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**Duties of directors,
according to US (State Delaware) corporate law and
corporate law of Georgia
(Comparative Analysis)**



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Introduction

Georgian law from comparative perspective with regard to American law has never been studied in English. This paper is intended to study duties of directors in Georgia in comparison with the General Corporation Law of the State of Delaware in the United States of America.

As *Hamilton* has put it, “the basic relationship between the corporation and its directors is common law in origin. The duties of care and loyalty (and the subdivision of the general duty of loyalty, the prohibition against usurping business opportunities belonging to the corporation) all clearly have their origin in common law and traditions. These common law traditions have given rise to a great deal of litigation; they define fundamental obligations in a complex relationship.”¹ Without exaggeration can be stated, that the Delaware law has influenced Company law not only within the USA. Moreover, Delaware has developed remarkable practice in the field of duties of directors. On the other hand, some three years ago the corporate law of Georgia became a subject of conceptual amendments. For example, mandatory regulation concerning the two-tier system of corporate governance (supervisory board and directors) has been actually removed.² This example shows that changes already made will cause a new development and understanding of duties of directors. Further research has shown that the Georgian reform was strongly influenced by the common law system including English and US law. However, it would be exaggeration to argue that the Georgian corporate governance model simply copied the system functioning in USA. Differences remain and continue to influence rights and obligations of individuals and legal entities. Two jurisdictions already mentioned above operate with different styles of thinking and terminology. Therefore, one may argue comparative study of the Georgian law of Entrepreneurs with the company law of Delaware might reveal interesting conclusions regarding new regulations and future developments of this field of law.

Some scholars argue, “transplantation” of law provisions from one system to the other might negatively influence the development of the receiving system.³ This opinion is considerable as the “transplant” implemented in the new legal system cannot work separately without any

¹ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 446.

² See Article 55(1) of Georgian Law on Entrepreneurs.

³ See Introduction in: *Zoidze, Bessarion*, Reception of the European Private Law in Georgia (in Georgian Language), Tbilisi 2005, p.V.



connections to the other norms of this system. Accordingly, the outcome of this paper is intended to clarify whether the revolutionized changes of Georgian law have led to reducing the negative effects of prior regulations.

One of the most important point of comparative law reads as follows, “the basic methodological principle of all comparative law is that of *functionality*. Incomparable cannot usefully be compared and in law the only things which are comparable are those which fulfill the same function.”⁴ Therefore, this method allows comparing the reformed provisions in Georgian law with the sophisticated law that has been developed in Delaware for over 100 years. One may argue that the decision of the Georgian legislature to remove the “German model of Corporate Governance” in favor of US regulations, might be better evaluated in comparative perspective taking into consideration recent developments in Company law in Delaware.

As to the main goals of the study, three points are to be indicated. First, this paper should be deemed focused on readers having some links with and understanding of English-speaking jurisdictions. Second, it might serve as an additional tool for lawyers and entrepreneurs whose interest in Georgian directors’ duties might be caused by their links or business in Georgia. Finally, yet importantly, this paper intends to be a useful guide for directors, lawyers and judges in Georgia. Furthermore, the practical purpose of the study should be found in its methodology. It will be focused on helping readers to orient themselves and to understand the content and results of different provisions of Georgian and US law. After reading this paper, one might be able to operate in the Georgian legal framework in the field of directors’ duties.

From the theoretical point of view, opportunities for English-speaking scholars to study institutes of the Georgian law are restricted due to lingual barriers. Accordingly, this paper might serve as one of the additional sources in English for interested scholars having no knowledge of the Georgian language and legal culture.

As opposed to the Delaware law, sources regarding duties of directors in the Georgian language are too poor. There are only several monographs and the commentary, which is published in 2002 and, therefore, seems to be outdated. Moreover, one of the main problems for the Georgian legal system is the unavailability of appropriate sources and materials. The appearance of the Supreme Court’s decisions on the Court’s website⁵ should be considered merely a first

⁴ *Zweigert, Konrad; Kötz, Hein*, Introduction to comparative law, Oxford 1998, p. 34.

⁵ See www.supremecourt.ge.



step, which is not able to change the common situation in this field. One may also argue the Georgian Bar association⁶ and the High Council of Justice⁷ shall do more for further development.

Accordingly, due to the lack of appropriate practice of Georgian courts in the field discussed in this paper, some issues will remain less clear. For these issues one might only suspect the future development of the regulation. Therefore, the effects of the suspected provisions may remain indefinite. However, the comparative study allows making an analysis taking into consideration the experience of more developed jurisdiction, in our case – the General Corporation Law of State Delaware.

1. Historical review of development of Georgian Corporate Law

Historically, Georgia is deemed a member of the Roman-German legal system.⁸ As repeatedly stated, there are two main differences between civil and common-law jurisdictions. Common law, as opposed to civil law, is a creature of courts, while civil law was emerged from Roman law. Civil law countries tend to codify their legislation in order to achieve unified applicability. It is unlikely to find such trends in common law countries.⁹ Taking into consideration these differences, the question for the future is whether there is an actual possibility to change the vector of the development of the private law system and how effective such radical changes might be.

The development of business activities and regulations in Georgia was strongly influenced by the historical cataclysms of the 20th century. Since the termination of the Russian empire in 1917, Georgia has gained independence. However, in 1921 Soviet Russia once more occupied Georgia. Therefore, reforms already begun in 1918-1921 were abrogated. Despite attempts of several scholars to develop the study of commercial law in Tbilisi State University, the Georgian government was very reluctant to maintain their initiatives. In the Soviet era, every attempt of private initiative was overridden. Therefore, there was no need for law regulating entrepreneurs' activities.

⁶ www.gba.ge .

⁷ www.hcoj.gov.ge .

⁸ *Zoidze, Bessarion*, Reception of the European Private Law in Georgia (in Georgian Language), Tbilisi 2005, p. 308.

⁹ *Gordley, James; von Mehren, Arthur Taylor*, An introduction to the comparative study of private law, Cambridge 2006, p. 3.



Since 1991, the Soviet empire has been destroyed and Georgia became an independent state for the second time in the 20th century. Taking into consideration the negative experience, the new government of the young state chose the course of integration in Euro-Atlantic structures in order to ensure the territorial integrity and further development of the nation.

After lengthy discussions, Georgia has adopted the law of entrepreneurs in 1994. After some 70 years of Soviet practice, the 1994 statute was the first legislative act in Georgia reflecting the European experience.¹⁰ More precisely, it was strongly influenced by German commercial law. Georgian and German experts created the law jointly.¹¹ Although deriving from the German model, this law is deemed an original creature of Georgian legislator. Any act with the same system and subject of regulation is unlikely to find in German law. Therefore, it was intensively argued in Georgian doctrine that sharing the general principle of German “Gesellschaftsrecht” (i.e. company law), Georgian law on entrepreneurs might not be considered a copy of its mother-jurisdiction.¹² However, the structure and even the names of these entities were in step with German law.¹³ For example, Georgian “Shezguduli pasuxismgeblobis sazogadoeba” (close corporation) is a direct translation of German “Gesellschaft mit beschränkter Haftung – GmbH”.¹⁴ Similarly, Georgian “Saaqcio sazogadoeba” is a translation of German “Aktiengesellschaft” and is actually translated into English as Joint Stock company.¹⁵ The same principles are in force for the personal partnerships.¹⁶

Since then, the law has been significantly amended several times. The tendency of shifting off the corporate law of Georgia was visible in 1999 and 2005 as well.¹⁷ For example, a member of supervisory board has rights to be elected in future again. Some authors argue that this element Georgian legislation has taken into account the experience of Corporate Law of USA.¹⁸ The last

¹⁰ *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 3.

¹¹ *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 3.

¹² *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. VII.

¹³ *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 15-19.

¹⁴ *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 17.

¹⁵ *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 19.

¹⁶ *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 3.

¹⁷ Law of Georgia on Entrepreneurs, Article 55. 12, Effective October 28, 1994, as amended on 14 of March 2008.

¹⁸ *Chanturia, Lado*, Corporate Governance and Liability of Directors in Law of Corporations, Tbilisi 2006, p. 168.



substantial amendments were enacted in 2008. The legislature shifted corporate law from the two-tier system to a mixed form with elements of two-tier and one-tier corporate governance.¹⁹

As to reasons of the substantial changes, they seem to be political rather than economical or legislative. The new administration of President Saakashvili is seeking to integrate Georgia in business and the capital markets world. Therefore, these amendments with other initiatives might be considered a strategic choice of the Georgian Government. Despite several doubts expressed regarding the effectiveness of this choice,²⁰ the course already declared seems unlikely to be reviewed at least for the immediate future.

Taking into consideration these facts, practicing lawyers and scholars have a great discretion to evaluate the new Georgian regulation and conclude whether this political choice is also justified from the economical and legislative point of view.

2. Legal Background

2.1. Sources of the Law

To begin with, one should address the issue of the legal background in order to clarify, which sources are tended to influence duties of directors in both jurisdictions.

As to Georgian Law on entrepreneurs, it serves as a unified legislative act providing for regulation of intra-corporation relations between the organs of the commercial legal entities.²¹

The law on entrepreneurs includes a general and a special part.²² Provisions of the general part may be applied for every commercial legal entity stipulated by this law. For example, article 9 of this law provides for regulation of “management and representation” in companies.²³ The law on

¹⁹ See the following Section “Legal Background”.

²⁰ For critical assessment from the political and strategic point of view see: *De Waal, Thomas*, Georgia’s choices – charting a future in uncertain times, http://www.carnegieendowment.org/experts/index.cfm?fa=expert_view&expert_id=479.

²¹ There are several other legislative acts regulating intra-corporative relations. For example, Commercial Banks Act and Insurance Act include appropriate provisions with this regard, however, the law on entrepreneurs serves as a basic regulation for commercial entities in Georgia.

²² *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 15-16.

²³ Since the 2008 amendments, the terminology of the law also became a subject of conceptual review. For example, the general name for every commercial entity, “Sazogadoeba”, which was a translation of German “Gesellschaft”, was shifted to “kompania”. The latter word has no equivalent in German language but is compatible with the English word “company.” Therefore, although



entrepreneurs provides for exhaustive enumeration of commercial legal entities, which might be created in Georgia.²⁴

If a Joint-stock company is a listed company under the Law of Georgia and its securities are publicly traded on the securities market, or is licensed by the Financial Supervisory Agency of Georgia or the number of shareholders exceeds 100, the creation of the Supervisory Board consisting of at least 3 and not more than 21 members is required. In any other case, the creation of the Supervisory Board is not mandatory.²⁵ Furthermore, corporate governance of Joint Stock companies is a subject of additional and special regulation.²⁶ Directives of the National Bank of Georgia also regulate the corporate governance in commercial banks and insurance companies. The National Bank serves as a supervisory body for commercial banks and insurance companies, which might be constituted in Georgia only in the form of Joint stock companies.²⁷

As to the Delaware approach, the Delaware General Corporation Law²⁸ serves as a threshold point for regulation of commercial legal entities. However, as opposed to Georgian law on entrepreneurs, the role of the former legislative act is much more different. The statutory law in Delaware might not be considered the only and most important source of the law. Sophisticated case law, as the “know-how” of state Delaware is an important source for the flexibility and efficacy accompanying the everyday business of the courts in Delaware. Finally, yet importantly, although Delaware has not enacted the Model Business Corporation act,²⁹ interrelation between the Delaware law and the act is not a subject of discussion. However, Delaware continues to be the example of other states reforming their law concerning business entities. The format of this paper does not allow writing about these interrelations more precisely. Comparisons are to be made between the Georgian law and that of the corporation law currently in force in Delaware.

the name of the law is the same, it is actually a transformation of the law on entrepreneurs into company law. Accordingly, the amended terminology might also serve as a good evidence of “Americanization”.

²⁴ *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 13.

²⁵ Law of Georgia on Entrepreneurs, Article 55. 1, Effective October 28, 1994, as amended on 14 of March 2008.

²⁶ Law of Georgia on Entrepreneurs, Article 56, Effective October 28, 1994, as amended on 14 of March 2008.

²⁷ See: Law on Commercial Banks of Georgia Article 2.1.

²⁸ See: *Balotti, R. Franklin; Finkelstein, Jesse A.*, Delaware Law of Corporations & Business Organizations, Statutory Desk book, 2009 ed., Delaware General Corporate Law.

²⁹ <http://apps.americanbar.org/buslaw/committees/CL270000pub/nosearch/mbca/sembled/20051201000001.pdf>.



2.2. Corporate Governance developments

To put it briefly, corporate governance includes rules about the managerial authority of directors. Corporate governance must answer the question, who decides what in what circumstances and who bears responsibility for business judgments made by the board of directors.³⁰

Discussion about good corporate governance has become popular in courtrooms and in doctrine as well. However, good corporate governance is not a static notion with strict content. Despite the possibility to outline several basic principles, corporate governance is developing in court decisions and the judges should adequately react depending on the circumstances important for every concrete case.³¹

Corporate governance and issues related with this topic are one of the most important issues nowadays. Similarly, problems related to corporate governance become very sensitive in Georgia. The development of investment banking and insurance system and foreign investments in Georgian business brings to light the importance of the effective control of management of the company. Paramount importance has the system of the management of the company and the question whether this system might be attractive for investors. In spite of the fact that the level of corporate governance has improved over time, it is fair to say that the Georgian corporate governance culture is very far from contemporary international standards.

On the other hand, lack of experience and poor links with international practice are the most important factors influencing the current development of corporate governance in Georgia. However, it should be stated that several projects conducted by international organizations³² have to some extent changed the situation. Nevertheless, the qualification of directors and officers and their awareness of principles of good corporate governance remain immense problems for the Georgian business society.

³⁰ Cox, James D., How Delaware Law Can Support Better Corporate Governance, in: Kieff, Scott F.; Paredes, Troy A. (editors), Perspectives on Corporate Governance, New York 2010, p. 340-341.

