GEPLAC ACTIVITIES

Reform of the Law on Entrepreneurs

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1. Background

The Law on Entrepreneurs, which was adopted in 1994, played an undoubtedly crucial role in the development of entrepreneurial relations in Georgia, based on the fundamentals of a market economy. This Law served as the basis for the privatisation process, as well as for the incorporation of many companies, and generally laid the basis for the system of corporate governance.

For the time being, when more than ten years have passed since the adoption of the Law, the practice of its application revealed many deficiencies. It became apparent, that some crucial issues were either not regulated by the Law or regulated in such a general and vague manner that in practice, enterprises encountered problems with respect to its application. Furthermore, all this coincided with the new phase of approximation of Georgian legislation with the European one. Namely, the Government of Georgia commenced work on the National Programme for the Harmonisation of Georgian Legislation with that of the EU. The Georgian-European Policy and Legal Advice Centre (GEPLAC), in the capacity of governmental adviser in the filed of development of the National Programme, conducted a comparative analysis of Georgian legislation and EU standards, which among others included company law. As a result, a number of inconsistencies and deficiencies were revealed that necessitated further legislative changes.

The above processes put the necessity of essential revision of the Law on Entrepreneurs on the agenda. Under the initiative of the Ministry of Justice of Georgia, a special working group was set up which included the participation of representatives from the Ministry, GEPLAC, the German Agency for Technical Assistance (GTZ), the International Financial Corporation (IFC) as well as the private sector (Georgian Business Federation). The main task of the working group was the removal of deficiencies of the Law of Georgia on Entrepreneurs and its harmonisation with European legislation.

During the elaboration of the draft law, the working group based its work on the European Company Law Directives, as well as the experience of EU Member-States and the

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US. A daft law on the amendments to the general part of the law has already been prepared. Below we shall give a short overview of the draft law and try to give the Georgian reader a clear idea concerning its major innovations:

2. Pre-Registered Company

One of the most important innovations of the draft Law is the article on pre-registered companies, which is aimed at the regulation of relations arising in-between the periods of signing the charter of the company and its registration in the company register.[1] In legal practice, problematic was the issue of what kind of formation are we facing when the company charter has been notarised, but the company itself is not yet registered in the company register. Furthermore, for the registration of a company it is necessary for the company concerned to enter into agreements directly related to its incorporation (e.g. receipt of contributions of the partners). The draft law clarifies this issue and gives the detailed description of the legal nature of the formation existing before its registration in the company register.

From the moment of notarisation of the charter, the pre-registered company is entitled to use the company name, however in order to make it clear with what kind of legal formation the participants of legal relations are dealing, the company is obliged to add the postscript "in the process of incorporation" to its company name.

The draft law also sets the framework within which the company acts as an independent bearer of rights and obligations. However, the main precondition is that the relations the company concerned enters into must serve its purpose, i.e. its incorporation. The draft law gives several examples of these types of relations, but the list is not exhaustive; namely a pre-registered company is entitled to open bank and securities accounts on is own behalf, to be entered into public and securities register as a proprietor, and to be a party to legal proceedings.

The draft law offers three sources for the regulation of internal relations among the partners of a pre-registered company. First of all, this is the company charter in its capacity as the company's primary governing document. At the same time under the draft law, provisions are also applicable with respect to internal relations, a precondition of which being that the company is in fact not yet registered. The third source of regulation of internal relations is the provisions of the Civil Code on joint activities.

The draft law also regulates the distribution of the rights and obligations acquired and assumed on behalf of the company. Namely, the rights are the common rights of the partners of the company, irrespective of their share participation in the company. The obligations assumed on behalf of the company are also distributed between each partner, as well as any person who assumed such obligation, such persons being jointly and severally liable before the creditors.

[1] The institute of pre-registered companies is not a n innovation for the law of commercial and non-commercial companies. In the countries of traditional codification (e.g. in Germany) this institute was mainly acknowledged and developed by court practice. In modern legal systems it is already regulated by laws in details (e.g. in Macedonia).

An important innovation is the provision on legal succession of rights and obligations, which originated before the registration of the company. According to the draft law, the pre-registered company ceases to exist upon registration in the company register while all its rights and obligations mechanically pass to the registered company. This provision essentially differs from the approach provided for by the current Law, under which joint and several liabilities of the partners are maintained after the registration of the company.

3. Non-cash Contribution to Subscribed Capital

Certain changes concerned the mechanism of making non-cash ("in-kind") contributions in companies with limited liability, in which similar to the previously employed practice, requires the valuation of an independent expert. This provision was developed on the basis of the Council Second Directive,[2] under which "Non-monetary contribution may be formed only of assets capable of economic valuation. However, an undertaking to perform work or supply services may not form part of these assets".

The purpose of the respective provision of the Directive is the protection of shareholders and creditors through maintenance of the capital – the creditors, on the one part, must be aware of what may be transferred to the company in exchange for the shares and on the other part, must be sure, that transferred assets have material value. Due to the complexity and unreliability of valuation, the performance of work or supply of services in exchange for shares or stocks is prohibited.

One more restriction with respect to non-pecuniary contributions is related to time frames for making such: "Contribution is to be made in assets, which shall be transferred to the company within a period of one year following its incorporation or the registration of the increase in the subscribed capital". The Second Directive provides for a maximum period of five years for the transfer of consideration other than in cash.[3] However, the laws of certain countries of continental Europe provide for a lesser period with a view to avoiding misunderstandings and depreciation of assets, a policy that in our opinion is more reasonable. As a rule, transfer of assets is delayed in cases, when another enterprise is the asset to be transferred as a non-cash contribution.

