

# JURISPRUDENCE

## INTRODUCTION WITH THE MAIN FEATURES OF CORPORATE GOVERNANCE OF A JOINT STOCK COMPANY ACCORDING TO THE NEW LAW OF GEORGIA ON ENTREPRENEURS

**Dolidze D.**

*Doctor of Juridical Sciences*

*Associate Professor of the Alte University*

*Associate Professor of the Caucasus International University*

*Georgia, Tbilisi*

*Invited Doctor at the Gori State Teaching University*

*Georgia, Gori*

### Abstract

Georgian models of corporate governance of a Joint Stock Company are analyzed in the paper using a comparative-legal research method. The period from 1994 to present is reviewed. Special focus is made on separate institutions integrated in corporate governance by the new Law of Georgia "On Entrepreneurs" and the goal of these institutions is to ensure efficiency of this process.

**Keywords:** corporation, corporate governance, entrepreneur, enterprise, one-tier, two-tier, board, director, manager, executive, non-executive, supervision, interest, independent, diligence

Corporate governance is a unified system of management and control of companies. [1] It is a category regulating the internal organizational system according to which a corporation is managed and supervised. [2] In general, depending on the managerial levels at which management and control powers are exercised, one-tier and two-tier systems of corporate governance are identified. In the recent period, the so-called "mixed" corporate governance system has become rather popular. It represents an intermediary option which defines the scope of discretion of the company and allows it to select the most optimal corporate governance model based on the challenges existing in the process of foundation or event during the further activities. [3] For example, the classic mixed system of corporate governance is recognized by the French Law "On Commercial Societies" (Loi n°66-537 du 24 juillet 1966 sur les sociétés commerciales), as well as the Regulation No 2157/2001 on the Statute for a European company (SE). Both normative acts define one and two-tier management systems and provide an opportunity for selecting a desirable model out of them.

In general, regulating corporate governance of a Joint Stock Company in Georgia can be divided into three stages:

First, the Law of Georgia "On Entrepreneurs" adopted in 1994 – the normative act having German roots - should be mentioned. In particular, under Articles 55 and 56, management of a Joint Stock Company fell within the competence of directors and control over them was within the exclusive competence of the Supervisory Board. By such approach, the Georgian normative act established rather strict conditions for disjunction of functions between managers within a Joint Stock Company when combining of each other's functions by management or control bodies was prohibited.

The version of the Law of Georgia "On Entrepreneurs" effective before 2008 directly defined the role of

the Supervisory Board as the control body of the company managers and established the rules of its formation. In particular, according to Article 55 of the Law, the Supervisory Board was a mandatory management body of a Joint Stock Company and the company directors or other executive officers could not become its members.

Thus, the Georgian corporate law shared the approach of the German analogue, by establishing a so-called "two-tier" system of corporate governance. According to the German "Stock Corporation Act" (paragraphs 76 and 111), two main management bodies: Management Board (Vorstand) and Supervisory Board (Aufsichtsrat) are mandatory for all Joint Stock Companies: (Aktiengesellschaften).

The second stage covers the period from 2008 to 2021. In this case, amendments made to the Law of Georgia "On Entrepreneurs" in 2008 are significant, according to which the two-tier model of corporate governance was rejected and the original system was established which was not successful, as history showed. In particular, according to the above amendments, under Article 55 of the Law of Georgia "On Entrepreneurs", only several types of organizations were identified which were instructed to have a Supervisory Board (for example, commercial banks), while in other cases, this Board became optional. An organization could make a decision to create a Supervisory Board or distribute the powers of this body to other management bodies. In this regard, these amendments allowed for combining the potential functions of the Supervisory Board by the Directorate, i.e. the Georgian Law rejected the need of the Supervisory Board, by recognizing its functions at the same time. For example, pursuant to sub-paragraph a), paragraph 7, Article 55 of the Law, the first function of the Supervisory Board was to monitor the activities of each director of the company. In connection with composition of the Supervisory Board, it should also be

mentioned that according to paragraph 2, Article 55 of the Law of Georgia "On Entrepreneurs", "Any person may be a member of the Supervisory Board. The Charter may define the member (members) of the Supervisory Board to be the director (directors) of the joint stock company".

Such approach served as the basis for creation of the problem according to which it became possible, by distributing competences within the company, to create a situation when the control body would be the person/body whose activities had to be controlled. Such an outcome would expose the quality of control, as the specific activity, to a risk and would have a negative impact on efficiency of corporate governance of the joint stock company as a whole. This is an incorrect approach of corporate governance. [4]

The third stage began in 2022 when the Parliament of Georgia adopted an absolutely new Law "On Entrepreneurs". The main purpose of this normative act is to contribute to stimulation and development of a business environment in Georgia through elimination of lack of legislative regulations and limiting the almost unlimited limits of the charter autonomy. By its content, the Law is rather contemporary and actively attempts to harmonize with the EU regulations existing in the relative field.

