

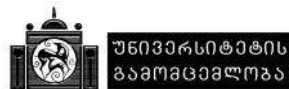


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**Faculty of Law**

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**Vakhtang Bachiashvili\***

## **Contract Interpretations According to the Principles of European Contract Law and Expediency of Implementation of These Principles in Georgian Legislation**

### **I. Introduction**

The principle of freedom of the contract is the opportunity given to the parties to the legal relationship by the legal system to determine the contents, as well as the means for implementation of proprietary benefits and duties to be executed and generated as a result of private type relationships between the parties. Legal system acknowledges the principle of private autonomy<sup>1</sup> of parties and based on the respect to parties rejects to implement the function of regulator as well as arbiter and considers the initiation, implementation and completion of contract relationships as the subject for free negotiations between the parties.

The essence of private autonomy is revealed in the capabilities of specific individuals to determine the contents of his/her private life relationship based on his/her desire.<sup>2</sup> To achieve above mentioned goal the efforts of the individual alone are not sufficient. To achieve desired objective he/she often requires co-participation of other individuals. In these terms deal or expression of will is the mean for realization of freedom of action or personal autonomy.<sup>3</sup>

The possibility for the individual to determine the contents of the contract can become the subject of regulation if there are differing positions of parties to the specific legal relationship related to the duties undertaken or rights granted to the parties. In this case there is a need to interpret the expressed will. The legal system for these cases creates normative base, considering the definition of regulatory rules for the contract interpretation. Civil Code of Georgia (CCG)<sup>4</sup> contains special norms covering the issues of interpretation of contract and expression of will. The above is the research topic of the present article.

The globalization process is accompanied with the attempts to internationalize the national legislations, expressed in the development of unified rules. These rules can be considered as the agreed position of states participating in the development process; these are the recommendations which are expedient not only for the implementation in the national legislations of the countries participating in

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<sup>1</sup> For the Private autonomy principle, see *Kereselidze D.*, *The Most General Principles of Private Law*, Tbilisi, 2009, 8 (in Georgian).

<sup>2</sup> *Erman W.*, *BGB, Handkommentar*, 12. Auflage, Band I, Köln, 2008, 344.

<sup>3</sup> *Kereselidze D.*, *AT des ZGB*, 2005, 167 (see: *Kereselidze D.*, *The Most General Principles of Private Law*, Tbilisi, 2009, 10 (in Georgian)).

<sup>4</sup> Civil Code of Georgia, "Parliament Collections, Legislative Additions", No 31, 1997, 1.

the process, but also for those countries which expressed the desire to enter the unified legal system and establish themselves there.

Following the declared policy of Georgia on European Integration and membership in the European structures, it is prudent to assess and analyse such an important unified rule developed in the EU framework, as Principles of European Contract Law<sup>5</sup> (Hereinafter referred to as Principles). Due to the volume of the article the topics of the present article are: norms regulating the interpretation of contract, which can be considered as important recommendation to the Georgian legislation if there is a need of reform to the CCG. It is also expedient to analyse the norms regulating the contract interpretation under the CCG and the issue of possibility to regulate the principles in a systematic manner.

## **II. Regulation of Contract Interpretation Based on the Principles**

In the process of regulation of contract interpretation, principles consider specific theories valid in the private law. The natural,<sup>6</sup> as well as normative<sup>7</sup> interpretation methods are used. Based on the private autonomy and freedom of contract the Principles acknowledge the preference of the Natural method of contract interpretation, however with the condition that the definition and therefore the interpretation of mutual intention of parties is considered as the best way for the contract interpretation.<sup>8</sup> Based on the above, the need for contract interpretation is created when the contract contains biased, unclear or ambiguous provisions,<sup>9</sup> as well as when the extremely clear and obvious text does not reflect the common will of the parties to the contract.

Normative method of contract interpretation takes so called "secondary" place in the process of determination of contents of the argued provision. Objective meaning to the provision under interpretation can be given only in case if the common intention of the parties or special interest of one of the parties could not be determined.<sup>10</sup>

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<sup>5</sup> Principles of European Contract Law, is the model law, so called "soft law", which was developed by the Commission on the European Contract Law. The commission was chaired by Dutch law professor – Ole Lando, therefore the alternatively the principles are referred to as "Lando Principles".

<sup>6</sup> In case of natural interpretation the real will of the demonstration of the will is given the priority. In case of demonstration of will which is obligatory for acceptance the interests of the will accepted should be also considered. However, the cases when the will accepter clearly knew the desire of the will demonstrator, despite the fact that the will was against his/her internal desire are not subject for protection. To see in detail refer to: *Brox H., Walker W.D.*, Allgemeiner Teil des BGB, 32. Auflage, 2008, 59.

<sup>7</sup> In case of normative interpretation priority is given to the objective meaning of the expressed will; For detail see: *Brox H., Walker W.D.*, Allgemeiner Teil des BGB, 32. Auflage, 2008, 61-62.

<sup>8</sup> PECL, Art. 5:101 (1), available at:

<[http://frontpage.cbs.dk/law/commission\\_on\\_european\\_contract\\_law/PECL%20engelsk/engelsk\\_partI\\_og\\_II.htm](http://frontpage.cbs.dk/law/commission_on_european_contract_law/PECL%20engelsk/engelsk_partI_og_II.htm), 16.12.2012.

<sup>9</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 287.

<sup>10</sup> In relation to the above refer to: *Antoniolli L., Veneziano A.*, Principles of European Contract Law and Italian Law, A Commentary, Hague, "Kluwer Law International", 2005, 253.

Article 5:102 of the Principles lists down the specific circumstances which can be used for the contract interpretation. The above circumstances are not comprehensive; therefore the court may take into consideration the circumstances not provided in the list.<sup>11</sup> The circumstances listed in the Article 5:102 can play important role in the determination of common intention of the parties to the contract (Article 5:101 (1)), as well as in case of utilization of objective interpretation method (Article 5:101 (3)).<sup>12</sup>

Articles 5:103 – 5:107 of the Principles cover the alternative versions of contract interpretation. The Principles define in the straightforward manner the superiority of the one version among the various versions of contract interpretation. However it must be considered that such superiority shall not result in ignorance of common intention of parties and interpretation contradictory to such common intention.

## 1. Reflection of Theories on Contract Interpretation in the Principles

The "Theory of Will" and "Theory of Expression", important for the German law,<sup>13</sup> due to the importance of common intention of parties, look limited. Competition between the "Theory of Will" and "Theory of Expression" is important only for the unilateral error doctrine and does not damage the essence of contract interpretation.<sup>14</sup>

The contract interpretation theories are the main axis around which all the principles are spinning. It provides ranging for the principles and tries to find balance between the "Subjective" and "Objective" theories.<sup>15</sup> Article 5:101 (1) determines the need for interpretation of the contract based on the common intention of parties even if it differs from the exact meaning of the wording. The above can be explained with the fact that the contracts are developed by the parties and the judge must respect their obvious or implied intention, even if their desire was expressed ambiguously or vaguely.<sup>16</sup> Otherwise the parties can become the victims of the formalism. As a result of such formalism the parties can be limited with the specific provision of the contract even if such provision was developed erroneously or due to such provision they faced the situation which was not considered by any of the parties.<sup>17</sup>

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<sup>11</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 247.

<sup>12</sup> *von Bar C., Zimmermann R.*, Grundregeln des Europaeischen Vertragsrechts, Teile I und II (Studienaufgabe), Muenchen, 2002, 347.

<sup>13</sup> According to the "Theory of will" the contents of the contract is limited with the imagination and intention of the party to the contract; as for the "Theory of Expression" – the contents of the contract are determined based on the expressed will of the party to the contract. For details see: *Pawlowski H.M.*, Allgemeiner Teil des BGB, Grundlehren des buergerlichen Rechts, 7. neu bearbeitete Auflage, Heidelberg, 2003, 203.

<sup>14</sup> *Canaris C.W., Grigoleit H.C.*, Interpretation of Contracts, Towards a European Civil Code, 3<sup>rd</sup> Edition, "Kluwer/ Nijmegen: Ars Aequi Libri", 2004, 451.

<sup>15</sup> Beatson, p. 31; Treitel, pp. 8-9; Ghestin, No. 390; Ghestin et al., 2001, nos. 9 et seq., Mazeaud, H. et al. No. 123; Cian/Trabucchi, Art. 1362, sub X. Moreover Art. 4.1, 4.2 Unidroit Principles (see: *Canaris C.W., Grigoleit H.C.*, Interpretation of Contracts, Towards a European Civil Code, 3<sup>rd</sup> Edition, "Kluwer/ Nijmegen: Ars Aequi Libri", 2004, 452).

<sup>16</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 288.

<sup>17</sup> *Canaris C.W., Grigoleit H.C.*, Interpretation of Contracts, Towards a European Civil Code, 3<sup>rd</sup> Edition, "Kluwer/ Nijmegen: Ars Aequi Libri", 2004, 450.

Ranging of "Subjective" and "Objective" theories is in favour of "Subjective" theories. The court shall first try to determine the common intention of parties, and if it is not possible to determine such intention, then it is possible to use the objective method of interpretation.<sup>18</sup>

## **1.1. "Subjective" Theory**

According to the "Subjective" theory the purpose of contract interpretation is to determine the intention of each party to the contract in the moment of entering the contract.<sup>19</sup> Article 5:101(1) of the Principles considers as prevailing rule interpretation of contract based on the common intention of the parties. According to article 5:101(2) it is possible to interpret the contract with the consideration of special interest of one of the parties only in the event if it was not possible for the other party not to be aware of the special interest of the mentioned party at the moment of contract signing.

### **1.1.1. Determination of Common Intention of Parties to the Contract**

According to the Principles, common intention of parties to the contract is the main orienteer required for the interpretation of contract. In the event of existence of common intentions, the exact meaning of the contract moves to the background. In case of conflict between the exact meaning of the written contract and common intention of parties, the preference is given to the latter.<sup>20</sup> The judge should start the contract interpretation with the examination of common intentions of the parties which were in place at the moment of contract signing.<sup>21</sup> Based on the above, following the contract signing change of intention of one of the parties cannot influence the binding power of the common intention existing at the moment of contract signing and it is determinant in the process of interpretation of provision under question/debate.

Existence of common intention of parties gains the special attention in so called consumer contracts, where the standard provision of the contract takes the major part of the contract. It has to be mentioned that common intention of parties can also exist for the standard provisions, in particular when the party not participating in the drafting of the contract, held sufficient knowledge and agreed with the provision.<sup>22</sup> Sufficient knowledge may consider special knowledge not possessed by the gene-

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<sup>18</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/Nijmegen: Ars Aequi Libri", 2002, 244.

<sup>19</sup> *Canaris C.W., Grigoleit H.C.*, Interpretation of Contracts, Towards a European Civil Code, 3<sup>rd</sup> Edition, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 452.

<sup>20</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 244.

<sup>21</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 288.

<sup>22</sup> *von Bar C., Zimmermann R.*, Grundregeln des Europaeischen Vertragsrechts, Teile I und II (Studienaufgabe), Muenchen, 2002, 342.



ral circle of consumers, but possessed by the person well aware of specific relationships. It might be the entrepreneur involved in the provision or purchase of subject of the contract or the party with extensive experience in the area. Therefore for the standard provisions of the contract the judge must consider the status of other party in the process of identification of common intention. One cannot request the general consumer to have knowledge about all details of standard provision.

Individually written negotiations between the parties somehow contradict with the contract interpretation based on the common intention of parties. According to such written negotiations the parties agree that the written contract contains the agreement on all issues and all pre-contract negotiations or agreements, not included in the written contract cannot become its part.<sup>23</sup> According to the some views<sup>24</sup> the process of determination of common intention is compatible with the rule which prohibits finding such a way out which supplements or contradicts written contract; as this rule covers only the external elements making the meaning of the provision clear and does not contradict it.

In the process of determining the common intention of parties, the judge shall pay special attention to the circumstances listed in the article 5:102 of the Principles.<sup>25</sup> The list of such circumstances is not comprehensive.<sup>26</sup> Therefore, the list is not obligatory and does not prohibit consideration of other circumstances.<sup>27</sup> Article 5:102 covers only the most commonly encountered and important cases relevant to the contract interpretation.

### 1.1.2. Contract Interpretation in Favour of the Special Interest of One Party

Article 5:101 (2) of the Principles considers the contract interpretation in accordance with the intention of one of the parties, if it is proved that such intention had an objective to give the contract specific meaning and at the moment of contract signing it was not possible that the other party had not been aware about the intention of the first party.

Above mentioned regulation does not infringe upon the right of other party to the contract to trust the will expressed by the counter agent and to assign to it the meaning, which is generally accepted. The above considers the circumstances when the conflict between the external expression of will by the party and internal intention is obviously recognizable. It is considered that the above rule can

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<sup>23</sup> Compare PECL, Art. 2:105: Merger Clause.

<sup>24</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 244.

<sup>25</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 288.

<sup>26</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 247.

<sup>27</sup> *Antoniolli L., Veneziano A.*, Principles of European Contract Law and Italian Law, A Commentary, Hague, "Kluwer Law International", 2005, 257.

only have limited spectrum of utilization, as it is not easy for the party to prove that the other party could understand the unusual, specific meaning of words.<sup>28</sup>

According to the view of some commentators, it is possible to use the article in the event when it was not possible for the other party not to be aware of the specific intention of the first party, as well as in other cases.<sup>29</sup> In case if the party left the fact without attention, the party is bound with the specific intention assigned by the first party.

According to one position,<sup>30</sup> based on the rule, the specific intention of the party can also substitute the exact meaning of the contract as it is defined under the article 5:101 (1).

## 1.2. "Objective" Theory

According to article 5:101 (3) of the Principles – if it is not possible to determine the intention of parties, the contract shall be interpreted according to the meaning which could be assigned to the contract by the person with the equal capabilities to the parties, under the similar circumstances. Declaration of intention, as the emanation of autonomy of individual does not exist under the social vacuum. It determines the reasonable expectations from others, and the above cannot be left without attention.<sup>31</sup>

The main problem with the above interpretation is related to the expression of reasonable and fair essence of the contract.<sup>32</sup> Article 5:101 (2) of the Principles gives preference to the party assigning the specific meaning to the will expressed by him/her, as for the article 5:101(3) – it considers the intention not properly stated by the party expressing his/her will, due to which the other party is only required to consider the expressed will in a reasonable way and in these terms, the interpretation of contract under the objective criteria is in line with the interests of other party. In line with the objective criteria, the interpretation should not violate the interest of the parties, for which they entered the contractual relationship. The court, justifying it with the interpretation should not change the contract and should not direct it against the obvious intention of the parties.<sup>33</sup> To avoid the above the Principles do not consider objective interpretation off the context, it considers the interpretation which could be used by the reasonable persons with the similar experience and pertaining to the same class of society as the

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<sup>28</sup> *Antoniolli L., Veneziano A.*, Principles of European Contract Law and Italian Law, A Commentary, Hague, "Kluwer Law International", 2005, 253.

<sup>29</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 289.

<sup>30</sup> *Ib.*, 289.

<sup>31</sup> *Zimmermann R.*, The Law of Obligations, Roman Foundations of the Civilian Tradition, Cape Town/Wetton/Johannesburg, "Juta & Co, Ltd.", 1992, 636.

<sup>32</sup> *Canaris C.W., Grigoleit H.C.*, Interpretation of Contracts, Towards a European Civil Code, 3<sup>rd</sup> Edition, "Kluwer/Nijmegen: Ars Aequi Libri", 2004, 449.

<sup>33</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 242.

parties.<sup>34</sup> Taking into account the above, expression of the same will by the different persons can have different legal meaning.<sup>35</sup>

## 2. Circumstances to Be Considered in the Contract Interpretation

Article 5:102 of the Principles lists the circumstances important for the interpretation. As mentioned above, these circumstances are not comprehensive and any other circumstances may become decisive for the interpretation purposes. The main characteristic of the list is gradual gradation from the factors which are specific to the parties to the contract (their negotiations, behaviours, interpretations agreed between parties on the similar provisions, established practices on implementation of obligations), to the factors that might be important for the sight of external observer (generally accepted meaning, habits, principles of honesty).<sup>36</sup> Despite the above, each of the circumstances can be equally important for the determination of common intention of the parties as well as for the prudent interpretation.<sup>37</sup>

### 2.1. Pre-contract Negotiations

According to the article 5:102 (a) of the Principles, the contract interpretation takes into account the circumstances under which the contract was concluded including the pre-contract negotiations.

In the event if one party assigned the specific meaning to the provision included in the letter sent to other party and the other party did not consider such meaning as arguable, when such opportunity was given to the party,<sup>38</sup> the contract is interpreted with the consideration of definition given in the letter, even if it was not reflected in the contract between the parties.

The interpretation of contract based on the pre-contract negotiations should consider the provision under the article 2:105 of the Principles on the universal validity of provisions agreed in written, according to which any agreement or statement, which is not fixed in writing in the contract, does not become its integral part. Such agreement can be useful for the cases when during the negotiations the statements or promises declared by the parties were based on the assumptions which were later rejected by the parties.<sup>39</sup>

If such agreement is not fixed in the contract, according to the article 2:105 (2) of the Principles, it is only possible to assume that the intention of parties was not to include their preliminary negotiations or agreements as the integral parts of the contract. In general, article 2:105 (3) of the Principles

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<sup>34</sup> *Antoniolli L., Veneziano A.*, Principles of European Contract Law and Italian Law, A Commentary, Hague, "Kluwer Law International", 2005, 253.

<sup>35</sup> *AltKomm-BGB/Hart, &&133/153 Rz 38* (see: *Pawlowski H.M.*, Allgemeiner Teil des BGB, Grundlehren des bürgerlichen Rechts, 7. neu bearbeitete Auflage, Heidelberg, 2003, 209).

<sup>36</sup> *Antoniolli L., Veneziano A.*, Principles of European Contract Law and Italian Law, A Commentary, Hague, "Kluwer Law International", 2005, 257.

<sup>37</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 291.

<sup>38</sup> *Ib.*

<sup>39</sup> *Ib.*, 152.

considers it possible to use the preliminary negotiations of the parties in the process of contract interpretation and considers it unacceptable to exclude or limit such general rule, except for the individual agreements. Interpretation of contract based on the pre-contract negotiations can become especially useful for the types of contracts, for which long and complicated negotiations are required.<sup>40</sup>

## **2.2. Actions of Parties Following the Conclusion of the Contract**

Based on article 5:102 (b) of the Principles, the actions of the parties following the conclusion of agreement are considered in the process of contract interpretation. The above norm may play important role for long-term liability legal relationships. The things considered as agreed at the specific stage of relationship between the parties, cannot be subject for the different interpretation at the future stages of relationship, if such interest has not been declared at the beginning.

The illustrative example for the above mentioned case relates to the contractual relationship between the German producer of office appliances and its representative in North France;<sup>41</sup> it can be also considered as competition between the interpretation of contract based on the actions of parties following the contract conclusion and interpretation based on the practices established between the parties.

## **2.3. Essence and Purpose of the Contract**

According to article 5:102 (c) of the Principles, the contract interpretation shall consider the essence and purpose of the contract. It is possible to determine the essence as well as the purpose of the contract via the systematic analysis of integral document, which plays important role in the interpretation of the contract based on the principles of integrity of the contract.<sup>42</sup>

## **2.4. Practice Established Between the Parties**

According to the article 5:102 (d) of the Principles the contract interpretation should consider interpretations, which were already used by the parties for the assessment of similar provisions and

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<sup>40</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 292.

<sup>41</sup> According to this contract, the pre-condition for termination of the contract without notification was significant un-observance of the undertaken liabilities by the borrower. One of such liabilities was monthly visits to 20 universities in the North France. Representative of entrepreneur deemed that monthly visits considered only visits during the study process and not during the holidays. Taking into account the above he/she visited the Universities 11 times a year and was providing information to the entrepreneur. After 4 years, the Entrepreneur terminated the contract with the motive of considerable un-observance of contract liabilities. As during 4 years credit has not expressed any objections, it was considered that the "monthly visits" could be reasonably interpreted with the consideration of only those months when the study process was active in the universities. See. *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 292.

<sup>42</sup> Compare. PECL, Art: 5:105.

practice already established between the parties. As mentioned above, there are conditional boundaries between the interpretation based on the above criteria and interpretation based on the actions of parties following the contract conclusion. The things considered as practices established between the parties can be also considered as the interpretation based on the actions following the contract conclusion.

## **2.5. Generally Accepted Meaning**

According to article 5:102 ( e) of the Principles, the contract interpretation shall consider the generally accepted meanings and interpretations already in place for the similar provisions, for the notions and expressions in the specific areas. Interpretation according to this criterion can be useful for the provisions which have technical meaning in the specific sectors, and it is different from its usual meaning.<sup>43</sup> Existing interpretation of similar provisions first of all cover the standard provisions of the contract.<sup>44</sup>

## **2.6. Habits**

According to article 5:102 ( e) of the Principles, the contract interpretation should consider habits. Habit can be interpreted as the process of business relationship or collection of non-single behaviours, which are generally accepted for the specific period of time by those, who are involved in the business relationships.<sup>45</sup> This part of the Principles shall be interpreted in connection with the article 1:105, according to which the parties are bound by the habits agreed between each other. This agreement can also be expressed obviously by means of concluding actions.<sup>46</sup> According to article 1:105 (2) of the Principles, the parties are bound by such habits, which can be generally considered as acceptable for the persons similar to the parties to the contract who are under the similar circumstances, except for the cases when implementation of such habit is not reasonable. In such case the habits are binding even if there is no agreement between the parties.<sup>47</sup>

In the event of contract interpretation based on habits, we are dealing with habits which are prevailing at the place of the contract conclusion, even if it is difficult to determine such place.<sup>48</sup>

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<sup>43</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 247.

<sup>44</sup> *Ib.*

<sup>45</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 104.

<sup>46</sup> *Ib.*

<sup>47</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 104.

<sup>48</sup> *von Bar C., Zimmermann R.*, Grundregeln des Europaischen Vertragsrechts, Teile I und II (Studienaufgabe), Muenchen, 2002, 348.