Also based on the Second Directive the detailed content of the report on the valuation of non-cash contributions was established:
– The nominal value of the shares (stocks), which are issued in exchange for the contribution other than in cash;
– The total of excess amount (accountable par) in cases in which shares (stocks) are issued above the nominal value;

[2] Second Council Directive of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (77/91/EEC), Article 7.
[3] Article 9 II of the Second Directive.

– Description of each of the assets comprising the contribution as well as of the methods of valuation used and the date of valuation;
– Statement concerning the correlation of the value of contribution other than in cash and the value of the shares (stocks) issued in exchange thereof.

The nominal value of the shares (stocks) issued in exchange for the contribution other than in cash, the subject of contribution other than in cash and personal data of the payer of the contribution must be indicated in the charter. If this information is not contained in the charter, agreements made with respect to such contributions shall be considered as invalid. In this case, as well as in cases of violation of the requirements concerning non-cash contributions, the partner is liable to pay in cash the value of shares (stocks) received in exchange for the non-cash contribution.

We could have made a draconic law as a result of the above which would have obliged the partner, who had already transferred assets of certain value to capital, to pay the contribution for the second time in cash for even a minor procedural derogation. For the purpose of avoiding such a result, we borrowed the following mechanism from the English law:[4] a court may wholly or in part relieve a partner from paying the consideration for shares (stocks) in cash, if the latter proves that the company had received assets of equal economic value in exchange for the shares (stocks).

The draft law provides for the introduction of a new article on agreements with founder partners, which is based on the Second Directive.[5] Any agreement, under which before the expiry of a time period of at least two years from the registration of the company, the company concerned acquires any asset belonging to a founder partner, the value of which totals 10 or more percent of subscribed capital, shall be subject to approval of the general meeting and registration in the company register, otherwise it shall be invalid.

In Europe, the above provision serves the purpose of elimination of fraudulent mechanisms of avoidance of valuation of contribution other than in cash by an independent expert. The case addresses the well established practice of founding partners paying consideration to subscribed capital in cash, but within a period of several months following the incorporation of the company, buying assets from them at a price set in advance – as a result the requirement on independent valuation of contribution other than in cash is avoided.

4. Disclosure at the Stage of Registration

Changes also concerned the so-called disclosure obligation imposed upon legal persons. Disclosure, or the public dissemination of information related to company management, capital, financial standing and other important issues is the price to be paid by persons united in a company for the purpose of attaining corporate juridical personality and limited liability. Insofar as the policy of disclosure is the most important mechanism for the protection of the interests of third persons and creditors, we tried our best for the

[4] Companies Act 1985, Article 113.
[5] Article 11 of the Second Directive.

draft law to reflect the provisions, commonly acknowledged by the European law in this field, to maximum extent possible.

Although the current Law requires the public disclosure of many types of information embodied in the EU Directives on Company Law, the minimum standards introduced by the EU in this field at the initial stage are far wider (the First[6] and the Second Council Directives). With a view towards further improvement of the Law, changes concerned all types of disclosure, namely, the registration of the facts in the company register (Article 5), which are then automatically related to the other types of public disclosure – publication in a printed gazette, and the disclosure of mandatory data to be included in the company letterhead (Article 19).

As regards the information to be submitted at the stage of registration, it should be mentioned initially that pursuant to the EU Second Directive,[7] the draft restored the requirement removed under the previous amendments made to the Law (24.06.05) on the indication of the subject of activities in the application for registration (Art. 5.3.1). Furthermore, the subject of activities became a mandatory pre-requisite of the charter of a limited liability companies. In our opinion, the importance of the mandatory indication of the subject of activities in articles of association and in the company register is apparent and does not require special justification, however we shall briefly outline the basic aspect, which make this issue so important:

– As far as the legislation provides for certain restrictions with respect to the choice of organisational-legal forms, the court is to have the information concerning the goals (subject of activities) of the legal person made upon its registration, in order to identify whether the selected legal form corresponds to the goals of the legal person concerned;

– The Indication of the subject of activities is also important for the registration body to verify the lawfulness of the subject of activities of the legal person, and in the case of establishing the unlawfulness of such – to refuse the registration;

– Identification of the subject of activities in the charter and the necessity of the decision of Partners' Meeting for each change to it is the important mechanism of protection of partners' interests. A partner (and this particularly concerns the shareholder of a joint-stock company), who purchases the share of the company and transfers certain assets to it for consideration, should be sure that the company will use these assets for specific purposes envisaged by the company charter. Thus, the shareholder's right, who invested resources in a specific type of activity, will be violated if the director is authorised to change the directions of company activities at his own discretion;

– The previous provision involves the issue of liability of a director. If restrictions, provided for by the statute have no importance in external relations, and derogation from the

[6] First Council Directive of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community (68/151/EEC)

[7] Article 2 (c) of the Second Directive.

subject of activities does not affect the transactions made with third persons, they entail certain legal consequences in intra-company relations. Namely, company partners are allowed to raise the issue of liability of a director if the latter entered into transaction, which is beyond the subject of activities, envisaged by the charter.

According to the Second Directive, the list of instruments to be submitted upon the registration of joint-stock companies was expanded. Namely, companies of this type are to submit any agreements on granting special rights, if such are provided by the company charter. This provision aims at the protection of creditors and partners during the process of incorporation of the company against disadvantageous transactions. Special rights (advantages) in this case mean the rights, which do not derive from the membership of the company, but exist in parallel with the former and can be granted to an individual partner or a third person. For example, the right to purchase goods, particularly a highly remunerative, pre-emptive right to obtain information, etc. For the validity of such an agreement, it is necessary the charter to state what privileges are granted and to whom.[8]

A Joint-stock company is also obliged to submit the approximate estimate of all the expanses necessary for the incorporation of the company. Incorporation expenses include: taxes, (notary, court) fees, royalties for advisory services, publication expanses, stocks printing expanse, etc. The charter should also include the amount of total expanses. If the exact amount of total expanses is not available, the approximate amount should be indicated, based on real calculations.

