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## Comparative analysis of Ukrainian and European law on the foundations

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## **Comparative analysis of Ukrainian and European law on the foundations**

### **Introduction**

Ukrainian legislation on legal entities undergoes permanent transformations and one of its main directions of reforming is the harmonization of the national legislation with the legislation of European Union (EU). However, the Decree of the Cabinet of Ministers of Ukraine (CMU) dated from June 9, 2010 no. 1196-p, which ratified the Plan of measures concerning the State Program for Adaptation of Ukrainian Legislation to the Legislation of the European Union in 2010<sup>1</sup>, pointed out priority areas, in which first of all the abovementioned adaptation should be implemented. It did not consider the legislative acts regulating the legal status and peculiarities unenterprising legal entities' activity.

Despite the fact that the problem of legal status, classification and peculiarities of non-profit entities' economic activity, in particular of the foundations, have been a subject of scientific research of numerous civil lawyers and representatives of the School of Business Law for a long time, regarding the nature and contents of this concept debates and discussion still proceed. They have not found its logic conclusion in one scientific point of view as well as in legislation, which has a negative influence on the practice of applying norms concerning the foundations.

The problem of legal regulation of foundations' activity and their legal status has been developed on monographic level by the following scientists: Evgeniy Bulatov, Ivan Zhigalkin, Dmitriy Leshchenko. Besides, problems of certain types of foundations and unenterprising companies have been analyzed in civil literature, in particular, in the works of Galina Erygina, Maria

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<sup>1</sup> Law of Ukraine of 18.03.2004 no. 1629-IV, *On the State Program for Adaptation of Ukrainian Legislation to the Legislation of the European Union*, [online] <<http://zakon1.rada.gov.ua/cgi-bin/laws/main.cgi?nreg=1196-2010-%F0>>.

Tikhonova, Vadim Chepurnov. However, none of the monographies, scientific works or articles does contain more or less thorough analysis of European experience of foundations' legal status regulations.

Thus, the purpose of this article is to analyze the experience of legal status regulation and foundations' economic activities in Member States and to identify possible ways of improvement of Ukrainian law in this area, taking into account the possible unification of Ukrainian and European legal rules.

### **Legal status of the foundations**

Regarding the definition of the foundation it should be noted that Ukrainian legislation does not contain the expanded and clear definition. The Civil Code of Ukraine only indicates that the foundation is an organization founded by one or more persons (founders), which do not participate in its administration and operative management, by means of combining their assets in order to achieve a goal defined by the founders at the expense of the foundation's property<sup>2</sup>.

Analysis of this definition and its comparison to the interpretation of the definition of "corporation", as well as the analysis of scientific positions on this matter, allows us to distinguish the following features of the foundations:

- 1) it's a legal form of non-profit organization,
- 2) there is a prohibition on profit distribution in favor of the founders or other pre-defined entities;
- 3) it is established on basis of a founding act by one person or several persons, among who no corporate relationships exist and who are not its members;
- 4) there is no membership,
- 5) it is created for non-commercial activities by combining (allocating) the founders property, which is used to achieve the non-entrepreneurial purpose<sup>3</sup>.

Regarding the last feature, there are other points of view on this matter. In particular, Ivan Zhigalkin notes that the "foundations property has the

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<sup>2</sup> Code of Ukraine of 16.01.2003 no. 435-IV, *The Civil Code of Ukraine*, [online] <<http://zakon.rada.gov.ua/cgi-bin/laws/annot.cgi?nreg=435-15>>.

<sup>3</sup> E.V. Bulatov, *Legal status of an institution as a subject of economic relations* [in Ukrainian], Institute of Economic and legal research of NAS of Ukraine, Donetsk 2005, p. 20; I.P. Zhigalkin, *Foundation as legal entity* [in Ukrainian], Kharkiv 2009, p. 20; D.S. Leshchenko, *The legal institutions status in Civil law of Ukraine* [in Ukrainian], The National University of Internal Affairs, Kharkiv 2005, p. 20.

end use and should be used solely to achieve, firstly, a public benefit purpose, defined by its founder, secondly, the ones, which are related to the objectives defined by the founder by their nature and aimed at achieving public benefit purpose”<sup>4</sup>. It is hard to agree with this statement, as long as Ukrainian legislature (the Civil Code, the Commercial Code of Ukraine and special acts) does not contain obligatory norms concerning the specific non-commercial purposes of foundations, then there is usually a circle of beneficiaries that has to be indefinite, but the purpose of the foundation may be the protection of the interests of a certain group of individuals (disabled persons, sportsmen, etc.).