## **2.7 Principle of Fairness<sup>49</sup>**

According to article 5:102 (g) of the Principles, contract interpretation shall consider the principle of fairness. The above principle is used for contract interpretation as well as for the examination of implementation of obligations, contract conclusion and its authenticity.<sup>50</sup>

The English equivalent of the principle of fairness is divided into two parts: first part "good faith" is considered as the subjective concept of the principle (honesty and cleanness of the mind), the second part, "fair dealing" focuses on the ethical criterion of the principle and states that considering the inexperience of beginner, involved in the business relationships the interpretation favourable for the latter should be chosen.<sup>51</sup>

## **3. Choice between the Alternative Interpretations of the Contract**

Articles 5:103 – 5:107 of the Principles regulate the issues on the acknowledgment of the prevalence of one option for the contract interpretation in case if there are more than one such interpretations. In each case the Principles attempt to give priority to such alternative interpretation which based on the reasonable assumption the best fits common intention of parties or special and respectable interest of one of the parties.

### **3.1. Interpretation of the Provisions which were not Agreed Individually**

According to article 5:103 of the Principles, when the meaning of provision which was not agreed individually is vague, the prevalence can be given to the interpretation which is against the interests of the party who included such provision into the contract.<sup>52</sup>

The original of this provision is encountered in the Roman tradition, especially in the antique Principle "ambiguities contra stipulatorem".<sup>53</sup> Nowadays it is acknowledged in the legislation as well as in many national and international preventive laws.<sup>54</sup>

The essence of the above provision is protection of position of the party, which is considered as the "weaker" participant of the contract. The purpose of the provision is not determination of common

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<sup>49</sup> Good faith and fair dealing.

<sup>50</sup> *Ioseliani A.*, Principle of Fairness in the Contract Law (Comparative Law Study), "Georgian Law Review", Special Edition, 2007, 16 (in Georgian).

<sup>51</sup> *Antoniolli L., Veneziano A.*, Principles of European Contract Law and Italian Law, A Commentary, Hague, "Kluwer Law International", 2005, 258.

<sup>52</sup> So called - Contra proferentem rule.

<sup>53</sup> *Antoniolli L., Veneziano A.*, Principles of European Contract Law and Italian Law, A Commentary, Hague, "Kluwer Law International", 2005, 260.

<sup>54</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 294.

intention.<sup>55</sup> It is based on the idea that party drafting the arguable provision or the whole contract bears the risk of all its deficiencies.<sup>56</sup> It provides recommendation to those modern judges and scientists, who are desperately looking for the mechanisms to combat against the unfair standard provisions.<sup>57</sup> The purpose of interpretation of the provision which was not agreed individually is to protect the legal status-quo, which would exist if the issue of ambiguity of the provision was not raised.<sup>58</sup>

Above article of the Principles regulates all provisions which were not agreed individually, especially the standard provision of the contract.<sup>59</sup> Interpretation of standard provisions in the consumer contracts draws attention to the fact that this is an offer to one party of the agreement as well as to the indefinite circle of consumers. Therefore, in the process of interpretation of contract containing the standard provision we shall be guided with the principles relevant to the objective interpretation.<sup>60</sup> The above considers the meaning of the provisions for the social groups participating in the contract.<sup>61</sup>

It must be considered that the rule for interpretation against the person drafting the provision has recommendation nature. It plays the function of guidelines.<sup>62</sup> Considering the above the judge can interpret the provision which is not agreed individually in favour of the party who included the provision into the contract, taking into account specific circumstances.<sup>63</sup>

### 3.2. Acknowledgement of Prevalence of Provision which Is Agreed Individually

According to article 5:104 of the Principles the provision which is agreed individually is given priority to the provision which is not agreed individually.

The above article can be considered as the rule regulating contract collision. Therefore, as a precondition there should be one contract containing the contradicting provisions on the same issue and one of such provisions was individually agreed, and the other one – was not. To use the above article it

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<sup>55</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 250.

<sup>56</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 294.

<sup>57</sup> *Zimmermann R.*, The Law of Obligations, Roman Foundations of the Civilian Tradition, Cape Town/Wetton/Johannesburg, "Juta & Co, Ltd.", 1992, 641.

<sup>58</sup> *Canaris C.W., Grigoleit H.C.*, Interpretation of Contracts, Towards a European Civil Code, 3<sup>rd</sup> Edition, "Kluwer/ Nijmegen: Ars Aequi Libri", 2004, 461.

<sup>59</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 250.

<sup>60</sup> *Pawlowski H.M.*, Allgemeiner Teil des BGB, Grundlehren des bürgerlichen Rechts, 7. neu bearbeitete Auflage, Heidelberg, 2003, 223.

<sup>61</sup> *Ib.*

<sup>62</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 250.

<sup>63</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 294.

is not necessary to have ambiguous or vague provision. On the contrary the provisions are so clear, that their irrelevance to each other can be easily determined. Acknowledgement of priority of individually agreed provision is considered as reasonable based on the fact that it reflects the common intention of parties and is not provision developed unilaterally.<sup>64</sup> Even in this case, the principles are not inclined in favour of "subjective" theories.

The above rule covers not only the irrelevances in the contracts drafted initially but also any modifications taking place following the conclusion of the contract. Moreover, it does not matter whether the irrelevance is identified between the printed or written contracts or agreement between the parties was achieved orally.<sup>65</sup> The provision agreed individually shall be given priority in all cases.

### **3.3. Interpretation Based on the Integrity Principle of the Contract**

According to article 5:105 of the Principles, in the process of contract interpretation the provisions shall be interpreted considering the contract integrity principle. This article gives priority to the systematic interpretation. Any provision shall be interpreted based on its context, as deviation of language norms from the mathematic accuracy gives the observer opportunity to understand the meaning of the notion in isolation.<sup>66</sup> Moreover the common intention of parties can be only found in the form of the sequential and systematic notions. The same provision cannot be understood with the different meaning in the different sections of the contract.<sup>67</sup>

This article will play important role in the interpretation of so called "framework" contracts and contracts developed based on the above contract. The notion of "whole contract" must consider "the whole group of contracts",<sup>68</sup> concluded based on the framework contract. If the special contract based on the framework-contract considers the specific regulation, the common intention between the parties can be considered at a higher level in such special contract. Therefore consideration of article 5:104 of the Principles is more reasonable.

### **3.4. Acknowledging the Priority of Interpretation Granting the Binding Power to the Contract**

According to article 5:106 of the Principles such interpretation shall be given priority, which ensures the granting of binding power to the contract provisions instead of the ones which annul such binding power. The above rule is based on the generally accepted assumption that parties desire to ac-

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<sup>64</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 295.

<sup>65</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Principles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 253.

<sup>66</sup> *Antoniolli L., Veneziano A.*, Principles of European Contract Law and Italian Law, A Commentary, Hague, "Kluwer Law International", 2005, 265.

<sup>67</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 294.

<sup>68</sup> *Ib.*, 296.



hieve contract objectives via the reasonable and fair means.<sup>69</sup> It is reasonable to assume that achievement of such objectives is possible in case of validity of agreement and not in case of its termination.

The above article of the Principles is based on the presumption of acknowledgement of persons as reasonable persons, who were considering that the contract concluded would have full power.<sup>70</sup> Hence if on one hand the vague provision is interpreted in the way resulting in cancellation of such provision and on the other hand the same provision can be interpreted in the way ensuring its validity and clarifying the ambiguous provision, the latter should be given the priority.<sup>71</sup>

The above regulation has nature of guidelines.<sup>72</sup> Therefore it has non-obligatory, recommendati-on meaning.

### 3.5. Solution of Problem Related to the Irrelevance of the Translation and Original

According to article 5:107 of the Principles, in the event when contract is drafted in two or more languages, without any of them prevailing, and in the vent of irrelevance between the versions, the pri-ority is given to the interpretation based on the version drafted initially.

It concerns not the vague provisions but extremely clear provisions which are provided with the contradictory contents in the contracts drafted in different languages. Giving priority to the initially drafted version is justified with the following – as the contract was written in the given language it ex-presses the common intention of the parties in the best way.<sup>73</sup> In certain cases this position is evaluated as speculation, especially considering the fact that the parties generally draft the agreement in different languages with the purpose to make contract contents better understandable for each of the parties.<sup>74</sup>

Some authors<sup>75</sup> in the discussion of the above article focus on somewhat contradictory nature in relation to the contra proferetem rule determined under the article 5:103 of the Principles, especially when the original contract as well as provisions not agreed individually are drafted by the same party. It has to be mentioned that such competition is rarely encountered, as contra proferentem rule defines the rule for the interpretation of ambiguous provision against the offering party, which is more special case compared with the irrelevance of different language versions of the contract.

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<sup>69</sup> Cf. e.g. Ghestin et al. No. 33 (see: *Canaris C.W., Grigoleit H.C.*, Interpretation of Contracts, Towards a European Civil Code, 3<sup>rd</sup> Edition, "Kluwer/ Nijmegen: Ars Aequi Libri", 2004, 462).

<sup>70</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 297.

<sup>71</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Princpiles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 255.

<sup>72</sup> *Ib.*, 255.

<sup>73</sup> *Lando O., Beale H.G.*, Principles of European Contract Law, Parts I and II, London/Boston, "Kluwer Law International", 2000, 298.

<sup>74</sup> *Canaris C.W., Grigoleit H.C.*, Interpretation of Contracts, Towards a European Civil Code, 3<sup>rd</sup> Edition, 2004, "Kluwer/ Nijmegen: Ars Aequi Libri", 463.

<sup>75</sup> *Bush D., Hondius E.H., van Kooten H.J., Schelhaas H.N., Schrama W.M.*, The Princpiles of European Contract Law and Dutch Law, A Commentary, Hague/London/New York, "Kluwer/ Nijmegen: Ars Aequi Libri", 2002, 256.

### III. Regulation of Contract Interpretation Based on GCC

GCC regulates the provisions important for the contract interpretation in the general section and in the general section of liability law. General section of GCC covers the interpretation of expression of will; as for the general section of liability law – it covers the interpretation of the contracts based on the various criteria.

#### 1. Reasonable Judgement

According to the article 52 of GCC, in the process of will interpretation the will shall be determined as a result of reasonable judgement, and not only based on the literal meaning of the statement. Mentioned formulation is essentially based on the BGB<sup>76</sup> formulation.<sup>77</sup> As a result of literal analysis of the norm, it is important to determine the will of the one demonstrating the will and the judgement over the determination shall follow the reasonable criteria. Therefore it fits the expression of will which is not obligatory for acceptance, which does not touch the issue of trustworthiness of the addressee.<sup>78</sup> The best example of the above is the will (testament), which is interpreted according to the true will of the person granting the will.<sup>79</sup> Determination of the will serves as protection of the interests of person expressing the will, however the purpose of the interpretation can be protection of the interests of the one expressing the will as well as the one accepting the will and determination of objective essence of the will expression.<sup>80</sup> Article 52 of GCC cannot play important role in the interpretation of expression of will which is obligatorily acceptable. In this case the article needs specification.<sup>81</sup>

In the process of commenting to the above article some authors<sup>82</sup> draw attention to such understanding of specific statements in the contract as it is generally accepted and not to the way it is understood by specific parties, specific persons. This position stresses the objective criteria of interpretation, which may play important role in the interpretation of imperative norms of GCC. As for the cases where we deal with the conditions agreed in accordance with the dispositional norms, the meaning assigned by the party to the arguable provision should be given the priority, serving the reasonable judgement purposes.

In the process of regulation of interpretation of will which is obligatory for acceptance and interpretation of mutually obligatory contracts, it is important for the GCC to consider the contents of article 5:101 of the Principles and focus on the contract interpretation based on the common intention of

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<sup>76</sup> Bürgerliches Gesetzbuch nebst Einführungsgesetz vom 18. 08. 1896, RGBL. No. 21, 195; &133 - Bei der Auslegung einer Willenserklärung ist der wirkliche Wille zu erforschen und nicht an dem buchstäblichen Sinne des Ausdrucks zu haften.

<sup>77</sup> *Kereselidze D.*, The Most General Principles of Private law, Tbilisi, 2009, 252 (in Georgian).

<sup>78</sup> *Kereselidze D.*, The Most General Principles of Private law, Tbilisi, 2009, 252 (in Georgian).

<sup>79</sup> BGHZ 80, 249; 86, 45 (see: *Pruetting H., Wegen G., Weinreich G.*, BGB Kommentar, Luchterhand, 2006, 136).

<sup>80</sup> For the interpretation reasons, see: *Koehler H.*, BGB, Allgemeiner Teil, 31. Auflage, Muenchen, 2007, 115 and et al.

<sup>81</sup> *Kereselidze D.*, AT des ZGB, 2005, 185 (see: *Kereselidze D.*, The Most General Principles of Private Law, Tbilisi, 2009, 252 (in Georgian)).

<sup>82</sup> *Zoidze B.*, Comments to GCC, Volume 1, Tbilisi, 2002, 174 (in Georgian).

parties or interpretation based on the special interest of one of the parties, to ensure the private autonomy and specification of liberty principles for the utilitarian objectives.

## **2. Contract Interpretation Based on Residential Place of the Parties**

According to article 337 of GCC, if the specific statements in the contract can be understood in different ways then priority will be given to the meaning which is generally accepted in the residential place of parties to the contract. If the parties live in different areas, the location of acceptant has the decisive power.

The necessary pre-condition for using the article is the possibility of unequal interpretation of specific statements in the contract. The statement may not be vague, however giving possibility for ambiguous understanding. GCC considers the interpretation of the contract based on the residential location of parties to the contract as the best way for solution of such problem. If parties live in different areas then the location of the accepting party will be given the priority.

In case of inclusion of rule regulating the contract interpretation based on the common intention of parties in the GCC, it is expedient to give to this norm subsiding, subordinated importance. If the issue of provision vagueness is raised, the interpretation based on the residential area may not coincide with the common intention of parties. We can consider this rule as one of the manifestations of objective interpretation based on the geographic criteria, which must acknowledge the prevalence of subjective interpretation criteria.

### **2.1. Interpretation Made at Joint Residential Location of Parties**

As mentioned above the interpretation based on the joint residential area of the parties may not always ensure the result which is in line with the common intention of parties. However the main purpose of this regulation might be the reasonable assumption of the fact that the parties were understanding the arguable provisions at the moment of the contract conclusion in the way which is generally accepted in the area they live. Similar provisions are covered in the article 1159 of Civil Code of France and article 1369 of Civil Code of Italy.<sup>83</sup> Critics of the mentioned regulation state the following argument – contract negotiations may take place at the different location and contract may be concluded at a different place and that the location of implementation of contract liabilities is more closely connected with the contract contents.<sup>84</sup>

### **2.2. Interpretation at the Residential Area of Accepting Party**

If the parties to the contract live at different locations, the interpretation at the location of accepting party will be given the priority. Mentioned regulation is relevant in the event of expression of will

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<sup>83</sup> *Kereselidz D.*, *The Most General Principles of Private Law*, Tbilisi, 2009, 257 (in Georgian).

<sup>84</sup> *Antoniolli L., Veneziano A.*, *Principles of European Contract Law and Italian Law, A Commentary*, Hague, "Kluwer/ Nijmegen: Ars Aequi Libri", 2005, 270.

which is obligatory for acceptance. Hence, the residential place of the accepting party shall be interpreted as the location of addressee of the will.<sup>85</sup>

### **3. Contract Interpretation Based on the Relevance to the Contract Contents**

According to article 338 of GCC, in case of existence of inter-exclusive statements or statements with multi-meanings the priority is given to the statement which the best fits the contract contents. This article stresses the need for the interpretation of specific provisions in the systemic way considering their inter-connection with other provisions of the contract,<sup>86</sup> as the context may play more important role for the determination of common intention than the isolated consideration of arguable provision.<sup>87</sup> The similar provision is considered under article 5:105 of the Principles.

### **4. Contract Interpretation based on the Trade Habits and Traditions**

According to article 339 of GCC, in the process of determining rights and liabilities of the parties to the contract the trade habits and traditions can be taken into consideration.

In order to consider the rule as trade habit or tradition, it is necessary to have such rule used for the specific time period, accepted by all parties and to be actually implemented.<sup>88</sup> The trade habits and traditions cover the "trade habits and traditions" established between the parties and not the habits followed by the parties as the valid legislation.<sup>89</sup>

Based on the analysis of the norm, it is not obligatory for use. It can be "taken into consideration". It cannot substitute imperative norms, and in case of dispositive norms – the trade habits and traditions are given the priority.<sup>90</sup> Moreover, it is not necessary that the person expressing the will or the person accepting the will is aware of such trade habits and traditions.<sup>91</sup>

### **5. Interpretation of Standard Provision of the Contract**

According to the article 345 of GCC, if the text of standard provisions of the contract is vague, it is interpreted in favour of the second party.

The purpose of the above mentioned norm is to force the party offering the standard conditions to include the clear and straightforward provisions in the contract; include the provisions which are

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<sup>85</sup> *Kereselidze D.*, *The Most General Principles of Private Law*, Tbilisi, 2009, 257 (in Georgian).

<sup>86</sup> *Ib.*, 258.

<sup>87</sup> For samples, see *Chanturia L.*, *Comments to GCC*, Volume III, Tbilisi, 2001, 163 and et al (in Georgian).

<sup>88</sup> Soergel/Wolf, &157, Rn. 63 (see: *Chanturia L.*, *Comments to GCC*, Volume III, Tbilisi, 2001, 166 (in Georgian)).

<sup>89</sup> *Kereselidze D.*, *The Most General Principles of Private Law*, Tbilisi, 2009, 258 (in Georgian).

<sup>90</sup> *Chanturia L.*, *General Section of Civil Law*, Tbilisi, 2011, 325 (in Georgian).

<sup>91</sup> BGH LM Nr 1 zu &157 (B); Frankf NJW-RR 86, 912 (see: *Pruetting H., Wegen G., Weinreich G.*, *BGB Kommentar*, Luchterhand, 2006, 194).

clear for the medium level consumer.<sup>92</sup> As the standard provisions of the contract are intended for the multiple usage, it is targeted for unlimited circle of persons; for the expression of such will it is decisive to consider the comprehension (perception) level of the medium level participant of the relationship; and/or if the expression of the will is targeted to the limited circle of specialists, then the medium level of perception of such specialists should be considered.<sup>93</sup>

Article 5:103 covers the similar regulation; however it covers the standard provisions of the contract as well as all provisions agreed individually. It must be also considered that this article of the Principles has recommendation nature, however article 345 of GCC determines in a straightforward way that interpretation of contract's standard provision shall be made against the offering party.

It is expedient to widen the relevant regulations in the GCC similarly to the Principles, and to cover any provision not individually agreed under the principle of interpretation against the offering party. The above will be justified under the function of fairness principle, which is the basis for contra proferentem rule and protects the interests of the party who reasonably and fairly trusted the offerer and the will expressed by the offerer.

#### **IV. Conclusion**

Based on the analysis of relevant articles of the Principles and GCC it is expedient to develop several recommendations; considering such recommendations will make the GCC better in relation to the regulation of contract interpretation and will make it closer to the European unification process, which will play important role in the process of integration of Georgian law with the common European legal area:

1. The fundamental criteria in contract interpretation should be the interpretation based on the common intention of parties, ensuring the private autonomy and the most optimal realization of liberty principles of the contract. The interpretation based on the objective criteria must be used only in extreme cases, when all attempts to determine the common intention of parties or the special interest of one of the parties were unsuccessful.

2. The contract interpretation based on the residential place of the parties shall be used only in cases, when it is impossible to determine the common intention of parties. Accordingly, pre-condition for the utilization of article 337 of GCC must not be only the possibility to interpret the specific statements in the contract in different ways, but also the impossibility of determining the common intention of parties.

3. Similar to the Principles, it is expedient to widen the area of validity for the regulation of contra proferentem rule in the GCC and the principle of interpretation of the contract against the offe-

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<sup>92</sup> *Chanturia L.*, Comments to GCC, Volume III, Tbilisi, 2001, 192 (in Georgian).

<sup>93</sup> Larenz/Wolf, Allgemeiner Teil, &28 C II Rn. 81 ff. (see: *Chanturia L.*, General Section of Civil Law, Tbilisi, 2011, 327 (in Georgian)).

rer to be expanded to the standard provisions of the contract as well as to any provisions not agreed individually.

4. Based on the universal nature of the liberty principle of the contract, it is reasonable to reflect the rule relevant to the article 5:106 of the Principles in GCC, which will determine the prevalence of the interpretation granting the binding power to the arguable provision compared with the interpretation annulling such provisions.

**Michael Bichia\***

## **Civil Legal Responsibility for Invasion of the Advocatory Secret**

### **1. Introduction**

The advocatory Secret from a single standpoint, is interesting on its procedural point of view, but the deep study signifies that it may contain quite a serious substantive legal importance. Besides, civil legal protection of the advocatory Secret has never been the subject of legal study in Georgia. Therefore, in the framework of this article this is the issue to be highlighted and for this purpose some procedural aspects of the advocatory secret must have been taken into account. Therefore, to study the civil legal sources of the advocatory secret, one should figure out namely what is the civil legal field the advocatory secrets attributed to. Besides, to determine the advocatory secret scale is important to figure out how private legal relationships can be cleared out. This issue is even more important if we take in consideration the fact that the procedural legal study uses the term of the advocatory Secret Classified but initial, namely civil legal aspects of this issue still stay unheeded. Furthermore, this information is protected by Constitution of Georgia, Criminal Code, Civil Code, Law about Advocates and the Code of the Advocates Ethics. However, Georgian Law does not recognize the term "advocatory secret" Classified. European Convention for Human Rights guarantees protection of the mentioned. The signifying role of the European role is another issue to be taken in.

The goal of this study to determine the scale for the Information classified and who might be the subjects of this relationship, so as to pin point the addressees for whom this protection is the issue. Besides, the contents taken around this topic is another subject of the study (including the rights and liabilities). The purpose of it is to define the extent by which this relationship might be different from other legal ones and what its peculiarities are. Besides, determining the nature of relationship between Advocate and their clients will also mean the possible responsibility for illegal access and spreading of the advocatory secret classified (might contain the subjects, damage, illegal behavior, causes and guilt). This issue addresses the problem of the legal claim and might cause the competition of such.