And finally, based on the fact, that the draft law envisages certain requirements for candidates for the post of director of limited liability and joint-stock companies (for details see: Chapter 6), the statement of the directors certifying that they meet the requirements provided for by the law should be submitted for registration.

The draft law removes a material deficiency in the current Law on Entrepreneurs, namely, that now the minimum mandatory requisites of a company charter have been defined. Although under Georgian legislation, the charter is the only instrument outlining the rights and obligations of the company partners, while also providing the basic normative framework for the organisational arrangement of the company, Article 32 of the Civil Code of Georgia provides for the minimum requirements with respect to the contents of the charters of unions and foundations. Thus, in practice the provisions of the Civil Code are applied by analogy with respect to the legal forms of business activities, a state of affairs that naturally, does not allow for comprehensive regulation of this issue, in particular with respect to the charters of joint-stock companies.

With a view toward removal of this particular deficiency, the working group developed mandatory content for company charters, based on the provisions of the EU Second Directive.[9] Namely, that the charter of a limited liability company, a joint-stock company or a co-operative should include the following data:
– Organisational-legal form of the company and its company name (firm);

[8] Article 3 (k) of the Second Directive.
[9] Articles 2 and 3 of the Second Directive.

– Location (registered office);
– Scope of company activities;
– The amount of subscribed capital;
– Consideration of each of the founding partners, and respective share;
– Quantitative composition of the bodies with managerial, representative and supervisory functions;
– Duration of the company, unless it is established for an indefinite period of time;
– Personal data of every natural person, who signed the company charter, and if the statute is signed on behalf of a legal person – its registration data.

The charter of a joint-stock company should as well include:
– The amount of subscribed capital, if there is such;
– The nominal value and number of shares;
– If the consent of the company is required for the transfer of shares, conditions for granting consent;
– In the case of existence of various classes of shares, their number and conditions for issuing;
– Nominal value of shares issued for the consideration other than in cash, together with the nature of the consideration and the name of the person providing this consideration;
– Any special advantage granted to anyone who takes part in the formation of the company;
– Approximate estimate of all expenses related to the incorporation of the company.

Thus, assuming that the charter is the most important resource for the partners and creditors, provision of its mandatory requisites in the law must be considered as a positive step forward in the light of protection of the interests of both partners and creditors.

The draft law clarified Article 5.3 of the current Law, which provides for the liability of directors and partners for the accuracy of data submitted for the purpose of incorporation of the company. In addition, the draft law provides for liability in the case of deliberate or gross negligence.

5. Disclosure after the Registration

The draft law clarifies and reinforces the obligation of registration of changes to the company charter and in the case of each of these changes, submission of the full text of the revised charter of the company to the company register. In addition, the list of facts mandatory for registration has been supplemented with information concerning company dissolutions or liquidations appointment of liquidators (which includes an indication of their identity and respective data) and completion of liquidation.

For joint-stock companies and limited liability companies, as well as for companies with limited liabilities, more rigid standards of disclosure have been set, namely, they are additionally required to submit an annual balance, profit-loss accounts and activity accounts to the company register. However, with respect to this last provision it is necessary to identify adequate means by which to secure due compliance with this obligation on the part of the company. Unlike other mandatory requirements for registration, in the disclo-

sure of which the company is personally interested, such data acquire legal value only after the registration, and in its relations with third persons the company is authorised to rely only on registered facts, and thus it is impossible to apply a similar treatment with respect to the submission of annual reports. Thus, there arises the necessity of providing a special sanction for non-fulfilment of this obligation. In our opinion, the best way to regulate this issue is through the imposition of administrative responsibility on the management of the company. Consequently, the working group has also prepared draft changes and amendments to the Code of Administrative Offences.

As for the third type of disclosure – business letter, in this case as well, we expanded the circle of data, which should be indicated on a business letter (letterhead) of the company on a mandatory basis. Namely, the list given in Article 19 was supplemented by the obligation to indicate the amount of subscribed capital, and if the latter is not fully paid-up, the amount of remaining outstanding contributions, and to indicate that the company is in the process of incorporation. The draft law also provides for mandatory posting of all relevant data on the company web-page (if there is such), which will be indicated in a business letter. It should also be mentioned that similar to the violation of the obligation of submission of annual reports to the register, in the case of violation of the requirements provided for in Article 19.2, administrative liability of the management of the company shall be imposed.

According to the requirements of Council First Directive, Article 7 was refined, by regulating the legal validity of company instruments, while aiming to protect the interests of the third persons. Namely, the changes offered by us embody the mechanism for protection of bona fide third persons – with respect to the transactions made within a period of fifteen days following the registration (of facts), the company is not able to rely on these facts with respect to a third person, if the latter proves, that he was not and could not have been aware of these facts. Under proposed changes in the case of inconsistency between registered and published facts, registered facts shall prevail, however a bona fide third person is entitled to relay on published facts, and in this case it is the company who is obliged to prove, that the person concerned was aware of the registered facts.

6. Requirements with Regard to the Directors

Article 9 on Company Management and Representation underwent considerable revision. This concerned both the form and content of the articles. It was divided into several annotated articles according to the content, thereby becoming more flexible, easily interpretable and based on practice particular to Western experience.

The new version of the Article introduced certain requirements with respect to the personal qualifications of directors. A director is to be a natural person of full legal capacity. A director may not be a person against whom a legally enforced judgement of “guilty” was delivered on the basis of Articles 205-207 of the Criminal Code of Georgia (unlawful actions, violation of accounting procedures and non-submission of an application in the case of bankruptcy, respectively), which was not dismissed or whose criminal record was

not cleared. In addition, a person who has been deprived of the right to pursue certain professional or other activities may not serve as a director, if the subject of activity of the company fully or partially coincides with one in which he is prohibited from participating.