If we refer to the foundation law of EU countries, as long as there are no suitable directives or decisions aimed at harmonizing standards concerning the foundations (a project of European Foundation Statute has not been adopted yet), there are less relevant discrepancies.

European Foundation Statute would provide further benefits to the foundation sector. It would help to clarify terms and the concept of foundations as organizations with their own resources and independent governance. It would also help to develop a common definition of “public benefit purpose” of the foundations, as currently the term “foundation” is much too loosely used. But now within the EU each Member State has a slightly different understanding of what foundations are. Foundations are independent, separately constituted non-profit bodies with their own established and reliable sources of income. They are usually but not exclusively funded by an endowment, and have their own governing boards. They have been given goods, rights and resources to perform work and provide support for public benefit purposes, either by supporting organizations or individuals or by operating their own programs. They do not have members, but associate private resources for public interest purposes<sup>5</sup>.

The main focus of European Foundation Centre at present time is to see a European Foundation Statute become law, which would do much to overcome the barriers which impede foundations’ cross-border work. The Statute would have the effect of unleashing foundations’ potential economic impact on public-good activities.

So, as we have no harmonization of foundation law in EU, there are more or less significant differences in foundation law in the Member States. For example, the Netherlands legislation does not contain strict requirements for foundations (pursuit of any lawful purpose, no minimum initial endowment required, only rudimentary control by the public attorney as the State authority and with largely unconstrained economic activities, there are

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<sup>4</sup> I.P. Zhigalkin, *op. cit.*, p. 5.

<sup>5</sup> G. Salole, *Why Is the European Foundation Statute Needed?*, „The International Journal of Not-for-Profit Law”.

no restrictions on the implementation of business establishments), in contrast to French law (pursuit of only public benefit purpose, minimum initial endowment of usually € 1000,000, strong monitoring by the State supervisory authority). But we can still identify common features that foundations in the European Union have. It is an independent organization (in most countries with its own legal personality), which has no formal membership, is supervised by the State supervisory authority, is created to serve a public benefit purpose (in some Member States: to achieve any lawful purpose), for which the founder(s) allocated certain property or has provided an endowment and determined the foundations' purpose and statutes, which also creates a by-law of the foundation. But the above listed features of foundations are applicable for civil law countries only<sup>6</sup>.

In common law countries (Cyprus, Ireland, Malta and the United Kingdom) legislation distinguishes between "charitable trusts", "charitable company", and newly created "charitable incorporated organization". However, these legal forms only have certain similarities with the features of the public benefit foundations (absence of membership and corporate structures and legal personality. For the matter of that, in the United Kingdom it seems to be common to regard all "charities" as one single category (without a distinction between charitable trust, charitable company and charitable incorporated organization).

For example, the legislation of the US unlike the one of common law countries, uses the term "foundation", although the understanding of which differs significantly from the "foundation" in the civil law country. In the United States, a "foundation" is a sub-category of a tax-exempt "charity" (trust or non-profit corporation) defined by some functional criteria depending on the source of its income. The Internal Revenue Code distinguishes between "private foundations" (usually funded by an individual, family, or corporation) and public charities (other charities that raise money from the general public). Private foundations have more restrictions (e.g., prohibition from controlling affiliated enterprises) and fewer tax benefits than public charities.

In addition to the above mentioned features the European foundations are generally (but not always): are created for an indefinite period, exist under control of public authorities, should not allot the received profits (donation, gift, inheritance, etc.) between the founders or between the members of foundation executive body. As Ukrainian, European legislation usually consolidates full legal personality for foundations, which includes limited liability and full transactional capacity. The only exception is Luxembourg,

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<sup>6</sup> *Feasibility Study on a European Foundation Statute. Final Report*, European Commission, p. 224 [online] <[http://ec.europa.eu/internal\\_market/company/docs/eufoundation/feasibilitystudy\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/eufoundation/feasibilitystudy_en.pdf)>.

where the foundations are allowed to hold only immovable property if it is necessary for reaching a public benefit purpose. The reason for this is the preservation of influence theory of “dead hand” or “mortmain”<sup>7</sup>. Historically, the foundations for a long time (until the twentieth century) were dooming property to serve a specific purpose (for example, the provision of educational services), giving “them into a ‘dead hand’ (main morte, Tote Hand)”<sup>8</sup>. And the founder of the foundation defined the purpose and limited legal capacity of his foundation. A similar situation existed until recent times in Belgium and Italy, the outdated provisions were abrogated by the relevant laws in 2002 and 1997, thus, expanding the foundations legal capacity. In France the corresponding limitation is still preserved, but only with respect to the public benefit associations.