The new Law "On Entrepreneurs" entirely rejected the models of corporate governance of a joint stock company existing before. In particular, a mixed system of corporate governance of a joint stock company is established today and it allows an organization to select a desirable model on its own. According to Article 182(1) of the Law, bodies of a Joint Stock Company are General Meeting and management body if a monistic (one-tier) system of governance is selected and General Meeting, Supervisory Board and managerial body in case of introduction of a dualistic (two-tier) system of governance.

An important peculiarity of the Law of Georgia "On Entrepreneurs" is that the acts itself defines the concepts of monistic and dualistic systems of governance. According to the Law, dualistic governance system implies that a Joint Stock Company has a Supervisory Board in addition to General Meeting and the management body, while monistic system implies that a Supervisory Board is not created in a Joint Stock Company. It should also be mentioned, that according to Article 182(2), a decision about selection of a desirable governance model is made at the moment of founding the organization and it is necessary to incorporate it into the charter. The already selected system may also be changed later on the basis of decision of the General Meeting.

If we compare with the German analogous law, in case a Georgian Joint Stock Company selects a two-tier corporate governance system, it will be subject to almost the same regulation regime as incorporated in the German Stock Corporation Act. In particular, a Joint Stock Company will be obliged to separate competences of management and supervision bodies. In case the principle of prohibition of position overlap envisaged by Article 214(1) of the Georgian Law will apply according to which a member of the Supervisory Board

of a Joint Stock Company may not be concurrently a member of management body of a Joint Stock Company at the same time. This is certified by the principle of prohibition of the power of management body of a company with the Supervisory Board incorporated in the German Stock Corporation Act. According to paragraph 76(1) of the German Stock Corporation Act, the Management Board is to manage the joint stock company, while according to paragraph 111(1), the Supervisory Board is to supervise the Management Board. Paragraph 105(1) envisages that a member of the supervisory board may not concurrently be a member of the management body (Management Board).

As for the outcomes of selection of a monistic model, though a Supervisory Board is not created at the company at that moment, but its competence is maintained again. For this purpose, similar to the best practice of one-tier corporate governance, directors will be classified as executive and non-executive persons within the management body. In particular, management competence is the power of the executive branch entirely, while supervision of their activities will be delegated to non-executives, i.e., the role of the Supervisory Board, like in case of introduction of a monistic system of corporate governance, will be undertaken by non-executive persons. The approach of the Anglo-American corporate governance is shared here, according to which the management and supervision functions are distributed within the Board of Directors. In the USA, supervision functions are performed by independent directors of corporations and in England, this is done by their equivalent non-executive persons. [5]

One of peculiarities of the new Georgian Law is that a person managing of a Joint Stock Company is referred as a manager here, while the director was named as the managing person in the previous laws. The present Law does not specify the category of the manager and leaves it to the discretion of the company.

In addition to selection of corporate governance systems, the new Law "On Entrepreneurs" also offers a number of norms aimed at facilitating the company governance process. In this regard, first it should be mentioned that the type of contract to be made between managers, Supervisory Board members and the company has been established and it is called a Service Agreement (Dienstvertrag on German). By this approach, the Georgian lawmakers considered the pre-existing practice of the Supreme Court of Georgia into consideration. According to Article 45(1) of the Law "On Entrepreneurs", Once a decision on the appointment of a person to the position is made, a service agreement shall be concluded between the company and such person. Service agreements shall not be subject to the provisions of labour law. By this approach, the Law emphasizes the special corporate-legal status of managers and Supervisory Board members. According to the organic theory of a legal entity, these persons represent the company, i.e. their activities are equal to the activities of the organization and therefore, assigning such status to them is justified. A service agreement defines remuneration and other privileges of managers. Norms of the Civil Code apply to this Agreement. [6]

Article 203(1) of the new Law establishes the principle of managing the Joint Stock Company under its responsibility. According to the approach, when performing its functions, the management body of a joint-stock company is not obliged to follow the instructions of supervising bodies or individual shareholders of the Joint Stock Company. Despite the fact that some transactions to be carried out by managers may require prior consent of the Supervisory Board, control should be separated from interference into the activities to be controlled. By this provision, the Georgian Law agrees with paragraph 76(1) of the German Stock Corporation Act, which provides an adequate guarantee of functional autonomy of the Management Board of the Joint Stock Company.

In the process of corporate governance of the Joint Stock Company, the new Law of Georgia "On Entrepreneurs" focuses on the right of control of shareholders (including minority shareholders). For this purpose, the possibility of the so-called "actions for avoidance - Rescission Suits (Beschlussmängelklagen on German) is incorporated in the Law. In general, this institute is considered as one of the distinctive attributes common for the German Corporate Law. [7] According to paragraph 243(1) of the German Stock Corporation Act, "A resolution adopted by the general meeting may be challenged on grounds of its violating the law or the by-laws by bringing an action for avoidance".