It should be explained why only those persons who have committed an offence in the bankruptcy field, and not some other graver economic crime, e.g. fraud, are prohibited from holding the office of director. This is due to the fact that in crimes committed during the process of bankruptcy. damage is caused not only to the partners who are able to appraise the personal trustworthiness of candidates for director, and thus had ample opportunity to possibly have voted against their candidacy, but also to the creditors and the society at large as well, who are not able to chose, and thus require legal protection. Furthermore, introduction of similar restrictions for every kind of economic offence would have considerably reduced the number of candidates, while the introduction of the prohibition for only certain offences would have definitely entailed questions, whether a person guilty of fraud is unacceptable for the office of a company director and not, say, the violator of accounting rules.

There are different approaches to this issue in Europe. In Germany, only persons who have committed crimes with respect to bankruptcy are prohibited from holding the offices of director.[10] On the other hand, under the United Kingdom's Company Directors Disqualification Act, directors and managers may be deprived of the right of company management for several years on any grounds, if they constitute persistent breaches of company law[11] or fraud[12].

7. Representation Authority

With a view to avoiding inconsistent interpretations and court decisions, provisions, concerning company representation in relations with third persons have been elaborated in a more clear-cut and detailed manner. Even though the company charter, internal regulations or the decision of any body of the company may provide for some restrictions with respect to representative authority, these restrictions are valid only within intra-company relations, while the representative rights of a duly authorised person or body are unrestricted with respect to third persons. Procedural requirements necessary for giving consent to a transaction were considered to be sufficient.

Similar wording safeguards the interests of a bona fide third person. The latter should not be obliged to study company instruments and minutes of company bodies before entering into each transaction in order to ensure that none of the essential or procedural requirements has been violated.

On the other hand, a different treatment is provided for those cases, in which upon entering into a transaction, a counterpart was aware or should have been aware that the action exceeded the powers of the person or body with representative authority, or that proce-

[10] § 73 III Aktiengesetz.
[11] Company Directors Disqualification Act, 1986, Article 3.
[12] Ibid, Article 4.

dural requirements had been violated. In these cases, the court shall invalidate a transaction within a period of 18 months following the entering into of such a transaction, upon the request of a director, a member of a supervisory body or a partner. It should as well be stressed that under the First Directive[13] and reforms ongoing in the United Kingdom[14] , the draft law envisages that only the fact that a third person could have become aware about the restriction of the representation authority from the company register does not prove that he definitely was aware or should have been aware of it.

Even in the case of entering into a transaction through the abuse of power, a director has the opportunity to correct the violation. That is to make the body, which had the power from the very outset, certify the transaction concerned. Under the English case law,[15] the advantage of this action is that after the approval of the transaction, it is impossible to file a lawsuit based upon such violations, and thus there is no danger of its invalidation.

The draft law incorporated such mechanisms popular in the West, as the so-called derivative lawsuit, which enables a partner to file a lawsuit against third persons, in our case, against a director. In such countries as thee the US and the United Kingdom, company partners have more than one mechanism for the protection of their rights, including their business rights, and thus with a view to avoiding the abuse of the right to file a derivative lawsuit there is a certain judicial control over such lawsuits in the above countries[16] . In our country, unlike the European ones, the restriction of the right of a partner to apply to the court will leave them to the mercy of fate. Taking account of this situation in cases of violation of the obligation to be honest, prohibition of competition, and violation of the procedure of entering into transaction with a related party by a director, each of the partners will be authorised to apply to the court for the protection of his rights.

8. The Obligation of Fairness

Changes also concerned the obligations of integrity ("fiduciary duty") of the company management. The initial decision of the working group was for the incorporation of the so-called business judgement rule in the draft law, which would protect directors in the case of making decisions detrimental to the company. However, in the end we decided to leave the privilege of definition of this rule to the Georgian courts, while the concept of integrity, similar to the established US practice[17] was added to the obligation of awareness concerning the subject matter of a decision, along with the obligation of care and to act in company interests.

In our opinion, the provision made to the Law of Georgia on Entrepreneurs in June 2005 introducing the so-called "corporate opportunity doctrine" into Georgian legislation requires revision. In Western legal theory and case law, the prohibition of a director from the use of information related to company activities for personal purposes ("usurping a corpo-

[13] Article 8.2 of the First Directive.
[14] *Davies*, Gower and Davies' Principles of Modern Company Law, 146.
[15] *Re Horsley & Weight Ltd* (1982) Ch 442, (1982) 3 All ER 1045 (Court of Appeal).
[16] *Soderquist, Sommer, Chew, Smiddy*, Corporations and Other Business Organisations, 4th Ed (1997), 667.
[17] *Smith v Van Gorkom* 488 A. 2d 858 (1985).

rate opportunity") is an integral part of the fiduciary duty owed the company and continues even after the director's leaving his office.[18] According to the amendments introduced to the Law on Entrepreneurs, provisions in the company charter or separate agreement of the partners is required for the maintenance of the validity of this prohibition. Furthermore, some compensation may be provided for what is an inherent obligation of the director due to its nature.

We believe that it would have been better for this provision to have had the following wording: "Without the prior consent of a meeting of the partners, or of the supervisory council, if such a council exists, a company manager shall not use business opportunities related to the scope of activities of the company for personal purposes, about which he became aware in the course of fulfilment of his official duties, or through the use of company property or information, and which would have been of interest to the company in an objective opinion. Prior consent is not required when a meeting of the partners or supervisory council has already considered the opportunity and decided against it. This obligation remains valid for a period of three years following the retirement of the person concerned, or until winding up of the company".