Thus, the aspects mentioned above have both theory and practical meaning. They have been considered by comparatively legal, normative, analytical, synthetic and sociological applications so that the problem is thoroughly studied. So, this article is a try to determine the civil foundation for the Defense information classified so as the legal faults are further fully eradicated.

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## 2. The Scopes of the Advocatory Secret Concept

Georgian Legislation does not use the term "advocatory Secret" but contains the norms to protect it. The law about Defense, Criminal Code and Civil Code do recognize professional secrecy, also confidential information whose one of the fields advocatory secret is considered.

Here one must specify the aspects of the advocatory activities, so that one has the notion to which of the fields the advocatory Secret is to be attributed to. Quite often it is closely used along with professional practice. But in reality this phenomenon can hardly be considered as the monopoly field of a client. Truly, it concerns everything that belongs to the practical side of Defense. The foreground of these relationships is the allocation of Defense mandate from the owner of the classified information to their Defense representatives.<sup>1</sup> Though, the point is, professional and advocatory secret are two different issues. Professional secrecy covers not only Lawyer but others too.<sup>2</sup> Hence, professional secrecy is much wider a notion than the classified advocatory secret. Advocatory secrecy is one of the professional secrecy issues.

According to the paragraph two of the Georgian Law of Advocates, Advocatory activities means the issuing of the legal advice to the person who applied for help; client representatives for constitutional, administrative, civil or criminal case disputes in court; the preparation of documents by the third person in detention, investigation and forensic study agencies and producing any kind of legal document in the client's person; providing such legal consulting, which is not connected to the third person representation. Therefore, practical side of defense belongs to this sphere.

Protection of legal secrecy may also concern the means of communications (email), while through this very help some confidential information can be transmitted and thus the threat of its revelation can increase.<sup>3</sup> Besides, the necessity to protect the private sphere may also come on agenda list.<sup>4</sup> For this reason advocatory secret is considered as an aspect of private rights protection.<sup>5</sup> This, on its own, is connected to the right of self identification, while the classified advocatory secret may include the right of non revelation. Thus, this phenomenon is another aspect of secrecy right protection, another reflexive reaction.<sup>6</sup> Here the problem ramifies in two: correspondence movement and protection of data related to the Defense relationships.<sup>7</sup> Accordingly, interest conflict may arise.

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<sup>1</sup> Aufsichtsbehörde über die Rechtsanwälte 2001.06.12. (AR 01 3) Entscheidung

<sup>2</sup> *Niggli M.A.*, Unterstehen dem Berufsgeheimnis nach Art. 321 StGB auch Unternehmensjuristen? (Eine Verteidigung des materiellen Strafrechts gegen die Freunde des Verfassungs rechts, zugleich eine Antwort auf Pfeifer), "Anwalts Revue Del'Avocat", 8/2006, 279.

<sup>3</sup> *Hilgard M.C.*, Kein Anwaltsgeheimnis für den Schriftverkehr zwischen Unternehmen und Unternehmensjuristen, "CH-D Wirtschaft", 4/2008, 15-16.

<sup>4</sup> *Rioutl J.L., Vock M.B., Schumacher Gr.K., Jokl J.*, Sichere E-Mail Kommunikation bei Rioutl & Partner Rechtsanwälte/Anleitung zur Benutzung des Secure Messaging von PrivaSphere, 1-3, available at: <[http://www.anwalt-zh.ch/pdf/Securemail\\_infobrief.pdf](http://www.anwalt-zh.ch/pdf/Securemail_infobrief.pdf)> [05.02.2013].

<sup>5</sup> *Spielmann D.*, Das anwaltliche Berufsgeheimnis in der Rechtsprechung des EGMR, "Österreichisches Anwaltsblatt", 07-08/2010, 346-355.

<sup>6</sup> *Härtig N.*, Anwaltsgeheimnis: Schutz vor dem Datenschutz, Der Beschluss des Kammergerichts vom 20.8.2010, "AnWB", 11/2011, 50-51.

<sup>7</sup> *Hoffet F.*, Der Schutz des Anwaltsgeheimnisses im Verfahrensrecht des Bundes, Thema/Question Du Jour, "Anwalts Revue Del'Avocat", 5/2012, 226.



But, at the same time it's not excluded that the advocacy secret classified may concern some other sensitive fields. At the same time, the advocacy secret is much higher a responsibility than sheer data protection.<sup>8</sup> The fact is, the Advocate representative is not liable to consider the issue of the Advocatory secret simply as the strongest right for the data protection. A lawyer should avoid creating those contradictory situations that generally occur due to the wide interpretation of the defense right by which the lawyer himself is the one to decide whether the data concerning the third party is to be applicable to those that are to be protected by the clientele protection rights. However, those data which don't represent the subject for the advocacy secret (for example the data from employee and supplier) are subject of the general protection rights. This issue does not create the necessity for the definition of the secrecy data protection.<sup>9</sup>

Therefore, in this professional secrecy everything's implied (facts, documents) – issues which have been revealed to Advocate due to their cooperation with a client. Therefore under this mandate the secrecy is strictly protected.<sup>10</sup> However, based on professional activity a lawyer notifying giving assessments towards his client in a report thus infringes the principle of secrecy while these kinds of assessment might go against the privacy right of the client.<sup>11</sup>

It must be also noted that the right for secrecy protection is widespread and stays valid even after the client's death.<sup>12</sup> When lawyers are obligated towards the heirs at the transmittal of the will the role of the advocacy secret is also considerably important. When the one who is to execute the will knows some facts from the will author's lawyer, then the one is responsible for keeping them confidential while the author of the will should have the possibility to rely on this confidence. However the priority interest here is the possibility to detect the delict of the murder case of the custodian or the just distribution of the will (especially of the obligatory part<sup>13</sup>).

Besides, the advocates (Defense) care about protection of professional confidentiality – with the help of auxiliary people.<sup>14</sup> Therefore, those notes should also be included into the advocacy secret issue, which these people received during the Defense practice implementation.

Thus, the kinds of legal advice contain (except for representation) other types of juridical assistance. Therefore it's quite logical that the Advocatory secret contains the points that should be thoroughly learnt so as the lawyer has the ability to carry out judicial consulting. Therefore for advocacy secret protection it is considered reasonable the advocacy secret issue be widely

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<sup>8</sup> KG: Anwaltsgeheimnis stärker als Datenschutz, "Anwaltsblatt", *Busse F.* (Herausgeber), Jahrgang 60, 11/2010, 802-803.

<sup>9</sup> BRAO-Novellierung, Vorschläge des DAV zur Änderung der Bundesrechtsanwaltsordnung (Stand: 30. August 2006), Entwurf einer Änderung der Bundesrechtsanwaltsordnung Textvorschlag, "AnwBl", 11/2006, 740.

<sup>10</sup> Beschluss der Aufsichtskommission über die Rechtsanwälte vom 2. September 2004, 4.

<sup>11</sup> Regarding the mentioned see the Decision №029/11, Ethics Commission of Georgian Bar Association, 2011.

<sup>12</sup> *Dorjee-Good A.*, Das Anwaltsgeheimnis ist auch gegenüber den Erben des Klienten zu wahren (BGE 135 III 597), "Successio Heft", 4/2010, 301.

<sup>13</sup> *Künzle H.R.*, Interessenkollision im Erbrecht: Willensvollstrecker, Notar, Anwalt, "SJZ", 108/2012, 7-8.

<sup>14</sup> *Hoffet F.*, Der Schutz des Anwaltsgeheimnisses im Verfahrensrecht des Bundes, Thema/Question Du Jour, "Anwalts Revue Del'Avocat", 5/2012, 224; see about distinguishing advocate and bankconfidentiality issue *Müller T.*, Das Geheimnis um das Bankkundengeheimnis, "Jusletter", 3 Mai/2010, 8.

interpreted so that it contains the data received from the clientele to Defense and revelation of which would be less favorable for the client.<sup>15</sup>

These kinds of data may exist towards any representatives of any kinds of profession and the law about lawyers (Defense) will and cannot concern them as it corresponds only to the lawyers. Besides, the legal rights for representatives are also different. That is why it is quite reasonable we use the term "Advocatory Secret" that should be protected by the lawyers registered at Georgian Advocacy Bar.

### **3. The Advocatory Secret as an Object of Civil Relationship**

The issue of legal responsibility is legally defined for the advocatory Secret subject. A lawyer should protect Advocatory secret for any person<sup>16</sup> that represents the absolute right specification while the "absolute are those rights that can be violated from any person and therefore must be protected from everyone".<sup>17</sup> These rights emerge during the relationship process of their owner beyond the legal frame.<sup>18</sup> Hence the issue of legal responsibility of defense takes place that is considered as the moral case of the lawyers.<sup>19</sup>

Besides, the objects of the personal, nonmaterial rights are nonmaterial virtues if nothing else occurs from their essence. It is predicted that these absolute rights exist on their own, without the legal relationship and it does not regulate them, but in case they are violated, it automatically guarantees their protection.<sup>20</sup> So, by force of judicial fact the absolute right beyond the legal relationship acquires the legal "garments" and then becomes the object of such. Therefore, nonmaterial virtues that are non circulative and non transitional represent the usual rights in civil relationship.

What about the relative right, it is contradicted by the obligations of a specific individual – not only to restrict himself against performing of an action but also behave in some positive manner in an authorized person's favor.<sup>21</sup> Therefore, here the subjects are personified and the relative rights occur according to the legal relationship.<sup>22</sup> Thus, the relative right is considered in the framework of the compulsory relationship and the objects of which will stay in the same one.

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<sup>15</sup> *Krasavchikova L.*, Private Life of Citizens under the Legal Protection, Moscow, "Judicial Literature", 1983, 153-154 (in Russian).

<sup>16</sup> *Rioutl J.L., Vock M.B., Schumacher Gr.K., Jokl J.*, Sichere E-Mail Kommunikation bei Rioutl & Partner Rechtsanwälte/Anleitung zur Benutzung des Secure Messaging von PrivaSphere, 1-3, available at: <[http://www.anwalt-zh.ch/pdf/Securemail\\_infobrief.pdf](http://www.anwalt-zh.ch/pdf/Securemail_infobrief.pdf)> [05.02.2013].

<sup>17</sup> *Bratus S., Yoffe O.*, Civil Law, Moscow, "Knowlegde", 1967, 41; *Kobakhidze A.*, Civil Law, General Part, I, Tbilisi, 2001, 100 (in Russian).

<sup>18</sup> *Prediger E.J.*, Die Grundlagen des Eigentumsrechts, available at: <<http://doctorate.ulbsibiu.ro/obj/documents/REZ-GERM-PREDIGER.pdf>> [07.05.10].

<sup>19</sup> *Krasavchikova L.*, Private Life of Citizens under the Legal Protection, Moscow, "Judicial Literature", 1983, 152 (in Russian); about the ethics of advocates, the secret of a principal not to be revealed that was trusted to the lawyer on confidentiality principle see: *Baikov A.*, Ethical Norms of Soviet Advocate Behavior, "Soviet Justice", №10, 1966, 16 (in Russian).

<sup>20</sup> *Lapach V.*, Civil Rights Objects System: Theory and Court Practice, Saint Petersburg, "Judicial Centre Press", 2002, 115, 106 (in Russian).

<sup>21</sup> *Yoffe O.*, Soviet Civil Right, General Part, Property Right, General Study for Liabilities, "Leningrad University Edition", 1958, 75 (in Russian).

<sup>22</sup> *Malein N.C.*, Civil Law and Rights of a Person in USSR, "Judicial Literature", 1981, 105 (in Russian).

Therefore the very relationship is protected which the person trusted to the lawyer under the mandate.<sup>23</sup> And thus, if based on the principle<sup>24</sup> of the free agreement<sup>25</sup> the advocacy secret is justly chosen, parties will correlate in the framework of the legal relationship. However, regarding the objects of such an agreement, to activate the mechanism of compulsory protection it is necessary the Advocatory Secret issue be associated with the objects of that agreement, which is relevant to law, is morally steady and circulative.<sup>26</sup> For example, these are the confidentiality protection, submitting a report. Otherwise the specific signs of absolute relationship should be taken in view.

#### 4. The Rights and Duties Emerged from the Advocatory Secret

As known, under the civil right the legal authority is considered that is attributed by law to an individual through the civil relationship so as to enable him protect his own interests including the way attainable in court. The civil rights themselves, except for the Civil Code, are also given by other laws.<sup>27</sup> And with this regard the right for advocacy Secret, as an absolute right, is protected by the Civil Code. But regarding the signs of the advocacy secret, the law about Advocates is also important.

According to paragraph 19, part 1 of the law the lawyer performs his duty only according to agreement where all provisions are foreseen. Another fact is also to be considered – in some specific cases the lawyer has the legal right for specially designed warrant or order (Law about Advocates, paragraph 19, part 2).

Besides, the lawyers are the authorized people who must be reliable for the subjects of their authority and be trustful for them. That is why the central role in lawyers' authority is the protection issue of those people who represent such subjects (paragraph 709<sup>28</sup>). This gives birth to specific duty in person of the one of Defense to protect the client's secret (professional one). This duty should be regarded as the central one in the framework of the advocacy Secret.<sup>29</sup> This is an attorney's right so as he (she) provides his objects with the necessary information but in case of request supply them with the information concerning the work performed, also report after the work is complete (paragraph 713, part 1).

It should be noted that during the correspondence, there is a threat for the information to be leaked. It may concern the sensitive, delicate subjects.<sup>30</sup> Therefore the lawyer should try his (her) best to protect the confidential information, the fact maintained by paragraph 714, part 1.

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<sup>23</sup> *Prediger E.J.*, Die Grundlagen des Eigentumsrechts, available at: <<http://doctorate.ulbsibiu.ro/obj/documents/REZ-GERM-PREDIGER.pdf>>[07.05.10].

<sup>24</sup> Beschluss der Aufsichtskommission über die Rechtsanwälte vom 2. September 2004, 4.

<sup>25</sup> *Chanturia L.*, About the Principle of Freedom of Contract, Das neue Privatrecht, "Georgien – Postsowjetische Umbrüche und Hoffnungen auf Europa, Arbeits- und Diskussionspapier", Alexander von Humboldt Stiftung, Bonn, 6/2006, 28.

<sup>26</sup> The features that should be non-commitant for legal relationship objects; see *Osakve K.*, Relative Law, Scheme Comment, Moscow, "Lawyer", 2008, 93, 543-544, 82 (in Russian).

<sup>27</sup> *Chanturia L.*, General Part of Georgian Civil Law, Tbilisi, "Law", 2011, 98 (in Georgian).

<sup>28</sup> Bundesgericht, II. zivilrechtliche Abteilung, Urteil vom 15. September 2009 (4A-15/2009) (privatrecht), Das Anwaltgeheimnis nach dem Tode des Klienten, mit Bemerkungen von Prof. Dr. iur. *Fargnoli I.*, 3.

<sup>29</sup> Aufsichtsbehörde über die Rechtsanwälte 2001.06.12. (AR 01 3), Entscheidung.

<sup>30</sup> See in detail *Hilgard M.C.*, Kein Anwaltsgeheimnis für den Schriftverkehr zwischen Unternehmen und Unternehmensjuristen, "CH-D Wirtschaft", 4/2008, 15-16.

Just for the purpose of sensitive information protection, the lawyer should take care about immunity protection and maintenance issue of their principals – this time we regard those who have applied for legal consulting and whose rights and interests must be protected as of their special legal specification requires. At the same time, the Advocatory immunity implies protection of the lawyer, defense documentation and the building necessary for case processing, communication channels with the clients as the source of information through the communication with the lawyer. Accordingly, the limitations applied for the information use concern not only the will and interests of the clients, but the immunity that is guaranteed by the advocatory secret. Thus, the problem of the secrecy protection from unauthorized people concerns two main aspects: a) Advocatory immunity and b) the access of the advocatory secret for the third party with the legally accepted ground.<sup>31</sup> Besides, thin walls and hermetic doors can fence off the lawyers' office from anteroom. Therefore during the legal consultation to exclude other clients be witnesses of the process, the lawyer should guarantee the impermeability of the sound and do his best so as the clients do not meet each other the information related to cases be not the subject of circulation.<sup>32</sup> Besides, the lawyers of opposing parties should have the possibility to have info availability from each other, and the fact that they work in the same building is not considered as the privacy violation. For this principle to be violated, one of the parties should testify the submittal of the information to the party lawyer. Here it is important the lawyers work in different rooms which have independent entrances. They should have their keys (can be locked) and the information (papers, documents) should be kept separately.<sup>33</sup> These circumstances are also given in paragraph 714 that guarantees secrecy protection and represents the precondition for protection of the private life.

Here one may even speak about the interest conflict – the fact the lawyer should notify their clients. The interest conflict arises if the lawyer, client, ex client or the third parties private interests work negatively on the defense representation. Furthermore, the lawyer should not come out the kind of relationship that puts the client's interests under threat. However, if such kind of relationship already exists, the lawyer should do their best to avoid the interest conflict cases.<sup>34</sup> The lawyer should not use the information received from the client against the one, also avoid any cases that would contribute to the leakage of such. This is the threat that may have negative implications for both current or ex clientele. During the advocacy process the lawyer should guarantee the confidentiality issue with the same effort (paragraph 714, part 1) and the priorities of the client proper.<sup>35</sup>

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<sup>31</sup> *Pilipenko Y.*, General Trends in Advocate Confidentiality Study, "Journal of Ukrainian Academy of Advocate Law", №2, 2009, 22-24, available at: <<http://www.nbu.gov.ua/e-journals/Chaau/2009-1/09pysiat.pdf>> [06.02.10] (in Ukrainian).

<sup>32</sup> *v. Meiss R.*, Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rüegger Verlag", 1975, 110-111.

<sup>33</sup> See Decision №086/10, Ethical Commission of Georgian Bar Association, 2010 (in Georgian).

<sup>34</sup> Decision №022/11, Ethical Commission of Georgian Bar Association, 2011 (in Georgian); the Supreme Court of Georgia because of the right legal position of this case ruled the decision of the ethical commission regarding the warning for disciplinary responsibility as valid (Decision №ds-S/7-11, Disciplinary Chamber of the Georgian Supreme Court, 2011 (in Georgian)).

<sup>35</sup> Decision №092/10, Ethical Commission of Georgian Lawyer's Association, 2011(in Georgian).

Thus, the precondition of the advocacy secret and legal relationship between the lawyer and their clients is the principle of the right performance of the legal, defensive role. Furthermore, as a client has less possibility to assess which information is most relevant for the proper protection of his interests, it is important the client provides the lawyer with the full fledged information about the case. And this is the very point so as the client has the possibility to trust the principle of advocacy secret that is of unlimited character.<sup>36</sup>

Regarding the age of the secrecy, paragraph 714, part 2 specifies that the liability for not spreading the facts continues after the agreement validity gets expired. The lawyer is bound to protect the information for the time unlimited according to Georgian law about Advocates, paragraph 7, part 1, points a, b.<sup>37</sup>

## 5. The Subjects of Civil Legal Relationship Occurred from the Principle of Advocatory Secret

The main participant of civil legal relationships is an individual, at the same time it can be unions or in general legal entities, even the state itself. According to paragraph 11 of the law about defense, since this moment it has ability to be represented as the carrier of the civil rights and responsibilities. The possibility for having rights is an abstract notion, while the right itself – specific.<sup>38</sup> The form of possibility acquirement might be considered ability for having personal rights.<sup>39</sup> Therefore, the foundation for personal right emergence might be birth, at some extent agreement – during the validity period of the advocacy secret. Besides, the law may authorize a person with the non property right – for example the right of a person in commerce to protect the secrecy of their firm.<sup>40</sup>

Regarding the advocacy secret, one of the private legal relationship subject is (might be) a lawyer or the person having a free profession who abides to the law and the norms of professional ethics and represents a member of Georgian bar association (law about advocates, paragraph 1, part 2). A client is a party whose interests are protected by the lawyer. According to paragraph 3' of law about Advocates, one of the most important principles of defense is the secrecy protection. Therefore the legislators took it as reasonable to single out by a separate paragraph (5, a, b and g primes) the liability of a lawyer to fulfill honestly professional functions and the rights of other participants of the

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<sup>36</sup> *Dorjee-Good A.*, Das Anwaltsgeheimnis ist auch gegenueber den Erben des Klienten zu wahren (BGE 135 III 597), "Successio Heft ", 4/2010, 301.

<sup>37</sup> See the Law of Advocats, available at: <[http://gba.ge/pdf/2010/kanoni\\_advokatta\\_shehexeb.pdf](http://gba.ge/pdf/2010/kanoni_advokatta_shehexeb.pdf)> [27.05.10]; aboutadvocateliability at confidentialinformationtrustedsee *Münch H.*, Der Schutz des Einzelnen vor Presseveröffentlichungen durch den Deutschen Presserat und die britische Press ComplaintsCommision, Eine Untersuchung zur Spruchpraxis unter besonderer Berücksichtigung des zivilrechtlichen Rechtsschutzes der Privatsphäre (Dissertation), Konstanz, 2001, 51, available at: <[www.buskeismus.de/literatur/privatsphaeremuebcg.pdf](http://www.buskeismus.de/literatur/privatsphaeremuebcg.pdf)> [10.07.09]; *Boner W.*, Aktuelle Entwicklungen im Anwaltsrecht, Weiterbildungsveranstaltung des Aergauschen Anwaltsverbandes AAV vom 24. September, 2009, Aarau, 6.

<sup>38</sup> *Chanturia L.*, General Part of Civil Law, Tbilisi, 2011, 165-166, 246-251, 175-176 (in Georgian).

<sup>39</sup> *Kereselidze D.*, General Ideas of Private Law, Tbilisi, 2009, 135 (in Georgian).