³¹ Cox, James D., How Delaware Law Can Support Better Corporate Governance, in: Kieff, Scott F.; Paredes, Troy A. (editors), Perspectives on Corporate Governance, New York 2010, p. 349-350.

³² For example, the project supported and conducted by the International Financial Corporation (IFC) was an important tool for improving best practice of corporate governance in Georgian commercial banks. For more information, please see: Corporate Governance Survey of Companies, Georgia 2008, supported and conducted by IFC in Tbilisi, <http://www.ifc.org/gcgp> (last visited: 12.07.2011).



Taking into consideration that the boards are frequently objects of attacks from shareholders, creditors or society, some authors argue “the board has been molded to serve as a scapegoat.”³³ Therefore, good corporate governance should seek a balance between the responsibility of board members and their rights to render risky and flexible decisions what they reasonably believe to be in the best interests of the company as a continuing entity.

3. Directors’ rights

3.1. Directors’ right of access to board information and to participate in board action

The role of director is a demanding one particularly with regard to decision-making. “Directors do not “do” things in the same sense as doctors, lawyers, architects, or plumbers. Their duties consist principally of overseeing management, establishing corporate policy, and weighing major business transactions.”³⁴ Accordingly, the right of access to the company information is extremely important.

There is no special Georgian regulation regarding the directors’ right to have access to the information. However, taking into consideration the main duties of directors according to Georgian law,³⁵ one may argue fulfillment of the duties would not be possible without access to the information of the company. One may also consider the role of Georgian courts and their case law in this field. Courts should be obliged to encourage directors’ justified attempts to have such access. Such decisions are rare or even unlikely.

In Delaware, subject to any agreement between shareholders or any amendment to the certificate of incorporation, directors are entitled to have access to the information concerning the company’s activities and board proceedings. However, the right might be restricted taking into consideration the nature and content of the information. Shareholders may have a legitimate

³³ *Mitchell, Lawrence E.*, The Trouble With Boards, in: Kieff, Scott F.; Paredes Troy A. (editors), *Perspectives on Corporate Governance*, New York 2010, p. 59.

³⁴ *Hanks, James J. Jr.*, Evaluating Recent State Legislation on director and Officer Liability Limitation and Indemnification, in: Reprinted from *The Business Lawyer* Vol. 43, No.4, August 1988; a Publication of the Section of Business Law of the American Bar Association 1988, p.1232.

³⁵ See: “Director’s duties” in this paper.



interest in restricting the right of some directors to some information in certain situations. Absence of such restriction automatically serves as a proof of directors' right to have access to the information.³⁶

3.2. Access to legal advice

Generally, the director in office might not be denied access to the legal advice provided for the purposes of boards' activities. However, it does not mean that the board is not entitled to deprive one or more specific directors of that right. For example, the board may appoint a special committee and empower only the members of the committee to have access to the legal advice. Creating such committees seems to be a good tool in order to protect the information including some danger for the company in case of its disclosure.³⁷

As already mentioned, Georgian law does not address this kind of issues. Generally, access to the legal advice might be considered one of the key rights of Georgian directors as well. However, for want of case law and direct regulation provided by the legislator there is nothing to comment or compare. One may merely expect that the further development of the companies and their competition will inspire cases and appropriate court decisions in this field.

4. Director's duties

4.1. Conceptual similarities and differences

Duty of directors is a very broad notion. It must be noted at the outset that generally, directors are mandatory persons managing corporations and representing them in different relations with other entities and individuals.³⁸ According to the Georgian law, the management and the representation of the company shall be vested on the directors.³⁹ Moreover, Georgian commentators argue activities carried out by the directors are so specific that the competence of

³⁶ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 94.

³⁷ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 120.

³⁸ *Chanturia, Lado; Ninidze, Tedo*, *Commentary of Law of Entrepreneurs of Georgia*, 3rd ed., Tbilisi 2002, p. 119.

³⁹ Law of Georgia on Entrepreneurs, Article 56.1, Effective October 28, 1994, as amended on 14 of March 2008.



the board of directors shall not be transferred to any other organ of corporation.⁴⁰ This opinion is in step with general trends of American developments according to which “boards of directors have long been given significant powers and accorded significant discretion in their role as overseers of corporations. It remains cardinal percept of U.S. corporate governance, most notably the law of Delaware, that directors rather than shareholders manage the business and affairs of a corporation. This managerial power carries with it fundamental fiduciary obligations to both the corporation and its shareholders.”⁴¹

As *Hamilton* has put it “Duties of directors may be divided into two broad categories: a duty of care and a duty of loyalty. These duties are generally referred to as “fiduciary duties” and directors are sometimes referred to as “fiduciaries”. Directors are expected and indeed encouraged to commit the enterprise to risky ventures in order to maximize the return to shareholders.”⁴²

Despite the principal compatibility, Georgian law is not able to pretend to precise regulation of directors’ activities. For example, in the often-cited case *Smith v Van Gorkom*⁴³ the Delaware Supreme Court described the fiduciary duty of directors as including a duty of care and a duty of loyalty,⁴⁴ whereas such distinction is not familiar in the Georgian law. In general, directors in Delaware owe fiduciary duties of care and loyalty to the corporation itself and not to its creditors. They are expected to act in good faith and with the honest belief that the action they take are in the best interests of the corporations and are designed to maximize the wealth of the shareholders.⁴⁵

Under Delaware law and the Model Business Corporation Act the duties of a director apply individually director by director, and not collectively to the board as a group. A director in different situations will be exposed to different liabilities. While a director’s duty remains constant, its application will differ according to the situation. For example, the duty of a director

⁴⁰ *Chanturia, Lado; Ninidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 119.

⁴¹ *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 498.

⁴² *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 444-445.

⁴³ Supreme Court of Delaware, *Smith v Van Gorkom*, 488A.2d 858 Delaware 1985,

<http://international.westlaw.com/find/default.wl?sp=intbuhrs->

[000&rp=%2ffind%2fdefault.wl&sv=Split&rs=WLIN11.04&cite=488A.2d+858+&fn=_top&mt=314&vr=2.0&findjuris=00001](http://international.westlaw.com/find/default.wl?sp=intbuhrs-000&rp=%2ffind%2fdefault.wl&sv=Split&rs=WLIN11.04&cite=488A.2d+858+&fn=_top&mt=314&vr=2.0&findjuris=00001)

(last visited 30.06.2010).

⁴⁴ *Welch, Edward P.; Turczyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 82.

⁴⁵ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 497.



when the company has financial troubles, or when it is intended that the company has to be sold, should be analyzed separately. Addressing the issue, Georgian law on entrepreneurs stipulates that directors shall be required to perform their assigned tasks in good faith and with due diligence. In the case of failure to perform his duties, a director shall be liable to pay damages to the company. The directors shall be liable jointly with their whole property, directly and personally. In the case of establishment of occurrence of damage, the directors shall be required to prove, that they acted commensurate Article 9 (6) Law of Georgia on Entrepreneurs. The company shall not be entitled to waive the request for damages. This request may be used by the creditors, if they have not received the compensation for their claims.⁴⁶ It remains questionable whether the word “jointly” in the wording of the law excludes director’s individual liability. Taking into consideration the lack of restrictions with this regard in the entire text of the law, one may argue, a director’s individual responsibility might be enforced by courts. Furthermore, being the only provision addressing the issue of directors’ duties, the latter norm must be interpreted broadly in order to cover all of the cases that might appear in practice. However, the relationships with the Directors and the members of the Supervisory Board shall be regulated by this Law, the charter and the agreements made with them.⁴⁷ Moreover, it is a broadly accepted approach in the US that the “directors’ duty runs to the corporation and to the entire body of stockholders generally, as opposes to specific groups of stockholders. It is a commonplace phenomenon of corporate governance that corporate directors will confront situations involving conflicting interests of different stockholder groups. In such cases, the directors are not enjoined to lie inert. The case law recognizes that the directors may take whatever action that in their proper exercise of business judgment, will best serve the interests of the corporation or the entire body of stockholders.”⁴⁸

The situation in Georgia seems to be different. Frequently, Georgian shareholders are reluctant to entrust “their” company to the independent and professional directors. Trying to influence managerial decisions, the majority of Georgian shareholders or other persons affiliated with them often tend to serve as directors despite the lack of appropriate knowledge and experience in the concrete field of business. This situation might negatively influence the development of good

⁴⁶ Law of Georgia on Entrepreneurs, Article 56.4, Effective October 28, 1994, as amended on 14 of March 2008.

⁴⁷ Law of Georgia on Entrepreneurs, Article 9.7, Effective October 28, 1994, as amended on 14 of March 2008.

⁴⁸ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 88.



corporate governance. Generally, a director owes a duty to further the interest of the corporation and to give it the benefit of his uncorrupted judgment. He may not take secret profit in connection with corporate transactions, compete unfairly with the corporation, or take personally the profitable business opportunities that belong to the corporation.⁴⁹ However, preservation of this principle is unlikely to wait in the latter constellations, when directors act in their own self-interests or in the interests of one or more particular shareholders. Thanks to such an approach, the interest of the company as a separate legal person having its own rights and obligations seems to be diminished.

However, it would be an exaggeration to argue that such constellations are not possible in Delaware. Sometimes, taking into consideration the circumstances, which accompany election of directors, some of them frequently, “feel themselves as “figureheads” or “honorary directors” without any real obligation or responsibility to the corporation. They may involve a spouse who agrees to be a director in order to meet a statutory requirement that the board consist of at last three directors as a favor to the other spouse. Some directors may erroneously believe that since they are a minority of the board they have no responsibility for what is happening. A failure to direct at all is a serious violation of the duty of care.”⁵⁰

Therefore, failure to fulfill obligations may take place everywhere. Differences occur when law and order of the appropriate jurisdiction is not able to create a system, which will avoid or at least reduce the negative effects of wrongdoing accomplished by directors. However, such constellations are unlikely in Delaware, where the role of case law and the courts is immense.⁵¹

4.2. The Advantage of Outside Directors in Corporate Governance

Different legislatures operate with different concepts determining the notion of the independent (outside) director. The most important thing is what is required of directors. Some authors argue that, despite intensive researches concerning the so called “non-management directors”, the role

⁴⁹ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 478-479.

⁵⁰ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 450-451.

⁵¹ *Cox, James D.*, How Delaware Law Can Support Better Corporate Governance, in: Kieff, Scott F.; Paredes, Troy A. (editors), Perspectives on Corporate Governance, New York 2010, p. 339.



and mission, practical advantages and disadvantages of the outside directors remain unclear.⁵² The main reason of such a qualification might be the theoretical approach to the issue causing the inconsistency of the rules.⁵³

The appropriateness of independent directors has become more urgent and current in Georgia since the last amendment of the new law on entrepreneurs.⁵⁴ According to the amendment, directors of a Joint Stock Company are permitted to be members of the Supervisory Board simultaneously. Therefore, if an executive director becomes a member of the Supervisory Board his status will be similar to the inside directors in Delaware. Accordingly, other members of the Supervisory Board having no other links with the company might be considered outside directors. However, cases of such regulation in practice only rarely⁵⁵ speak about any trends of further developments.

There is a cliché that inside directors dominate in the boardroom and will always be reluctant to work with independent directors; however, it seems to be exaggerated. First, election of independent directors to the board is a signal for potential investors that the board is ready to be monitored by independent and disinterested professionals. Second, involvement of independent directors in board proceedings can serve as a good protection for inside directors against shareholders suits.⁵⁶ However, these arguments seem ineffective in Georgia. First, the majority of Georgian directors and shareholders are not able to attract investors by appointing the independent members in the supervisory board because of the poor quality of their integration in the stock market. There are only few listed companies in Georgia and only one or two of them are able to sell their stocks on an international level.⁵⁷ As to the avoidance of shareholders suits thanks to independent directors, it also seems not to be effective. As already argued, Georgian

⁵² *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate Law Journal 2007, Vol. 32, p. 73, available at: <http://heinonline.org/HOL/Page?handle=hein.journals/decor32&id=1&collection=journals&index=journals/decor>.

⁵³ *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate Law Journal 2007, Vol. 32, p. 73.

⁵⁴ See Article 55.1.

⁵⁵ The only publicly famous case is the CEO of Liberty Bank Georgia presiding the supervisory board of the same bank at the same time. Interestingly, the CEO is a former prime minister of Georgia and one of the initiators of the amendments in the law on entrepreneurs, well-known among practitioners as "American amendments".

⁵⁶ *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate Law Journal 2007, Vol. 32, p. 106.

⁵⁷ For example, the Bank of Georgia operates on London Stock Exchange. See:

<http://www.londonstockexchange.com/exchange/prices-and-markets/stocks/summary/company-summary.html?fourWayKey=US0622692046USUSDIOBE>.



shareholders prefer to manage the companies controlled by them themselves or by appointing (not electing) people who have already gained their own personal confidence. Therefore, the role of shareholders suits is not significant and therefore implies no danger for the directors having good personal relations with the majority of shareholders. Sometimes directors suing against the Supervisory Board due to their dismissal, refer to the procedural rules regulating the proceedings conducted by the supervisory board. However, such attempts are not successful. The Georgian Supreme Court has expressly declared about the boards' right to dismiss the director if his managerial skills and abilities have become an impediment for the further development of the company.⁵⁸ Therefore directors tend to be "faithful" and not to express independent initiatives.

Besides, it would be very hard, if not impossible, to find even one case when a director or the member of the supervisory board was acting against shareholders and for the protection of employee/s. Because of the lack of corporate experience and corporate culture, directors, supervisory board and employees are perceived as follows: shareholders, members of the supervisory board and members of the board of directors are one side and employees are another side of the bridge. It is deemed that a director has to follow the wishes of the shareholders or the supervisory board; otherwise, he may be viewed as a "bad" director and will be dismissed. Accordingly, this view is not acceptable. A good director (manager) is the director who is a good mediator and serves for shareholders and for employees simultaneously and not the one, who stands on the one side of the bridge. No matter on which side he stands.