9. Agreements with the Directors

The draft Law regulates the relations of the company with the directors more comprehensively. For a long period, only one sentence of the Law on Entrepreneurs concerned this field, according to which the supervisory council could enter into so-called "service" agreements with the directors. Unfortunately, the laconic nature of this provision led to its incorrect interpretation by the courts, and thus faulty decisions have been made for years now. For example, a general director of one enterprise was reinstated to his office on the grounds that at the time of dismissal he was on sick leave, and consequently the requirements of the Labour Code had been violated by his dismissal.

It should be mentioned that equating a director with an ordinary employee, and thereby extending provisions of the Labour Code to the former, means neglecting the widely applied western practice in this area. A director my not be considered an employee, as he is not hired, but is an employer, who makes labour agreements with others, and is quite free in his activities. And as a consequence of this right, the partners should be able to dismiss him at any moment.

As a result of changes made to the Law on Entrepreneurs in June 2005, a new 9.8[1] paragraph was developed, which states that "The Labour Code shall not apply to the relations between directors and the supervisory council". Despite this progressive step forward, we still consider it necessary to further specify the ways of regulating these relations and thereby to provide appropriate answers to all outstanding questions.

[18] *Broz v Cellular Information Systems, Inc.* 677, A.2d 148 (1996) in the USA; I*ndustrial Development Consultants Ltd v Cooley* (1972) 2 All ER (1972) 1 WLR 443 in the United Kingdom; *Canadian Aero Service Ltd v O'Malley* (1973) 40 DLR (3d) 371 in Canada.

If we take the German example, a special Chapter of the German Civil Code "On Service Contracts" regulates service contracts made with the directors. In Germany this very part of the Code provides for general conditions for making such contracts and accords minimum rights to directors (e.g. stipulates the time frames for the notification of an individual concerning the cancellation of the contract, as well as any other conditions that might apply). Unfortunately, our Civil Code says nothing about service contracts or similar relations.

On the other hand, the absence of specific articles of the law does not present any problem, for example, in the United State or the United Kingdom, where relations between the Directors and the company are regulated solely by their service contracts. It is considered that directors have more powers and consequently are capable to bargain for better conditions for themselves and, thus they do not require any additional protection from the state.

According to the draft law, the partners meeting or the board of directors, if there is any, are authorised to dismiss a director at any time without giving respective justification, which shall result in the cancellation of the contract made with the director. Any Contract contradicting this provision is invalid. Even though directors in our country do not enjoy the same powers as their western colleagues, a mechanism for their protection was indeed developed. And unless a greater amount is envisaged by contract, in the case of cancellation of the contract made with a director, the latter must be paid either three months or six months salary, provided he has held the office of the director for more than five years.

Based on European practice and law[19] exceptions were also envisaged, when a director is not entitled to any compensation at all for a particularly gross violation of his duties. In our case, this would be a violation of the obligation of integrity, prohibition of competition, or a valid court judgement entered against the director.

10. Transactions with Related Parties

A special article of the draft law deals with one of the most critical problems of the world in the field of corporate management – regulation of transactions made with related parties. Like many Western countries,[20] we have paid particular attention to voluntary disclosure, the various mechanisms of making such transactions made with related parties while insuring that this treatment will apply only to limited liability and joint-stock companies.

First and foremost the circle of persons, who may be considered as "interested persons" during the process of making a certain transaction, was identified. These are: a company director, a member of the supervisory council, or a partner, who owes more than 20 percent of the authorised capital of the company. The latter shall be considered as interested person if he or his relatives of the first or second degree directly or indirectly:

[19] § 84 III Aktiengesetz.
[20] In the United Kingdom: Companies Act 1985, Article 317.

– are participants in the transaction;
– are the owners of 20 or more percent of a legal person, that is a participant the transaction;
– are directors or the members of the supervisory council of a legal person, that is a counterpart in the transaction;
– are considered as such under the company charter;
– will receive some benefit from the transaction.

An interested person is liable to inform forthwith the directors and supervisory council concerning any past or future transactions, in which he is an interested person, as well as the nature of his interest. Such a transaction is subject to prior approval of the supervisory council, and if such a council does not exist, then, by the partners meeting. However, any interested person is prohibited from voting in any of the company bodies. If the majority of the supervisory council is comprised of interested persons, or the value of the transaction exceeds 20 percent of the balance value of company net assets, or a lesser amount provided for by the company charter, the transaction is subject to approval of the general partners meeting. A person who fails to disclose his interest in a particular transaction shall be liable for any damages incurred by company as a result of the transaction.

What are the consequences for violation of the rules regulating the entering into of transactions with related parties? We based our assumptions on the US case law, where a company is entitled to apply to a court for the invalidation of the transaction or for damages. However non-compliance with the rules does not automatically result in the invalidation of the transaction:, as the court will assess the fairness of transaction terms, and if it considers that the company has not incurred any damages, the transaction will remain valid.[21] Under terms of the draft law, upon the application of a director, a member of the supervisory council or any partner within a period of 18 months following the date of entering into the transaction, the court is entitled to invalidate the transaction made in breach of the requirements of this article, if it is proved that the company has sustained damages by reason of the transaction concerned, or the transaction would have been made with different terms in the of absence of the interested relationship.

11. Dissolution/Liquidation and Winding up of the Company

One more important innovation of the draft law is the detailed regulation of the termination of the existence of a company. Namely, pursuant to the requirements of the First Council Directive,[22] the two stages of the termination of the existence of a company have been regulated in a consistent manner. Dissolution and “winding up” occur first, which are then followed by the cancellation of the registration of the company.

As regards the first stage of terminating the existence of the company, it should be mentioned, that the draft law makes an explicit delineation between dissolution and liquidation, while providing the legal basis for the legal consequences of these two events, in addition to their general procedural requirements.

[21] *Lewis v S.L.&E., INC*. 629 F.2d 764 (1980).
[22] The First Directive, Chapter III.