Shareholders's action for avoidance is a legal mechanism of challenging the power of resolutions adopted by the general meeting. According to Article 93 of the Law of Georgia "On Entrepreneurs", resolutions of the general meeting may be appealed by some shareholders, i.e. validity of such resolutions may be challenged if they violate the requirements of the legislation or the statute. [8] (resolutions adopted in violation of the respective procedural rules of convening and holding the general meeting (voting) may also be implied here). As a rule, shareholders exercise their powers through the general meeting. Therefore, it is inadmissible to exert any illegitimate pressure on the proceedings of the general meeting by the shareholder whereby the rights of other colleagues will be violated. The final resolution of the general meeting may be not shared by all shareholders, but it must be complete from procedural point of view.

Thus, ultimately, a shareholder's action for avoidance is the mechanism for exercising the right of control (appeal), through which monitoring of the resolution of the general meeting is carried out, in terms of securing its lawfulness.

Provisions of the new Law regarding diligence of managers are also noteworthy. Article 50 of the Law "On Entrepreneurs" provides a definition of a manager's duty of care. In particular, a manager shall conduct the company's business legitimately and with the diligence of a manager in good faith, in particular, each action of a manager shall be based on sound mind (by avoiding conflict of interest), in the belief that his/her actions are in the best economic interests of the company. Thus, there is an obligation to consider interests of the company by the manager and act in accordance with these interests. [9] The concept of interests of a

German company is also seen here. When interpreting paragraph 76 of the German Stock Corporation Act, in response to the question about whom the managers trust, the German Federal Court of Justice mentioned that the corporate compass is the interest of the enterprise. [10]. The German Management Board is responsible for independent management of A Joint Stock Company based on the company interests, and during this process it considers interests of shareholders, its employees and other interested parties (stakeholders), for the purpose of sustainability, in terms of value creation. Thus, this regulation in the Georgian Law can also be understood from this point of view. The probability of bringing economic benefit occurs only on the basis of acting in accordance with the company interests.

Finally, it should be mentioned that incorporation of the concept of freedom of entrepreneurial decision (Business Judgement Rule) in the Georgian Law represents a qualitatively new regulation on the way of independent action of manager in accordance with the company interests. To a certain extent, Article 52 of the Law establishes taking a justified risk by a manager. In particular, if the manager could have reasonably believed that he made the business decision on the basis of sufficient and reliable information, in the interests of the company, independently, and without conflict of interest or another person's influence and such action still appears to be detrimental to the company, responsibility of the performer of action is excluded. Thus, directors have certain freedom for making corporate decisions according to their judgment. [11]

Despite the fact that the new Georgian Law offers rather innovative approaches in the process of corporate governance of the Joint Stock Company and in respect to management bodies (members) engaged in this process, there still remain some significant issues which need to be clarified.

In particular, it is necessary that the Georgian Law establishes eligibility criteria of managers and Supervisory Board members. Against the background, according to which functional autonomy of managers is ensured, it is necessary to define standards meeting of which will allow them to perform their own tasks properly. When talking about the duty of care of managers and they are required to tailor their own activities to the company activities, it is mandatory to establish the minimum competence level and the person acting within this minimum competence level will be expected to observe the categories of diligence and loyalty. It is inadmissible to exempt a manager from responsibility on the grounds that it did not have relevant knowledge or competence for performing a specific action, which ultimately appeared to be only damaging.

It is also noteworthy that the Georgian Law does not mention any criteria defining the status of non-executive persons. Under conditions when the Law provides an opportunity of selecting a desirable system on the basis of a mixed corporate governance model, it is necessary to clearly outline the specific requirements according to which a respective status may be assigned

to a manager. In this regard, the definition of non-executive managers (directors) and the main requirements to be met by a person (preconditions defining his/her status are implied) to be considered as a non-executive manager are noteworthy.

As a general conclusion it can be said that in respect to the concepts defined in the part of a Joint Stock Company governance, the new Law "On Entrepreneurs" seems to attempt to return to the German origins. At the same time, the Georgian model of corporate governance of a Joint Stock Company is innovative. It also tries to be flexible and be tailored to the corporation requirements. The opportunity of granting freedom to the organization in this regard is encouraged. However, it should also be mentioned that regardless of the model chosen by the corporation, it is desirable that the rules established in respect to each system are complete and unambiguous. It is inadmissible to give advantage to this or that model by the organization bypassing the legislative requirements and on the basis of the desire to achieve an easy regime. Establishment of limits of high statute autonomy and granting an unlimited discretion to the company in the process of internal organizational formation are not justified.

To conclude, the new Georgian Law has been effective for just 5 months and this period is rather short to make some specific conclusions. At this stage we can only assume that the Law will be able to ensure the initially implemented purpose in the long run, and the Georgian lawmakers will be ready to make the process of corporate governance of Joint Stock Companies more effective by making further additions and amendments to the Law.

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