Defence Update
03 February 2021 | International

UKRAINE BRINGS FRESH TOUCH TO ITS DEFENCE THROUGH CORPORATISATION

With the active development of cutting-edge weaponry, aircraft engines, satellite and other security solutions, Ukraine has proved competitive in international military and defence markets. Yet, bringing its production capabilities and efficiency of the part of the industry administered by the state to the next level required more systemic changes, including through legislation.

On 29 January 2021, a Draft Law No. 3822 On the Particulars of Reforming the State-Owned Enterprises of the Defence and Industry Complex (the "Law", "Defence Corporatisation Law") passed First Reading with the Ukrainian Parliament.

The Law seeks to secure legal transformation of the Ukrainian defence and enable new investment opportunities, too. It primarily applies to the reorganisation of the State Concern

Ukroboronprom (the “Ukroboronprom”, “Concern”), which serves as a management company in the Ukrainian state military and defence running its affiliated enterprises and facilities. The reorganisation applies to over 100 state-owned enterprises in 5 major defence sectors operating under the Concern’s umbrella. It also introduces new model of the industry’s corporate management in conformity with the OECD Principles of Corporate Governance.

Below, we have outlined top-3 takeaways of the upcoming changes in this regard.

Takeaway 1 – Gradual reorganisation

The structural and institutional reorganisation of the Ukrainian defence started in 2018 with the adoption of the 2028 Defence Development Strategy by the government resolution No. 442-p (the “Strategy”). The Strategy seeks to incentivise the industry and sets out an action agenda on multiple fronts. It provides for the reforming of the public procurements in the defence, corporatisation and launch of joint ventures, introduction of new defence projects, adoption of NATO standards, updating of the manufacturing facilities, and expansion of a share in overseas markets. In order to execute the Strategy, the industry needed more up-to-date regulations that would facilitate its development and unlock its investment potential.

The Defence Corporatisation Law currently submitted with the parliament is designed to fulfil the above objectives and exercise reorganisation in several stages.

Stage 1

This envisages mainly the due diligence and free transfer of assets between Ukroboronprom’s entities, aiming to establish firm foundation for further corporatisation.

The assignment would take place under a simplified procedure in respect of property, goods, inventories, IP rights, affiliated loan, suretyship, guarantee and other financial agreements.

The proposed simplified procedure entails, both as a matter of construction of law and contracts in effect, among others, (i) the lack of obligation to generally seek creditors’ consent for the replacement of a debtor during debt assignment; (ii) the lack of creditors’ right to claim performance security, or claim early termination, or performance of contracts and repayment of compensation for damages; (iii) restriction to terminate suretyship and guarantee (counter-guarantee) agreements; (iv) permission to complete the reorganisation prior to satisfying the creditors’ claims; (v) lifting of restrictions to the use of specific property items, including under attachments and other encumbrances, to pay up companies’ authorised share capital.

The encumbered property of Ukroboronprom’s entities and enterprises, where state shareholdings are managed by the Concern, will be released and transferred to the reorganised companies, upon replacement with equally valued property without prejudice to creditors’ rights.

Generally, stage 1 provides for complex preparatory works to be conducted before the corporatisation *per se*, while Ukroboronprom would remain to act as an authorised management company in respect of assets and property in state defence until completion of stage 2.

Stage 2

Ukroboronprom will be subject to reorganisation into a joint-stock company (the “JSC”) enabling, among others, its adoption of the full-fledged corporate governance.

The newly established JSC would also enjoy specific temporary tax exemptions for its net profit made from the reorganisation.

The exemptions would apply if money is used to pay up the authorised share capital of state defence enterprises to stabilise their financials, upgrade production, invest in R&D, or secure their reorganisation, or is transferred to investment and innovation development funds.

Stage 3

This stage includes reorganisation of 100+ state defence enterprises operating under the Concern’s umbrella into commercial entities, and establishment of industry business units as joint stock companies.

Takeaway 2 – Supervisory boards

The Defence Corporatisation Law also upgrades the existing corporate governance in the state defence. Not only it amends the management bodies of the entities that would be reorganised in the future, but also extends its requirements to the presently operating Concern.

Accordingly, by its Final Provisions the Law seeks to amend the Law of Ukraine No. 3531-VI dated 16.07.2011 On the Particulars of Managing the State Defence Facilities. It is proposed that the Ukroboronprom’s supervisory board include seven individuals instead of five as is currently the case, although in practice there are only three members appointed, and their office tenure be three years instead of five. It is suggested that three individuals should serve as independent directors, whilst the remaining four – as representatives of the state. The Law clarifies the selection principles, and stipulates that *only Ukrainian citizens may serve as independent directors, subject to their professional background, skills and competencies*.

The amendments also apply to the JSC and in principle, to commercial entities to be established after the reorganisation if the supervisory boards would be created on their part.

In view of the above, it is expected that Ukroboronprom may soon be available for business professionals to its supervisory board after the Law is finally adopted and takes effect.

Takeaway 3 – Investment prospective

It should be noted that following the reorganisation of Ukroboronprom and its enterprises, the JSC and commercial entities would act as successor companies in respect of all of their rights and obligations. This translates to the fact that obligations existing at the time of newly established entities, including under defence public procurement contracts, state defence capability and security promotion programmes, international sales contracts, would continue to be effective and fulfilled.

At the same time, Ukraine's defence includes many facilities and enterprises that are not used or managed efficiently. To this end, the Law provides, among others, that the integral property complexes of the Concern's entities and state shareholdings managed by the Concern, which are not engaged in defence public procurements, will be assigned to the Ukrainian State Property Fund. On its part, the Fund would sell the above to domestic and international investors through privatisations under transparent auction procedures.

Overall, the on-going structural attempts in facilitating the industry's development are appreciated. It is expected that with the adoption of the Defence Corporatisation Law, favourable opportunities would arise for investors, business professionals and the Ukrainian defence in the foreseeable future.

Key contact:

Should you be interested in pursuing opportunities in the defence industry and require more details, to this end, or in case of any related or other queries, please reach out to Serhiy or your alternative contact at BOULDERS.

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