<sup>40</sup> *Chikvashvili S.*, Responsibility for Moral Damage, Tbilisi, 2003, 8-9 (in Georgian).

process.<sup>41</sup> Besides, this virtue guaranteed by the legal discipline was confirmed by the private law according to paragraph 713 of the law about defense as the principle of the advocatory secret. What about fulfillment of this obligation, it is carried out by the honesty principle (paragraph 8, part 3 of the same law). Therefore, the parties mentioned above are the subjects of relationship based on equality and private autonomy (paragraph 1, part 2 of the tenth paragraph), whose rights limited by legal restrictions and the ones that are set in agreement.<sup>42</sup>

So, the lawyers comply to the principle of advocatory secret in everything that was based on their legal relationships with their clientele proper. Besides, the lawyers care about protection of the advocatory secret with the help of auxiliary persons.<sup>43</sup> Here one can speak about a lawyer's assistant. Correspondingly, he is another person responsible for maintaining confidentiality no matter the time gone. Without the client's permission the assistant should not detect the information in view (paragraph 17, parts 2, 3, part 1 of paragraph 7, points a, b of the same law). A lawyer's interim is considered under the same category, the one who, according to the lawyer's directives, fulfills his (her) functions. The interim should not be interviewed as a witness for the cases that had been revealed to him (her) through their professional work. He is the subject of liabilities given under paragraph 7, as well as professional secrecy principle according to the same law – paragraph 16, part 1, 3 and 4.<sup>44</sup>

Apart from the mentioned above, the threat of the information classified comes also from the people who help the lawyer implement his job in non legal practice, for example their personal assistants. During the work she receives by telephone the data about the clientele, also through the letters dictated by the lawyer and the statements ready to be confirmed or written down. Once a lawyer abides to constant vigilance and accuracy, the personal assistance has availability only for the facts the lawyer transmits to his clients or the third party representatives. The same might be said about cleaners.<sup>45</sup> Thus, for the job of confidentiality protection the whole bureau of defense must be involved and so any representative (employer) of the legal consulting institution (an accountant, personal assistant and others<sup>46</sup>). Therefore protection of the advocatory secret of defense would be illusory from this standpoint if not for the personal assistant, who is to prepare a letter, be actively involved in the same process.<sup>47</sup>

Besides, it is reasonable a lawyer and a representative be separately taken so as in the end their norms are to be rearranged according to the spheres of their practice. The fact is, there is a principle in the legal civil relationship, according to which the parties can rule the case in court both directly or

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<sup>41</sup> Georgian Law on Advocates, 2001, available at: <[http://gba.ge/pdf/2010/kanoni\\_advokatta\\_shesaxeb.pdf](http://gba.ge/pdf/2010/kanoni_advokatta_shesaxeb.pdf)> (in Georgian) [27.05.10].

<sup>42</sup> *Chanturia L.*, General Part of Civil Law, Tbilisi, 2011, 85-89 (in Georgian).

<sup>43</sup> *Hoffet F.*, Der Schutz des Anwaltsgeheimnisses im Verfahrensrecht des Bundes, Thema/Question Du Jour, "Anwalts Revue Del'Avocat", 5/2012, 224.

<sup>44</sup> See the law on the web page: [http://gba.ge/pdf/2010/kanoni\\_advokatta\\_shesaxeb.pdf](http://gba.ge/pdf/2010/kanoni_advokatta_shesaxeb.pdf) [27.05.10].

<sup>45</sup> *v. Meiss R.*, Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rüegger Verlag", 1975, 109-110.

<sup>46</sup> *Drobishevskaya T.*, Personal Nonproperty Rights of Citizens and Their Civil-legal Protection, Krasnoyarsk, Krasnoyarsk State University, 2001, 78 (in Russian).

<sup>47</sup> *v. Meiss R.*, Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rüegger Verlag", 1975, 177-178; *Hellwig H.J.*, Non-legal Outsourcing und Anwaltsgeheimnis (Die Ermächtigung in der BRAO nutzen: Satzungsversammlung kann es regeln), "AnwBl", 7/2012, 591-592.

through their representatives (the same law, paragraph 93<sup>48</sup>). Besides, according to paragraph 40, part 4 of the law about defense, people who have not passed tests for Advocate and have no testimony for taking those, enjoy the right to participate in the first instance trials only (and not in courts of appeal or cassation). Though, participation of local government, state agency for their cases proper is an exception from the rule, therefore it is reasonable the rules for protections of advocatory secret be also applied to them while functional relationships between clientele and representatives is also at hand but in current case the use of the law about Advocates is not possible for disciplinary sanctions. They simply need to protect the civil rights or otherwise the implications of the law (paragraphs 709, 723) will get in force.

It must be noted that defense along with the agency lawyers (legal consultants) must do their best to create a strong mechanism for the advocatory secrecy and enhance it for further applications. Thus, in judicial literature it is clearly said that for the legal consultants it is crucial their professional secrecy is strictly regulated. Professional secrecy is a subject not only for the lawyers but other legal persons whose legal practice is different from that of defense. Therefore, industrial lawyers<sup>49</sup> are also considered as subject of professional secrecy.<sup>50</sup> Hence, the lawyer beyond the legal framework of the law about defense should be subjects of confidentiality protection principle according the ethical norms of their practice proper. Besides, paragraphs 709-723 are applicable to the lawyers mentioned.

What about the issue, when lawyer's responsibility ceases to be valid to act according to the interests of their clients, this ends to be such only after the client's decease. But some liabilities sprung before death do not disappear but spread over the posthumously over the client's successors.<sup>51</sup> Here it is logical to raise questions: after the client's death what is the form the fulfillment of the secrecy is to be performed? Is a lawyer liable not to reveal the secrecy to successors just like he wouldn't for the third party representatives? Are successors in general in full legal right to share the principle of secrecy of defense?<sup>52</sup>

According to the law about defense, the agreement ceases to be valid after the moment of the client's death, surely if anything else is not agreed upon. Accordingly, in case of other agreements, the agreement designed may not lose power and thus neither does the warrant. In this case the successor takes place and authority to change the status of agreement, the fact to be informed to attorney.

<sup>48</sup> *Liluashvili T.*, Comment of Georgian Civil Procedural Code, Tbilisi, 2004, 176-177 (in Georgian).

<sup>49</sup> *Pfeifer M.*, Art. 321 StGB als Grundlage eines uneingeschränkten Anwaltsgeheimnisses – mit Ausführungen zu einem Berufsgeheimnis von Unternehmensjuristen, eine Replik auf *Niggli M.A.*, "Anwalts Revue Del' Avocat", 9/2006, 331-337; also see *Pfeifer M.*, Gilt das Berufsgeheimnis nach Art. 321 StGB auch für Unternehmensjuristen, "Anwalts Revue Del' Avocat", 4/2006, 166-169.

<sup>50</sup> See *Niggli M.A.*, Unterstehen dem Berufsgeheimnis nach Art. 321 StGB auch Unternehmensjuristen? (Eine Verteidigung des materiellen Strafrechts gegen die Freunde des Verfassungsrechts, zugleich eine Antwort auf *Pfeifer M.*), "Anwalts Revue Del' Avocat", 8/2006, 279-280.

<sup>51</sup> See Bundesgericht, II. zivilrechtliche Abteilung, Urteil vom 15. September 2009 (4A-15/2009) (privatrecht), Das Anwaltgeheimnis nach dem Tode des Klienten, mit Bemerkungen von Prof. Dr. iur. *Fargnoli I.*, 3.

<sup>52</sup> *Dorjee-Good A.*, Das Anwaltsgeheimnis ist auch gegenüber den Erben des Klientenzu wahren (BGE 135 III 597), "Successio Heft", Nr. 4/2010, 303; it's arguable whether the confidential information of advocate owned by the principle is to be represented by the heirs, it's also essential that the bank representative does not reveal information regarding private issues of the principal. Regarding the mentioned see: Bundesgericht, II. zivilrechtliche Abteilung, Urteil vom 15. September, 2009 (4A-15/2009) (privatrecht), Das Anwaltgeheimnis nach dem Tode des Klienten, mit Bemerkungen von Prof. Dr. iur. *Fargnoli I.*, 2.

Agreements are considered to be valid in power (prolonged) unless the details for the status changes are informed to the attorney (paragraph 721, part 3. According to paragraph 721, part 2, if agreement loses power because of the client's death, the agreement is considered as extended in legal power only if the delay in agreement performance will pose any threats to the heir and the one does not take any measures.<sup>53</sup>

It is noteworthy that the heir of the secret owner is not the third party person, but the testator's legal representative who keeps the secret for the mentioned.<sup>54</sup> As the heirs are not secret holder another problem is how they are able to represent the right authority while the deeply personal rights cannot be bequeathed by inheritance.<sup>55</sup> But the right for keeping the secrecy is broad and keeps its validity after the client's death.<sup>56</sup> One may say that the lawyer can (and one is obliged to do so) testify the obligation for keeping the secrecy while related to them. Besides, the secrecy for defense towards the third party is unlimited for protection and also keeps being such towards the heirs.<sup>57</sup> However it would be fair to note that the right for report does not lose its validity after the contract agreement is expired and extends to the heirs proper. Therefore, each authorized person (defense) would be accountable towards the task giver; besides he is obliged to protect the mandate from the third party if revelation of the information trusted would negatively affect the course of the case. These two obligations issued from the task fulfillment are valid and applicable towards the heirs correspondingly and the authorized persons cannot refuse the data based on restrictions given in the contract during the relationship of the last.<sup>58</sup>

The fact is that for protection of honor it is possible the advocatory secret be also protected. Protection of Honor is the process guaranteed by the constitution, the principle that cannot be contradicted by any of the legal norms (the law about speech and expression). Furthermore, the memory of the deceased is also to be protected, which is so organic and immanent in our reality.<sup>59</sup> Therefore, the aspects counted above perform as the ones efficient for establishing the mechanisms of the advocatory secret for the one passed.

## **6. Specification of Advocate and Client Relationships**

Considerable part of professional ethics of Advocates is dedicated to the specification of fiduciary relationships and thus counts the principles of professional practice among which confidentiality, trust and

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<sup>53</sup> Decision №as-39-486-06, Civil, Industry and Bankruptcy Chamber of the Supreme Court of Georgia, 2006, available (in Georgian) at: <[www.supremecourt.ge](http://www.supremecourt.ge)>.

<sup>54</sup> *Dorjee-Good A.*, Das Anwaltsgeheimnis ist auch gegenueber den Erben des Klienten zu wahren (BGE 135 III 597), "Successio Heft", Nr. 4/2010, 303.

<sup>55</sup> *Künzle H.R.*, Interessenkollision im Erbrecht: Willensvollstrecker, Notar, Anwalt, "SJZ", 108/2012, 7-8.

<sup>56</sup> *Dorjee-Good A.*, Das Anwaltsgeheimnis ist auch gegenüber den Erben des Klienten zu wahren (BGE 135 III 597), "Successio Heft", Nr. 4/2010, 301.

<sup>57</sup> Bundesgericht, II. zivilrechtliche Abteilung, Urteil vom 15. September 2009 (4A-15/2009) (privatrecht), Das Anwaltgeheimnis nach dem Tode des Klienten, mit Bemerkungen von Prof. Dr. iur. *Fargnoli I.*, 6.

<sup>58</sup> *Dorjee-Good A.*, Das Anwaltsgeheimnis ist auch gegenüber den Erben des Klienten zu wahren (BGE 135 III 597), "Successio Heft", 4/2010, 300.

<sup>59</sup> *Bichia M.*, Privacy Protection according to Georgian Civil Law, Tbilisi, 247 – 259 (in Georgian).



priority of the client's interests are included. The obligation for confidentiality is not limited in time.<sup>60</sup> In the principle of ethics trust has its recognition, according to which it is determined by the level of defense honesty, merit, unbiased approach, competence and unassailability. The lawyer should behave in the way the trust addressed to him from their clients comes under suspicion. These qualities are his professional liabilities. Besides, there is a confidentiality principle according to which the information available for the lawyer is considered as confidential during performing of their duties.

Besides, according to the law about normative acts, paragraph 7 (part 1) and also to the law about international agreements, paragraph 6, part 1, the international agreement of Georgia is recognized as the integral part of Georgian law. Thus, for the further legal refinement and efficient protection of rights it is important the international agreement is also to be considered. Besides, the approach of European Law is also of much interest. In German law the ethical obligations of defense are differentiated so as he (she) guarantees the proper protection of the secrecy – the criminal delict of the private secrecy and procedural right to protect the mentioned. Their common feature is to protect the confidentiality of the information received from the client.<sup>61</sup>

In England the duty of protection for advocacy secret (Lawyer's Confidence) and the legal way of such (Legal Professional Privilege) are singled out. Here the virtue protected is the right for communication that exists between the lawyer and his clients to be thoroughly protected. Therefore the authorized person is not the lawyer themselves but the principal. Besides, unlike German law, the English right for confidentiality protection contains not only the aspects of communication with defense, but also legal consulting issued by the lawyer that possibly extends on agency lawyers and the ones who work both in UK or abroad. In theory, the secrecy of defense expresses itself in two forms: the right for non revelation of the sensitive information received and procedural right. But abroad the secrecy of defense is often associated with performance of advocacy duties in relation to protection of the public interests. Besides, paragraph 6, point 1 of European convention and paragraph 14, point 1 of the law of political and civil rights are dedicated to protection of this very right. The lawyer's right concerning the confidentiality issue to serve the principal contains the issues of both written and oral messages in the frame of this relationship. It is to be noted that the lawyer enjoys the right to refuse the revelation of the secret<sup>62</sup> – that is recognized by procedural law.

It must be also noted that according to the European Court for Human Rights the link between the private life the secrecy of defense can be really close. In this case we can think about protection of the address proper, correspondence, the meetings with the lawyer without any resistances. Thus, it is not excluded that based on the interpretation of the private sphere (paragraph 8 of European Convention) the violation of the advocacy secret may cause the same violation of the private life principle.<sup>63</sup>

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<sup>60</sup> See Professional Ethics of Advocates, see the webpage: <[https://docs.google.com/viewer?url=http://gba.ge/pdf/2010/eTikis\\_kodexi.pdf](https://docs.google.com/viewer?url=http://gba.ge/pdf/2010/eTikis_kodexi.pdf)> [28.06.10].

<sup>61</sup> *Wolf Chr., Hasenstab S.*, Die grenzüberschreitenden Schutz des Anwaltsgeheimnisses in Europa, Kollisionsrechtliche Überlegungen anlässlich der EuGH-Rechtssache Akzo Akcros, "Brak-Mitteilungen", 41. Jahrgang, 4/2010, 151.

<sup>62</sup> *Ib.*, 151-157.

<sup>63</sup> *Spielmann D.*, Das anwaltliche Berufsgeheimnis in der Rechtstprechung des EGMR, "AnwaltsBlatt", Jahrgang 60, 6/2010, 373-380; see also Decisions of European Court of Human Rights: *Niemietz v. Germany*, 16/12/1992; *Wieser Bicos Beteiligungen GmbH v. Austria*, 16/10/2007; *Tamosius v. UK*, 19/09/2002.

Therefore the issues listed above may get combined under the same features - that is the special relationships between the lawyer and their clients gets established and is based on the principle of trust. Besides, so as the lawyer has the full possibility to base the claim of the legal ground, it is important the case be displayed into the full picture. And thus, to detect more details and represent the case in the full color the trust between the lawyer and their clients is crucially important, but to secure this fact the information received should be properly protected. At times the criminal case can be especially difficult for defense; the accused may swear that he (she) realizes the implications for misleading their lawyers. In cases like these he (she) can always refuse the mandate offered. In the civil process the acceptance of the principal's trust and the less motivation of the client to rely sometimes may cause a conflict with defense. Here the quality of trust and openness in communication increases the rational capabilities of the defense to work while an experienced lawyer bases much on these very issues.<sup>64</sup> Thus, in judicial literature it's fairly noted that the prerequisite for the confidentiality protection is the just performance of the lawyer's duties and the serious, accurate protection of those rules aimed at the advocatory secret along with principles of independent, unbiased maintenance.<sup>65</sup>

So, this relationship should be based on trust; that is without trust this relationship between the lawyer and the principal is not a solid, legal consulting and neither can be considered as the just performance of the right. Therefore the secrecy of defense is linked to the direct guarantee not simply for the ownership of the information, but to the straightforward must for receiving such.<sup>66</sup>

Furthermore, the client realizes the necessity to apply to defense with the full information including all relevant details both as personal and the ones that might be of some connection with the case. This creates the relationship between the parties that is based on mutual trust and gives possibility for reasonable cooperation. In this form the case concerns the spheres that might be those of the clients or the third party representatives. The client is the secret holder. The close the information is to the case that should be changed between the client and defense, the more threats it contains to be further revealed. Thus, to protect the confidentiality sphere the lawyer should come out from the principle recognized each detail of the information under the separate sphere and the carrier of the one in view. The only one exception is the well known cases. The consulting received from the lawyer is another sphere of confidentiality defense.<sup>67</sup>

There is another fact to be separately noted, namely that in the case given the lawyers activity is one of those specific. That fact is that the lawyer from one side must be of help but from the other must be and comply with the laws of court practice and determination of truth. Surely the lawyer is not liable to report the court about the circumstances of his client. The lawyer is liable to report the court only the information that represents his (her) professional duty.<sup>68</sup>

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<sup>64</sup> v. Meiss R., Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rügger Verlag", 1975, 106-107.

<sup>65</sup> Boner W., Aktuelle Entwicklungen im Anwaltsrecht, Weiterbildungsveranstaltung des Aergauschen Anwaltsverbandes AAV vom 24. September 2009, Aauar, 16.

<sup>66</sup> Hoffet F., Seckler D., Vom Anwaltsgeheimnis zum "Legal Privilege", "SJZ", 2005, Nr. 14, 334.

<sup>67</sup> v. Meiss R., Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rüegger Verlag", 1975, 107-109.

<sup>68</sup> v. Meiss R., Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rüegger Verlag", 1975, 176-177, 211-212.

Thus the features of the advocacy secret in frame of the legal relationships are: the special legal case of the subjects, the system of ethical norms, the contents of which is determined by specification of a particular case, complicated objects – that is the synthesis of public and private virtues that can be damaged once the secrecy is revealed. Besides, while considering these objects, the legal regime of defense is surely important aimed at the principal's immunity in the way the limitations for the legal consultations be defined regarding the unauthorized reception of information of the kind not specified, its further use and extension.<sup>69</sup>

## 7. Responsibility for Violation of Advocatory Secret

If a lawyer does not abide to the laws aimed at advocacy secret protection and professional ethical Code, then the issue of disciplinary sanction might be raised (paragraph 32, part 2 of the law about defense). The disciplinary sanctions to be applied to Advocate are: warning, retrieving the license from 6 months to 3 years; suspension of the bar association membership (paragraph 32, point 1, (part 2)). Another reason for suspension mentioned is the court ruling recognizing the lawyer guilty for deliberate infringement (paragraph 21<sup>3</sup>, part 1, d part). The lawyer shares responsibility for action committed according to the rule defined by Georgian law (paragraph 36 of the law about defense) is the one contains the signs of the crime. Besides, for the crime committed both criminal and administrative measures might be cumulatively applied.<sup>70</sup> Therefore the violation of the secrecy of defense causes the accountability issuing from the violation of both professional and ethical norms (paragraph 7, part 2 of the same law). But the same principle does not exclude the civil (administrative) blame. Thus if the violation of the confidentiality does not contain any signs of crime, then it is considered as a delict.

For the purposes of research, the civil blame advanced towards the lawyer once they have violated the confidentiality principle is of extreme importance – the fact different from disciplinary responsibility issue. In fact, by violating the absolute right like the one of secrecy of defense, the new legal (delict) relationship is raised (paragraph 317, part one and paragraphs 992 – 1008). Accordingly, the subjects of this relationship are the victim – a creditor (both physical and legal entity) and the inflictor of the damage – the debtor who represents only the delectable entity. However, according to paragraph 992 of the same law, the restitution of the damage implies the structure of certain circumstances, namely several responsibility prerequisites should be at hand. These are the components of the action, unlawfulness, duty/culpability responsibility for delict, damage, the cause

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<sup>69</sup> *Pilipenko Y.*, General Trends of Advocate Confidentiality Issue, "Journal of Ukrainian Academy of Legal Advocate", №2, 2009, 1, 4, 10, 34, available at: <<http://www.nbuv.gov.ua/e-journals/Chaau/2009-1/09pysiat.pdf>> [06.02.10] (in Ukrainian).

<sup>70</sup> See *v. Meiss R.*, Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rüegger Verlag", 1975, 176-188. For the procedural aspects of criminal justice concerning the advocacy secret see *MefariSvili G.*, Life and Law, 2<sup>nd</sup> Refilled Edition, Tbilisi, 2008, 206-219 (in Georgian).

for responsibility issued and legal implications: compensation for damages, Exclusion of the Responsibility.<sup>71</sup>

### **7.1. The Violation of Advocatory Secret**

For the liability defined by paragraph 992, first of all the composition of action should be present, which consists of three components: the violation of legal values, the performance and cause of the action performed, which is the foundation of the liability case. This time the case might concern the violation of the legal virtue defined by paragraph 18 and 992 of the same law about defense if personal rights are violated. It must be noted that the legal virtues are thoroughly listed by the law (life, body, health and freedom). Accordingly, they cannot be widened by analogy. Through, the rights are given here in a resilient way and are not limited, namely, the property is determined by law including "the other rights" that as the property one represent the absolute character. The rest of the rights are those of personal one.<sup>72</sup> It is linked with the rights of a person and might concern the general forms of revelation of the secrecy of defense. Besides, the property damage is restituted only if those personal rights are violated which are listed in paragraph 18 of the law about defense.<sup>73</sup> Besides, it is important the rights for freedom of personal development guaranteed by the constitutional law of Georgia be legally widened (paragraph 16), where one of the rights is considered to be that of a personal one. The right for private life protection is linked to the mentioned right, which can be damaged once the secrecy of defense is violated. Accordingly, here one can claim the rights defined by paragraph 18 of the law about defense. However, paragraph 992 is also important that gives possibility for protection of unforeseeable legal virtues. For the damage caused civil responsibility issue is filed, namely if the damage is cumulative, the action is unlawfulness, there is the case between the damage and the action performed and finally is there is the blame present (general delict<sup>74</sup>).

The violation of the advocatory secret creates damage - that is the limitation or elimination of physical or legal entity right or welfare. The material result for the violation, if it contains the valuable form, in civil studies represents the intellectual damage<sup>75</sup> or in other cases it can be represented as a non intellectual one.<sup>76</sup> Besides, the damaged caused to an individual can have a material worth<sup>77</sup> or during the

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<sup>71</sup> *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 1. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2003, 190-192; *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 4. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2006, 203-205.