Opinions regarding the special role of outside directors for the company seem to be controversial. Irving S. Shapiro, former Chairman of the Du Pont Company and a distinguished personality in the field of corporate governance stated that if the directors are 'to help to provide informed and principled oversight of corporate affairs, a good number of them must provide windows to the outside world.' He added this is "at least part of the rationale for outside directors, and especially for directors who can bring unique perspective to the group." On the other hand, it was intensively argued that, the number of outside directors should be enough to influence the real decisions of the board. The American Law Institute proposal states a preference for the majority of the directors without any significant links with the company. This recommendation seems to be especially important for the members of the audit committee. Those opposing this opinion argue that it does not matter whether directors are inside or outside

⁵⁸ Supreme Court Decision # the 3k-654-03, 27th of May 2003. Unreported decision, available only in Georgian language.



and the outside directors rather often are reluctant to impact the board's business judgments with suitable recommendations and suggestions. Sometimes the outsiders are unable to fulfill their duties properly for want of time and even the knowledge and the experience. Expertise in one field of business does not assure expertise in another field; and being a good operating executive does not assure being a good overseer or monitor.

The primary goal for the independent non-management director should be monitoring of the executives' management of company's business and affairs⁵⁹. Complete fulfillment of this mission is possible only if the non-management directors feel themselves truly independent from the other directors (and from the shareholders as well). On the other hand, the activities of independent directors should be an additional source of objective information and perspective concerning the company and about the company's assets.⁶⁰ Moreover, the independent director being free of influence of the majority shareholder/s is in a position to protect against abuse against the minority's interests, for example, by disclosing appropriate information regarding the company or a particular transaction.⁶¹

Furthermore, non-management directors may be beneficial in addressing self-dealing by other board members. Having no other links with the company, an assessment made by an independent director might be of paramount importance in order to determine whether the self-dealing has caused the breach of the duty of directors.⁶²

As to the abilities of non-management directors, they must be good mediators balancing controversial interests within the company. Additionally, they must realize that the company itself is a separate person with its own interests.⁶³ Independent directors are considered to be a protection for shareholders, specifically against management, not against other shareholders.⁶⁴ Therefore, an independent director should always be reluctant to interfere in conflicts between shareholders, although sometimes he or she may not avoid a decision favored by some shareholders but opposed by others. This is why each director's duty is to act in what he or she reasonably believes to be in the best interests of the corporation as a continuing entity.

⁵⁹ See: Delaware General Corporation Law § 141; Model Business Corporation Act § 8.01.

⁶⁰ *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate law Journal 2007, Vol. 32, p. 84.

⁶¹ *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate law Journal 2007, Vol. 32, p. 80-81.

⁶² *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate law Journal 2007, Vol. 32, p. 80.

⁶³ *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate law Journal 2007, Vol. 32, p. 85.

⁶⁴ *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate law Journal 2007, Vol. 32, p. 94.



Another frequently asked question regarding the independent directors is whether they are subject of a different standard of duty of care. The Supreme Court of Delaware has answered this question negatively by arguing that “there is no basis in the opinion for distinguishing between the outside directors and Van Gorkom and Chelberg.”⁶⁵ Generally, courts and legislators in Delaware are reluctant to interfere in the business judgments rendered by the board of directors.⁶⁶ Similarly, in a Georgian case concerning director’s liability the Supreme Court has argued whether the members of the Supervisory Board might be jointly liable with the executives for the damages incurred. A director of a joint stock company was sued for the alleged breach of duty of care and good faith. The plaintiff argued the director failed to appear before the City Court of Batumi as a representative of the company. Due to the defendants’ failure to appear before the court and to deliver additional evidence regarding the case the court has rendered judgment by default in favor of the plaintiffs – the former employees of the company. According to the decision, the joint stock company was liable to pay compensation to the employees. The City Court did not satisfy the lawsuit against the director, whereas the Court of Appeal has ruled in favor of the joint stock company. The Supreme Court accepting the Court of Appeals’ ruling, also questioned whether the chair of the supervisory board, being aware of the director’s conduct regarding the litigation was also liable for breach of the director’s duty of care. The Supreme Court especially highlighted that directors and members of the Supervisory Board are liable according to the same standards of duties. The key issue for the qualification in this case was the fact that the chair of the Supervisory Board personally attended the previous hearings in the courtroom and was aware of the date of the last hearing.⁶⁷

⁶⁵ Supreme Court of Delaware, *Smith v Van Gorkom*, 488A.2d 858 Delaware 1985.

⁶⁶ *Clarke, Donald C.*, Three Concepts of the Independent Directors, *Delaware Corporate Law Journal* 2007, Vol. 32, p. 79-80.

⁶⁷ Supreme Court Decision # the as-899-1185-09, 26th of March 2010 (in Georgian language). Georgian text is available at: www.Supremecourt.ge.



4.3. Duty of care

4.3.1. Ambit of applicability

As to Georgian regulation, the law on entrepreneurs⁶⁸ provides that “directors and the members of the Supervisory Board shall discharge their duties in good faith; in particular, they shall be required to care as an ordinary, sensible man would have cared when holding a similar office and in similar situation, and to act in faith that this action is the most beneficial one for the company.” The wording of the provision inspires to look for similarities with “the care of an ordinarily prudent person in the same or similar circumstances” provided by the Delaware law. However, Georgian courts have not yet worked out the standards for “sensible men holding the similar office.” Moreover, the Georgian law as opposed to the Delaware law does not provide for directors’ liability to deal with alternatives before them with a special care. One may argue, the principles outlined by the Delaware case law and doctrine would be an excellent tool for Georgian judges and lawyers when dealing with a director’s duty of care.

Generally, a director in Delaware owes a duty to the corporation to exercise proper care in managing the corporation’s affairs. Most State statutes in the US are drawn from or are similar to § 8.30(a) of the 1984 Model Business Corporation Act. According to this Act, “a director shall discharge his duties as a director 1) in good faith 2) with the care and ordinarily prudent person in a like position would exercise under similar circumstances and 3) in a manner he reasonably believe to be in the best interest of the corporation”.⁶⁹

Directors’ liability may be caused by failure to make a reasoned and well-advised decision, or failure to act in order to prevent the loss of the company.⁷⁰ Moreover, subjective circumstances, such as illness, age etc. of the director cannot serve as a tool to avoid the responsibility. Occupying the position in the company’s management implies at least one discretion – to resign if the person feels himself not to be able to meet the obligations stipulated by the charter or bylaws of the company. A director will not be free from his obligations merely declaring that they

⁶⁸ Article 9.6.

⁶⁹ *Hamilton, Robert W.*, *The law of corporations*, St. Paul 2000, p. 448.

⁷⁰ *Smith, Jeffrey A.; Morreale, Matthew*, *Global Climate Change and U.S. Law*, ed. 2007, p. 498.



are too burdensome for him.⁷¹ Although one may argue, “these principles reduce significantly but do not eliminate entirely, the risk of liability of directors for breaches of the duty of care,”⁷² the minimum of the standard should be identified. It will only help the directors and their lawyers to be aware of the minimum of their responsibility. For example, according to the Court of Chancery, if a director was aware of deliberations on the issue conducted within the board of directors but was reluctant to participate in a voting procedure, he should be considered against the decision. This principle helps courts and companies in situations when the director’s position regarding the transaction seems to be not sufficiently clear for qualifying his action as breach of duty.⁷³

Notwithstanding these principles the extent and nature of directors’ liability is one of the intensively discussed issues in the Delaware case law and doctrine. Opinions differ, whether the performance of directorial duties need be merely negligent or imprudent or must achieve the level of “gross” negligence.⁷⁴ Gross negligence has been defined as “reckless indifference to or deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.”⁷⁵ Practitioners consulting clients regarding their directorial responsibilities cannot ignore the debate over the standard of care. The Supreme Court’s attempts to work out guidelines suitable at least for the majority of the cases inspire more questions.⁷⁶

Generally, the abdication of managerial duties might be considered a breach of duty of care. To put it briefly, directors must supervise direct and control the activities of the company.⁷⁷ The case law suggestions in this field make clear that in non-self-dealing transactions directors are liable to decide and rely on only checked and reasoned information collected and obtained for them. However, liability of the directors must not be extended to the quality of the information provided by officers and other employers of the company. The duty of care implies action in good faith based on the information at hand, not revising the sources of the information.⁷⁸

⁷¹ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 451-452.

⁷² *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 453.

⁷³ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 119.

⁷⁴ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-40.

⁷⁵ *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 500.

⁷⁶ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-41.

⁷⁷ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 79.

⁷⁸ Section 141(e) of Delaware General Corporate Law provides that members of the board of directors or committees of the board shall, in the performance of their duties, be “fully protected“ in relying in good faith upon the records of the corporation



Accordingly, “directors neither do nor breach their duty of care where, through no fault of their own, relevant information is withheld from them by others.”⁷⁹

However, the minimum standard of obtaining information should also be clarified. Directors should apply themselves in order to analyze all of the alternatives regarding the transaction taking into consideration its significance, amount and other circumstances.⁸⁰ The good faith of directors in obtaining and evaluating information serves as a threshold point for qualification.⁸¹ As *Smith v Van Gorkom* has shown, even the financially disinterested directors may be personally liable for their business decision if they fail to act with the requisite care.⁸² Therefore, lack of financial interest is not sufficient for acting in good faith.

To conclude the above-mentioned issues, one may agree that “the duty of care reaches every aspect of an officer’s or director’s conduct, since in its classic formulation it requires these parties to act with “the care of an ordinarily prudent person in the same or similar circumstances.” Despite its sweeping scope, however the duty of care is litigated much less than the duty of loyalty, primarily because the law insulates directors from liability based on negligence (as opposed to knowing misconduct) in order to avoid inducing risk-averse management of the firm.”⁸³

These aspects of duty of care are in the middle of the way of their development in Georgia. Original principles and standards are not yet outlined. Therefore, several points of the Delaware General Corporation Law already mentioned above might serve as additional tools in order to clarify the content of the Duty of Care in Georgian law.

and upon such information, opinions, reports, or statements presented to the corporation by any of the corporation’s officers or employees or committees of the board or by reasonably selected outside experts or consultants. See also: *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-45.

⁷⁹ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 104.

⁸⁰ “For example, when the decision is to sell the company or to engage to recapitalization that will change control of the firm, the gravity of the transaction places a special burden on the directors to make sure that they have a basis for an informed view.” See: *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 82.

⁸¹ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 82.

⁸² *Allen, William T.; Kraakman, Reinier; Subramanian, Guban*, Commentary and Cases on The Law of Business Organization, New York 2007, p. 257.

⁸³ *Allen, William T.; Kraakman, Reinier; Subramanian, Guban*, Commentary and Cases on The Law of Business Organization, New York 2007, p. 242.



4.3.2. Directors' decisions made under special circumstances

The business world is changing dramatically fast and directors should have discretion to be flexible in order to act in the best interests of the company. The provision, which eliminates or limits liabilities of directors, is not familiar in Georgian law. However, it should be considered a very important provision, which would encourage a director to make a risky decision. Sometimes a risky decision is the only way to contribute to success of the company and avoid additional problems. If the director in good faith, in belief that the action is in the best interest of the company and according to full and sufficient information makes a decision, he or she must be protected from liability if this decision appears unsuccessful. This provision is already accepted in Delaware and may play a positive role for future development of good corporate governance in Georgia.

Limitation of a director's liability is generally familiar in the United States of America. As Hanks has put it: "the principal public policy issue in director and officer liability legislation is the allocation of the economic cost of the directors' exculpated conduct. Under every director liability statute except New Mexico, liability is (under the selfexecuting statutes) or may be (under the charter option statutes) limited for at least simple negligence and gross negligence. In some states, liability maybe limited even more broadly."⁸⁴

The Court of Chancery in Delaware has stated that, in the world of business individuals are often required to act based on less than perfect or complete information. Delaware case law tends to protect directors when the time limits of the concrete transactions are not sufficient for complex study of the issue. However, several preconditions should be fulfilled. First, the members of the board must act in good faith and have to be disinterested. Second, the significance of the immediate decision should be considered and the director should believe their activities are in the best interests of the company.⁸⁵ Nevertheless, making balanced decisions seems to be difficult taking into consideration the experience of Delaware companies and appropriate case law. It was intensively argued that "Boards that have failed to exercise due care are frequently boards that

⁸⁴ *Hanks, James J. Jr.*, Evaluating Recent State Legislation on director and Officer Liability Limitation and Indemnification, in: Reprinted from *The Business Lawyer* Vol. 43, No.4, August 1988; a Publication of the Section of Business Law of the American Bar Association 1988, p. 1231.

⁸⁵ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 106.



have been rushed.” The demarcation line between breach of the duty and director’s natural right to make risky decisions remains unclear.⁸⁶ The abstract principles with this regard seem unlikely to be found. Therefore, the problem might be resolved on a case-by-case basis. Moreover, under some circumstances, intervening market changes may require directors to determine whether a previously negotiated deal was still fair.⁸⁷ Additionally, the potential for director liability for breach of the duty of care may also be substantially reduced where the certificate of incorporation includes a provision authorized by subsection 102 (b) (7) of Delaware general corporate law.⁸⁸ The subsection adopted by the Delaware legislature in 1986, authorizes Delaware corporations to limit or eliminate director liability for breach of the fiduciary duty of care.⁸⁹ The Georgian business and law society might adopt this provision by implementation of the appropriate norm in the law on entrepreneurs⁹⁰; or the practicing lawyers should rely on the flexible regulations of the law. For instance, the terms of reference and the scope of liability of a director in Georgia shall be specified by the law on entrepreneurs or/and a company charter.⁹¹ Besides, the powers of the directors shall be specified by the agreements made with them in accordance with the charter. In the case of absence of such stipulation in the charter the general managerial powers, established by law, shall apply.⁹² These provisions make it possible to implement the above-mentioned regulation in Georgian law if individuals involved in business would have a real interest in this regard. However, as already argued, the undeveloped managerial market and lack of experience might cause some reluctance of Georgian shareholders to implement such a provision in the charter of their company. It would be also questionable whether Georgian courts will be ready to enforce this norm already implemented in a charter. On

⁸⁶ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 106.

