise appraisal rights.
c. Determining whether the price being paid for business assets being sold by a JSC with a view to liquidation of the JSC and distribution of the proceeds to shareholders represents fair value.

The purpose of valuation will determine the type of valuation that should be obtained and methodology used.

Various aspects of value must be considered when performing a valuation of the business. Is the business to be valued based upon a going concern concept? Or is a valuation of the assets in liquidation required? To what degree is there a ready market for the business, or interest in the business that is being valued? Different aspects of values will normally produce different figures.

In business valuation, the most widely used definition of value is fair market value. Fair market value is used for transactions with significant impact to external parties such as minority shareholders, tax and government authorities. In estimating fair market value, it is hypothetically assumed that the willing buyer and willing seller deal at arm’s length, without being influenced by any special motivation or have no compulsion to buy or sell, both parties having reasonable knowledge of relevant facts.

Price is what you pay; value is what you hope to get. This definition implies that the value is the most probable price in cash or cash equivalent that would be paid if the property was placed on the open market for a reasonable period. The distinction between price and value is crucial. In the real world, businesses are bought and sold for a *price*. The appraiser's purpose, though, is to estimate *value*. Compared to the appraisal environment required by the definition of fair market value, the conditions that exist in the real world often influence price without affecting value.

Why fair market value is not necessarily a final goal

FAIR MARKET VALUE assumes no particular buyer or seller and is hypothetical. This is "the value of the marketplace". It further assumes no compulsion on the part of the hypothetical buyer and the hypothetical seller. In other words it is a partially empirically based mathematical approach that provides a reasonable range of values for a non-strategic buyer with no compulsion to buy and as a consequence provides a good starting point for all valuations but only a starting point for a strategic acquirer.

INVESTMENT VALUE on the other hand assumes a "value to a particular investor based on individual investment requirements", as distinguished from the concept of Fair Market Value, which is "impersonal and detached".

METHODS OF VALUATION

Business valuation is a mix of art and science. Generally, there are four main methodologies that practitioners use to value businesses. These are:

1. Asset based valuation (can be segmented into 4 approaches);
- book value
- replacement cost
- appraised value
- capitalized earnings (or excess earnings or multiple of earnings)
2. Discounted cash flow;
3. Comparable transaction method;
4. Comparable public company method.

To arrive to the most relevant value, the seller or purchaser should be using the method that is the most appropriate in each given situation and circumstances. As explained below, the comparable transaction and comparable public company methods are likely to be of limited use in a developing market such as Ukraine. The asset based valuation and discounted cash flow methods are likely to be the more useful methods. Moreover, as explained in the discussion of the discounted cash flow method, the discount rate that is appropriate for use under such method is a critical variable and may depend upon the nature of a transaction and whether the person for whom the valuation is intended is a business enterprise or a shareholder/investor.

Once the total value of business is estimated, the value per share can be further determined based on the total number of shares issued and outstanding.

1. Asset Based Valuation. This valuation method is based on the premise that the value of a business can best be determined by adding the value of all the assets of the company and subtracting the liabilities, leaving a net asset valuation.

An asset-based valuation can be further segmented into four approaches:
a) book value;
b) replacement cost;
c) capitalized earnings;
d) excess earnings (or multiple of earnings).

a) Book Value. In some instances, a business is worth no more than the value of its tangible assets. Selling such a business is often a matter of getting the best possible price for the equipment, inventory, and other assets of the business.

The book value of a company is obtained from the balance sheet by taking the adjusted historical cost of the company's assets (cost less accumulated depreciation) and subtracting the liabilities. Tangible book value is calculated the same way as finding regular book value, except that intangible assets (like goodwill) are excluded in the calculation. If the business assets are being sold in liquidation so that they will not be used by the buyer as part of a going concern, then no value should be assumed for goodwill.

In determining the adjusted book value of certain assets, the seller should estimate the approximate market value of such assets. Very often the asset's adjusted historical cost recorded in the balance sheet may significantly differ from the market value. **Example**: the building in the center of Kiev may be easily sold for a million dollars though according to the balance sheet may have only the $300 thousand as a net historical cost. **Another example**: airline companies rent or own the rights to operate the boarding gates at the various airports. The balance sheet adjusted historical cost of these rights may be very low compared to the market value that depends on the limited number of gates available and location and usage of the airport facilities.

b) Replacement Cost. Replacement cost reflects the expenditures required to replicate the operations of the company. Determining replacement cost is essentially a make or buy decision.

Sometimes companies or individuals will purchase a company just to avoid the difficulties of starting from scratch. The buyer will calculate his or her start up needs in terms of money and time. Next he or she will look at the business and analyze what it has and what it may be missing relative to the buyer's start up plan. The buyer will calculate value based on his or her projected costs to organize personnel, obtain leases, obtain fixed assets, and cost to develop intangibles such as licenses, copyrights, contracts, etc.).