<sup>72</sup> *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 1. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2003, 190, 193; *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 4. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2006, 203.

<sup>73</sup> Comment of Georgian Civil Code (*Chanturia L.*), Book I, Tbilisi, 2002, 70-71 (in Georgian).

<sup>74</sup> *Shengelia R.*, Delict Liabilities in Civil Law, in Collection of Articles Dedicated to the 80 Year Jubilee of TSU Law Faculty: Acute Problems of State and Law, *Shengelia R.* (Ed.), "Tbilisi State University Press", Tbilisi, 2003, 184 (in Georgian).

<sup>75</sup> Comment of Georgian Civil Code (*Chanturia L.*), Book 4, Volume 2, Tbilisi, 2001, 378-381 (in Georgian).

<sup>76</sup> *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 1. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2003, 192; *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 4. Auflage, Grasberg bei Bremen, Rolf Schmidt GmbH, 2006, 205.

time specified the damage might have only non material specification but acquire it afterwards. Thus, the nature of damage depends on the presence of the monetary equivalent for the one.<sup>78</sup> Accordingly, non material damage can be purely physical or physical suffering but might be not only property but have the implications of the property virtue violation.<sup>79</sup> So, in commercialized circumstances along with the personal rights there is a trend that under the prolonged observation shows that the violation of this right might be caused by the same cause occurred by the property damage.<sup>80</sup>

## 7.2. The Unlawfulness

According to paragraph 992 of the law about defense, to determine the blame caused by the violation of the principle of the secrecy of defense, unlawfulness<sup>81</sup> regarding of delinquent action must exist. The confidentiality might be violated by determined action that cases responsibility. From the legal standpoint, in this action both positive action and inaction can be considered. However, the occurrence of obligation may not account to importance – whether the action of performed by actual intrusion or exclusion of the one.<sup>82</sup> In addition, the action should definitely be illegality that is created by the inadequacy of the law or agreement.

The action illegality might violate the rights of an individual guaranteed by different legal norms,<sup>83</sup> namely the right for secrecy of defense. The unlawfulness may contain the unauthorized proliferation of the data received from the private sphere, also proliferation of the factual data regarding the person or illegal acquisition of information. However, one should make it clear now whether the circumstances like consent, public interest or the interest taken upon by the public represent the ones that exclude the issue of legal responsibility.<sup>84</sup> Furthermore, the data containing the private information might be considered as subject to the secrecy of defense to be protected.

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<sup>77</sup> *Shengelia R.*, Property Damage and Liability for the Restitution Proper, Tbilisi, 1991, 3 (in Georgian); about civil-legal responsibility features see *Zoidze B.*, About the Notions of Legal-civil Responsibilities, "Matsne" of the Georgian USSR Academy, Series of Economics and Law, №3, 1985, 85-95 (in Georgian).

<sup>78</sup> *Ninidze T.*, Moral Damage According to the Civil Law, "Soviet Law", №3, 1985, 85-95 (in Georgian).

<sup>79</sup> *Bliatskin S.*, Compensation of Moral, Non-property Damage, Everyday Judicial Periodical "Law", Sunday July 24, №29, 1911, 1614-1615; *Zayets A.*, Compensation of Moral Damage according to the Soviet Law in magazine "Week Periodical of Soviet Justice", 1927, N 47, 1467 (in Russian); also see: *Hütte F.*, *Helborn M.*, Schuldrecht Allgemeiner Teil, 3. Aufl., Bremen, "Verlag Rolf Schmidt GmbH", 2005, 342.

<sup>80</sup> *Joussen J.*, Schuldrecht I, Allgemeiner Teil, Stuttgart, "W. Kohlhammer GmbH Stuttgart", 2008, 377.

<sup>81</sup> *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 1. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2003, 191; *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 4. Auflage, Grasberg bei Bremen, Rolf Schmidt GmbH, 2006, 204; also see *Perger T.*, Ehrenschutz von Soldaten in Deutschland und anderen Staaten, Köln, (TUP-Productions) (Dissertation), 2003, 84, available at: <<http://ub.unibw-muenchen.de/dissertationen/ediss/perger-tilmann/inhalt.pdf>> [10.09.10].

<sup>82</sup> *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 1. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2003, 190-191.

<sup>83</sup> *Shengelia R.*, Property Damage and Compensation Liability, Tbilisi, 1991, 4 (in Georgian).

<sup>84</sup> *Münch H.*, Der Schutz des Einzelnen vor Presseveröffentlichungen durch den Deutschen Presserat und die britische Press Complaints Commission, Eine Untersuchung zur Spruchpraxis unter besonderer Berücksichtigung des zivilrechtlichen Rechtsschutzes der Privatsphäre (Dissertation), Konstanz, 2001, 124-126.

Therefore, it is not excluded that the illegal propagation of this data may automatically mean the violation of the advocacy secret.

At the same time one should note that the lawyer (representatives) may share civil responsibility for improper practice performance in case damage is caused. For example, a lawyer had been practicing defense law for ten years and properly protected his clients' secrecy. But once because his office room was not properly arranged, the lawyer put his client's information (including some private details of his) into another lawyer's desk that was available for other clients. Because the lawyer was absent, they had the possibility to read the information and used it against the owner of the secret - the reason defense lost the case. Surely, the fact itself caused damage which can be of intellectual or (and) non-property character. Hence, the lawyer was not successful enough to guarantee protection of the client's secret and thus violated the rules proper. The action, unlawfulness, caused damage.

Also the confidential sphere of a client will be violated if based of fiduciary relationship the lawyer will pass on the confidential data of his client to the third party representatives or at least makes it available for them. By this action the lawyer also violates the obligation towards the principle of trust assigned in agreement (law about defense, paragraphs 709-723). Therefore, while failing to fulfill the duty the client is able to resort to the norms of compulsory law.<sup>85</sup> However, here satisfaction of the property interest should mostly be meant.

As mentioned, in the office proper conditions should be secured so that the third party representatives have no access to confidential information<sup>86</sup> while breaking this rule might cause confidentiality damage.<sup>87</sup> Besides, according to the law about defense, paragraph 8, part one, the lawyer should not perform kind of the action that would cause threat to his client's interests and confidentiality protection issue. In addition, the lawyer should care about keeping and protection of the principal's immunity.<sup>88</sup> Violation of these rules indicates to the contradictory action of defense towards the law that may cause accusable damage (paragraph 992 of the same law).

### **7.3. Reasons behind the Violation of Advocatory Secret and the Action Illegality**

For the violation of responsibility of advocacy secret according to paragraph 992 of the law about defense to impose the right accountability it is necessary the cause be thoroughly studied, that is the damage should be represented as result of the action performed unlawfulness. Thus, for accountability to be issued there should be the adequate reasonability between the violations of defense confidentiality and action unlawfulness.<sup>89</sup>

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<sup>85</sup> *v. Meiss R.*, Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rüegger Verlag", 1975, 188-189.

<sup>86</sup> *Ib.*, 110-111.

<sup>87</sup> Decision №086/10, Ethical Commission of Georgian Bar Association, Dec. 15, 2010.

<sup>88</sup> *Pilipenko Y.*, General Trends of Advocate Confidentiality Issue, "Journal of Ukrainian Academy of Legal Advocate", №2, 2009, 22-24, available (in Ukrainian) at: <<http://www.nbu.gov.ua/e-journals/Chaau/2009-1/09pysiat.pdf>> [06.02.10].

<sup>89</sup> *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 1. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2003, 192.

According to the theory of causality of direct and indirect theory in practice, the reasonability of the link represents the objective link that exists independent from human mentality or will. The causal interconnection between the action and results (consequence) practically emerges only in case the counter legal action ends up with the results proper or once the imminent threat of such is at hand.<sup>90</sup> Besides, if the link between the secrecy violation and the act is nonessential and the damage is caused by another reason, then in this case the property related responsibility will not arise.<sup>91</sup>

Though, due to the advocatory secret violation some damage may occur to which the non property damage presumption can be attributed. Thus, by committing the counter legal action it is presumed that non-property damage has been caused (unless opposite is proved). Consequently, exception may concern the person with mental disorder while they have no ability to realize the suffering caused by the violation of both mental and physical nature.<sup>92</sup>

Therefore, if defense violates the secrecy rights, this violation may cause the restitution issue.

#### 7.4. Blame

In case the advocatory secret is violated it is also necessary the assumption of responsibility based on the blame be also determined. The point is that the subjects of the right of advocatory secret protection who cause damage to the principal must offer the restitution proper. One concerns the definition of the delict and blame. Here one should determine whether the property of the one is right enough for damage restitution so that the person has ability to satisfy the party with the property in view. That is the property itself should be determined and issues related to it. This, on its own, is connected to the person's blame or the issue whether the person acted deliberately or on incident.<sup>93</sup>

Thus, according to the general rule, the principle of the damage assumption of blame is used in civil law. According to this principle the afflicting party is considered the one to be charged unless being able to prove the opposite. That is why the load of evidence should be distributed between the parties in view.<sup>94</sup>

Besides, in civil law the exception from this rule is also recognized when the blame for non-property damage can be determined even without existence of such. The accountability of the lawyer without attributing the non-property blame may arise if the case concerns the matter of life or health for the principal from the aggravated source of threat; besides in illegal custody or unreasonably criminal case or unauthorized administrative, punitive measures have been performed; other cases of

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<sup>90</sup> *Nachkebia G.*, Criminal Law, General Part, Tbilisi, 2011, 264-265 (in Georgian).

<sup>91</sup> *Shengelia R.*, Property Damage and Compensation Liability, Tbilisi, 1991, 5 (in Georgian).

<sup>92</sup> *Barabadze N.*, Foundations of Moral Damage Restitution Issue, Journal "A Person and Constitution", №3, 2005, 69-71 (in Georgian).

<sup>93</sup> *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 1. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2003, 192; see about forms of blame (deliberation and incidence) *Schlechtriem P.*, Schuldrecht Allgemeiner Teil, 5. neubearbeitete Aufl., Tübingen, "Mohr Siebeck", 2003, 169-173. See about incidence *Hütte F., Helborn M.*, Schuldrecht Allgemeiner Teil, 3. Aufl., Bremen, "Verlag Rolf Schmidt GmbH", 2005, 204, 206-207.

<sup>94</sup> See Comment of Georgian Civil Code (*Chanturia L.*), Book 4, Vol. 2, Tbilisi, 2001, 378-379 (in Georgian).

honor or merit related data has been promulgated.<sup>95</sup> In this case non-property blame is being spread upon not only the ones who caused the damage but the ones who use the legal authority and presume material responsibility for the person towards whom the damage has been caused. For example if through the actions of public officer the non-property damage has been caused, the state is the party responsible for the one; if inadequate information has been spread, which caused damage to privacy, the mass media agency is the one responsible for the damage caused.<sup>96</sup> But in case of damage to privacy, public officers along with the state in general share the mutual responsibility according to the solidarity principle. Besides, presumption of guilt for the state official is always at hand and the state agency is free of blame in proved to be innocent. The mentioned above, on its own, is linked to paragraph 413 of the law about defense, which along with paragraph 1005 of the same law and is considered cumulatively. If this kind of material result does not come to light and the case satisfies the points given under paragraph 992 of the same law, the aggrieved party enjoys the right to ask for material restitution. But as the non-property damage restitution has no legal ground, it is reasonable paragraph 1005 clarifies the possibility for restitution once this kind of damage has been caused.<sup>97</sup> That is, non-property damage is to be restituted in case of bodily or health damages.<sup>98</sup> Thus, the constitutional understanding of the non-property damage must also be expressed in paragraph 18 so that the principle of non-property damage restitution does not lose the sense.<sup>99</sup>

But in case of responsibility without blame the negative responsibility is detached from its positive aspect and represents another one unlike the responsibility itself. In general, the ideal caused by damage in civil rights may serve to be used towards the absolute rights the violation of which may cause the nature of the delict responsibility. Accordingly, the delict responsibility is preceded by the absolute legal relationship and the damage is caused here. In the case given, a new kind of responsibility is formed. But unlike the one determined by agreement, in contract relationships there is a positive aspect of responsibility while by violation of the contract liability the new contract liability will not occur and the party should stick then to fulfillment of the one with responsibility proper.<sup>100</sup>

## **8. The Legitimization of the Violation of Advocatory Secret**

From the study it is quite clear that sticking to some rule is necessary so that the advocatory secrecy is not violated. However, some exception from this general rule of law is still admitted, namely in case of presence of the written permission from the principal or the supervisory body of

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<sup>95</sup> Regarding the mentioned see *Barabadze N.*, Foundations of Moral Damage Restitution Issue, Journal "A Person and Constitution", №3, 2005, 72-73 (in Georgian).

<sup>96</sup> *Akhvlediani Z.*, Liability Law, Tbilisi, 1999, 73-74 (in Georgian).

<sup>97</sup> *Barabadze N.*, Moral Damage and the Problem of Moral Damage Restitution, Tbilisi, 2012, 196, 210 (in Georgian).

<sup>98</sup> *Schmidt R.*, Schuldrecht Besonderer Teil II – Gesetzliche Schuldverhältnisse, 1. Auflage, Grasberg bei Bremen, "Rolf Schmidt GmbH", 2003, 167; see also *Medicus D.*, Schuldrecht I, Allgemeiner Teil, Ein Studienbuch, 13. neubearbeitete Aufl., München, "Verlag C. H. Beck", 2002, 271; see *Hütte F., Helborn M.*, Schuldrecht Allgemeiner Teil, 3. Aufl., Bremen, "Verlag Rolf Schmidt GmbH", 2005, 371.

<sup>99</sup> *Chikvashvili S.*, Responsibility for Moral Damage, Tbilisi, 2003, 190(in Georgian).

<sup>100</sup> *Nachkebia G.*, Guilt as a Social Philosophic Category, Tbilisi, 2001, 272-273, 173 (in Georgian).



defense, the revelation of the secret is not a punitive action.<sup>101</sup> At the same time, according to professional code of defense if revelation of the secrecy from the lawyer is necessary, it is necessary he (she) is protected from the blame processed<sup>102</sup> in cases determined by this law. However, according to the principles of principal's priority, the lawyer should always act according to the interests of his client and set them above private or those of the other people's ones (professional code of Advocates, paragraphs 3, 4, 5<sup>103</sup>). The code of the ethics of Advocates shares the very rule determined by Georgian constitution saying that person has the right to refuse giving testimony against him.

## 9. The Competition of Requirements Raised by the Violation of Advocatory Secret

The lawyer, as one of the parties representing civil legal relationships, enjoys the right to perform any action that is not restricted or specified by law (law about Advocates, paragraph 10, part two). However, this also has its own frames. If violation of the norms mentioned above cause damage towards the principal through blame, the lawyer is responsible and will be accused according to the civil law. This concerns the private autonomy of defense that is restricted both by law and agreement.

As seen, a contract may be another foundation for advocatory secret. Therefore, in the framework of liable relationships, the damage caused must be taken in responsibility as a prerequisite of the contract relationship. But the issue itself should be raised according to the specification of such a relationship and the terms of agreement proper. Furthermore, the contract requirement should be linked not to the absolute but the relative right violation issue. But as the right for advocatory secret is the absolute one, the violation of such creates a delict responsibility. Thus the case is about which of the legal foundation requirement one has to choose to protect their personal rights.

During the legal claims the issue of the bulk of evidence is to be foreseen. In fact, during the contract agreement, the debtor should prove that fulfillment of liabilities did not happen to be possible due to those externalities beyond of her scope and therefore she must not be held responsible for the damage caused. What about non agreement liability claims, here the bulk of evidence comes upon the claimant so as the guilt of defendant is to be proved.<sup>104</sup>

In addition, the aging of requirements is also to be considered. The contract requirement can age with the time while according to paragraph 130 of the law about advocates, the starting point of the aging for the contract requirement starts from the very time when a person got informed or had to be informed about the violated right. In this case the delict requirement can be real as the three year long

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<sup>101</sup> v. Meiss R., Die persönliche Geheimsphäre und deren Schutz im prozessualen Verfahren, Diesenhofen, "Rüegger Verlag", 1975, 179; see also Beschluss der Aufsichtskommission über die Rechtsanwälte vom 2. September 2004, 4-5.

<sup>102</sup> If a lawyer found out about the principal or the third party representative thought the legal way but not through the client herself, then the lawyer may use these data to mitigate the blame of his client; see *Krasavchikova L.O.*, Private Life of Citizens under the Legal Protection, Moscow, "Judicial Law", 1983 155 (in Georgian).

<sup>103</sup> For the Code of Professional Ethics of Advocates, see the webpage: <[https://docs.google.com/viewer?url=http://gba.ge/pdf/2010/eTikis\\_kodexi.pdf](https://docs.google.com/viewer?url=http://gba.ge/pdf/2010/eTikis_kodexi.pdf)> [28.06.10 18:40].

<sup>104</sup> *Dundua M.*, Delict Responsibility and Contract Responsibility in Relation, "Journal of Law", N1, 2009, 56 (in Georgian).

period for the damage restitution gets counted from the very moment when the aggrieved found out about the damage or the person liable to compensate it (law about advocates, paragraph 1008). However, the goals of special and general norms are also to be considered. At the same time one party should not be in vivid disadvantage than the other one, besides the issue of legal relevancy simplification should also be considered.<sup>105</sup> Here it should be noted that during the legal relevancy the judge is never limited by the legal evidence given in the claim; here it is clear that one should come out from the very foundation the prerequisites of which are easy and quick to determine. At the same time it should be clarified which foundation of the claim be taken for least costs raised for the trial.<sup>106</sup> Thus, according to this criteria that legal foundation of the claim should be verified which mostly corresponds to the purpose of the goal regarding its economic and legal point.<sup>107</sup>

## 10. Conclusion

As revealed, advocacy secret is a broad notion, but it is included in professional secrets according to its essence. Professional secrets apply to other persons too, not only to the advocates. As for the advocacy secrets, the information given to the advocate in the frameworks of the mandate, which is necessary to provide a legal assistance, is considered under it. That's why, in order to protect the advocacy secret, it is advisable to make the advocacy secret as broadly interpreted, to protect the information given to the advocate by the trustier, spreading of which is not desirable for the client.

In addition, if the parties determined the advocacy secret as object of their relation on the basis of the principle of freedom of contract, they will act in the scope of obligations. However, in the connection with the object of such contract, in order to switch on the forced protection unit, the object of contractual relation must meet the demands of law compliance, morality and flow capacity. In other cases, only signs of absolute relation must be foreseen. In addition, the private sphere can be revealed in this information, which is well presented in European court of human rights. Here the concept that by violation the advocacy secret, one's private life can be humiliated is highlighted. So, professional secret protection is a prerequisite for privacy protection. The mentioned is important for establishment of effective rights protection in Georgia.

As for the subjects of advocacy secret, first of all advocates are members of circle. However, they care for protection the professional secret with the help of others too. These individuals are the lawyer's assistant and intern, who are also in blame of professional secret protection by law. As for the other supporters, foreseeing the specification of advocacy secret, it is recommended to use the term "duty of confidentiality". Cleaner, accountant, secretary and others should be discussed in such context. "The law about advocates" does not apply to the persons, who are not registered advocates at the association of advocates, but they are the lawyers. It is important for them to establish their

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<sup>105</sup> *Chachava S.*, Requirements and Requirement Foundation Competition, Tbilisi, 2011, 187 (in Georgian); *Thost P.*, Die Anwendungen des § 477 BGB auf Mangelfogeschäden (Dissertation), Hamburg, 2000, 131-133.

<sup>106</sup> *Boelingi H., Chanturia L.*, The Methodology of Court Rulings Concerning the Civil Cases, Tbilisi, 2004, 44 (in Georgian).

<sup>107</sup> Decision №as-973-1208-04, Civil, Industry and Bankruptcy Chamber of the Supreme Court of Georgia, 2005, available (in Georgian) at: <[www.supremecourcourt.ge](http://www.supremecourcourt.ge)>.

professional code of ethics. However, the Criminal Code - Article 714 of the duty to protect the secret applies to the mentioned persons, which is entailed by assignment of contract. That's why the client can operate according to the norms of obligatory law in the case of failure to comply with the assignment contract. In addition, it is true that personal rights are not transferred by inheritance, but heirs should be able to protect the inheritance rights here, despite the termination of the obligation, as protection of advocacy secret is not limited in time.

Advocate (representative) can be imposed of civil liability in the case of harmful effect of improper practice. According to the CC 992 article, the advocate will be imposed of civil liability for the damage, if there is damage, causal connection and cumulative fault. In addition, the violation is legitimated by the written consent of the secret owner (client) or supervisory authority of advocacy, public interest, and the moment of avoiding prosecution for themselves. Accordingly, in given circumstances civil liability is excluded.

Thus, the research revealed that the main features: the special legal condition of the subjects of defenses the rights of advocate's secret, fiduciary character of relation; specificity of ethical norms; complex object of relationship, created in connection with the advocacy secret.

It seems that the requirements for the issue of competition can be created by encroachment of advocacy secret. In the given case, one should foresee the peculiarities of comparative and absolute relation, the nature of damage, the burden of proof, the issue of remoteness, equality and fairness of the parties, simplification of correct imposing, procedural costs. Foreseen the mentioned criteria, a specific legal basis for the request, matching the case, should be selected.

**Ilonia Gagua\***

## **Role and Function of Law in Apportionment of the Burdens of Proof between Parties (Comparative Legal Reference)**

### **I. Introduction**

As a result of a judicial reform in Georgia being conducted according to the recommendation of the Ministers' Committee of European Union it has been received that justice on civil cases is performed on the basis of competitiveness and disposition principles which as opposed to the inquisitive<sup>1</sup> justice does not require the ascertainment the objective truth on cases by court. In discussing disputes court relies on the activity and initiative of the parties and trials each certain civil case only within the proof presented by the parties and makes not the essentially right decision as it was characteristic for courts before the reform but makes the justified decision giving the fair completion of the process.

So in modern procedural law in the conditions of the action of disposition and competitiveness principles a procedural result of the consideration of the dispute (conflict) arisen between the parties, a substantive result, depends just on the realization of the burden of proof. It is important to apportion of the burdens correctly, as a precondition of the fair completion of the process.