⁸⁷ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 107.

⁸⁸ A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. See: *Balotti, R. Franklin; Finkelstein, Jesse A.*, *Delaware Law of Corporations & Business Organizations*, Statutory Desk book, 2009 ed., p. 104.

⁸⁹ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 107.

⁹⁰ As already known, *Smith v Van Gorkom* has inspired to enshrine the principle in law of State Delaware.

⁹¹ Law of Georgia on Entrepreneurs, Article 47.3, Effective October 28, 1994, as amended on 14 of March 2008.

⁹² Law of Georgia on Entrepreneurs, Article 56.2, Effective October 28, 1994, as amended on 14 of March 2008.



the other hand, lack of regulation and protection serves as an impediment for the future development of best practice of corporate governance. Georgian directors prefer to be “agents of shareholders” rather than to pursue an independent policy in the best interests of the company.

4.4. Duty of loyalty

4.4.1. Ambit of applicability

Directors being key persons of a company might have their personal business interests as well. Therefore, the danger to misapply directors’ rights and obligations in order to obtain some benefits exists and will always exist. Directors’ duty to avoid such danger is often addressed as duty of loyalty.⁹³ The duty of loyalty implies directors’ liability to exclude competition with the company. Directors are obliged to act in good faith in order to contribute to the company’s success rather than to benefit themselves from the opportunities that might belong to the company.⁹⁴

There is no sufficient regulation in Georgian corporate law about the duty of loyalty. As opposed to the sophisticated provisions of Delaware statutory and case law, Georgian legislature has restricted itself with general wording. Some authors in Georgian doctrine argue that an expression of the duty of loyalty may be deemed article 9.5 of the law on entrepreneurs.⁹⁵ According to the article, directors shall not be entitled to discharge the same activity they perform within the company or to participate in another company in the capacity of a personally responsible partner or a director without the consent of the partners, unless otherwise envisaged by the charter.⁹⁶ The article mentioned above is about conflict of interest.⁹⁷ As a reflection of the duty of loyalty in Georgian law, might be also deemed article 9.6: the directors and the members of the Supervisory Board shall not be entitled to use the information about the company

⁹³ *Smith, Jeffrey A.; Morreale, Matthew*, *Global Climate Change and U.S. Law*, ed. 2007, p. 504.

⁹⁴ *Allen, William T.; Kraakman, Reinier; Subramanian, Guban*, *Commentary and Cases on The Law of Business Organization*, New York 2007, p. 241.

⁹⁵ *Jugeli, Giorgi*, *Protection of Capital in Joint Stock Company*, Tbilisi 2010, p. 249.

⁹⁶ Law of Georgia on Entrepreneurs, Article 9.5, Effective October 28, 1994, as amended on 14 of March 2008.

⁹⁷ *Jugeli, Giorgi*, *Protection of Capital in Joint Stock Company*, Tbilisi 2010, p. 249.



activities for personal gain, of which information they became aware in the course of discharge of their duties or due to their official status, without the preliminary consent of the shareholders' meeting.⁹⁸ Furthermore, by virtue of an agreement made with the directors and the members of the Supervisory Board, this obligation may remain valid after resigning the persons concerned, but for not more than three years. It shall be possible to provide for compensation for this obligation, the amount and the payment procedure of which shall be specified by this agreement.⁹⁹ There is a good tradition of implementation of the mentioned provisions in companies' charters. However, enforcement of these norms by the courts is unlikely to be found. The duty of loyalty in Delaware will not be interpreted in a manner that directors have no right to be in other contractual relations with the company. Such contracts are considered principally permissible if the terms are entirely fair. However, making their decisions directors must not deal with company's assets in order to achieve their personal goals or obtain any profit from these transactions. To put it briefly, every manipulation that might cause profit for directors and loss for the company should be considered a breach of director's duties, more precisely, of the duty of loyalty.¹⁰⁰ In order to fulfill the duty of loyalty directors must affirmatively do everything to avoid loss of the company or refrain from actions that might cause negative results. Directors must qualify themselves whether there will be alleged conflicts between their duty of loyalty and self-interests. As a rule, they are obliged to deal with the issue with special care.¹⁰¹

Furthermore, it has been intensively argued in US doctrine that "the fair treatment that a fiduciary owes to his beneficiary includes the obligation not to take for oneself profitable opportunities that come to the beneficiary under certain sets of circumstances. The duty of loyalty includes, on some circumstances, a duty of disclosure. The intentional failure or refusal of a director to disclose to the board defalcation or scheme to defraud the corporation of which he has learned in itself constitutes a wrong unless a recognized privilege against disclosure pertains. In addition, officers and directors must exert all reasonable and lawful efforts to ensure that the corporation is not deprived of any advantage to which it is entitled."¹⁰²

⁹⁸ Law of Georgia on Entrepreneurs, Article 9.6, Effective October 28, 1994, as amended on 14 of March 2008.

⁹⁹ Law of Georgia on Entrepreneurs, Article 9.6, Effective October 28, 1994, as amended on 14 of March 2008.

¹⁰⁰ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 83.

¹⁰¹ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 83.

¹⁰² *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 84.



The duty of loyalty might be breached with fraud, bad faith or self-dealing. Some authors argue that directors' actions in favor of the one group of shareholders against another might be also interpreted as a breach of the duty,¹⁰³ however, every payment itself, made by the director on behalf of the company does not imply a breach of loyalty.¹⁰⁴ As a precondition of their good faith, directors must deal with their business independently excluding any negative influence on their activities.¹⁰⁵

Additionally, the use of confidential information, which belongs to the company, might be considered a breach of the duty, if thanks to the information the director has obtained a benefit ensuring his personal interests. Moreover, if the director intends to benefit himself as a shareholder by giving confidential information to third parties, his behavior should be qualified as a wrongdoing against the company. However, Delaware law does not see a breach of the duty in the director's activities if the director has dealt with the transaction in good faith but the changed circumstances has contributed for the personal benefit of the director.¹⁰⁶

4.4.2. Interested or Self-Dealing Transactions

4.4.2.1. Interest of Directors

It was intensively argued that directors should be independent in whatever constellations. The Delaware case law is in favor of such independence even in cases of majority stockholders. Directors are considered to be independent from the majority stockholder as well.¹⁰⁷ As the Supreme Court of Delaware put it in the *Paramount* case, "under normal circumstances, neither the court nor the stockholders should interfere with the managerial decisions of the directors."¹⁰⁸ Therefore, being an independent player in intra-company relations, directors might have their own interests. For instance, interest should be implied when the director is a stockholder of the

¹⁰³ Welch, Edward P.; Turezyn, Andrew J., *Folk on the Delaware General Corporation Law*, 2005 ed., p. 84-85.

¹⁰⁴ Welch, Edward P.; Turezyn, Andrew J., *Folk on the Delaware General Corporation Law*, 2005 ed., p. 85.

¹⁰⁵ Welch, Edward P.; Turezyn, Andrew J., *Folk on the Delaware General Corporation Law*, 2005 ed., p. 86.

¹⁰⁶ Welch, Edward P.; Turezyn, Andrew J., *Folk on the Delaware General Corporation Law*, 2005 ed., p. 89.

¹⁰⁷ Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., *Delaware corporation law and practice*, New York 2010, p. 15-17.

¹⁰⁸ Supreme Court of Delaware, *Paramount Communications Inc. v. QVC Network*, 637 A.2d 34, February 04, 1994, available at: <http://international.westlaw.com/find/default.wl?sp=intbucrs-000&rp=%2ffind%2fdefault.wl&sv=Split&rs=WLIN11.04&cite=637+A.2d+34&fn=top&mt=114&vr=2.0&findjuris=00001> (last visited 17.06.2011).



other entity being an alleged counterpart of the transaction involving the company. On the other hand, the director might have other purported benefits from the transaction. If this interest seems to be “material” the director will be deprived of his right to apply protection of the business judgment rule (see sub-title 6).¹⁰⁹ In *Cede & Co v Technicolor Inc.* the Court of Chancery¹¹⁰ and the Supreme Court of Delaware have attempted to determine the “materiality” criterion of directors’ interests.¹¹¹ There is no similar case in Georgian case law, however, the possibility to develop an original regulation exists.

The factor whether the interest is financial or not does not play an important role for the purposes of qualification. Delaware case law is a good authority for the arguments that every dispute should be considered individually and differently depending on the circumstances.¹¹² For example, when dealing with alleged interests of the director in two different companies, the courts have tended to weigh two sets of interests in order to qualify whether the director is able to meet his engagements in both situations. However, there are also cases where courts have refused to apply the latter method.¹¹³

For determination of directors’ interests several questions need to be answered. In whatever situation, directors are liable to be fair regarding the activities of the company. The notion of fairness includes the directors’ liability to deal fairly with the transaction in order to obtain a fair price for the company involved.¹¹⁴ Furthermore, if there is an alleged breach of the duty, in Delaware judges have the obligations to qualify whether the transaction in which the director is deemed to be interested is void or voidable and whether the other directors or majority stockholder should bear any kind of responsibility for their acceptance.¹¹⁵ The Georgian law has its own answer regarding the remedies. More precisely, when directors have caused the company damage due to violation of the rules of the conflict of interest, the violator shall be required to relinquish the right to claim the remuneration from the company concerned and compensate the damage. The right to claim damages, inflicted by these persons on the company, may be enjoyed

¹⁰⁹ Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-12.

¹¹⁰ Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-12.

¹¹¹ Welch, Edward P.; Turezyn, Andrew J., Folk on the Delaware General Corporation Law, 2005 ed., p. 108.

¹¹² Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-14.

¹¹³ Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-13.

¹¹⁴ Welch, Edward P.; Turezyn, Andrew J., Folk on the Delaware General Corporation Law, 2005 ed., p. 111.

¹¹⁵ Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-18.



by a shareholder or the holders of 5% shares in a joint-stock company, and in other companies, by each of the partners.¹¹⁶ This principle in Georgian law is often addressed as “conflict of interests” in the company.

4.4.2.2. Self-dealing

Dealing with companies transactions is considered everyday business of directors. However, a transaction where directors and the company are counterparties implies the danger of wrongdoing against the company and in favor of the directors. Alleged unfair treatment is and always will remain as a risk of self-dealing transactions.

Self-dealing is not addressed with proper care in Georgian law; however, one may argue it is to be derived from the general notion of the duty of loyalty. The already mentioned articles 9.5 and 9.6 Law of Georgia on Entrepreneurs might serve as a good tool to develop distinguished case law in this sphere. The lack of appropriate case law must not be understood as lack of violations in the Georgian managerial market. The classic form of conflict of interest is an agreement between the company and the manager, when on both sides of the agreement is one person. The existence of such agreements arises doubts of using corporate resources for personal purposes.¹¹⁷ The interested person, who has breached the rule of conflict of interest imposed by law, is liable to compensate the damage caused by self-dealing, if it becomes clear that, in case of an independent decision the result would be better. Arguments about an alleged breach of obligation might be considered justified, if the interested director was aware or would have to be aware of the conflict of interest and he did not disclose this fact and use his vote in favor of the decision. The burden of proof that the duty was breached and this fact caused damage for the company is on the plaintiff. Except direct damage, the director has to pay back everything what he got from the self-dealing contract. The limitation period for this claim is eighteen months from the moment of conclusion of the self-dealing contract.¹¹⁸

¹¹⁶ Article 9.5

¹¹⁷ *Jugeli, Giorgi*, Protection of Capital in Joint Stock Company, Tbilisi 2010, p. 249.

¹¹⁸ *Jugeli, Giorgi*, Protection of Capital in Joint Stock Company, Tbilisi 2010, p. 252.



Despite the form of the transaction, the burden of proof is deemed to be the obligation of the directors, not of the plaintiffs.¹¹⁹ Therefore, in Delaware, the business judgment rule¹²⁰ has no applicability if the case concerns self-dealing transactions. However, plaintiffs seeking to challenge a transaction as self-interested must themselves satisfy certain threshold requirements. For example, if the plaintiff has voted in favor of the self-dealing transaction, this action deprives him or her of the right to attack the deal before the court.¹²¹

The early common law approach regarding self-dealing transactions was not flexible enough. Self-dealing transactions were considered automatically voidable. Some authors argue that the black and white rule of the law has served as an impediment of business trade. Self-dealing transactions were considered automatically voidable, whereas there are and will always be such contracts that are entirely fair for companies and therefore there is no need to declare them automatically null and void. For example, due to banks' and other financial organizations' reluctance to invest money in company's projects, directors might make a decision to give loans to the corporation. Such an agreement is to be considered in the best interests of the company and must not be a subject of review in order to invalidate the contract between the company and the director. By referring to these reasons judges in the State Delaware have changed their approach in favor of such transactions provided the disinterested directors and/or shareholders have approved the transaction as entirely fair for the company.¹²² Accordingly, self-dealing in the US is not entirely forbidden. Company law statutes principally welcome transactions approved by disinterested directors.¹²³

In Delaware law self-dealing transactions are not restricted to "pure business" transactions. For example, if the director also serves as an officer of the company his salary will be also considered as a matter of self-dealing.¹²⁴

¹¹⁹ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 467.

¹²⁰ See Sub-title 6, Business Judgment Rule.

¹²¹ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-11.

¹²² *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 468.

¹²³ *Clarke, Donald C.*, Three Concepts of the Independent Directors, Delaware Corporate law Journal 2007, Vol. 32, p. 107.

¹²⁴ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 474.