A reasonable premium of above the sum of projected start up costs may be offered because of the effort and time being saved by the buyer. The more difficult, expensive, and/or time consuming startup is likely to be the higher the value would be based upon this method.

c) Capitalization of earnings. A common method of valuing a business is called the Capitalization of Earnings (or Capitalized Earnings) method. Capitalization refers to the return on investment that is expected by an investor. There are many variations in how this method is applied. However, the basic logic is the same.

Example. To demonstrate the capitalized earnings method of valuation, imagine a mythical and highly oversimplified business – the business is simply a post office box to which people send money. The magic post office box has been collecting money at the rate of about $10,100 per year steadily for ten years with very little variation. It is likely to continue to collect money at this rate indefinitely. The only expense for this business is $100 per year rent charged by the post office. So the business earns $10,000 per year ($10,100-$100). Because the PO box will continue to collect money indefinitely at the same rate, it retains its full value. The buyer should be able to sell it at any time and get his initial investment back.

A buyer would look at this "minimum risk" business earning $10,000 and compare it to other ways of investing his or her money to earn $10,000 per year. Let's assume a near no risk investment like a savings account or government treasury bills currently pays about 8% per year. At the 8% rate, for someone to earn the same $10,000 per year that the magic PO box earns, an investment of $125,000 (125,000 x 8% = $10,000) would be required. Therefore, the PO box value is in the area of $125,000.

Now the real world of business has no magic PO boxes and lacks "no risk" situations. Business owners take risks and have expenses, and business equipment can and usually does depreciate in value. The higher the perceived risk the higher the capitalization rate (percentage) that the buyer will use to estimate value. Rates of 20% to 25% are common for business capitalization calculations. That is, buyers will look for a return on their investment of 20% to 25% in buying a business.

d) Excess earnings. This method is similar to the capitalization method described above. The difference is that it splits off return on assets from other earnings (that is why it is called the excess earnings or multiple of earnings method).

For example, Mr. Owner runs a business that manufactures novelty products. His company has Tangible Assets of $300,000. Mr. Owner's business has earnings of $120,000. The rational reason for owning business assets is to produce a financial return. Let's say that a reasonable return on Mr. Owner's Tangible Assets is 15% per year. A reasonable number should be based on industry averages for return on assets adjusted to current economic conditions. For example, Mr. Owner or his advisors may have looked up industry standards and found that the current average return on assets is 15%. Let's suppose that Mr. Owner's business is better than average in these factors and assign a multiplier of 3.63.[21] Therefore, the value of this business can be determined as follows:
A. Fair market value of tangible equipment $300,000
B. Total Earnings $120,000
C. Earnings attributed to Tangible Assets
($300,000 x 15%=$45,000) -$45,000
D. Excess Earnings ($120,000 - $45,000=$75,000) $75,000
E. Value of excess earnings ($75,000 x 3.6=$270,000) $270,000
F. **Estimated Total Value (A+E) $570,000**

The value of the company's intangible assets should be the subject of a separate analysis and assessment.

3. Discounted Cash Flow. As a methodology, discounted cash flow is often considered the

[21] The excess earnings' multiplier is a reciprocal of the capitalization rate. E.g. earnings multiple 3 equals capitalization rate of 33.3% (1/3). The multiple depends on such factors as the level of risk involved in the business, the attractiveness of the business and the industry, competitiveness, and growth potential. The higher the factor used, the higher the estimate of the business will be. A typical number is 3. That is, a business that is judged to be very average in terms of the level of risk involved, the attractiveness of the business, the industry, competitiveness, and growth potential would use three as a multiplier. The actual multiplier used is a mix of opinion, comparison to others in the industry, and industry outlook.

preferred method to value businesses. What sets this approach apart from the other approaches is that it is based on estimated, future operating results rather than on historical operating results. As a result, companies can be valued based on their estimated future cash flows, which may be somewhat different from historical results, especially if a potential buyer expects to operate some aspects of the business differently.

Discounted cash flow analysis consists of estimating future cash flows, deriving a discount rate and applying this discount rate to the future cash flows and terminal value. This detailed analysis depends on accurate financial projections and discount rate assumptions. The resulting valuation is the sum of discounted future cash flows and the discounted terminal value.

The first step in conducting a discounted cash flow analysis is to project future operating cash flows over a projected holding period, generally five years. These projections are generally done before debt (but after taxes) to obtain an accurate indication of future free cash flow. The future free cash flow is the cash left after operating the business and investing in necessary property, plant and equipment, but before servicing debt or paying out any cash to owners.

The second step in the discounted cash flow analysis is to develop a discount rate. The discount rate is often is referred to as the weighted average cost of capital (WACC) and is best thought of as a percentage which represents the return expected by an owner of the company commensurate with the risk associated with the investment.

For an established company considering capital expenditures via asset acquisitions or purchase of a business, the discount rate is generally calculated by deriving the company's cost of equity capital and the company's after-tax cost of debt (note that although the cash flows are projected on a debt free basis, it is important to derive a WACC based in part on the company's expected cost of debt, since this reflects the company's level of risk). These financing costs are weighted and result in a WACC percentage, or discount rate. The cost of equity capital is generally determined using the capital asset pricing model (CAPM), which is based on three inputs: (1) the risk free rate (the expected return on long term government bonds - currently about 6%), (2) the beta, which is a measure of the relative volatility of the company's share price compared to an index of market prices)[22], and (3) the equity risk premium (the expected rate of return on common stocks in the long run – currently about 8%). The derived discount rate is applied to the projected future cash flows to determine the present value of the future cash flows.