### **II. Peculiarity of Apportionment of the Burdens of Proof between Parties**

#### **1. The Importance of Apportionment of the Burdens of Proof**

In the Civil Procedural Code<sup>2</sup> of Georgia there is no legislative definition of the burden of proof. The essence of the burden of proof in the civil procedural law cannot be understood without comprehension of its practical usage in modern judicial proceeding. The burden of proof should be defined by relating it to the final result of procedural legal relationship, to the procedural result of consideration of case. In the presented research the burden of proof is understood from the following point: the burden of proof is a legal obligation of a participant party of the dispute to perform a certain procedural action; the sanction for non-

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<sup>1</sup> Latin *officium* – public; Latin *inquisitio* – investigate, questioning. A principle of officiality or inquisition is a processual principle according to which court is able to investigate facts basing on the own authority. See: *Tsipelius R.*, *Doctrine of Juridical Methods*, the 10<sup>th</sup> Revised Publication, München, 2006 (Translation into Georgian – *Totladze L.*, Scientific Editor *Turava M.*, 2009, 119).

<sup>2</sup> Reception date: 14.11.1997, "Parliament Notifications", 31.12.1997, 47-48.

performance of this duty is that unfavorable substantive results will be inevitable for the party which failed to perform this procedural duty properly.

The rule of sharing the burden of proof between the parties only concerns the ascertainment of disputable juridical facts. There are two different kinds of juridical facts: facts which do not require presenting proof and facts for confirmation of which it is obliged to present proof<sup>2</sup>. In addition the burden of proof is applied to material facts.<sup>3</sup>

In the discussion of all the civil disputes the burden of proof is not apportioned between the parties. The initiation of the proving process is done by the defendant who does not recognize a claim. If a defendant recognizes a claim, then a plaintiff is exempted from proving the facts and in such a case the plaintiff is not obliged to represent the proof.

The ascertainment of the facts of case is connected with the performance of procedural actions of participants of case and court, namely collection, submission, investigation and next evaluation of evidence. The purpose of distributing functions between the parties and court is to establish dispute facts of case. In pursuance of apportioning of the burdens one party which must establish certain facts is exempted from establishing the facts which must be established by the defendant party and on the contrary the defendant is exempted from establishing the facts which must be established by the plaintiff. Correspondingly a rule of apportioning of the burdens between the parties points to two main factors, namely which party of the process must establish these or those factors and from establishing of which factors is exempted this or that party.

It should also be noted that the apportionment of the burdens of proof between the parties has not only procedural legal but substantive importance as well. It means that an undesirable substantive result caused by non-performance of procedural obligations will be turned out for the party which will not perform his/her legal obligation.

We should conclude that the apportioning of the burdens of proof between the parties is a precondition of manifesting activity and self-initiative of the parties.

The sharing the burden of proof has a big importance from the point of view that it stimulates the parties to find and submit evidence to court for establishing those disputable factual circumstances which must be confirmed by them, that is an inevitable precondition of making a justified decision on the case.

Based on the above a second conclusion can be made, according to which the purpose of the sharing the burden of proof between the parties is just making a justified decision.

## **2. Principles of Competitiveness and Disposition, as Basics of the Apportioning of the Burdens of Proof**

In juridical literature it is justly noted that the exact explanation of the legal nature of the realization of the burden of proof and apportioning of it is impossible without considering the principles of equality of rights and competitiveness.<sup>4</sup> In judicial inquiry sharing the burden of proof

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<sup>3</sup> *Gottwald P.*, Beweislast und Beweisführung im Wettbewerbsprozeß, Rechtsvergleichende Untersuchung zum deutschen, amerikanischen und schwedischen Recht, GRUR Int. 1982, 695, available at: <<http://beck-online.beck.de/?vpath=bibdata%5Czeits%5Cgrurint%5C1982%5Ccont%5Cgrurint.1982.695.1.htm&pos=19&hlwords=beweislastumkehr#xhlhit>>, [17.10.2010].

<sup>4</sup> *Todria T.*, The Importance of Actual Facts in Cassation Court, Tbilisi, 2011, 273 (in Georgian).

between the disputing parties is a concrete expression of the principle of equality of rights of parties. "The foundation of acknowledgement of equality of human rights before law was laid by natural law."<sup>5</sup> Natural duties as well as natural rights for every human must be equal. This equality must be reflected and spread in any sphere of social relations,<sup>6</sup> including procedural legal relations. Equality of rights plays the most important role in development of the civil procedural legal relationship.

Legal proceedings on civil cases is carried out on the basis of the parties' competitiveness, which means that participant parties of case enjoy equal rights and opportunities to ground their requests or to reject the other party's requests, considerations or/and proofs. The principle of competitiveness covers the parties' activities only in the sphere of establishment actual circumstances of case. The concrete reflection of the competitiveness principle is a regulation given in Article 102 of Civil Procedural Code of Georgia according to which each party must prove the circumstances on which it establishes its requests and answer. The concrete reflection of the competitiveness principle is Article 232<sup>1</sup> of Civil Procedural Code of Georgia according to which in case of failure to produce answer. In the terms stated by the 2<sup>nd</sup> part of Article 201, and if it is caused by an inadequate cause, a judge can make a judgment by default without oral hearing.

Within the action of the disposition principle court is restricted; the parties decide themselves whether to start a dispute in court or not, how to conduct and settle it. The parties decide themselves which factual circumstances and proofs they have to submit to court. These facts pointed out by the parties are court syllogism.<sup>7</sup> It is a concrete event defined in time and space which form objective justice as a basis of a legal action.<sup>8</sup>

So we can conclude that the principles of competitiveness and disposition represent procedural legal foundations of apportioning of the burdens of proof between the parties.

It is certain that the civil procedural law of Georgia is influenced by the civil procedural law of continental European countries. Therefore it is interesting to discuss individual questions of procedural law of continental European countries (German, France) in relation to the question under study.

The civil procedural law of Georgia is very close to the German civil procedural law. Both of them are characterized by the exceptions allowed from the disposition principle, it's about interfering of court in private legal relations. In the civil procedural law of Germany a proving process consists of two stages: 1. submission of proofs by means defined by the law of proving; 2. collection, investigation and evaluation of proofs. In process of proving a German judge is entitled to interrogate the parties on his/her own initiative, to charge the parties with submission the documents possessed by them. Court is entitled to interrogate one or both participant parties about a concrete fact without

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<sup>5</sup> *Gschnitzer F.*, Allgemeiner Teil des bürgerlichen Rechts, 2. neubearbeitete Auf., Wien/New-York, 1992, 11-12 (see: *Burduli I.*, Development of Business (Trade) Laws in Georgia and Germany (Comparative Legislative Survey), Tbilisi, 2007, 21).

<sup>6</sup> *Seelmann K.*, Rechtsphilosophie, 2. Auf., München, 2001, 65. (see: *Burduli I.*, Development of Business (Trade) Laws in Georgia and Germany (Comperative Legislative Survey), Tbilisi, 2007, 21).

<sup>7</sup> Syllogism (Greek: syllogismos) deductive reasoning, in which from two given reasonings (premises) is drawn the third (conclusion) one, see Dictionary of Foreign Words, Lexicographer *Chabashvili M.*, Tbilisi, 1964, 350.

<sup>8</sup> *Rosenbeg L., Schwab K., Gottwald P.*, Zivilprozessrecht, München, 2009, 638.

the solicitation of the parties and apportioning of the burdens of proof between the parties.<sup>9</sup> Court uses such empowerment if the collection, investigation and evaluation of proofs (if any) do not give the enough ground to prove the authenticity of the factual circumstances.<sup>10</sup>

Like the Georgian procedural law certain exceptions acceptable by the disposition principle can also be found in the French procedural law. A rule of apportioning of the burdens of proof between the parties is strengthened by Article 9 of the Civil Procedural Code of France, according to which each party is obliged to prove the facts by the rule specified in the law to meet its request.<sup>11</sup> It's true that in the French procedural law the parties have the procedural initiative, however according to the current legislation of France in order to state the circumstances indicated by the parties a judge is entitled to collect proofs on his/her own initiative as well, namely a judge is entitled: 1. to appoint a commission of experts;<sup>12</sup> 2. to call the parties to give the explanation;<sup>13</sup> 3. in order to perceive the facts to take part in examining them;<sup>14</sup> 4. to request documents being with one of the parties or with the third person.<sup>15</sup> It is important to note Article 11 of the French Criminal Code, according to which court and the parties participating in the process are collaborating in the collection of proofs and proving process. On the basis of the solicitation of the party the court is entitled to demand the submission the proofs from the party or from the third person. For non-performance the abovementioned demand the court is entitled to use a daily increasing penalty.<sup>16</sup> By the French legislation each party is obliged to submit the proofs to the second party for the familiarization with them. For non-fulfillment of this obligation a penalty is provided.<sup>17</sup> As a result of studying certain peculiarities of German and French procedural law we can develop some vision concerning the expansion the range of the judge's activities in the proving process: in order not to make unfair judgment in each certain case and not to restrict generally the further development of law, caused by extremely harsh defense of the disposition principle in Georgian civil procedural law, the court must not only be a passive supervisor of the procedural competition of the parties and wait for a procedural result of their competition without taking part in it. By maintaining objectivity court must perform active guidance of the process. In the process of guiding the competitiveness of the parties court must not only explain the participants of the case their rights and duties and warn them about the expected results for performance and non-performance of the procedural actions, but must cooperate with them in the realization process of their rights and in order to state the circumstances of the case must create preconditions of comprehensive and complete investigation of the proofs and correct usage of material legislation. Moreover stating the compliance of the factual circumstances indicated in the action with a concrete substantive-legal

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<sup>9</sup> *Michalski L.*, Bayreuth, Beweisvereitelung durch beweisbelastete Partei und Nachholbarkeit in der Berufungsinstanz, "NJW", 1991, 2069, available at: <<http://beckonline.beck.de/>> .

<sup>10</sup> Civil Procedural Law of Germany (translated from German), Moscow, "Wolters Kluwer", 2006, 94.

<sup>11</sup> *Vincent J., Gulnchar S.*, Procedure Civile, 27<sup>th</sup> Ed., Paris, "Daloz", 2003, 57.

<sup>12</sup> Code de Procedure Civile, Centre Edition, avec le Concours de *Despres I., Darget L.* (Redacteur aux Editions), "Daloz", 2009, Art. 322.

<sup>13</sup> *Ib.*, Art. 84-198.

<sup>14</sup> *Ib.*, Art. 295.

<sup>15</sup> *Ib.*, Art. 138-142.

<sup>16</sup> *Ib.*, Art. 11.

<sup>17</sup> *Ib.*, 132-137.

norm is the right as well as the obligation of the court. In making a legal assessment of the dispute a judge is completely independent as opposed to working on factual grounds of the process and is not restricted with the principles of disposition and competitiveness. Legal assessment of requests presented by the parties and reported factual circumstances is only a prerogative of the judge. For the completion of the process fairly it is very important to extend a range of the judge's activity. However we must not forget that on the basis of the specifics of this or that civil dispute it is impossible to define a range of the judge's activity without the analysis of the important factual situation of the case.

For strengthening the above mentioned considerations I can recall the recommendation of the Ministers' Committee of European Union dated on the 13<sup>th</sup> of October, 1994, about increasing the effectiveness and role of the judge, according to which: "Considering interests of justice a judge should give the parties impartial explanations for procedural issues".<sup>18</sup> In property-legal disputes parties represented without defense attorneys for supporting realization of the burden of proof often need some explanations of individual questions.<sup>19</sup> The mentioned authority can basically be realized by courts of first instance from the viewpoint that on the preparatory stage of case court is not restricted procedurally to appeal the party to focus upon certain factual circumstance, important for the case and to produce the appropriate proof to confirm it.

### **3. The Role of the Court in Apportioning of the Burden of Proof**

In apportioning of the burdens of proof court is charged with the most important role which is due to the fact that substantive law does not regulate in detail the rules of apportioning of the burdens between the parties. Under these conditions court is guiding by the general regulation of apportioning of the burdens stated by Article 102 of the Georgian criminal law, according to which each party must prove the circumstances upon which it bases its requests and answers.

From the viewpoint of expansion of court activities it is interesting to discuss the experience of common law countries. It is true that in these countries there is quite a different system of law, though at present in Continental-European law it is observed reception of legislation of common law countries. In spite of the competitiveness principles of the parties considered and defended by the procedural legislation, the legislation of France,<sup>20</sup> Germany and Georgia contains the norms emphasizing the existence of signs of the so-called inquisitive justice. It is not surprising, as the ways of approaching the competitive and inquisitive processes are evident. In relation to the question under research there are discussed current legal acts of England and the United States of America. They are interesting because they contain certain peculiarities of courts' activities in the proving process which will help to comprehend the apportionment of the burdens in a new manner.

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<sup>18</sup> Recommendation №R(94) 12, Independence, Efficiency and Role of Judges, adopted by the Committee of Ministers of the Council of Europe on 13 October 1994 and Explanatory Memorandum, Supreme Court of Georgia, Human Rights Center, Tbilisi, 2001, 28.

<sup>19</sup> *Gardley J.*, *Foundation of Private Law, Property, Tort, Contract, Unjust Enrichment*, Oxford, "Oxford University Press", 2006, 116.

<sup>20</sup> *Vincent J., Gunichard S.*, *Procedura Civile*, 27<sup>th</sup> Edition, Paris, "Daloz", 2003, 231-232.



Interesting is the USA's model, where a question concerning which party must prove this or that circumstance is settled by court.<sup>21</sup> The burden of convincingness which is often called a risk of unconvincingness causes different results.<sup>22</sup> The party which is charged with a burden of convincingness will fail in a suit, if it is not able to convince a judge and jurors of the factual circumstances by submitting relevant evidence.<sup>23</sup> In federal rules about evidentiary material there can't be found regulating legal norms of sharing the burden of proof.<sup>24</sup> Such norms are formulated in the procedural legislation and doctrine of the USA. According to the federal rules of the civil process a party upon bringing an action must point out the grounds of request or the facts, on the basis of which a disputable legal relationship arose. By the facts pointed out by the defender and the defendant's reply court will finally define which party will be charged with the burden of convincingness.<sup>25</sup>

In Georgia within the bounds of action of the competitiveness principle a role of court in collecting evidentiary material is rather limited as opposed to the experience of common law countries. It indicates that only parties (plaintiff, defendant, third persons with an independent plaintiff's claim and third persons without an independent plaintiff's claim) are obliged to produce evidence in court. Court can demand evidence in cases only defined by law from the party which is not obliged to prove this fact.

#### 4. Rule of Apportioning of the Burden of Proof between Parties

In civil legal proceedings there are special and general rules of apportioning of the burden of proof. In some cases rules of apportioning of the burdens are formed in material-legal norms and are expressed by an imperative form. This is a case, when some norms together with the rules of material-legal behavior contain procedural-legal components as well. Such norms are civil-legal norms, which in matter points to apportioning of the burdens.

The basic rules of apportioning of the burden of proof in civil procedural law of Georgia and Germany are similar. In legal proceedings of both countries there are some exceptions stated by the law of departure from the disposition principle, the talk is about the court intervention in private legal relations; for example court can on its own initiative investigate parties, assign commission of experts, oblige them to submit their documents, though it must be said that this authority of court is strictly regulated by procedural legislation. The regulation of the authority means that for this court initiative

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<sup>21</sup> *Baicker-Mckee S., Janssen W.M., Corr J.B.*, A Student's Guide to the Federal Rules of Civil Procedure, St. Paul, "West Publishing Company", 1997, 148.

<sup>22</sup> *Levin L., Shuchman A., Yablon P., Charles M.*, Cases and Materials in Civil Procedure, New York, "Westburg", 1997, 83.

<sup>23</sup> Federal Rules of Civil Procedure, 1997-98, Educational Edition, St. Paul, "West Publishing Company", 1997, 07. Federal rules about proofs can be discussed as a standard of a law of evidence as in federation, as well as in the states. Before the acceptance of federal rules a code of evidence was in force only in four states – in California, New Jersey, Kansas, Utah, see: *Muller C., Kirkpatrick L.C.*, Evidence, Boston/New York/Toronto/London, 1995, 4-5.

<sup>24</sup> *Joseph W., Glannon A.*, Student's Guide to Understanding Civil Procedure, Boston/Toronto, "Little, Brown and Company", 1987, 199-205.

<sup>25</sup> *Kay Kane M.*, Civil Procedure in a Nutshell, 3<sup>rd</sup> Edition, St. Paul, "West Publishing Company", 1991, 159-160.

it is needed to observe the preconditions strictly stated by procedural code, namely court has the mentioned authority, if: a) the collection, investigation and evaluation of proof is not enough for the legislative organ to make sure in the existence of factual circumstances; b) a judge is authorized to question the parties for clarification the circumstances which are important for the settlement of the case; c) on its own initiative court can assign a commission of experts on the important question connected with the consideration of the case at any stage of the consideration.

By detailed instructions to the proving procedure unlike the Georgian and German procedural law distinguishable is law of evidence which is in action in common law countries. It must not be unexpected considering that in countries of common law (England, the USA) a proving procedure and generally proofs are paid special attention to as opposed to the continental European countries. (Georgia, Germany, France). The above mentioned issues are separately regulated by "evidence law".<sup>26</sup>

In evidence law of England there are two different types of burden: burden of evidence and burden of adducing evidence. The first one is connected with the norms of substantive law; the other is connected with the subjects having this procedural obligation. The burden of adducing evidence must be performed at an initial stage of legal proceedings and is aiming at adducing sufficient evidence for starting the process. At this stage a plaintiff is facing two barriers. First he/she must adduce sufficient evidence; otherwise a judge will cease judicial proceedings on the case. If the plaintiff overcomes this barrier, he/she will have a second barrier to overcome- realization of the burden of evidence which means to assure court of factual circumstances given in the plaint.<sup>27</sup>

So a task of the burden of adducing evidence is to state the essence of the dispute or in other words to reveal the basic points of the dispute. At the preparatory stage a subject of the dispute is being stated and competitive papers are being exchanged, which help the awareness of the parties and avoids the unexpectedness effect at judicial session. As it is seen in English legal proceedings the obligation of adducing evidence is separated from the burden of evidence, as the main point is not to prove any fact, it is only necessary "to call" the evidence. According to the rules of 1995 about civil legal proceedings the administration is divided into two groups. To the first group belongs the obligation of court to appeal the parties to cooperate and to the second group belongs the obligation of courts to guide the process. For this purpose court as fast as possible from adducing the plaint must: identify disputable aspects; take part in collecting the evidence, particularly must conduct hearing and collect evidence by telephone or other communication means; prolong or shorten a period of procedural action, suspend the proceedings until some event or period; appeal to the party or its representative to appear before the court and etc. Moreover Britain's civil court is authorized to control the collection process of evidence pointing out disputable issues and ways of adducing them in court. In such a way was changed a disposition principle dominated in England and consideration of a case does not depend on revealing the will of the interested persons and when parties are opposed, where the judge only plays a role of arbitrator, there is not stated the objective truth, but the truth serving to a fair completion of the process.<sup>28</sup>

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<sup>26</sup> "Evidence Law".

<sup>27</sup> *Cross R., Wilkins N.*, Outline of the Law of Evidence, London, "Brown and Company", 1987, 27-28.

<sup>28</sup> *Baicker-Mckee S., Janssen W.M., Corr J.B.*, A Student's Guide to the Federal Rules of Civil Procedure, St. Paul, "West Publishing Company", 1997, 149-151.

## 5. Presumptions as the Grounds of Apportioning of the Burden of Proof between Parties

The grounds of apportioning of the burden of proof are also presented by suppositions (so-called presumptions) foreseen in civil law. "The existence of presumptions is necessary, so that the participants of relationship will not be in uncertain, obscure state and their legal status will not be hanging in the air".<sup>29</sup> In civil law there is not a complete system of presumptions or apportioning of the burdens between the parties. In some cases a law does not show directly which party must prove a certain fact or specifically on proving which facts a presumption about the existence or non-existence of other factors arises. It is natural, as "Law cannot and must not fix all the possible correlation options of rights and duties. The law norm can only express the basic signs. That's why the rule of law defines the results of the participants' actions only by abstract form. In addition law in the process of its development falls behind the development of social relations. This conservatism of law objectively needs compensation in the process of its contact with social relations. Such compensatory function is done by the court in the process of applying of a law".<sup>30</sup> When, material law does not state the presumption of the fact, this issue is regulated by the court. In such a case a person applying a law is governed by the common regulation of sharing the burden of proof (Article 102 of the civil procedural code of Georgia). Besides some rules of sharing the burden of proof is stated by the court practice, which in its turn fills up the legislation gaps. From this point of view the court is just that authorized organ which has the right to fill up the material law afterwards and develop it.

Suppositions (the so-called presumptions) follow from the norms of material law and in addition to this they are grounds of apportioning of the burdens. In legal proceedings apportioning of the burdens between the parties is done by force of presumptions. Laws very often contain suppositions (presumptions) about the existence of facts. If there are characteristic signs of presumption of the fact for the circumstances of the case envisaged by the law, the supposed fact does not need to be proved. For example, the obligation to pay interest can be originated from the grounds which don't generally create the obligation to indemnity. According to §288 of German civil legislation in case of delay execution of pecuniary obligation by a debtor, a creditor without representing additional proofs can demand to pay interest by the debtor.<sup>31</sup> Proving is needed for the fact, which explains the supposition and also for the composition of the norm containing the presumption. Against it the opposite party within the limits of the legislation must prove the reverse, namely must prove that the supposed fact does not exist. The norm, containing the presumption, is often provided for by substantive law and is intended for appropriate processes. Substantive character of presumptions means receiving certain substantive results for the subjects of substantive legal relationship.

So in case of disputes there are operating procedural-legal functions of substantive presumptions. In each certain case it is checked whether the presumption existed in the civil legal norm belongs to the sphere of interest and if it is possible to share the burden of proof by using it .

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<sup>29</sup> *Chanturia L.*, Introduction to the General Part of Civil Law, Tbilisi, 1997, 160 (in Georgian).