4.4.2.3. Corporate opportunities

Information and awareness about different business opportunities become more and more important for successful transactions. Delaware case law has adequately reacted to the issue and developed some regulations preserving the rights of the companies and accordingly its shareholders from the wrongdoer directors. Generally, a director will be able to benefit from the company's opportunities, if these opportunities were disclosed before the company, which refused to use them. As the Supreme Court of Delaware held in the case of *Guth v Loft Inc.*,¹²⁵ "doctrine of corporate opportunities is a reflection of the duty of loyalty. A director is not allowed to use corporate opportunities for personal purposes, if he or she has become aware while enforcing his liabilities, corporation has capacity to use the opportunity, this is in the corporate prospective of the company, and if taking this opportunity might become beneficial for the company."¹²⁶ If the opportunity belongs to the company, the wrongdoer director or officer will be deprived of all benefits received from the opportunity in favor of the company, if by applying of the opportunity the company would gain a practical advantage.¹²⁷

Taking into consideration the opportunity rule, directors and officers must consider the issue with special care. They have to apply themselves not to do anything against such opportunity on the one hand and to act in favor of the company in order to gain such opportunities, on the other.¹²⁸ However, this obligation of directors and officers is not absolute. For example, "when a business opportunity comes to a corporate officer or director, in his individual capacity rather than in his official capacity, and the opportunity is one which, because of the nature of the enterprise, is not essential to his corporation, and is one in which it has no interest or expectancy, he may treat the opportunity as his own, the officer or director may not wrongfully embark the corporation's resources therein."¹²⁹

¹²⁵ Supreme Court of Delaware, *Guth v Loft Inc.*, 5A 2d. 503, Delaware April 11, 1939,

<http://international.westlaw.com/find/default.wl?sp=intbuhrs->

[000&rp=%2ffind%2fdefault.wl&sv=Split&rs=WLIN11.04&cite=5+A.2d.+503%2c&fn=top&mt=314&vr=2.0&findjuris=00001](http://international.westlaw.com/find/default.wl?sp=intbuhrs-000&rp=%2ffind%2fdefault.wl&sv=Split&rs=WLIN11.04&cite=5+A.2d.+503%2c&fn=top&mt=314&vr=2.0&findjuris=00001) (last visited 29.06.2011).

¹²⁶ *Jugeli, Giorgi*, Protection of Capital in Joint Stock Company, Tbilisi 2010, p. 171.

¹²⁷ Supreme Court of Delaware, *Guth v Loft Inc.*, 5A 2d. 503, Delaware April 11, 1939.

¹²⁸ Supreme Court of Delaware, *Guth v Loft Inc.*, 5A 2d. 503, Delaware April 11, 1939.

¹²⁹ Supreme Court of Delaware, *Guth v Loft Inc.*, 5A 2d. 503, Delaware April 11, 1939.



Concepts created by the court only may be used as a general guideline; each case needs to be judged independently, by taking into account the special circumstances of the specific case.

There are no Georgian law provisions directly addressing the issue. However, some regulations are available. For example, according to the law on entrepreneurs, the directors and the members of the Supervisory Board, if there is such, shall not be entitled to use the information about the company activities for personal gain, of which information they became aware in the course of discharge of their duties or due to their official status, without the preliminary consent of the partners' meeting.¹³⁰ The restricted wording of the provision, addressing only "information" and not the company opportunity that might be much broader, does not allow to speak about this institute more precisely.

Moreover, not codified in Georgian law, enforcement of the corporate opportunity principle needs higher standards of corporate governance culture. The majority of Georgian directors and lawyers are not aware of this principle, whereas it does not mean that there is no possibility of its enforcement. As already mentioned with regard to self-dealing transactions, the general notion of duty of loyalty is successfully reflected in Georgian legislation. Therefore, an amendment of the law on entrepreneurs is not the only way of reducing the negative effects of applying companies' opportunities in directors' and officers' benefits. Company charters and agreements with directors with awareness of lawyers about these tools might be considered a more flexible way for the enforcement of the best practice of corporate governance in Georgian law.

4.4.2.4. Directors conduct as stockholders

Directors being also stockholders of the company are persons with "double status". Therefore, their rights and obligation as director and as stockholder always will be interrelated. Generally, such constellations must not be deemed a violation of the duty of loyalty.

If a shareholder of the company in Georgia serves as a director at the same time, he or she may be found personally liable, but not as a shareholder. Whenever a decision concerns a dispute between the company and one of the partners, the partner concerned shall be devoid of the

¹³⁰ Law of Georgia on Entrepreneurs, Article 9.6, Effective October 28, 1994, as amended on 14 of March 2008.



voting right.¹³¹ A shareholder will be liable under the provisions of the law on entrepreneurs imposing personal liability on the director of the company if there is the case of breaching fiduciary duties. According to the general principles of Georgian law, shareholders shall not be entitled to any remuneration other than the company dividends. In the case of violation of this rule, the shareholder who received that remuneration shall be required to return it or to compensate in cash the inflicted property damage. The directors and the Supervisory Board shall be liable to the company for the violation of this principle jointly, directly and with the entire property. The general meeting shall not be entitled to waiver this right. Creditors of the company may use this right if they have not received the compensation for their claims from the company.¹³² However, a shareholder may enter in contractual relationships with the company (including a director or a member of the Supervisory Board) and receive the contractual remuneration other than the dividends.¹³³

As to Georgian doctrine, being a shareholder of the company does not necessarily mean that this person is a director as well. To be designated as a director of the company a decision of the general meeting of shareholders is necessary.¹³⁴ Furthermore, together with shareholders, directors and members of the supervisory board are liable against the company. If they are not acting as an ordinarily prudent person in the same place, in good faith, they will be found liable for damages incurred.¹³⁵

If a director qua stockholder in Delaware negotiates the sale of his stock and benefits from the deal to the same extent as other stockholders, it is not a breach of loyalty.¹³⁶ Thus, a director breaches the duty of loyalty “if he uses confidential information to secure a better deal for himself alone or if he secures more advantageous treatment by a promise, express or implied, that he will promote the buyers interest within the corporation. A director also breaches a duty of loyalty if he reveals confidential information to third parties in order to benefit himself as a shareholder. However, a director does not breach his duty if he maintains his contractual rights

¹³¹ Law of Georgia on Entrepreneurs, Article 91.4, Effective October 28, 1994, as amended on 14 of March 2008.

¹³² Law of Georgia on Entrepreneurs, Article 57.2, Effective October 28, 1994, as amended on 14 of March 2008.

¹³³ Law of Georgia on Entrepreneurs, Article 57.3, Effective October 28, 1994, as amended on 14 of March 2008.

¹³⁴ *Chanturia, Lado; Nimidze, Tedo*, Commentary of Law of Entrepreneurs of Georgia, 3rd ed., Tbilisi 2002, p. 116.

¹³⁵ *Burduli, Irakli*, Fundamentals of The Corporate Law, Tbilisi 2010, p. 460.

¹³⁶ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 89.



under a merger agreement that was fait to the stockholders when agreed upon, but which, because of changed circumstances, now favors him at the stockholders expense.¹³⁷

According to Delaware case law, even the majority stockholder serving as a director and able to elect the other members of the board, will be unlikely to have power to influence the decision of the entire number of directors. However, this provision might become a subject of revising if the appropriate circumstances of the case lead to different conclusions.¹³⁸

If directors qua stockholders would be considered in violation of the duty of loyalty, the majority of Georgian directors would become wrongdoers. According to general practice in Georgia, the majority of directors are the stockholders of the same company. Sometimes the directors and shareholders are so “integrated” in “their” companies that the assets of the company are difficult to separate from that of the property of individuals. Therefore, urgency of clear regulation in this regard might not be disputable. The principles worked out by case law of Delaware should be considered one of the most useful sources in order to accomplish this complicated goal.

4.4.2.5. Effect of stockholder ratification

If taking into consideration that the stockholder ratification does not principally extinguish the breach of duty of loyalty,¹³⁹ one may argue that stockholder benefit is not the only aim of directors’ activities. Directors must act in the best interests of the company, which might be in contradiction to some stockholders’ intentions. However, according to the Court of Chancery, “in all events informed, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the bases of waste.”¹⁴⁰ Such ratification might have the validation effect in some constellations. However, the majority of transactions might not be ratified by majority vote. Despite stockholder ratification, the right of the minority shareholder to attack the transaction before the court continues to exist.¹⁴¹ The role of the articles of incorporation with

¹³⁷ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 89.

¹³⁸ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 91.

¹³⁹ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 108.

¹⁴⁰ *Welch, Edward P.; Turezyn, Andrew J.*, *Folk on the Delaware General Corporation Law*, 2005 ed., p. 109.

¹⁴¹ *Hamilton, Robert W.*, *The law of corporations*, St. Paul 2000, p. 489.



this regard seems to be decisive.¹⁴² Some authors argue the articles of incorporation or other agreement of shareholders are not able to validate transactions being manifestly null and void thanks to their content. For example, the absolute exclusion of liability for the breach of directors duties would be “probably ineffective.”¹⁴³

As to the Georgian regulation, one may argue it is principally in step with the Delaware law. Shareholders’ ratification is not the universal tool to avoid directors’ liability if there is a breach of their duties. For example, if the payment is necessary, the responsibility of the company management shall not be terminated because they were acting for the observance of the shareholders’ decisions.¹⁴⁴ This provision makes clear that a Georgian director should bear in mind their liability cannot be extinguished with the shareholder’s ratification. Such regulation will only promote the value of independence of Georgian directors. The Supreme Court of Georgia seeks to apply these principles in everyday practice. For example, the Supreme Court held seven years ago that a transaction accepted and signed by the director of a company is not voidable merely because of the lack of permission of shareholders. The director has a general power to represent the company in relations with other entities and individuals. Therefore, the transaction remains valid for the company and its counterpart, whereas this fact should not be interpreted as an exclusion of directors’ responsibility for the conclusion of the transaction, which is not fair for the company and does not reflect its best interests.¹⁴⁵

4.4.2.6. Compensation of Directors

The compensation of directors is an important issue and can play a decisive role for the future success of the company. Generally, compensation agreements concluded with directors and officers of the company should be considered as a special type of self-dealing transaction.

¹⁴² *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 490.

¹⁴³ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 490.

¹⁴⁴ Law of Georgia on Entrepreneurs, Article 9.6, October 28, 1994, as amended on 14 of March 2008.

¹⁴⁵ Supreme Court Decision # as-109-410-04, 6th of April 2004 (in Georgian language). Georgian text is available on www.Supremecourt.ge.



Moreover, this type of self-dealing is not avoidable. The occupation of the position immanently implies the right to compensation.¹⁴⁶

Compensation may be so called salary-based; however, there are some doubts expressed in doctrine whether directors with fixed incomes would be ready to undertake risky decisions, which might be profitable in a long-term perspective for the company.¹⁴⁷ On the other hand, a traditional stock-option plan can serve as an incentive for managerial initiatives; however, it demands additional costs. Therefore, the task to create a balanced compensation plan seems to need good experience, analyses and expertise.¹⁴⁸

Historically, in common law countries directors' right to compensation should have to be provided by the charter or bylaws of the company.¹⁴⁹ Statutory law in Delaware has changed the situation.¹⁵⁰ There is no restriction for directors to serve as officers of the company receiving the appropriate compensation. However, most of the companies prefer to entrust the right to define the sum of compensation to the independent outside directors.¹⁵¹

Despite the Court of Chancery's attempts in *Wilderman v Wilderman* to highlight some principles in order to resolve the compensation issue, some authors argue there is no common rule in this field.¹⁵² The lack of strict rules and a common template gives a broad discretion to companies to create a compensations plan that would be tailored on the concrete goals of shareholders and directors hired by them. Sometimes plans of compensation are directly linked with so called "golden parachutes" protecting managerial interests in case of takeover.¹⁵³ The Delaware case law

¹⁴⁶ Allen, William T.; Kraakman, Reinier; Subramanian, Guban, Commentary and Cases on The Law of Business Organization, New York 2007, p. 327.

¹⁴⁷ Allen, William T.; Kraakman, Reinier; Subramanian, Guban, Commentary and Cases on The Law of Business Organization, New York 2007, p. 327.

¹⁴⁸ Allen, William T.; Kraakman, Reinier; Subramanian, Guban, Commentary and Cases on The Law of Business Organization, New York 2007, p. 328.

¹⁴⁹ Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-78.

¹⁵⁰ "Under Section 141 (h), directors are authorized to compensate themselves as directors unless expressly prohibited or limited by charter or bylaw provisions. Section 144 generally saves such compensation arrangements from a claim of voidness or voidability if its requirements are met." See: Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-78.

¹⁵¹ Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-78.

¹⁵² Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-79.

¹⁵³ Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A., Delaware corporation law and practice, New York 2010, p. 15-79.



is a good illustration of the courts' reluctance to interfere in compensation issues.¹⁵⁴ Therefore, it should be argued discretion in this field is not restricted.¹⁵⁵

Directors' compensation is not a subject of special regulation in Georgia. The issue is within the ambit of contractual freedom. Generally, the law on entrepreneurs, the charter and any other appropriate agreement shall regulate the relationships with the directors and the members of the Supervisory Board.¹⁵⁶ The general meeting of shareholders shall be entitled, to make a decision on the remuneration of the members of the Supervisory Board.¹⁵⁷ If the Supervisory Board is created, remuneration of directors shall fall within its competence.¹⁵⁸ However, it remains questionable, whether allowing the directors to serve as members of the Supervisory Board at the same time, might cause problems regarding the remuneration issue. If we take into consideration that a person is not entitled to vote if the voting directly or indirectly concerns his personal interests, the directors being members of the Supervisory Board should be deprived of the right to vote in favor or against the compensation plan accepted by other members of the board. Similarly, the Georgian law on entrepreneurs¹⁵⁹ prohibits a shareholder from voting if that shareholder is interested in the transaction in question. Therefore, this article should be used, by analogy of law, for the purposes of remuneration issue for directors and the Supervisory Board. A member of the Supervisory Board is to be excluded from the voting procedure.