In the specific context of a JSC transforming itself pursuant to a transaction where the value to be paid to individual shareholders for their ownership interest is the question, it is unrealistic to expect most shareholders to have a WACC. Instead, the relevant discount rate used in such circumstances should be not less than the risk-free rate of return the investor could achieve by investing, e.g. in government debt securities. This rate should be adjusted upward to take into additional company specific risks as well macroeconomic-political risks bearing upon investments in Ukrainian shares.

In an inflationary environment, such as that currently prevailing in Ukraine, the discounted cash flow methodology also should take into consideration the potential impact on inflation on estimated future cash flows. There are two ways of doing this. One is to subjectively adjust the discount rate upward to allow for the anticipated effects of inflation. While this alternative

[22] Because of the limited liquidity of the Ukrainian stock market and the fact that many companies may not have publicly traded shares, it may be necessary to disregard beta. In the absence of a share price, it also may be necessary to use another metric, such a return on equity as the WACC cost component for share capital.

has the advantage of simplicity, it also may distort the adjustment because the compound interest effect inherent in the increased discount rate may not accurately reflect the impact of inflation on future cash flows in each future year included in the calculation. A better methodology, which is also subjective, is to adjust estimated future cash flows in each year for anticipated inflation based upon a weighted probability estimates of different inflation values.

The next major step involves calculating a terminal, or residual value. A terminal value calculation combines assumptions used to derive future projections and the discount rate to obtain a current value for a company's long term future cash flows. The assumption underlying this step is that a company is a going concern and that its value is imbedded in its ability to generate value not just today, but well into the future. A terminal value is calculated by determining the cash flow in the period beyond the last projected period. This predicted future cash flow is then capitalized by a percentage (represented by the company's discount rate less the predicted long term growth rate) and this capitalized figure is then discounted back to the present using the discount rate.

The terminal value can represent a large portion of the valuation. The terminal value of a piece of manufacturing equipment at the end of its useful life is its salvage value, typically less than 10% of the present value. In contrast, the terminal value associated with a business often is more than 50% of the total present value. For this reason, the terminal value calculation often is critical in performing a valuation. The terminal value can be calculated either based on the value if liquidated or based on the value of the firm as an ongoing concern.

Example of discounted cash flow calculation. For the purpose of valuation, the operating cash flows of a Company A for the next five years are estimated as below. It was also determined that the weighted average cost of capital is 15%. It is expected that the Company's cash flows after fifth year will be 40 million per year and therefore, based on the assumption that the Company will continue as going concern, the terminal value is calculated as follows = 40 million **:**15% (discount rate) = 266 million. The value of Company A can be determined as follows:

(in millions)	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal value
Revenues	100	120	130	130	130	
Cost of sales	(60)	(70)	(80)	(80)	(80)	
Operating expenses	(10)	(12)	(15)	(15)	(15)	
Other cash flows	5	5	10	10	10	
Taxes	(3)	(5)	(8)	(8)	(8)	
Total net cash flows	**32**	**38**	**37**	**37**	**37**	**266**

Discount rate - 15%

Discounted cash flow value is determined using the Net Present Value formula = **235 million**

$$\sum^{n} \frac{\text{values}_i}{(1+\text{rate})^i}$$

Where *i = 1 and n = number of cash flows in the list of values*

3. Comparable Transactions Analysis. Comparable transactions analysis involves obtaining financial and operating data from other, similar sale/purchase transactions and applying it to the valued company to obtain a predicted value. These historical purchase/sale transactions involve companies that have similar lines of business as the company being valued. In analyzing comparable transactions, valuation professionals will often divide deal price by some industry standard metric, such as EBITDA (Earnings before income taxes, depreciation and amortization). An average or the median of the resulting multiples is then multiplied by the target company's metrics to obtain a company valuation.

Although comparable transactions analysis can be an important valuation methodology, its usefulness is dependent on the relevance, quality and timeliness of historical transactions data, which is very problematic in Ukraine.

4. Comparable Public Company Method. Liquid capital markets are generally considered efficient at valuing companies. Each day, stock prices reflect the instantaneous and independent pricing decisions of buyers and sellers around the world. Thus, using existing public companies as a benchmark to value similar private companies is a viable valuation methodology.

The comparable public company method involves selecting a group of publicly traded companies that, on average, are representative of the company that is to be valued. What is important is that investors would view the comparable companies and the company being valued as similar. Each comparable company's financial or operating data (like revenues, EBITDA or book value) is compared to each company's total market capitalization to obtain a valuation multiple. An average of these multiples is then applied to derive the company's value. If several metric multiples are used, professionals will often weigh each metric based on the relative importance of the metric in the valuation of the company.

This method should be used only in developed economies where the capital markets are liquid efficient and fully transparent.