Under the draft law, the following are the main grounds for the dissolution of a company:
– Expiration of the prescribed term of the company charter if the company was created for a specific period of time;
– Withdrawal from the limited liability partnership from all its personally liable (generally liable) partners, unless any of the other partners assumes personal liability;
– Decision of the partners meeting on dissolution of the company;
– Opening of bankruptcy proceedings with respect to the property of the company;
– Entry into force of a court ruling on the rejection of opening of bankruptcy proceeding due to insufficient company assets (property).

In the light of protection of the interests of company partners and counterparts, exhaustive provision of the grounds for the liquidation of a company and its consequences in the law is of particular importance, as it is a regime that preludes the application of the generally applicable procedure of dissolution envisaged by the Civil Code. Under the draft law, a company is nullified in the following cases:
– The objects of the company are unlawful or contrary to generally acknowledged moral rules or public order;
– The charter does not state the name of the company, the objects of the company, the amount of the individual subscriptions of capital, or the total amount of the capital subscribed;
– Failure to comply with the requirement on the minimum amount of capital to be paid up before the registration;
– The incapacity of all the founding members of the company.

Decision on the liquidation of the company may be made by court at its own discretion or on the grounds of an application of a company partner, director, member of the supervisory council or a tax authority. Furthermore, before it is liquidated, the company is to be given the opportunity to remove the deficiency, which became the grounds for the application seeking its liquidation. To this end, the court must grant at least a three-month period to the company. Liquidation does not affect the validity of transactions made on behalf of the company. Partners shall be liable to make their contributions, if it is necessary for the fulfilment of their assumed commitments.

The dissolution and liquidation of a company is to be registered in the company register. Registration of the dissolution is the obligation of company directors or of the court depending on the reasons for the dissolution, while liquidation is to be registered by a court in all cases.

As mentioned above, the next stage of the dissolution or liquidation of the company is the commencement of the procedure of winding up company affairs. Exempt is the case, when bankruptcy proceedings are open with respect to company property.

During the process of winding up, the legal status of the company remains unchanged. However, the objective of winding up the company changes its previous corporate objectives. Thus, the company management bodies (except for directors), which according to the draft law maintain their powers, are restricted to this end.

As a general rule, winding up of a company is conducted by the directors. Some other persons may also be appointed as liquidators, if so provided by the company charter, or

decision of the partners. Furthermore, the draft law envisages the appointment of a liquidator by the court, as well as providing for the possibility of the latter's withdrawal. However, there must be material grounds for that. In this regard, the right to apply to the court is enjoyed by any partner of a company, 5 percent of the partners in a joint stock company, limited liability company and co-operative, and the supervisory council, if such exists.

The liquidator is to comply with the requirements that are provided for a company director (full legal capacity, limitation in holding offices for persons with criminal records). Under the same part of the law, the registration of the identity of the liquidator was added to the list of facts that are mandatory for the registration of the company.

Generally, liquidators are responsible for completing the current activities of the company, collecting claims, liquidating remaining assets of the company, and satisfying creditors' claims. In other cases, they have the rights and obligations similar to those of a company director. They manage the company at their own discretion, within the framework provided for winding up. However, it should be stressed, that the draft law provides for the logical exemption from the director's duty of non-completion, a duty that should not apply to liquidators.

Another novelty of the draft law is that in the case of a long-term process of winding up, the court may relieve the company from the obligation to conduct an audit of its financial statements, if the company standing is so apparent, that based on the interests of the creditors and the partners an audit is not required. This will free the company from unnecessary expenses.

The draft law also clarifies the procedure for notification of creditors. Special notices are served to the creditors known to the company, while for unknown creditors a public announcement is made in the printed media. Furthermore, the public announcement is to be made three times, with at least, one-week intervals.

An additional feature of the draft law is the granting of an option to continue the existence of a dissolved company. Namely, the partners meeting is entitled to terminate the winding up procedure at any moment by a 3/4 vote of outstanding shares, and to make a decision to continue the existence of the company on condition that the process of allocation of company assets to the partners is not already underway.

However, one should note that a company is entitled to seek this option only if one of the following circumstances is present:
– Grounds for the dissolution of the company was the expiration of the time for its operation provided in the company charter or by the decision of the partners;
– The company was announced as dissolved due to opening of bankruptcy proceedings, but bankruptcy proceeding have been suspended on the grounds of an application by the debtor, or was dissolved due to the submission of a rehabilitation plan by the debtor, which provides for the continuation of the existence of the company;
– The dissolution of the company was based on defects in its company charter, but the company has made changes to its charter, under which the deficiency was removed, and therefore a decision for the continuation of existence of the company has been accepted.

The last stage of the termination of the existence of the company is the cancellation of its registration. Under the draft law, after full allocation of company assets, the liquidators must apply to the tax authority requesting the registration of the completion of the winding up process, on the grounds of which the tax authority will cancel the registration. Company books and instruments must be maintained for a period of six years following cancellation of the registration in a safe place identified by the liquidators.

The draft law also envisages the option of cancellation of the registration of a limited liability company upon the initiative of a company director, partner, creditor, tax authority or the court, without going through winding up procedure, if it turns out that the company has no assets (insufficient capitalisation). This provision aims at the removal of companies lacking a true existence from civil circulation, in other words, it seeks the removal of those companies that exist only on paper.

12. Transformation

The draft law accords far greater attention and place to various types of transformation and reorganisation, which earlier were regulated solely by a couple of paragraphs that created many practical obstacles, as well as possibilities for the breach of the rights of partners due to numerous unregulated situations. Any company may be transformed into a company of some other legal form on the basis of a decision of the partners meeting. In the case of transformation, the requirements of the Law on Entrepreneurs with respect to the incorporation of a company of the particular legal form shall apply to the company undergoing transformation. After the transformation, the company will continue to exist with a new legal form, and all the rights and obligations of the company before transformation shall be transferred to the newly transformed company.