One may argue there is nothing to compare with the law of Delaware. As opposed to the Delaware law, Georgian law is not familiar of the clauses like "golden parachutes," protecting the directors' rights in case of takeover. The most widespread compensation plan for Georgian directors is a fixed salary, serving as a good evidence of a poor quality of developments in this field.

¹⁵⁴ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-80.

¹⁵⁵ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 118.

¹⁵⁶ Law of Georgia on Entrepreneurs, Article 9.7, Effective October 28, 1994, as amended on 14 of March 2008.

¹⁵⁷ Law of Georgia on Entrepreneurs, Article 54.6(h), Effective October 28, 1994, as amended on 14 of March 2008.

¹⁵⁸ Law of Georgia on Entrepreneurs, Article 55.8(g), Effective October 28, 1994, as amended on 14 of March 2008.

¹⁵⁹ Law of Georgia on Entrepreneurs, Article 53.4, Effective October 28, 1994, as amended on 14 of March 2008.



5. Good Faith

Despite some court decisions in Delaware, it was intensively argued whether good faith might be considered an independent duty of directors. Alternatively, according to some scholars, good faith is part and parcel of the duty of loyalty.¹⁶⁰

Generally, Delaware law provides for the presumption of good faith. Violation of the duty might be argued when “director acts in a manner unrelated to a pursuit of the corporation’s best interest”.¹⁶¹

Despite some pessimistic expressions in doctrine, Delaware courts have worked out strict principles to qualify the legal aspect of the duty of good faith.¹⁶² *Cheff v Mathes*¹⁶³ and *Smith v Van Gorkom*¹⁶⁴ are considered as good evidence of these arguments.¹⁶⁵

Generally, a breach of good faith does not always require the motivation to act in bad faith.¹⁶⁶ In *Disney* the Delaware Supreme Court has attempted to make clear the notion of bad faith¹⁶⁷ protecting the “the interests of the corporation and its shareholders” from an action “which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence.”¹⁶⁸ In another case, holding on the bad faith the Court of Chancery has stated that if directors know they must act but they have failed to do so by expressing manifestly disregard to their duties, their behavior might be considered as being in bad faith. The Delaware Supreme Court has added that “the relevant question is whether the Director Defendants failed utterly to attempt to obtain the best sale price.”¹⁶⁹ Furthermore, in *Stone v Ritter* the Supreme Court has

¹⁶⁰ *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 504.

¹⁶¹ *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 505.

¹⁶² *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-47.

¹⁶³ Supreme Court of Delaware, *Cheff v Mathes*, 41 Del. Ch. 494, 199 A.2d 548 Delaware 1964,

<http://international.westlaw.com/find/default.wl?sp=intbuhrs->

[000&rp=%2ffind%2fdefault.wl&sv=Split&rs=WLIN11.04&cite=+199+A.2d+548++&fn=top&mt=314&cvr=2.0&findjuris=0001](http://international.westlaw.com/find/default.wl?sp=intbuhrs-000&rp=%2ffind%2fdefault.wl&sv=Split&rs=WLIN11.04&cite=+199+A.2d+548++&fn=top&mt=314&cvr=2.0&findjuris=0001) (last visited 30.06.2011).

¹⁶⁴ Supreme Court of Delaware, *Smith v Van Gorkom*, 488A.2d 858 Del. 1985.

¹⁶⁵ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-46.

¹⁶⁶ *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 505.

¹⁶⁷ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-48-49.

¹⁶⁸ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-49.

¹⁶⁹ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-49.



affirmed interrelations between acting in good faith and the so called duty to monitor company's activities.¹⁷⁰

In *Lyondell Chemical Co. v Ryan* the Supreme Court held that there is no breach of good faith if the directors were aware about the details of the transaction taking into consideration consultations provided for them by professionals. Besides, the directors had intensively discussed the issue at several meetings. Referring to these circumstances, the Supreme Court was of the opinion that "a board of directors did not breach the duty of good faith because the directors did not "knowingly and completely fail to undertake their responsibilities" in approving a transaction".¹⁷¹

The brief illustration of Delaware case law shows that good faith might be treated as an independent duty in the directors' duties catalogue. On the contrary, there is no clear distinction between these duties in Georgian law. Merely the declaration that directors must act in good faith¹⁷² is not sufficient to answer the questions occurring about the issue. There is a rare decision of the Georgian Supreme Court,¹⁷³ in which the case was remanded to the Tbilisi Court of Appeal in order to clarify whether the director of the joint stock company had acted in good faith accepting the leasing contract with a close corporation. The question arose from the conducts of a former director. Since his resignation, the former director had created a close corporation. The latter corporation has concluded a leasing contract with the joint stock company. The subject of the leasing was almost all property of the lessor. According to the Supreme Court, the Tbilisi Court of Appeal had to clarify whether the new director was acting in good faith concluding the leasing contract, taking into consideration that the transaction was ratified by the Supervisory Board of the joint stock company. Decisions of the Tbilisi Court of Appeal are unreported; therefore, the future fate of the case is not available. However, the trend is interesting. It is evidence of the Georgian Supreme Court's attempts to promote good corporate governance in Georgian corporations. However, a distinction between director's duties in the courts' holding is unlikely be found.

¹⁷⁰ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-50.

¹⁷¹ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-49.

¹⁷² Article 9.5.

¹⁷³ Supreme Court Decision # as-717-988-05, 24th of March 2006 (in Georgian language). Georgian text is available on www.Supremecourt.ge.

6. Business Judgment Rule

The Business Judgment Rule, one of the remarkable institutes of American law, was created by courts trying to defend directors' rights when facing an unwanted takeover.¹⁷⁴ Some authors argue the first case where the Delaware Supreme Court has dealt with the business judgment rule, was *Zapata Corp. v Maldonado* (Del 1981).¹⁷⁵ Generally, the role of Delaware courts in working out main principles appropriate for the business judgment rule was immense. The Delaware approach is considered to be flexible enough to preserve directors' interests.¹⁷⁶

The notion of the Business Judgment rule is rather precisely clarified in the Delaware doctrine. According to one expression, "the business judgment rule represents a judicial syllogism derived from five fundamental tenets and from these tenets flows the business judgment rule: A decision by a board of directors (i) in which the directors possess no direct or indirect personal interest (ii) which is made (a) with reasonable awareness of all reasonably available material information, and (b) after prudent consideration of the alternatives. (iii) Which is in good faith, and (iv) which is in furtherance of a rational corporate purpose, will not be interfered with by the courts, either prospectively by injunction or retrospectively by imposition of liability for damages upon the directors, even if the decision appears to have been unwise or have caused loss to the corporation or its stockholders."¹⁷⁷ This long citation adequately reflects the complexity of the notion and its function to protect directors acting in good faith.

As to the interrelation between the business judgment rule and good corporate governance some authors argue "courts considering defensive maneuvers should begin their analysis not with the business judgment rule but with the statement, what good governance practices call for under the circumstances."¹⁷⁸ Therefore, the business judgment rule is considered a very good tool in the hands of judges in order to ensure good corporate governance.

¹⁷⁴ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 460.

¹⁷⁵ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 465.

¹⁷⁶ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 461.

¹⁷⁷ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-8.

¹⁷⁸ *Cox, James D.*, How Delaware Law Can Support Better Corporate Governance, in: Kieff, Scott F.; Paredes, Troy A. (editors), Perspectives on Corporate Governance, New York 2010, p. 349.



The main function of the business judgment rule is to prevent the courts' unjustified interference in directors' business judgments.¹⁷⁹ Provided all preconditions are fulfilled, the court has the obligation to terminate proceedings.¹⁸⁰ The goals of the business judgment rule are enforceable by accepting the presumption that making their decisions directors would have acted in good faith analyzing the information provided for them and in the best interests of the company. If there is no abuse of authority, the courts are obliged to respect the directors' business judgments.¹⁸¹ The Delaware General Corporation Law¹⁸² is characterized with a liberal approach concerning directors' liability. The statutory law tends to promote the exclusion of directors' liabilities provided the entire preconditions stipulated by law are fulfilled.¹⁸³ This approach inspires more and more people having managerial skills to apply themselves to act in the best interests of the company rather than to think about the alleged responsibility for risky decisions.¹⁸⁴

As opposed to the duty of care, requiring reasonable carefulness from directors, the standards of the business judgment rule are not very high.¹⁸⁵ Accordingly, the "reasonably prudent person" test is not applicable.¹⁸⁶ The goal to ensure directors' business judgments is only achievable with restriction of the courts' authority to review these judgments.¹⁸⁷

As *Bainbridge* has put it "the analysis herein proceeds from the premise that the business judgment rule, like all of corporate law, reflects an inherent tension between two competing values: the need to preserve the board of director's decision-making discretion and the need to hold the board accountable for its decisions. Court and commentators frequently focus almost solely on the latter value, emphasizing the need to deter and remedy misconduct by the firm's decision makers and agents."¹⁸⁸

¹⁷⁹ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-9.

¹⁸⁰ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-8.

¹⁸¹ *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 498.

¹⁸² *Balotti, R. Franklin; Finkelstein, Jesse A.*, Delaware Law of Corporations & Business Organizations, Statutory Desk book, 2009 ed., Delaware General Corporate Law 102 (b) (7).

¹⁸³ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 459.

¹⁸⁴ *Hamilton, Robert W.*, The law of corporations, St. Paul 2000, p. 460.

¹⁸⁵ *Bainbridge, Stephen M.*, The New Corporate Governance in Theory and Practice, New York 2008, p. 107.

¹⁸⁶ *Allen, William T.; Kraakman, Reinier; Subramanian, Guban*, Commentary and Cases on The Law of Business Organization, New York 2007, p. 252.

¹⁸⁷ *Bainbridge, Stephen M.*, The New Corporate Governance in Theory and Practice, New York 2008, p. 107.

¹⁸⁸ *Bainbridge, Stephen M.*, The New Corporate Governance in Theory and Practice, New York 2008, p. 107.



The Business judgment rule was intensively criticized arguing that it makes court review of directors' behaviors impossible. However, this opinion does not reflect the reality.¹⁸⁹ Generally, the applicability of the Business Judgment Rule is not a precondition for the absolute exclusion of the courts competence to review business judgments. For example, the Business Judgment Rule is not applicable if the decisions made by directors seem not to be independent or there is evidence they have acted in bad faith.¹⁹⁰ The Business Judgment Rule makes possible to deal with directors' misconduct in a more sophisticated way preserving the director's right to make decisions on the one hand and protecting the company from the wrongdoing of managers, on the other.¹⁹¹ Such "double profit" from the rule of law is only possible when the preconditions are structured in detail.¹⁹² Therefore, the Business Judgment Rule does not preclude courts from reviewing business judgments.¹⁹³

As opposed to the Delaware law, the business judgment rule was not implemented in Georgian legislation. However, one may argue, the standards of review of business judgments would exist in every more or less developed jurisdiction. For example, enacting a new law¹⁹⁴ in 2005, Germany has adopted the business judgments rule; however, some scholars argue there was no need for such an enactment because of the sufficient regulation in German legislation.¹⁹⁵ Therefore, the business judgment rule should be just considered as a good tool of balancing the conflicting interests in company relations. As already mentioned, the business judgment rule merely permits to consider cases in a more sophisticated way and may serve as an additional measure to ensure qualified decisions of Georgian courts. Being a rational principle of separation of the burden of proof, there will be no cultural or other impediment for implementing this rule in everyday business of Georgian directors, judges and lawyers.

Under Georgian corporate law (The Law of Georgia on Entrepreneurs, Article 9) the directors are responsible to discharge their duties in good faith, in particular they shall be required to act as an ordinarily sensible man would have cared when holding a similar office in a similar situation

¹⁸⁹ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-7.

¹⁹⁰ *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 504.

¹⁹¹ *Drexler, David A.; Black, Lewis S.; Sparks, Gilchrist A.*, Delaware corporation law and practice, New York 2010, p. 15-7.

¹⁹² *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 499.

¹⁹³ *Smith, Jeffrey A.; Morreale, Matthew*, Global Climate Change and U.S. Law, ed. 2007, p. 498.

¹⁹⁴ In German: Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts.

¹⁹⁵ *Chanturia, Lado*, Corporate Governance and Liability of Directors in Corporation Law, Tbilisi 2006, p. 42.



and to act in the belief that this action is the most beneficial one for the company. This article determines a general rule for directors and there are no specific rules. It determines merely the attitude of directors with their action and not the scheme of the action itself. It gives an answer to the question: “How”? And not to the question “what”? Hence, the discussed article has lack of functionality.¹⁹⁶

As to the responsibility issue, a provision that allows directors to rely on official conclusions of company employees may have paramount importance for Georgian case law. Generally, the manager of the company does not have comprehensive information regarding all issues about which he or she has to decide. Therefore, it seems to be justified to rely on conclusions of qualified persons while making a decision.¹⁹⁷

Georgian corporate law might share the experience of corporate law of Delaware and should impose protection by the business judgment rule and the same rule regarding the burden of proof as well. This would increase decision-making initiatives of directors acting in Georgian companies, they will feel safe and this fact can encourage them to be much more active and creative. These factors are very important in the decision-making process and can play a positive role in future development of Georgian company law.

7. Remedies

Remedies rendered for the breach of directors’ duties should be met with alleged damages caused by the wrongdoing of the directors. The Court of Chancery in Delaware attempts to tailor remedies rendered to the concrete circumstances of the case.¹⁹⁸ For example, rescissory damages should be considered justified if the wrongdoer fiduciaries have benefited from misapplying their rights.¹⁹⁹ Additionally, it was argued that the directors’ breach of the duty of loyalty does not cause the plaintiff’s right to attorney’s fees and expenses.²⁰⁰

¹⁹⁶ *Jugeli, Giorgi*, Protection of Capital in Joint Stock Company, Tbilisi 2010, p. 254.

¹⁹⁷ *Jugeli, Giorgi*, Protection of Capital in Joint Stock Company, Tbilisi 2010, p. 254.