<sup>30</sup> *Khubua G.*, Theory of Law, Tbilisi, 2004, 132 (in Georgian).

<sup>31</sup> *Dzlierishvili Z.*, Peculiarities of Execution of Money Obligations, Tbilisi, 2005, 45-46 (in Georgian).

### **III. Peculiarities of Innovative Apportionment of the Burdens Provided for by Civil Procedural Code of Georgia**

#### **1. Peculiarity of Innovative Apportionment of the Burdens in Hearing of Family Cases**

Implementation of innovations in legislation is connected with its perfection. The newest changes introduced in the civil procedural code of Georgia include institutes unknown for the civil procedural law before. There are new concepts, ideas, and categories. Novelties promote the development of civil society in the limits of the law-governed state which is necessary for the country.

The civil procedural code of Georgia regulates rules of judicial defense of different rights and interests. In many instances the substantive nature of these cases has a big influence on the procedure and form of their consideration. In Part seven of the civil procedural code of Georgia there are such institutes of civil justice which differ from the rest of plaintiff form regulated by civil procedural law. Cases of the category included in part seven of the civil procedural code also concern disputes arisen from family relations. The interest to them is caused by the non-traditional kind of apportioning of the burdens, which represented by a mixed form occupies the key position in this research.

Peculiarity of discussion of the disputes originated from family law relationship is due to the fact that the family relations have personal and long term character and at the same time includes protection of juveniles' interests.

One of the fundamental peculiarities as opposed to the discussion of cases of other category is the more widely usage of the search principle. The court which is discussing a certain family legal dispute is entitled not to be satisfied with the evidence represented by the parties and on its own initiative to define the circumstances without which the settlement of the case is impossible (subject of proving), after hearing explanations of the parties to demand proofs which were not pointed out by the parties but are important for confirmation the circumstances contained in the subject of proving. So the statement provided for by the first part of Article 354 of civil procedural code of Georgia is a special norm and preferential compared to the general norm provided for by Article 103.<sup>32</sup>

From the viewpoint of consideration of family cases German procedural law has certain peculiarities. Here on the basis of marriage-family legal relationship participates a prosecutor, as a representative of the state (civil procedural code of Germany §632, §636, §637). For example, an action for annulling marriage will be produced in court by the prosecutor against both spouses; if one of them is dead, then against the second spouse.

From the viewpoint of consideration of family cases German procedural law has other peculiarities, particularly to avoid lingering the process the judge is entitled to govern the legal proceeding and to exert considerable influence on the acceleration of the process and the result of the fair completion of the process. At any stage of conduction of a case the court ensures reporting explanations and making petition by the parties.<sup>33</sup> The court explains the parties the necessity of overcoming difficulties resulted from the disposition and competitiveness principles.<sup>34</sup>

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<sup>32</sup> *Dzlierishvili Z.*, Individual Issues of Procedural Civil Law, Tbilisi, 2007, 97 (in Georgian).

<sup>33</sup> *Grunsky W.*, Zivilprozessrecht, 11 Aufl., München, 2003, 36.

<sup>34</sup> *Luke W.*, Zivilprozessrecht, 8 Aufl., München, 2003, 5.

So in disputes coming from family-legal relationship together with the competitiveness principle has been given the right of material guidance, though there appears a question of proportion of these two principles – competitiveness of the parties and court activity. It is interesting by what dosage these two principles must be merged and used in the consideration of the case.

To solve this question the process must be formed on the basis of the competitiveness principle, however the court interfere must be admitted by a dose that will not breach the principle of disposition, the parties must not be restricted in the realization of their rights, the parties must not be forced to use this or that procedural right and these or those procedural rights must not be used independently, willfully against the will of the parties. Accordingly in the case of family matters a question of sharing the burden of proof must be solved in favor of the moderate balance between the competitiveness and inquisition principles. So the parties will not be either restricted by the activity of the court or oppressed by the passivity of the court.

## **2. The Peculiarity of Apportionment of the Burdens in Hearing Cases Connected with Confiscating and Transferring the Following Property to the State: Racketing Property, Property of: an Official Person, a Member of a Thievish Circle, a Man Trafficker, an Accomplice in Drugs Distribution or the Property of a Person Convicted by Subparagraph "c" of the Third Part of Article 194 of the Georgian Criminal Code**

In the beginning of the XXI century corruption has covered such spheres in Georgia, as: education, economics, art and others, causing regression instead of development of leading fields of social life. Nobody was responsible for the above mentioned activities. It was caused by the absence of the proper normative acts. The increase of illegal income in the state caused receiving a normative act on struggling against it. The irreversible process of harmonization the Georgian legislation with the legislation of the developed countries created the necessity of formation of anti-bribery and anti-racketing legal basis. On the 24<sup>th</sup> of June, 2004 the Georgian parliament received a law concerning "organized crime and racketing".<sup>35</sup>

By receiving the above mentioned law some changes and additions were made to the civil Georgia Chapter XLIV came into force by means of which was regulated legal proceedings connected with confiscating racketing property, property of an official person, a member of a thievish circle, a man trafficker, an accomplice in drugs distribution or the property of a person convicted by subparagraph "c" of the third part of Article 194 of the Georgian criminal code and transferring it to the state.

By the rule of a civil legal proceeding an action on cases of such a category is sued by a prosecutor, which is novelty for the Georgian present legislation.

In hearing of such cases presumptions are not acting, as the main assignment of the presumption – making resolution in favor of the party opposing to the unproved facts – is not observed in the mentioned proceedings. The burden of proof is apportioned in favor of the plaintiff, namely is

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<sup>35</sup> Georgian Law on Organized Crime and Racketing, "Parliament Bulletin", N2354, 2004 (in Georgian).

presumed that a defendant's property is unproved, illegal and the defendant is charged with the burden of proof in order to prove the fact of acquisition of the disputable property by lawful means.

The burden of proof of the plaintiff is only confined to confirming the reasonable suspicion; while with the burden of the contrary proof connected with the confirmation of the disputable property will be charged the defendant. If the prosecutor is not able to prove racketing, illegality and groundlessness of the property, it will be caused by unequal apportion of the burden of proof between the parties. For example, in hearing of one civil case the court explained that the plaintiff was only charged with the burden of proving a grounded suspicion and the defendant was charged with the contrary proving burden, connected with the reasonableness of the disputable property; the defendant was unable to produce a document confirming the purchasing of the \$1800000 worth property by lawful means.<sup>36</sup>

Georgian court has not had judicial practice so far in order to regulate legal relations of such confiscation of the property when there is a general agreement about the honesty of the purchaser, the observance of public order, promoting establishment of moral and fair society. However in the deals arranged within the limits of private autonomy the public order and the honest purchaser are facing one another.<sup>37</sup> The purchaser's fate completely depends on the alienator's legal state and his/her own providence. The innovative, even temporary uncertainty of theoretical-practical questions existed in Georgia is interesting from the European legislative viewpoint and of course it is interesting for post-Soviet and post-Communist countries.

The main point here is a fair balance of interests of an honest purchaser and the public order and considering more risk factors and guiding by them, which must be an estimation subject of court in each concrete case. At the same time "there must be observed interests of the weak participant party of the agreement in relation to the dealing and in case of an honest purchaser and in attempting to restore the social equality must not be forgotten to defend the interests of the weak party".<sup>38</sup>

From the above mentioned it can be concluded that we are discussing a legal institute unknown for the Georgian civil procedural law, the peculiarity of which is unequal apportion of the burden of proof. Non-traditional apportionment of the burdens is due to peculiarity of a legal dispute which represents restoration of public order by acquisition of property unlawfully.

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<sup>36</sup> Case №2b/932-09, Tbilisi Appellate Court, 2009, available (in Georgian) in Court Archives.

<sup>37</sup> *Palandt O.*, Bürgerliches Gesetzbuch, München, 2002, 61-62.

<sup>38</sup> *Cherednychenko O.*, Fundamental Rights, Contract Law and the Protection of the Weaker Party, A Comparative Analysis of the Constitutionalisation of the Contract Law, with Emphasis on Risky Financial Transactions, Vol. 5, München, "European Law Publishers", 2007, 4, 5.

#### **IV. Conclusion**

The conducted research shows that the apportionment of the burdens has a mixed nature. In order to state the importance of the apportionment of the burdens between the parties action and ex parte proceedings were analysed. There were studied common and different features of the apportionment of the burdens between the parties, as a result of which generally was received an unequal rule of apportioning of the burden of proof between the parties:

a) In some cases a substantive rule includes special rules regulating the apportionment of the burdens;

b) In other cases the court is guiding the apportionment of the burdens by general regulation stated by the civil procedural code; in such cases the apportioning of the burdens between the disputing parties is represented as a precondition of expansion of a court's passive role, when on the civil case is obtained not an objective truth, but a result serving a fair completion of the process.

c) From the viewpoint of the apportionment of the burdens between the parties in the civil procedural code there is considered an individual group of exceptions due to the material contents of the dispute and peculiarities of the relations.

**Ekaterine Lapachi\***

## **Principles of Registration of Property Rights on Immovable Things under Georgian and German Law**

### **1. Introduction**

Ownership is one of the essential elements of independent living - owner of the thing has the right to protect his/her own ownership and preclude any influence from any other person.<sup>1</sup> Regardless of the level of development, issue of arising ownership rights is central in any country and, respectively, in Georgia.

Ownership includes property. According to the Civil Code of Georgia (hereinafter, "CCG"), property is every thing as well as any intangible property benefit.<sup>2</sup> A thing may be either movable or immovable. Immovable things, first of all, include a plot of land that constitutes the basis of any economic system.<sup>3</sup>

Ownership of immovable things is one of the fundamental human rights recognized in the Constitution. Due to this fact, a special regime is determined to acquire ownership rights on immovable things.

Modern law of Georgia links issue of arising ownership rights on immovable things to registration in the public registry and attaches importance at the level of the Constitution. Hence, registration of rights on immovable things that closely relates to the issue of principles of registration of rights is a pressing issue. Principles constitute basic prerequisites upon which registration of property rights on immovable things is based on.

Principles of real estate book and registration of rights on immovable things are divided into material and formal types of principles.<sup>4</sup> Accordingly, each principle has both material as well as formal understanding. This is especially clearly demonstrated in the German law.

### **2. Principle of Registration in the Public Registry (Real Estate Book)**

First of all, a principle of registration in the real estate book should be emphasized. This principle is acknowledged and well established in German law. The same rule applies in Georgia with respect to the public registry. This principle implies following: arising, altering and terminating *ownership* and *other rights* depends on material principle of the agreement and registration. By

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<sup>1</sup> *Schmidt R.*, Sachenrecht II, Recht der unbeweglichen Sachen, 1. Aufl., Bremen, 2004, 26.

<sup>2</sup> Civil Code of Georgia, 1997, Article 147, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>3</sup> *Alekseev V.*, Real Estate: State Registration and Problems of Legal Regulation, Moscow, 2007, 4 (in Russian).

<sup>4</sup> *Winkler K.*, Aufsatz, Das Grundbuch; DStR 1991, 284, available at: <<http://beck-online.beck.de/>>.



concluding agreement, parties declare their intention and, hence, registration is carried out. However, it should be noted that registration is also required when legal acquisition takes place as a result of coercive enforcement.<sup>5</sup> Property rights on using immovable things and restrictions are also subject to the compulsory registration.<sup>6</sup> This refers to German legislation. As for Georgian legislation, registration in the public registry is mandatory for arising property rights, including ownership rights on immovable things<sup>7</sup> that is a material understanding of this principle.

According to German legislation, real estate book governs formal preconditions that is a basis for registration in the real estate book. The same rule applies under Georgian legislation. Article 8 of the Law of Georgia on Public Registry provides for formal preconditions when a registration authority registers rights.

### 3. Principle of Application

The process of maintaining real estate book is based on this principle. According to Georgian legislation, filing an application is the basis of registration in the public registry.<sup>8</sup> Therefore, starting registration process is based on an application or a decision of an authorized body. As for the formal principle, in case of arising or terminating as well as abandoning ownership or other rights, an application should be filed before the public registry.<sup>9</sup> German positive law provides for registration without such an application only in exceptional circumstances.<sup>10</sup> However, the Law of Georgia on the Public Registry does not envisage such an exception.<sup>11</sup>

### 4. Principle of Publicity

The principle of publicity provides protection to the participants of legal circulation and promotes credibility of the registry data. It should be noted that the principle of credibility of public registry data is inherent to any registration system. As book of acts containing transaction-related data, as well as real estate book, reflecting property rights on immovable things can serve as a reliable source of information to the third parties. The only difference refers to the conclusions that the third parties may draw in concrete cases. In case of records of the act, an interested person can trust only information about the type of the transaction and when the information about this transaction was entered in the registry. As for real estate book records, an interested person can be confident that the

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<sup>5</sup> *Schöner H., Stübe K.*, Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, 15. Aufl., "Verlag- C-H, Beck", München, 2012, 14.

<sup>6</sup> Civil Code of Georgia, 1997, Articles 289, 247, 243, 237, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>7</sup> Civil Code of Georgia, 1997, Articles 255, 257, 258-1, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>8</sup> Law of Georgia on Public Registry, Articles 8-1; 9-2, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>9</sup> Civil Code of Georgia, 1997, Article 184, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>10</sup> Grundbuchordnung[1], In der Fassung der Bekanntmachung vom 26., May 1994[2], §204, available at: <<http://beck-online.beck.de/>>.

<sup>11</sup> Law of Georgia on Public Registry, Article 8, available (in Georgian) at: <<https://matsne.gov.ge/>>.

real estate book (public registry) data on property rights are valid and property rights belong to the person referred to in the records.<sup>12</sup>

Real estate book and in Georgia -public registry records perform a role of evidence concerning existence of rights.<sup>13</sup>

In material terms, the principle of publicity promotes credibility of accuracy and precision of content of real estate book with participants of legal relations. Publicity of a real estate book - public registry - provides protection for acquirers in good faith. Georgian law, similar to European law, regulates the issue of acquirers in good faith of immovable things. "In favor of a person who acquires some right from another person on the grounds of a transaction while this right was entered in the public registry in the name of the alienator, the entry in the public registry shall be deemed to be accurate except when a complaint has been lodged against this entry, or when the acquirer knew about the inaccuracy of the entry."<sup>14</sup> Such a legal status of an acquirer in good faith is based on the specific purpose of public registry within the civil circulation mechanism. By its nature, the presumption of veracity and completeness of entries in the public registry in accordance with Article 312 of CCG is a legal fiction assuming that any fact of registration of a right in the registry is implemented completely and accurately. This fiction means that any objectively existed fact which indicates registration deficiency, cannot exclude assumption on appropriateness of the registered rights that is protected by the norm under discussion.<sup>15</sup> Good faith means that the owner is confident in lawfulness of his/her possession, i.e. believes that acquisition of property by him/her is a sufficient ground to have ownership right.<sup>16</sup> During acquisition of immovable things presumption of validity of real property and assumption of validity of the right to be acquired applies. The starting point in the civil circulation is the good faith which derives from the interests of participants of civil circulation. The presumption of veracity and completeness of entries in the public registry applies, i.e. entries in the registry shall be deemed to be accurate until its inaccuracy is proven.<sup>17</sup> These norms create a legal presumption that the right registered in the public registry does in fact exist or exists in such conditions in which it was registered and that a person registered in the public registry as an authorized person is in fact authorized. In a similar way, if a right registered in the public registry is deleted, it is assumed that it was canceled.<sup>18</sup>

The presumption of veracity of the public registry does not protect interests of a person registered in the public registry as an authorized person only. It has more importance because it also protects a participant of civil circulation which trusts the veracity of the public registry entries in good

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<sup>12</sup> *Alekseev V.*, Real Estate: State Registration and Problems of Legal Regulation, Moscow, 2007, 19-20 (in Russian).

<sup>13</sup> *Schöner H., Stüber K.*, Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, München, "Verlag-C-H, Beck", 2012, 4.

<sup>14</sup> Civil Code of Georgia, 1997, Article 312-2, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>15</sup> Decision No. as-465-435-2010, Chamber for Civil Cases, Supreme Court of Georgia, 2011, available (in Georgian) at: <[www.supremecourt.ge](http://www.supremecourt.ge)>.

<sup>16</sup> *Khvostov V.M.*, System of Roman Law, Moscow, 1996, 253 (see: *Kochashvili K.*, Interdependence of Possession and Ownership, "Law Journal", №1, 2011, 124 (in Georgian)).

<sup>17</sup> Civil Code of Georgia, Article 312-1, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>18</sup> *Chechelashvili Z.*, Property Law, 2009, 189 (in Georgian).

faith. Legal protection is manifested by the fact that acquirers in good faith of the real estate-related rights acquire such rights registered in the public registry which in fact do not exist and, thus, records are inaccurate. In addition, rights that are registered in the public registry, but in fact do not exist may only be acquired in case if certain preconditions exist defined by the law.<sup>19</sup> The principle of good faith considers individual action in relation to fairness criterion.<sup>20</sup> Obligation of a subject to consider interests of other person derives from freedom of action under good faith principle to the extent that does not cause disproportionate restriction on his/her own interests.<sup>21</sup>

The Supreme Court of Georgia interpreted in its decision that the purpose of the public registry is to ensure stability of civil circulation. It guarantees protection of rights of an acquirer in good faith. Based on this principle, when the presumption of veracity and completeness of entries in the public registry is discussed in the frames of institution of an acquirer in good faith, term "alienator" under Part 2 of Article 312 and Article 185 of CCG always refers to a person who is not entitled to alienate a right registered in the public registry in his/her name and, thus, is not entitled to make a transaction. Particularly in those cases when immovable thing is alienated by an unauthorized person but registered as owner of this right in the public registry, right of an acquirer ensured by Article 185 of the Civil Code attaches huge importance. In particular, according to the provision under discussion, proceeding from the interests of an acquirer, an alienator is deemed to be an owner if s/he is so registered in the public registry, except when the acquirer knew that the alienator was not the owner. The purpose of this provision is to protect civil circulation and, consequently, ensure high level of trust in the fact of registration in the public registry. An acquirer shall not be required to have more knowledge other than is prescribed by law. First of all, it is important that trust in the fact of registration in the public registry implies that right registered in the public registry in fact belongs to the alienator, i.e. the person who declares his/her intention to alienate the right registered in his/her name. Thus, stability of civil circulation means trust in and integrity of participants of civil relations, which is secured by the presumption of veracity and completeness of entries in the public registry. Therefore, according to this provision, right to ownership of an acquirer in good faith arises not for the reason that an unauthorized alienator became an owner of real property registered in the public registry because of registration fact, but because the law with the aim of protecting interests of civil circulation, attaches particular importance to the externally perceived facts which enjoy reasonable trust. In particular cases such a fact is registration of the right in the public registry.<sup>22</sup> Presumption of veracity and completeness of entries in the public registry is an important guarantee for the protection of trust and the principle of integrity established in civil circulation. It promotes stability of civil circulation.<sup>23</sup>

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<sup>19</sup> *Chechelashvili Z.*, Property Law, 2009, 189 (in Georgian).

<sup>20</sup> *Ib.*, 190.

<sup>21</sup> *Kereselidze D.*, Most General Systemic Notions of Private Law, Tbilisi, 2009, 83.

<sup>22</sup> Decision №as-465-435-2010, Chamber for Civil Cases, Supreme Court of Georgia, 2011, available (in Georgian) at: <[www.supremecourt.ge](http://www.supremecourt.ge)>.

<sup>23</sup> Interpretation of Norms Used in Decisions of the Chamber for Civil Cases of the Supreme Court of Georgia, Tbilisi, 2009, Ruling №3k-932-02, 2002, Subject of Interpretation, Presumption of Veracity and Completeness of Registry Data.

The formal principle of publicity means openness of real estate book for the participants of civil circulation in order to get acquainted with it.<sup>24</sup> One of the basic principles in maintaining real estate book is the principle of publicity. The rationale behind it is that land ownership as well as possession of immovable things is recognized when it is registered in the registry in the name of a concrete person. Moreover, registration serves the purpose of ensuring legal order.<sup>25</sup>

Formal principle is that the entries of real estate book – public registry - are open to any interested persons.<sup>26</sup> According to CCG, the procedure for organization and rules of availability of the public registry shall be defined by law. Hence, according to the Law of Georgia on Public Registry, data registered in the public registry and documents recorded in the registration authority are public and available to any person. However, there is an exception to this rule since the General Administrative Code of Georgia also envisages issues concerning protection of information privacy. The abovementioned law refers to such exceptions.<sup>27</sup>

Publicity arose not because of theoretical necessity but rather because of reality as a result of existing practice, in particular, to avoid such cases when the same immovable thing was used to be sold to different persons simultaneously.<sup>28</sup> Public availability is one of the necessary conditions that ensures reliability of registration as well as public control in respect of the validity of the registered data.<sup>29</sup> The principle of publicity is the main principle based on which a sense of calm is preserved for the participants of civil legal circulation since "the publicity of the registry makes it more easy for the participants of circulation to receive full information about the true conditions of rights of their partners".<sup>30</sup>

Any interested person may get familiar with real estate book.<sup>31</sup> Their interest must be reasonable as well as justifiable. Curiosity, incompetent or bad faith aims shall be precluded.<sup>32</sup> Under German law, principles of "publicity" and "reliability" have been merged. As a result, the principle of credibility of publicity of real estate book was established. This means that content of real estate books is legally recognized for all those who acquired right of ownership on land.<sup>33</sup> Introduction to the real

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<sup>24</sup> *Schöner H., Stüber K.*, Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, 15. Aufl., München, "Verlag-C-H Beck", 2012, 22.

<sup>25</sup> Das Grundbuch, DStR 1991, 284, available at: <<http://beck-online.beck.de/>>.

<sup>26</sup> Grundbuchordnung[1], In der Fassung der Bekanntmachung vom 26., Mai 1994[2], §17, available at:<<http://beck-online.beck.de/>>.

<sup>27</sup> Law of Georgia on Public Registry, Article 5 - 1, available (in Georgian) at:<<https://matsne.gov.ge/>>.

<sup>28</sup> See *Emiljanova E.*, Legal Problems of State Registration of Rights on Real Estate and Related Transactions, Samara, 2003, 14 (in Russian).