In order that creditors not to be caused undue damages, the partners of a general partnership, as well as general partners of a limited liability partnership shall be jointly liable for commitments, which originated before the transformation of the company, for a period of 2 years following the registration of the transformation.

A decision on the transformation of the company is made by the partners meeting. In general, partnerships and limited liability partnerships all the partners must agree to the decision. Due to logical reasons, the consent of all the partners is required in those cases as well, when a company with limited liability is transformed into a general or limited liability partnership (in order that the partners not to become liable to creditors with all their assets). This also applies when a limited liability or a joint-stock company is transformed into a co-operative. In other cases, unless the charter provides for a more stringent requirements, consent of the partners holding more than 3/4 of votes is required for approving a decision on transformation. In the cases of the existence of various classes of shares in a joint-stock company, 3/4 of the votes of each class is required.

Managerial personnel of the company must prepare and furnish all partners with a written report together with an invitation to a general meeting, which shall include the reasons,

goals, objectives of the transformation of the company, along with any other information related to the transformation, together with the new charter.

A company may be transformed only when the following conditions are met:
– Shares of the partners in the transformed company must be pro rata to their shares in the previous company;
– If the assets of the company in its previous legal form are not sufficient for meeting the requirement on minimum authorised capital of the transformed company, the remaining part must be paid up by the existing partners pro rata to their shares. Partners may additionally make a decision on the remaining part to be paid up by persons who are not the current partners of the company.

One of the most contentious and complicated issues turned out to be the development of the mechanism to be applied for the redemption of the shares of those partners, who do not want to be partners of the transformed company. In such cases, it is necessary to protect the rights of the partners, on the one hand insuring that they receive a fair price for their shares, while on the other hand seeking to protect the capital of the company, which if forced to make unreasonably large expenditures in this process, may be deprived of necessary resources.

Partners who have not participated in the partners meeting and those who voted against the transformation at the meeting concerned, shall be given a 30 day period following the meeting, for applying to the company in writing demanding the redemption of their shares. In exchange for the shares, the company is to pay the price, which corresponds to the share of the partner concerned in the balance sheet of net assets of the company, or in the case of a joint-stock company, to pay the market price of the shares, provided that it is higher than the amount corresponding to the share of the partner concerned in the balance sheet of net assets of the company.

A partner who does not agree to the redemption of his shares at the price offered by the company, shall be entitled to apply to the court within a period of 90 days following the general meeting and request an assessment of the value of his shares. If the independent expert appointed by the court, establishes that the value of the share is higher than the price offered by the company, the company is to redeem the shares at this higher price.

For the purpose of registration of the transformation in the Register, persons mentioned in Article 9.1 are required to submit an application within a period of three months following the making the decision seeking transformation, which shall be signed by the persons listed in Article 9.1, as well as members of the supervisory council. The other instruments (minutes of the partners meeting, personal data of the partners, and their share in the transformed company, etc.) must as also be submitted.

The tax authority shall register the transformation of the company upon meeting the requirements for the formation of the company with a new form. Transformation shall come into force upon its registration).

13. Reorganisation

As has already been mentioned, one of the main merits of the draft law is the detailed regulation of the transformation and reorganisation processes. Provisions of the draft law on transformation and reorganisation were elaborated on the basis of the Third[23] and Sixth[24] Directives.

The exhaustive regulation of reorganisation related issue offered by the draft law serves several purposes. First and foremost, it is necessary for the partners of the company under reorganisation to be kept adequately informed in as objective a manner as possible about the conditions of the reorganisation and their rights be suitably protected. Apart from this, the law should protect the company creditors as well, so that reorganisation does not adversely affect their legitimate interests. Finally, with a view to ensuring certainty in the law as regards relations between the companies concerned, between them and third parties, and among the members, the cases in which dissolution can arise must be limited by providing that defects can be remedied wherever that is possible, and by restricting the period within which dissolution proceedings may be commenced.

The draft law regulates all three forms of reorganisation – merger by acquisition, merger by formation of a new company and division. According to the definitions of merger by acquisition and merger by formation of a new company, the main criteria for distinguishing between these two forms is that in the case of merger by acquisition, one or more company (the merging company) is merged with another already existing company (the acquiring company). While in the case of merger by formation of a new company, two or more companies are amalgamated with a view to creating a new one. In both cases, the merging companies are dissolved without going into liquidation, and their assets and liabilities are transferred to the acquiring or newly created company, in exchange for which the partners of the merging companies receive shares in the acquiring or newly created company.

As regards division of a company, the draft law identifies three forms of division: division by the formation of a new company, division by acquisition, and combined division, which includes the elements of the first two.

In the case of merger, the acquiring or newly created company becomes responsible for all the commitments of the merged companies assumed before the reorganisation. In the case of division, the newly incorporated or acquiring companies are jointly responsible for such obligations assumed by the divided company before the division for a period of 2 years.

The decision on reorganisation is made by all companies involved in the reorganisation. In a limited liability company, the decision is taken by a partners meeting by 3/4 votes of total shares, and in companies with other legal forms, such a decision must be made unani-

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[23] Third Council Directive of 9 October 1978 based on Article 54 (3) (g) of the Treaty concerning mergers of public limited liability companies (78/855/EEC).
[24] Sixth Council Directive of 17 December 1982 based on Article 54 (3) (g) of the Treaty, concerning the division of public limited liability companies (82/891/EEC).

mously. If a joint-stock company, involved in a division, has more than one class of shares, the decision concerning merger shall be subject to a separate vote by each class of shareholders. If the commitments of the partners of any of the companies involved in the division are increased as a result of reorganisation, the decision on reorganisation must be made unanimously by the company partners.