¹⁹⁸ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 120.

¹⁹⁹ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 120.

²⁰⁰ *Welch, Edward P.; Turezyn, Andrew J.*, Folk on the Delaware General Corporation Law, 2005 ed., p. 120.



As to the Georgian approach, responsibility for the damages caused by the wrongdoing of directors is one of the main principles of Georgian corporate law. According to the law on entrepreneurs directors are jointly liable for the damage inflicted on the company due to non-fulfillment of these duties, with all their property, directly and personally. Refusal of the company to the claim of regressive payment or a company compromise shall be void if the payment is necessary for meeting the claims of the company creditors.²⁰¹

According to the Supreme Court of Georgia, directors' responsibility does not derive from the general rules of tort law. Questions on whether directors are liable to pay for the damages caused by their actions, should be answered according to the law on entrepreneurs. Tort law rules from the Civil Code are not applicable.²⁰² Taking into consideration the different regulation of tort law and commercial law claims in Georgian legislation,²⁰³ the holding of the Supreme Court seems to be justified.

With regard to attorney's fees and expenses, this sphere belongs to the field of civil procedure law; therefore, it does not depend on the remedies concerning the substance of the dispute and is strictly regulated by statutory provisions.

Conclusion

Due to its format, this research cannot pretend to be exhaustive in the field of corporate governance models in Georgia and in Delaware. However, several conclusions have to be highlighted.

First, the Georgian company law lacks effective tools to enforce its provisions in everyday business of companies, whereas courts in Delaware serve as key institutions in order to enforce the rule of law and to develop new regulations in the field of good corporate governance. On the changed circumstances the Georgian legislator has to react with amendment of statutory law, whereas Delaware regulations are being often developed in court decisions.

²⁰¹ Law of Georgia on Entrepreneurs, Article 9.6., Effective October 28, 1994, as amended on 14 of March 2008.

²⁰² Supreme Court Decision # as-959-1161-08, 24th of February, 2009 (in Georgian language). Georgian text is available on www.Supremecourt.ge.

²⁰³ See Article 1008 of Georgian Civil Code and compare with Article 15 of Georgian law on entrepreneurs.



By refusing the two-tier model and permitting executive directors to be a member of the supervisory board, the Georgian legislator has adopted a mixed version of corporate governance. It makes it possible to consider the members of the Supervisory Board as inside and outside directors. This amendment might be qualified as a step to the one-tier system widespread in common law countries. The appropriate decision of the Supreme Court regarding the creation of unified principles of responsibility for executive directors and members of the Supervisory Board is a good evidence for this argument.

As to the duty of directors, despite the declaration of general principles in the law on entrepreneurs, the distinction between several aspects of the duties is unclear. There are several court decisions serving as an evidence of the Supreme Court's attempts to outline some principles of liability; however, the current stage of development is far from ideal. On the other hand, duties of directors is not a static notion in Delaware, it continues to develop in case law and the experience collected over decades makes it possible to amend the law in a more sophisticated way.

On the other hand, the new regulation in Georgian law is liberal enough and gives a good chance and enough space for companies, lawyers and directors to develop original regulations through charters, bylaws and even court decisions. Moreover, the current stage of Georgian business developments and its integrity in transnational commerce is of poor quality. This factor serves as an impediment for progress. Although judges are not restricted in their interpretations, poor quality of their awareness and knowledge of international experience makes it impossible to render decisions inspiring new regulations and bridging the gaps of statutory law.

The Business Judgment Rule discussed in this paper might be a good example for the adoption of international experience in the field of corporate governance. However, merely amendments made in the law on entrepreneurs might not be considered sufficient for enforcement of this important principle already checked and proved in majority jurisdictions. The lawyers and the judges should be trained in order to be more acquainted regarding the technique of separation of burden of proof, the real functionality of the institute etc.

Just to conclude the above-mentioned topic, one may argue that the implementation of norms in other jurisdictions might be dangerous if the new rules are not tailored to the needs of the society and culture of the recipient jurisdiction. Comparative research based on case law and doctrine should be considered the best way for development of young and inexperienced jurisdictions.



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37. Model Business Corporation Act.



Appendix

THE LAW OF GEORGIA ON ENTREPRENEURS

(Fragments)

Article 9. Management and Representation

1. The managerial rights shall be enjoyed by: in a business partnership – all the participants, in a general partnership – all the partners, in a limited partnership – personally responsible partners (full partners), in a limited liability company, joint-stock company and cooperative – directors, unless otherwise provided for by the charter (in the case of a business partnership – by the participants' agreement).
2. A managerial activity shall mean an action, which directly or indirectly serves the purposes of a company.
3. The persons, mentioned in Paragraph 1 of this Article shall represent the company in legal relationships with a third person, unless otherwise provided for by the charter (in the case of a business partnership – by a member's agreement). The type and rules of representation shall be entered into the Company Register. The representative power, entered into Company Register shall not be subject to limitation in the relationship with a third person.
4. If counterparty was aware of the limitation of the power to manage a company, the represented business entity company may claim the invalidity of such an agreement within a period of eighteen months following the execution of the agreement. The same rules shall apply when the person enjoying the representative power and the counterparty were acting jointly with the purpose of causing damage to the company, which was represented by a representative.
5. The persons, mentioned in Paragraph 1 of this Article shall not be entitled to discharge the same activity they perform within the company or to participate in the other company in the capacity of a personally responsible partner or a director without the consent of the partners, unless otherwise envisaged by the charter. In a general partnership or limited partnership such consent may be given by the partners' meeting and in a limited liability



company, joint-stock company and cooperative – by the body which appoints (elects) directors. Consent to such an activity shall be regarded given when, upon the appointment as a manager of the company, the partners were aware, that the manager of the company was engaged in such an activity and nobody asked him to discontinue the activity concerned.

When the company was caused damage due to violation of the rules of the conflict of interest by the persons, mentioned in Paragraph 1 of this Article, the violator shall be required to relinquish the right to claim the remuneration from the company concerned and compensate the damage. The right to claim damages, inflicted by these persons to the company, may be enjoyed by a shareholder or the holders of 5% shares in a joint-stock company, and in the other companies, by each of the partners.

6. The persons, mentioned in Paragraph 1 of this Article and the members of the Supervisory Board shall discharge their duties in good faith; in particular, they shall be required to care as an ordinary, sensible man would have cared when holding a similar office and in similar situation, and to act in faith that this action is the most beneficial one for the company. They shall be jointly liable for the damage, inflicted to the company due to non-fulfillment of these duties, with all their property, directly and personally. Refusal of the company to the claim of regressive payment or a company compromise shall be void if the payment is necessary for meeting the claims of the company creditors. If the payment is necessary the responsibility of the company management shall not be terminated because they were acting for the observance of the partners' decisions.

The persons, mentioned in Paragraph 1 of this Article and the members of the Supervisory Board, if there is such, shall not be entitled to use the information about the company activities for personal gain, of which information they became aware in the course of discharge of their duties or due to their official status, without the preliminary consent of partners' meeting.

By virtue of an agreement made with the persons, mentioned in Paragraph 1 of this Article and the members of the Supervisory Board, the aforementioned obligation may remain valid after resigning the persons concerned, but for not more than three years. It shall be possible to provide for the compensation for this obligation, the amount and the payment procedure of which shall be specified by this agreement.



7. The relationships with the Directors and the members of the Supervisory Board shall be regulated by this Law, the charter and the agreements made with them.
8. In a company, where the state owns more than 50% of the total votes, a Supervisory Board may be created under a resolution of the Government of Georgia. In this case the representative of the state in the Supervisory Board may be a civil servant, provided his interests are not in conflict with those of the specific company. The members of the Supervisory Board, who are the civil servants at the same time, shall discharge their duties without respective remuneration and their performance shall not be regarded as the conflict of interests in civil service.
9. When a company is insolvent, or is facing the danger of insolvency the persons, mentioned in Paragraph 1 of this Article shall make an announcement thereabout commensurate with the procedure, envisaged by the Law of Georgia on Insolvency Proceedings without criminal delay, but not later than three weeks following the occurrence of the moment of insolvency. A statement concerning insolvency shall not be regarded as criminally protracted, when the persons, mentioned in Paragraph 1 of this Article treat this statement in good faith, envisaged by Paragraph 9.6 of this Article.”

Article 44. Concept of limited liability company

1. A limited liability company shall mean a company, whose liability to its creditors is limited to its whole property. A single person may also be entitled to establish such a company.
2. An agreement between the partners of the company on the reduction of the liability shall be void for third parties.
3. The capital of a limited liability company is divided into shares. A share shall be a negotiable right.

Article 46. Rights and Obligations of the Partners

1. The rights and obligations of the partners and initial distribution of shares shall be specified by the company charter (agreement made between the partners).



2. The charter may provide for the voting rights of the partners or/and the distribution of profit/loss not to be proportional to their shares.
3. The partners of a limited liability company shall be entitled to alienate or encumber their share in the company capital, unless a limitation is provided for by the charter.
4. The directors shall be required to immediately provide a partner with the information concerning the company activities on his demand and to give him access to company books and records.

Article 47. Company Management

1. The company managers shall discharge their powers through general meeting, unless otherwise envisaged by the charter.
2. The scope of activities on the general meeting, the procedure of holding a meeting and the decision making procedure shall be specified by this Law or/and a company charter.
3. The terms of reference and the scope of liability of a director shall be specified by this Law or/and a company charter.
4. The structure, composition and the rules of procedure of managerial bodies shall be specified by a company charter.
5. A person having the managerial and/or representative power shall submit the information about the share participation of the partners in the company to registering authority on an annual basis (as of 31 December of the previous year).

Article 51. Concept of Joint Stock Company

1. A joint-stock company shall mean a company, whose capital is divided into the shares of certain categories and certain amount defined by the company charter. A share is a non-materialized nominal security, which evidences the liabilities of a joint-stock company to its partners (shareholders) and the rights of the shareholder in a joint-stock company. The charter of a joint-stock company may provide for the threshold value, below which value the initial placement of shares of the category concerned shall be inadmissible (nominal value of shares). The liability of a joint-stock company shall be limited to its whole



- property. A shareholder of a joint-stock company shall not be responsible for company liabilities. The capital may be set at any amount upon the foundation of a joint-stock company.
2. The title of a shareholder to a share shall be evidenced by an entry into the register of shares of a joint-stock company or the entry of the nominal holder. A shareholder shall be given an extract from the register of the shares of the company or an extract for a nominal holder.
 3. A joint-stock company, which has more than 50 shareholders, shall be required to maintain the Shareholders' Register with the help of an independent registrar, on the basis of an agreement made with the latter. When the number of shareholders is less than 50, the company shall be entitled to maintain the Register either personally or with the help of an independent registrar.
 4. Transfer of the shares of a joint-stock company, whose Register is maintained by an independent registrar shall be effected commensurate with the procedure, envisaged by the Law of Georgia on Securities Market. In other cases, the shares shall be transferred through the introduction of respective amendments to the register of shares of the company, what should be certified by a person responsible for the maintenance of the register.

Article 53. The Rights and Obligations of a Shareholder

1. Unless otherwise envisaged by the law, the sole obligation of a shareholder shall be the payment of the contribution for obtaining the shares due to him. Imposition of any other obligation on a shareholder by a company charter, which is not envisaged by law, shall be void.
2. The shares of the shareholders in the profit shall be determined on the basis of the number and category of shares. The contributions, which are not made in full, shall participate in the distribution of profit pro rata the amount of already made contributions, unless otherwise envisaged by the charter.
- 3¹. A shareholder shall be entitled to request the explanations from the directors and the Supervisory Board and to present his opinion concerning each of the items of the agenda



at the general meeting. When a request is made in writing ten days prior to general meeting, it shall be fulfilled or reviewed as one of the topics of agenda. The issuance of the information may be refused only under the presumption of essential interest of the company, what should be substantiated in writing.

3². The holders of five percent of the shares shall be entitled to special inspection of the economic action or the annual balance sheet in whole, whenever they have sufficient grounds to believe, that there have been some violations.

3³. A shareholder or the group of shareholders holding 5% of shares of any category shall be entitled to request the holding of an extraordinary session of the meeting of shareholders from the authorities specified by the company charter (Supervisory Board or the directors). The request shall be made in writing and contain the topics of agenda, which should be concurrent with the legislation and be reasonably compatible with the goals and types of activities of the company. In this case the Supervisory Board or/and the directors shall be liable to hold the session of the general meeting not later than three month following the receipt of the written request. The Supervisory Board or the directors or a shareholder or the group of shareholders holding 5% of shares of any category shall be entitled to introduce amendments into proposed agenda. A shareholder or the group of shareholders holding 5% of shares of any category shall be entitled to make a request on convening an extraordinary session not earlier than 1 month following the last session.

3⁴. If a shareholder or the group of shareholders holding 5 percent of shares (initiators of the general meeting) address the relevant entity defined by the charter (the supervisory board or directors) with the request to hold an extraordinary session of the meeting of shareholders and the only issue included in the agenda is to dismiss the director(s), including the one, who is the chairman or the member of the supervisory board, the meeting shall be held pursuant to the rules described in this paragraph.

If the supervisory board does not convene a general meeting within 20 days after the request, the initiators of the general meeting, which had submitted the relevant request to



the authority stipulated by the charter, shall have the right to convene the general meeting.

Under the circumstances discussed above, the initiators of the meeting shall send an invitation on convening an extraordinary general meeting and indicating the sole issue on the agenda to all shareholders by an insured post, pursuant to the requirements of this article. It shall be inadmissible to add additional issues for discussion in the agenda. Under the circumstances, the extraordinary general meeting is authorised if it is attended by partners, which have 75 percent of total votes. If there is no quorum, the initiators may convene a new meeting but not earlier than in 20 days after the first meeting. The initiators of the general meeting shall convene a new meeting pursuant to the requirements set in this article. The meetings shall be authorised if it is attended by more than 75 percent of partners which have a vote. If there is no quorum, the initiator may apply to the court, according to the legal address of the company, which shall assign the relevant body of the company (supervisory council or directors) to hold an extraordinary meeting in 3 months after such decision is passed by the court.