Some Member States consolidated the require of approval by the State supervisory authority on acquiring by foundations some categories of assets (e.g., donations, immovable property). It is arguable whether such rules should be regarded as a limitation of foundations’ legal capacity or as a measure of (preventive) State supervision. We follow the latter approach, as long as the rational explanation for the existence of this rule is considered: less the fear of the “dead hand” and more the wish to prevent abuse (which is also the rationale for other rules of preventive State supervision). Consequently, these rules are discussed along with the other measures for State supervision.

There is no such rule in Ukrainian legislation regarding such foundations as legal entities of private law, but according to our point of view, any restrictions on transactions (even through the establishment of rules related to further approvals of these transactions) limit the capacity of a legal entity and are not the ordinary prevention of transgression from the side of foundations’ executive bodies.

## **Economic activities of the foundations**

An important issue, in our opinion, is to fix opportunities for foundations to carry out economic activities. According to the article 86 of the Civil Code of Ukraine foundations can carry out economic activities along with their principal activity, unless otherwise provided by law and in case their activity meets the purpose for which they were founded, and contributes to its achievement. But the Civil and the Commercial Codes do not contain a general rule as for the possibility for foundations to be a founder (member) of enter-

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<sup>7</sup> Ibidem, p. 52.

<sup>8</sup> I.A. Pokrovskiy, *The main issues of the Civil Law*, [in Russian], Moscow 1998, p. 351.

prise legal entities (private enterprises, corporations), as the article 167 of The Commercial Code of Ukraine clearly indicates that “holding corporate rights shall not mean entrepreneurship”, and is the mediated participation of the foundation in entrepreneurial activities of another entity. If we turn to special laws governing the status of a specific foundations’ type, for social-cultural foundations, it can be seen that there are no special limitations for such possibility. Thus, the Law on Higher Education of Ukraine (article 23) indicates directly that a university can be a founder (co-founder) of others legal entities which carry out their activities in accordance with the directions of educational, scientific and industrial activities of high school, and the “List of groups of internal funds of budgetary foundations, requirements regarding their founding and application directions” approved by Resolution of CMU from May 17, 2002 No 659 (article 1 § 2) indicates the funds, which public foundations receive from economic and industrial activity of auxiliary, educational-auxiliary enterprises, farms, workshops, which have legal personality<sup>9</sup>. Fixing this opportunity for a higher education institution is reasonable because there was a regulatory enactment in Soviet Union acting since 1929. It allowed to found industrial enterprises with legal entity’s rights for scientific research foundations, technical universities and colleges<sup>10</sup>.

If we turn to the experience of the Russian Federation, the Civil Code of Russian Federation stated that „foundations funded by owners may be participants in business companies and investors in partnerships with the permission of the owner, unless otherwise prescribed by law” (article 66 § 4). But in Russian civil literature the following matter remains controversial: should the subject of activities of enterprises, whose founders or members are non-profit organizations, meet their statutory purposes of the latter. A certain group of scientists supports the position that the correspondence has to exist<sup>11</sup>, another group of scientists indicates that legal entities established by foundations may carry out any kind of economic activity with no limits<sup>12</sup>. In Ukrainian civil literature this matter is not sufficiently developed. But there is a position, according to which it is suggested to introduce to legislation a legal provision that would prohibit the foundations to contribute to the authorized capital of the enterprises whose subject of activity does not correspond to its basic functions<sup>13</sup>. Besides, it is proposed to allot

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<sup>9</sup> Resolution of Cabinet of Ministers of 17.05.2002 no. 659, *List of groups of internal funds of budgetary foundations, requirements regarding their founding and application directions*, Official Bulletin of Ukraine, 2002, p. 1032.

<sup>10</sup> V.K. Mamutov (ed.), *Transparency of business entities and economy crime prevention* [in Ukrainian], Donetsk 2007.

<sup>11</sup> E.A. Sukhanov (ed.), *The Civil Law* [in Russian], Moscow 1998.

<sup>12</sup> M.J. Tihomirova (ed.), *Comments to the Federal Law on NGOs* [in Russian], vol. 1, Jurinfocentr, Moscow 1998, p. 816.