A key innovation of the draft law is the draft terms of reorganisation. This is an instrument to be developed by companies involved in a mandatory reorganisation, and which should include a detailed list of reorganisation terms. Namely, the draft terms of reorganisation should include, at minimum, the following information:
– the type, name and registered office of each of the companies involved in the reorganisation;
– the purposes, terms and conditions of the reorganisation;
– the value of the assets and liabilities, and in the case of division a detailed description of their allotment;
– the share exchange ratio and the amount of any cash payment, if such is provided;
– the terms relating to the allocation of shares in the acquiring company, the date from which the holding of shares entitles their holders to participate in profits of the company, as well as any special conditions affecting that entitlement;
– the date from which the transactions of the company subject to reorganisation shall be treated for accounting purposes as being those of one or another of the acquiring firms;
– the rights conferred by the acquiring or newly created companies on the holders of shares to which special rights are attached and the holders of securities other than shares;
– any special privilege granted to members of the administrative, management and/or supervisory bodies of the companies involved in the reorganisation;
– Composition of the new supervisory council(s), if required.

If any of the companies involved in the reorganisation is a joint-stock company, the draft terms of reorganisation is must approved by an independent expert. The expert's report, among other data, must state whether in his opinion the share exchange ratio provided for by the draft terms is fair and reasonable.

Joint-stock companies must also draw up a reorganisation report, which is to be prepared by a director and which should explicitly interpret the provisions of the reorganisation plan, the reorganisation purposes, and set out legal and economic grounds for such, in addition to the criteria and methods of determination of the share exchange ratio.

With a view toward protecting the interests of the partners, the draft law also provides for the detailed regulation of the procedure of notification of the partners concerning the reorganisation, and provides them with all necessary information. In particular, the partners should be notified at least 30 days prior to the meeting, and if one of the parties is a joint-stock company, the draft terms of reorganisation is to be registered in the company register.

During reorganisation, as well as in the case of transformation, the most important mechanism for protection of the interests of the partners is the right to demand the redemption of their shares. Namely, a partner who did not participate in the partners meeting held for the settlement of the issue of reorganisation, must be notified about the decision in accordance with the procedure provided for announcement of the meeting, within a period of 3 days following the meeting. Such partners, as well as those, who voted against the reorganisation must be given a 30-day period for requesting in writing that the company redeem their shares. The mechanism of buying out (pricing, determination of a fair price by the court) shares is identical to the provisions providing for the mechanism of transformation.

As for the mechanism of protection of the creditors, all creditors whose claims on the company exceed 10 000 GEL shall be served notice by registered mail of the company's possible reorganisation at least 45 days prior to the date of the meeting.

The draft law provides for simplified procedures of merger and division if the acquiring company is the holder of at least 90 percent of the subscribed capital of the merged or divided company. In such a case, a decision on merger or division does not require approval by a partners meeting the acquiring company. If the acquiring company is the holder of all the shares of the merged company, the draft terms of merger shall not include information about the exchange of shares, no audit is conducted, and the decision on merger does not require approval by a meeting of the partners of the merged and divided companies.

In the aforementioned cases, in order to insure adequate protection of the interests of the partners, it is mandatory that partners to be informed at least 30 days prior to the date of the coming into force of the reorganisation, as well as being furnished with all the necessary information. Furthermore, partners of an acquiring company, whose shares comprise five or more percent of the authorised capital of the company, and in general and limited liability partnerships, each of the partners is entitled to demand the convocation of a meeting within 15 days following receipt of notification of a planned reorganisation. In such cases, the decision on merger is to be made by a meeting of the partners. A partner of the acquiring company who did not vote for the decision on merger, did not attend the meeting, or who expressed his negative opinion on the merger or division in writing within 30 days, shall be entitled to demand the redemption of his shares, which shall be conducted in accordance with the aforementioned procedure.

The reorganisation shall come into force upon its registration. The draft law provides for a detailed list of instruments to be submitted to the Register.

And finally, the draft law provides for the exhaustive regulation of the issues related to the invalidation of the reorganisation. According to the draft law, a reorganisation that came into force following its registration in the register, may be invalidated by a court only if the decision of the partners meeting on the reorganisation was invalid. A partner or a creditor of a merged or divided company is entitled to file an action seeking the invalidation of the reorganisation within a period of 6 months following the date of delivery of the decision. If

it is possible to correct the deficiency that provides the basis for invalidating the reorganisation, the court must give a 3 months period to the company for the remedying this deficiency. The court shall send the decision on the invalidation of the reorganisation to the tax authority for its registration in the company register. The tax authority shall publish the information concerning the registration of the invalidation of the reorganisation in the public register in an official publication. Invalidation of the reorganisation shall not affect the commitments assumed by or with respect to the acquiring or newly incorporated company, which arose in-between the coming into force of the reorganisation and the registration of the court decision. Companies involved in the reorganisation shall be jointly liable for the obligations of the acquiring or newly incorporated company as stated in Article 14.6.

14. Branches

Under amendments to Article 16 of the Law, the procedure and time frames for registering of a company branch or an individual enterprise have been improved and defined in detail. Deficiency in the Law, related to the registration of a company or an individual enterprise in Georgia, earlier registered abroad, has been removed. In addition, this article of the Law was fully harmonised with the European Directive on Branches[25].

15. Commercial Representatives

The draft law enhances the provisions concerning various types of representatives. The purpose of the changes was the improvement of the text both from the point of view of substance and terminology. Instead of the phrase “the authority to conduct legal actions”, the term “authorisation” was introduced, and the term “an independent trader” was substituted by the term “distributor”. The provisions on mutual commitments of trade representatives and represented enterprises were widely regulated and fully harmonised with the European Directive.

[25] Eleventh Council Directive of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State (89/666/EEC).