- 3⁵. The holders of 5% of shares shall be entitled to request the copies of the transactions made on behalf of the company or/and the information concerning future transactions from the respective managerial authorities.
1. The shareholders shall be entitled to use their voting right for their own interests, except for cases, when the forthcoming decision refers the negotiation of a transaction with them or approval of their report. Whenever the dominant shareholder of a joint-stock company, existing on the territory of Georgia, applies his status in detriment to the interests of a joint-stock company, he shall be required to pay the respective compensation to the other shareholders. A dominant shareholder shall mean a shareholder or a group of jointly acting shareholders, who are practically capable of exerting decisive influence on the outcomes of the balloting at the general meeting of a joint-stock company.



2. Whenever a joint-stock company fails to exercise its claim against a third party, a shareholder shall be entitled to file an action demanding the fulfilment of the aforementioned claim on behalf and for the benefit of the joint-stock company. The former shall be regarded as an adequate plaintiff, provided the joint-stock company files sue against a third party within a period of 90 days following the receipt of the request, or fails to demonstrate, that filing of such action contradicts the company interests.

If the court meets the claim of the shareholder, the company shall be required to compensate the reasonable extrajudicial expenses, related to the claim to the shareholder, including lawyer's fee. The company shall be exempted from the compensation of these expenses, if it proves that the satisfaction of the claim turned out to be detrimental for the company. Whenever a shareholder is regarded as an inadequate plaintiff or the action is not satisfied, the shareholder shall be required to compensate the reasonable expenses to the company, incurred with respect to the shareholder's actions.

With due consideration of the property status the court may postpone the payment of court expenses for the benefit of the shareholder.

Article 54. General Meeting

1. Unless otherwise provided for by a company charter the regular general meeting shall be held on an annual basis within a period of 2 months following the preparation of the annual balance sheet, where the annual results and the other possible topics of agenda shall be considered. an extraordinary general meeting shall be held on request of the directors or the Supervisory Board or in other cases defined by this law on request of the shareholders. The Supervisory Board shall specify the registration date for a general meeting, which shall not be less than 45 days before the convening of the meeting and later than the announced date for convening the meeting. Only those shareholders who enjoyed the title to the shares for the registration date shall be entitled to participate in the general meeting.
- 1¹. The necessity of convening the general meeting shall be removed if the decision concerning the discussed issue is made by the shareholders, who own more than 75% of the total votes of the company. This decision shall be equal to the minutes of the meeting



and shall be regarded as a decision of the meeting. In this case the notice concerning the delivered decision shall be sent to the other shareholders. If the amount of shares, mentioned in this Paragraph is owned by more than one shareholder, holding of the general meeting shall be mandatory.

2. The general meeting of a joint-stock company shall be held at the legal address of the company or any other place on the territory of Georgia, by the authority specified by the company charter (Supervisory Board or the directors) after the expiry of 20 days following the publication of the notice concerning the convocation of the general meeting in a state official gazette, which shall be specified by the Financial Supervision Agency, or following the sending the invitations to the shareholders. Together with the notice on the convocation of the meeting subject to publication is the agenda and the recommendations of the directors and the Supervisory Board for making a decision. A notice on convening the meeting shall be accompanied with the description of the procedure, according to which a shareholder will be able to verify his right to participate in the meeting within a period of 10 days prior to the date of meeting.

An invitation to the general meeting shall be sent via a registered letter to the shareholders holding no less than 1% of the shares of the company with voting rights. In the case of a reporting company, the Financial Supervision Agency shall specify whether which holder holding less than 1% of share shall be served with the invitation by mail.

3. A shareholder shall be entitled to receive the confirmation to his right to participate in the general meeting and the number of votes under his disposal in advance, commensurate with the procedure envisaged by Paragraph 2 of Article 54. He shall participate in the general meeting on the basis of a personal ID and the data of the Shares' Register, presented at the meeting. Participation on the basis of a power of attorney shall be admissible.
4. A general meeting shall be chaired by the chairperson of the Supervisory Board, in his absence – by a deputy chairperson, in the case of absence of the deputy – by one of the directors. In the case of their absence the chairperson of the meeting shall be elected by the general meeting by simple majority of votes.
5. Unless otherwise envisaged by the charter, the general meeting shall have the decision making capacity when the partners which have at least half of the total votes are



presented. If the meeting does not have the decision-making capacity the chairperson shall be entitled to convene the new meeting with the same agenda within a certain period commensurate with the procedure envisaged by Paragraph 2 of Article 54, which meeting shall have the decision-making capacity if the partners who have no less than 25% of total votes are present. If the meeting is still not of decision-making capacity, the chairperson shall convene a new meeting with the same agenda within a certain period commensurate with the procedure envisaged by Paragraph 2 of Article 54, which meeting shall have the decision making capacity irrespective of the number of presented votes.

6. The general meeting shall be entitled:
 - a) To approve the changes to the company charter;
 - b) To make a decision on the reorganization or liquidation of the company;
 - c) To partially or fully annul the preferential right of a share holder to purchase securities (in the case of capital increase through the issuance of securities);
 - d) To accept or reject a proposal of the Supervisory Board or the directors on the disbursement of property and when these bodies fail to put forward an agreed proposal – to make a decision on the disbursement of the net profit;
 - e) To make a decision on the creation of the Supervisory Board (except for the case, when the creation of the Supervisory Board is envisaged by this Law);
 - f) To elect or withdraw the members of the Supervisory Board, to specify the term of office of a member of the Supervisory Board;
 - g) To approve the reports of the directors and the Supervisory Board;
 - h) To make a decision on the remuneration of the members of the Supervisory Board;
 - i) To elect an auditor;
 - j) To make a decision on the participation in court proceedings against the Supervisory Board and the directors, including the appointment of a representative for these proceedings;
 - k) To make a decision on the acquisition, alienation (or on such interrelated transactions) or encumbrance of company property, the value of which amounts for more than half of the value of company assets unless otherwise envisaged by the charter, except for the transaction which fall within the scope of ordinary performance of the company.



Unless otherwise envisaged by the Charter the decisions on every issue shall be made by the Supervisory Board or the directors.

7. Unless otherwise envisaged by the Charter of a joint-stock company, more than 75% of votes of present partners shall be required for the delivery of the decisions envisaged by Subparagraphs (a), (b) and (c) of Paragraph 6 of this Article, while more than 50% of votes of present partners shall be required for the delivery of any other decision.
8. During the election of the members of the Supervisory Board the shareholders may agree on the application of the accumulation principle, what shall mean:
 - a) Each of the shareholders shall distribute his votes amongst any amount of presented candidates in such a manner as for the total amount of cast votes not to exceed the total amount of votes owned by him;
 - b) A shareholder shall be entitled to cast only his vote for a candidate member of the Supervisory Board (a vote may not be cast against him);
 - c) When the number of candidates is less than or equal to the established number of the members of the Supervisory Board, every candidate, who received at least one vote, shall automatically become a member of the Supervisory Board; and when the number of candidates exceeds the established number of candidate, the candidates who receive the majority of votes shall be regarded as elected to the Supervisory Board.

Article 55. Supervisory Board

1. When a joint-stock company is a reporting company under the Law of Georgia on Securities Market and its securities are publicly traded on securities market, or is licensed by the Financial Supervisory Agency of Georgia or the number of shareholders exceeds 100, the creation of the Supervisory Board consisting of at least 3 and not more than 21 members shall be required. In any other case the creation of the Supervisory Board shall not be mandatory.
- 1¹. In the case of absence of the Supervisory Board its rights and duties envisaged by law may be distributed between the other managerial bodies of the company.



- 1². A member of the Supervisory Board shall be elected by the general meeting for a term of 1 year, unless some other term is envisaged by the decision of the general meeting or the charter. The term of office of a member of the Supervisory Board shall be extended after the expiry thereof until the convocation of the next session of the general meeting. A member of the Supervisory Board may be discharged of his office any time by the general meeting. A member of the Supervisory Board shall be entitled to resign any time. In the case of failure to elect a new member of the Supervisory Board within a period of 6 month following the withdrawal of a member, the court shall be entitled to appoint a new member under the submission of one of the shareholders, member of the Supervisory Board or a director, unless otherwise envisaged by the charter.
2. Any person can be elected as a member of the Supervisory Board. The charter may provide for a director(s) of the joint-stock company concerned to be a member(s) of the Supervisory Board. The Rules for creation of Supervisory Boards of commercial banks are defined pursuant to the law on Commercial Banks. For the cases described in paragraph 1 of this article, directors shall not form the majority in the Supervisory Board.
3. The Supervisory Board shall elect the chairperson and the deputy chairperson from amongst its members. In the case of failure to make a decision the secret balloting shall be held. In the case of equal distribution of votes the eldest of the candidates shall be appointed as the chairperson.
4. A chairperson (in his absence – a deputy) shall convene the sessions, identify the agenda. The minutes of the session shall be drawn up either by the chairperson or a secretary of the session.
5. The sessions of the Supervisory Board shall be held at least on a quarterly basis. An invitation shall be made in writing at least eight days prior and with the attachment of the draft agenda. The members of the Supervisory Council may be represented by the other members – one member by one other member only.
6. The Supervisory Board shall have the decision-making capacity, when at least half of its members are present. If the Supervisory Board is not of decision making capacity, the chairperson (in his absence – the deputy) shall be entitled to convene the new session within eight days, which session shall have the decision-making capacity in the case of presence of at least 25% of the Board members. If the Supervisory Board is still not of



decision making capacity the powers of the Supervisory Board shall be terminated and the chairperson (in his absence – the deputy) shall convene the general meeting.

7. The tasks and terms of reference of the Supervisory Board shall be:
 - a) The Supervisory Board shall control the performance of the directors;
 - b) The Supervisory Board may request the company performance report from the directors any time.
 - c) The Supervisory Board may control and inspect the financial statements of the company, also the proprietary units, in particular the company cash-desk and the situation with the securities and goods. Also the Board shall be entitled to assign the discharge of the foregoing tasks to individual members or specific experts;
 - d) The Supervisory Board shall convene the general meeting in the case it is necessary for the company;
 - e) The Supervisory Board shall inspect the annual reports, proposals concerning the distribution of profits and shall report about the foregoing to the general meeting; in its statement the Supervisory Board shall be required to indicate, whether how and to what extent it has inspected the company management during the past economic year, whether which part of the annual reports and performance reports were reviewed and whether or not these inspections resulted in essential amendment of final results;
 - f) To appoint the directors and discharge them any time, also to make and terminate the agreements with them.
 - f¹) In companies, where the state owns 50% of total votes, the Supervisory Board shall be required to agree the appointment and discharge of the directors with the holder of more than 50% of total votes of company. In the case of failure to attain an agreement between the Supervisory Board and the shareholders the decision on the appointment and discharge of the director shall be made by the general meeting.
- 7¹. The supervisory board shall be entitled to represent the company in the execution of the agreements with the directors, also to conduct the court proceeding against them on behalf of the company under the decision of the general meeting. The supervisory board shall be entitled to file an action against the directors without a decision of the general meeting.



- 7². The duties of the directors may be delegated to the Supervisory Board, under the circumstances envisaged by the charter.
8. Unless otherwise envisaged by the charter the following actions may be carried out under the consent of the Supervisory Board:
- a) Acquisition and alienation of more than 50% of the companies;
 - b) Establishment and closure of branches;
 - c) Approval of annual budget and long-term liabilities;
 - d) Assuming and securing liabilities, which exceed the amount, set forth by the Supervisory Board; It is impermissible to secure the liabilities of the Supervisory Board and directors, except for the cases when a relevant decision was passed by the general meeting;
 - e) Defining the scope of powers of directors;
 - f) Taking up of a new economic activity or the termination of already pursued one;
 - g) Establishment of the general principles of the economic policy;
 - h) Appointment and withdrawal of commercial representatives (procurists);
 - i) Making decision on the admission of company shares and other securities to stock-exchange;
 - j) Determination of the participation of the top management in profit and similar relationships, establishment the principles of their retirement provision and submission thereof to the meeting of shareholders for approval;
 - k) Making decisions on the acquisition or alienation of company assets (or the set of such interrelated transactions), the value of which exceeds the threshold set by the Supervisory Board;
 - l) Making decisions on those issues, which do not fall within the terms of competence of the general meeting and the directors.
9. Paragraph 6 of Article 9 and Paragraph 4 of Article 56 shall apply with respect to the responsibilities of the Supervisory Board.
10. The information concerning non-granting its consent by the Supervisory Board commensurate with Paragraph 8 of this Article shall be entered into the annual report of the joint-stock company, unless otherwise envisaged by the company charter.



Article 56. Directors

1. The management and the representation of the company shall be vested on the directors.
2. The powers of the directors shall be specified by the agreements made with them in accordance with the charter. In the case of absence of such stipulation in the charter the general managerial powers, established by this Law, shall apply.
3. The company shall be represented in the court and in the other relationships by the directors. The directors can not represent the company in courts if the case has been submitted against them by the company.
4. The directors shall be required to perform the assigned task in good faith and with due diligence. In the case of failure to perform his duties, a director shall be liable to compensate damages to the company. The directors shall be liable jointly with their whole property, directly and personally. In the case of establishment of occurrence of damage, the directors shall be required to prove, that they acted commensurate with Paragraph 6 of Article 9. The company shall not be entitled to waiver the request for damages. This request may be used by the creditors, if they have not received the compensation for their claims.

Effective October 28, 1994, as amended on 14 of March 2008.

THE CIVIL CODE OF GEORGIA

Article 1008. Limitation Period on Claim for Damages

The limitation period on a claim for damages resulting from a tort is three years from the moment at which the victim became aware of the harm or [the identity of] the person liable for compensation of the harm.