<sup>13</sup> E.V. Bulatov, op. cit., p. 4.

the rule in the Civil Code (and the Commercial Code) of Ukraine, that a foundation has to contribute to the authorized funds of enterprises (including corporations) only the property belonging to it, which had been received not from the founder, but at the expense of its own business and other economic activities<sup>14</sup>.

Concerning this matter we should refer to European experience. The civil law of the most European countries allows the foundations to carry out the business activity without any special clauses. But in some countries there are still certain restrictions on the “economic activities”. In this case, the grounds of such restrictions in most cases are the protection of creditors interests, sometimes foundations assets protection, as long as, according to European researchers, direct entrepreneurial activity is naturally more risky than investing. Therefore further EU legislation allows the foundations to create (or to be co-founder) of associated enterprises/ subsidiary corporations and companies (subsidiary trading company). The prohibition exists only in Lithuania, Slovenia and the Czech Republic (with some exceptions). Notably, the countries, which prohibit direct entrepreneurial activity of the foundations, in most cases allow the ownership of corporate rights as an alternative (in particular, Malta, Greece, Slovakia, and to some extent, Denmark<sup>15</sup>). But France and Luxembourg allow the foundation to create enterprises and corporations related to the main purpose of foundation activity (“if related to the main objectives of the foundation”)<sup>16</sup>.

Regarding this it must be pointed out that, according to the case law, the mere holding of shares, even controlling shareholdings, is insufficient to characterize as economic activity of the entity holding those shares, when it gives rise only to the exercise of the rights attached to the status of a shareholder or a member, as well as, if appropriate, the receipt of dividends, which are merely the fruits of the ownership of an asset. On the other hand, an entity which, owning controlling shareholdings in a company, actually exercises that control by involving itself directly or indirectly in the management thereof must be regarded as taking part in the economic activity carried on by the controlled undertaking.

Also “European Foundation Project: Draft” includes following rules: “European Foundations may not carry out a business in their own name. European Foundations may hold a controlling interest in a business enterprise

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<sup>14</sup> V.K. Mamutov (ed.), *op. cit.*, p. 334.

<sup>15</sup> A particular feature of Danish foundations is the possibility to engage in major commercial activities and use a special legal form to do so. The Act of 1991 on Commercial Foundations established the legal framework for foundations to either directly engage in commercial activities or hold controlling interest in commercial entities. The law also allows Danish commercial foundations to combine commercial and public benefit purposes and requires the charters of such foundations to include a regulation of distributing profits.

<sup>16</sup> *Feasibility Study on a European Foundation Statute...*, p. 91.

(or in another undertaking which operates a business) only if this business is within their public benefit purpose (related economic activities) or in the circumstances described in the next paragraph. European Foundations may hold a controlling interest in a business enterprise (or in another undertaking which operates a business) with a view to profit (unrelated economic activities) if any profits derived therefore are used only in pursuance of its public benefit purposes and the economic activities themselves are only ancillary to those purposes as a means to that end<sup>17</sup>.

Nevertheless, none of EU countries, which generally allow shareholding, fixes the restrictions related to transferring funds of the foundations, assigned to it by the founder. Therefore, to our opinion, the Ukrainian legislation has to fix the rules similar to the legislative statutes of France and Luxembourg, with the aim of foundations assets protection from scattering, and possible trespasses, and, in current realities, not to allow unrestricted participation of foundations in business establishments.

## **Conclusion**

All stated above points out that the Ukrainian foundation law allots the regulations similar to European analogues, although with some differences. In our opinion, the general rules on the legal status and possible forms of foundations' participation in economic activities should be precisely fixed in the Civil Code and the Commercial Code of Ukraine, taking into account the experience of leading European countries (in particular, with regard to fixing limits on the foundation of affiliated business entities).

## **Streszczenie**

### ***Analiza porównawcza fundamentów prawa ukraińskiego i prawa europejskiego***

Słowa kluczowe: fundacja, podmioty niekomercyjne.

Artykuł dotyczy podstaw prawnych umożliwiających prowadzenie działalności gospodarczej przez fundacje. Pomimo że status prawny, klasyfikacja i główne cechy działalności gospodarczej podmiotów niekomercyjnych, w tym fundacji, były badane przez ukraińskich prawników cywilnych i przedstawicieli School of Law, charakter i treść tego pojęcia są nadal przedmiotem dyskusji. Autorka przedstawia zasady prawne działalności gospodarczej fundacji w państwach członkowskich UE i na Ukrainie.

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<sup>17</sup> K.J. Hopt et al., *The European Foundation – A New Legal*, Cambridge 2006.