<sup>29</sup> See *Lazarevski A.* (Ed.), System of Registration of Rights on Real Estate. Experience of Foreign Countries, Moscow, 2000, 12 (in Russian).

<sup>30</sup> *Zoidze B.*, Property Law of Georgia, Tbilisi, 2003, 365 (in Georgian).

<sup>31</sup> *Böhringer* Rpfleger 1987, 181; *Böhringer* Rpfleger 1989, 309; Franz "NJW" 1999, 406; *Melchers* Rpfleger 1993, 309; *Schmidt-Räntsch* VIZ 1993, 432, 433; *Schreiner* Rpfleger 1980, 51. Vgl. RdNr. 14, 22 (see: *Säcker F.J., Rixecker R.*, Münchener Kommentar zum Bürgerlichen Gezetzbuch, 2009, 5. Aufl., Rdnr. 21-23, available at: <<http://beck-online.beck.de/>>).

<sup>32</sup> KGJ 20 A 173, 175; *Meikel/Böttcher* § 12 GBO RdNr. 4 ff (see: *Säcker F.J., Rixecker R.*, Münchener Kommentar zum Bürgerlichen Gezetzbuch, 2009, 5. Aufl., Rdnr. 21-23, available at: <<http://beck-online.beck.de/>>).

<sup>33</sup> *Emiljanova E.*, Legal Problems of State Registration of Rights on Real Estate and Related Transactions, Samara, 2003, 12-13 (in Russian).

estate book is called as "starting the legality".<sup>34</sup> The principle of publicity contains that any act having legal nature of things (transfer of right of ownership, defining servitude, mortgage, etc.) must be recorded in the real estate book and from this moment it acquires legal force for the third persons.

As it was noted above, this principle is reflected in the public trust in real estate book and presumption of its accuracy. In this respect, every transaction related to land is registered in the real estate book and, thus, society becomes aware about fate of each plot of land (§§891,892,893,894); property rights on immovable things become really visible for any interested person and if anyone is willing to check someone's ownership of real things, s/he may do that by looking at the registry data and receiving useful information.<sup>35</sup>

## 5. Principle of Exhaustive List of Rights

Principle of exhaustive list of rights implies that there are as many property rights as defined by law<sup>36</sup> (*numerus clausus*), i.e. range of property rights is listed in exhaustive manner in the law and there are as many rights as recognized by law. These rights are: ownership, superficies, servitude, usufruct, mortgage, security interest.<sup>37</sup> This principle belongs to the set of principles of immovable things, however, at the same it can be considered as a principle of registration in the "royal registry".

"Participants of the relations may use only those forms (rights) of domination on things which are established by law."<sup>38</sup> On the one hand, there is an exhaustive list of certain types of property rights defined by law (type of coercion or constraint)<sup>39</sup> and, on the other hand, legal certainty of content of these rights.<sup>40</sup> Substantial registration of modified rights is permitted only within the limits prescribed by law (type of fixation).<sup>41</sup>

Moreover, it should be noted that the Law on Public Registry provides for an exception of the mandatory registration. In particular, if one party to the transaction is a legal entity under private law and the transaction is concluded for a period of more than one year, the lease, sublease, rent, sub rent, lending, leasing and obligations on ownership on immovable things are subject to mandatory registration.<sup>42</sup>

<sup>34</sup> *Shershenevich G.*, Handbook of Russian Civil Law (Edit., 1907), Moscow, 1995, 149 (see: *Emiljanova E.*, Legal Problems of State Registration of Rights on Real Estate and Related Transactions, Saint Petersburg, 2003, 12-13 (in Russian)).

<sup>35</sup> *Zoidze B.*, Property Law of Georgia, Tbilisi, 2003, 7 (in Georgian).

<sup>36</sup> *Wilhelm J.*, Sachenrecht, 2. Aufl., 2002, Rdnr. 10; *Wolf M.*, Sachenrecht, 2. Aufl., 2005, Rdnr. 22f.; *Vieweg K., Werner A.*, Sachenrecht, 2. Aufl., Köln-Berlin-Bonn-Mün., 2005, 4.

<sup>37</sup> *Zoidze B.*, Property Law of Georgia, Tbilisi, 2003, 5 (in Georgian).

<sup>38</sup> *Chanturia L.*, Ownership on Immovable Things, 2001, 167 (in Georgian).

<sup>39</sup> *Staudiger-Seiler*, Einladung zum Sachenrecht, Rdnr.38; *Schwab/Prütting*, Sachenrecht, 32. Aufl., 2005, Rdnr. 17 (see: *Vieweg K., Werner A.*, Sachenrecht, 2. Aufl., Köln-Berlin-Bonn-Mün., 2005, 4).

<sup>40</sup> *Bauer/Stürner*, Sachenrecht, 17. Aufl., 1999, §1, Rdnr.7 (see: *Vieweg K., Werner A.*, Sachenrecht, 2. Aufl., Köln-Berlin-Bonn-Mün., 2005, 4).

<sup>41</sup> *Schöner H., Stüber K.*, Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, 15. Aufl., München, "Verlag-C-H, Beck", 2012, 19.

<sup>42</sup> Law of Georgia on Public Registry, Article 11, available (in Georgian) at:<<https://matsne.gov.ge/>>.

Type of each property right is precisely defined by law and is subject to determination based on individual's intention only within the limits of law. Therefore, parties to the relations are unable to determine property rights other than defined by law.<sup>43</sup>

There was an attempt by the courts to make corrections to the exhaustive list of property rights, in particular, to add two more property rights. These are: transfer of right on fiducial ownership and right to claim to receive future right. Since this initiative came from the judiciary and not from freedom in the making of contracts, thus, the principle of *Numerus clausus* has not been altered.<sup>44</sup>

## 6. Principle of Certainty (Specialty)

In line with this principle, the land on which legal rights are established, as well as identity of person whose rights are registered and content of the registered rights should be determined in veracious and complete manner (veracity and completeness).<sup>45</sup>

According to this principle, property rights exist only on certain things. This means that transactions can only relate to things determined on individual basis. This excludes existence of property transactions on determined generic things.<sup>46</sup>

Under German law, real estate book is organized according to certain plots of land. For each of them a separate "page" is assigned in the real estate book, consisting of several pages that are divided into five sections: title page, inventory records and three sections: Section I; Section II and Sections III.

Cover page serves to legal identification of the plot of land.<sup>47</sup> Under the Law of Georgia on Public Registry, in addition to the records on registered rights on immovable things, identification data of the subject and object of the rights is also entered in the public registry, including cadastral data on immovable things (Article 11-II).

At present many countries of the Continental Europe, e.g. Germany, Austria and Switzerland, have in place a modern comprehensive high-quality cadastre as well as registration of ownership on the basis of the same plots of land, while the European Mediterranean countries and Eastern European countries have cadastres which are not comprehensive or updated, and in fact they have systems of registration of transactions with less legal force.<sup>48</sup>

In various countries different systems of records exist concerning objects of immovable things. However, most of them have many shortcomings – systems in certain countries cover only partially,

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<sup>43</sup> Van Erp, Comparative Property Law, in: *Reimann /Zimmermann* (Eds.), Oxford Handbook of Comparative Law, 2006, 1053 (see: *Kereselidze D.*, Most General Systemic Notions of Private Law, 2009, 219 (in Georgian)).

<sup>44</sup> *Vieweg K., Werner A.*, Sachenrecht, 2. Aufl., Köln-Berlin-Bonn-Mün., 2005, 4.

<sup>45</sup> *Schöner H., Stüber K.*, Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, 15. Aufl., München, "Verlag-C-H, Beck", 2012, 18.

<sup>46</sup> *Schwab, Heinz K.*, Sachenrecht, Aufl. 22, 6 (see: *Chanturia L.*, Ownership on Immovable Things, Tbilisi, 2001, 167-168 (in Georgian)).

<sup>47</sup> *Lazarevski A.* (Ed.), System of Registration of Rights on Real Estate. Experience of Foreign Countries, Moscow, 2000, 19 (in Russian).

<sup>48</sup> *Larson G.*, Systems of Information on Land and Real Estate, Royal Institute of Technology, Stockholm, 2003, available at: <<http://www.geo-garant.ru/cgi-bin/content.pl?p=50&nid=17>>.

some are poorly maintained, some are of low quality, some do not have sufficient legal force. That's why in certain countries, including in Eastern Europe and some developing countries, different options are being considered with the purpose of improving existing systems. However, this requires significant funds and resources. Before starting to reform these systems, it's important to explore and develop methods in detail.<sup>49</sup>

It is necessary to develop simple methods as far as possible that can be used to improve registration system. If records and maps of certain accuracy are available, the best way will be to improve them in consistent manner, e.g. as it was done in Sweden. If it is necessary to carry out general review, or if there are no old data available, then it will be better to improve in systematized manner and cover each region gradually, step by step.<sup>50</sup>

Besides, the Law of Georgia on Public Registry provides for general principles of registration suggesting how registration is done, in particular, on the basis of registration or other documents and properly created electronic copies of these documents, as well as rules for filing application for registration and necessity of issuing registration extract and cadastral plan.<sup>51</sup> This is less likely to be assigned to the general principles of registration. It might be rather considered as a principle of registration procedures. This standard entails rules of submitting materials for registration and issuing documents after registration.

CCG prescribes preconditions for arising rights of ownership on immovable things. It is necessary to make a transaction in written form and register the acquirer of ownership right in the public registry.<sup>52</sup> In accordance with this principle, the acquirer of the property rights, subject and content of these rights as well as priority of rights – if several rights exist on a single object - should be determined for the third parties in precise and clearly understandable manner.<sup>53</sup>

## 7. Principle of Abstraction

German law envisages the principle of abstraction. Based on this principle, legal relations related to real property is independent from the purposes and conditions of the land related legal transactions;<sup>54</sup> according to German law, transactions that give rise to duties and disposals<sup>55</sup> are considered independently from each other, "abstractly". Moreover, German law envisages the principle of separation too; however, it rejected the necessity of "causas"<sup>56</sup> and established principle of

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<sup>49</sup> Larson G., *Systems of Information on Land and Real Estate*, Royal Institute of Technology, Stockholm, 2003, available at: <<http://www.geo-garant.ru/cgi-bin/content.pl?p=50&nid=17>>.

<sup>50</sup> *Ib.*

<sup>51</sup> Law of Georgia on Public Registry, Articles 9, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>52</sup> Civil Code of Georgia, Article 183, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>53</sup> Chanturia L., *Ownership on Immovable Things*, Tbilisi, 2001, 167 (in Georgian).

<sup>54</sup> *Ib.*, 168.

<sup>55</sup> "Verfügung" (see: Kereselidze D., *Most General Systemic Notions of Private Law*, Tbilisi, 2009, 218 (in Georgian)).

<sup>56</sup> "causa" (see: Kereselidze D., *Most General Systemic Notions of Private Law*, Tbilisi, 2009, 218 (in Georgian)).

abstraction. Nullity of transactions rising duty does not affect the validity of the disposal transaction.<sup>57</sup> In addition, the latter implies any change, i.e. arising, altering and terminating property rights."<sup>58</sup> "Ownership on movable things is transferred to the acquirer through the property contract (consent) and the thing itself. As for the ownership on the plot of land, it is transferred on the basis is a real property contract (concessions) and registration of the acquirer in the real estate book."<sup>59</sup> In Georgia, like in several other legal orders of the continental Europe (for example, in the Netherlands<sup>60</sup> and Austria<sup>61</sup>), the causal system is in place. Hence, the basis of transfer of rights ("causa") and transfer of things or real property transaction is separated.<sup>62</sup> In the causal system, validity of the property transaction directly depends on the validity of its grounds.<sup>63</sup>

The principle of abstraction is acknowledged in science as well as in judicial practice. In order to acquire ownership, under contemporary German law, it is not enough to conclude obligational-legal contract, but the property contract is also required, that means agreement among the parties on transfer of the property. In case of declaring the main contract as null and void, by virtue of property contract, acquirer of the property remains as the owner. The former owner shall require return of property not on the basis of property right of vindication, but rather on the of obligational-legal request for vindication of property received as a result of unjust enrichment.<sup>64</sup>

## **8. Principle of Subject-matter Verification (Legalite Principle)**

Content of a legal transaction on a property right must be clearly and specifically defined to enable the third party to ascertain, without any other sources, what property rights are attached to a particular thing and what kind of change is implementing.<sup>65</sup> This is the material sense of this principle.

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<sup>57</sup> There are some exceptions from this general rule (about the dependence on obligational right on arising property right) in German law (mortgage, security interest, preliminary records), see *Wolf*, *Beständigkeit und Wandell im Sachenrecht*, NJW, 1987, 2647, 2651 (see: *Kereselidze D.*, *Most General Systemic Notions of Private Law*, Tbilisi, 2009, 218 (in Georgian)).

<sup>58</sup> *Palandt/Heinrichs/Ellenberger*, BGB, 2008, Überblick vor § 104, RdNr. 19 ff., *Palandt/Bassenge*, BGB, 2008, Einleitung vor § 854, RsNr. 10, 13; *Larenz/Wolf*, *AT des Bürgerlichen Rechts*, 2004, § 23, RdNr. 63 ff., 78 ff. (see: *Kereselidze D.*, *Most General Systemic Notions of Private Law*, Tbilisi, 2009, 219 (in Georgian)).

<sup>59</sup> *Chanturia L.*, *Ownership on Immovable Things*, Tbilisi, 2001, 164-165 (in Georgian).

<sup>60</sup> *Ib.*

<sup>61</sup> General Civil Code of Austria, Paragraph 380 ("*Ohne Titel und ohne rechtliche Erwerbungsakt kann kein Eigentum erlangt werden*"), also: *Eccher* in: *Koziol/Bydlinski/Bollenberger*, *ABGB-Kommentar*, 2007, § 380, RdNr. 1 ff.; *Koziol/Welser/Kletečka*, *Bürgerliches Recht I*, 2006, 310f. (see: *Kereselidze D.*, *Most General Systemic Notions of Private Law*, Tbilisi, 2009, 217 (in Georgian)).

<sup>62</sup> *Drobnig*, *Transfer of Property*, in: *Hartkamp/Hesselink/Hondius/Joustra/du Perron/Veldman* (Eds.), *Towards a European Civil Code*, 2004, 734 et seq. (see: *Kereselidze D.*, *Most General Systemic Notions of Private Law*, Tbilisi, 2009, 218 (in Georgian)).

<sup>63</sup> "Concerning Georgian Law Option", see *Danelia*, *Principle of Separation on the Example of Contract on Donation 2008* (special edition), 42 and etc. (see: *Kereselidze D.*, *Most General Systemic Notions of Private Law*, Tbilisi, 2009, 218 (in Georgian)).

<sup>64</sup> See *Chanturia L.*, *Ownership on Immovable Things*, Tbilisi, 2001, 185 (in Georgian).

<sup>65</sup> BGHZ 21, 52 (56)=NJW 1956, 1356; *Wolf M.*, *Sachenrecht*, 21. Aufl., 2005, Rdnr. 26ff (see: *Vieweg K.*, *Werner A.*, *Sachenrecht*, 2. Aufl., Köln-Berlin-Bonn-München, 2005, 4).



In a formal sense, this principle applies only to real estate law (registration of rights). This means verification of formallegality in the process of making records by respective officials who lead this process.<sup>66</sup>This principleapplies to the registration system of Georgia as well.

## 9. Principle of Preference (Priority)

In accordance with the material principle of priority, order of rights on immovable things is defined by the sequence of registration in the real estate book (Civil Code of Germany §879).<sup>67</sup>

Under formal principle, higher quality of guarantees exists in respect of those persons who submitted the right to for registration earlier.<sup>68</sup>

In line with Georgian legislation, if, concerning a registration object, registration of several rights which have with the same content but are not mutually exclusive is requested, sequence of their registration is determined according to the time when they were submitted for registration.<sup>69</sup>Huge importance is attached to this issue if legal conflict arises.

In accordance with the principle of material preference, when plot of land is encumbered by several rights, order is determined by sequence of registration if rights are registered in the same sections of real estate books. If rights are registered in different sections, preference is given to a right which is registered by the earlier date;rights registered on the same day enjoy the same order. German Civil Code also envisages establishing different rules of sequence in case there is agreement between the parties; however, in order to give a legal effect to this rule, registration in the real estate bookies required.<sup>70</sup>It should be noted that preference is given to a right which is registered earlier.

According to the formal principle, in the registration body preference is given to a person who files an application requesting registration earlier than others.<sup>71</sup>

Under Spanish Civil Code, the right of ownership on immovable things is granted to the buyer who registers his/her right in the public registry first.<sup>72</sup> In case of claim between two property rights related to immovable objects, preference is given to the one which was registered in the real estate book earlier.

## 10. Principle of Registration

According to the material principle of registration, arising, altering and terminating ownership rights or other property rights on immovable things requires registration in the public registry after which these rights arise. At the same time, limited property rights - superficies, servitude, usufruct, as

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<sup>66</sup> *Schöner H., Stüber K.*, Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, 15 Aufl., München, "Verlag-C-H, Beck", 2012, Rdnr. 20.

<sup>67</sup> *Ib.*, Rdnr. 21.

<sup>68</sup> *Ib.*

<sup>69</sup> Law of Georgia on Public Registry, Article 13 - 2, available (in Georgian) at:<<https://matsne.gov.ge/>>.

<sup>70</sup> Bürgerliches Gesetzbuch, Verkündungsstand: 23.01.2013, § 879, available at: <<http://beck-online.beck.de/>>.

<sup>71</sup> *Schöner H., Stüber K.*, Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, 15. Aufl., München, "Verlag-C-H, Beck", 2012, Rdnr. 21, available at: <<http://beck-online.beck.de/>>.

<sup>72</sup> *Lazarevski A.* (Ed.), System of Registration of Rights on Real Estate. Experience of Foreign Countries, Moscow, 2000, 18 (in Russian).

well as security – mortgage and registered security interest - arise by registration in the public registry.<sup>73</sup>

In real estate books, information on legal status of objects of immovable things is recorded. To achieve this goal, any act related to immovable thing in accordance with the defined rules which results in transfer of rights on immovable things (transfer of ownership right establishing mortgage or servitude, etc.) must be entered in real estate book and only then it acquires legal force for the third parties.<sup>74</sup>

In addition, formal preconditions should be followed in the registration process that is necessary for registering immovable things in the public registry.<sup>75</sup> It requires participants of the relations to enter all property rights related to plots of land in real estate book.<sup>76</sup> Presumption of veracity and completeness of entries in the public registry – registry data are assumed to be accurate unless their inaccuracy is proven.<sup>77</sup>

## **11 . Principle of Agreement (Consensus)**

Transfer of property rights is carried out in accordance with the principle of material consensus. In addition to registration, agreement is required for transfer of ownership right on the plot of land, to encumber it with rights, provided by Article 873 of the German Civil Code. At the same time, agreement between an authorized person and another party is required concerning the property alteration and its registration in real estate book.<sup>78</sup> First of all, this principle embodies private autonomy of the parties;<sup>79</sup> exception is the registration of a right on the building attached to the land which requires only a unilateral declaration, i.e. in such cases agreement between the parties is not a precondition of registration. For the alteration of property rights agreement between the parties is required in addition to the registration, except in cases when unilateral declaration is sufficient. Under German law, this agreement depends on the obligational-legal relations between the parties (principle of abstraction). Unlike German law, principle of abstraction does not apply in Georgia. However, Georgian law also makes a distinction between property and obligational-legal transactions. Property agreements are independent of obligational-legal transactions (principle of abstraction).<sup>80</sup>

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<sup>73</sup> As it was noted, in accordance with the Law of Georgia on Public Registry, rights such as lease, sublease, rent, subrent, lending, leasing and rights related to use and possession as prescribed by public law, obligations related to right of ownership on immovable things, if legal entities under private law participate in the setransactions and the setransactions are made for a period of more than one year, should be registered in the public registry.

<sup>74</sup> Lazarevski A. (Ed.), System of Registration of Rights on Real Estate. Experience of Foreign Countries, Moscow, 2000, 16 (in Russian).

<sup>75</sup> Law of Georgia on Public Registry, Article 8, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>76</sup> Chanturia L., Ownership on Immovable Things, Tbilisi, 2001, 167 (in Georgian).

<sup>77</sup> Civil Code of Georgia, Article 312-1, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>78</sup> Chechelashvili Z. (Translator into Georgian and Editor), German Civil Code (as of 1 March, 2010), §873-1, Tbilisi, 2010, 183.

<sup>79</sup> Chanturia L., Ownership on Immovable Things, Tbilisi, 2001, 167 (in Georgian).

<sup>80</sup> Schöner H., Stüber K., Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, 15 Aufl., München, "Verlag-C-H, Beck", 2012, Rdnr. 15.

Under principle of formal agreement (basis of consent), unilateral consent is sufficient for registration in real estate book. Declaration of material-legal intention and agreement is required for alteration legal rights. Afterwards, one of the parties shall submit this agreement to the real estate office - Public Registry.<sup>81</sup> In Georgia, if a transaction is made through the notary, declaration submitted by one party is sufficient. However, if a transaction is made through the public registry as envisaged by the Civil Code of Georgia, it is necessary that an application is filed by the parties to the transaction.

Finally, it should be noted that in Georgia arising ownership and other property rights on immovable things requires registration of these rights in the public registry and, thus, principle of registration shall apply.

## 12. Principle of Credibility to the Real Estate Book Entries

Credibility of the public registry is the most significant principle inherent to all registration systems since all registered data is considered to be accurate for all acquirers in good faith until their inaccuracy is proven. This means preference of those persons whose rights are entered in the public registry. Credibility of the acknowledged principles means that the State assumes responsibility for entering records while maintaining the public registry and ensures their reliability.<sup>82</sup> The credibility presumption of the public registry implies accuracy of registration of the right of the buyer as well as accuracy of the registration of this right on the previous owner.<sup>83</sup>

According to the general rule, entries of the registry are considered to be accurate. Pursuant to Article 312(1) "an entry in the public registry shall be deemed to be accurate until its inaccuracy is proven". Under Georgian legislation, this is called as presumption of veracity and completeness of entries in the public registry. According to the Paragraph 2 of the same Article, "in favor of a person who acquires some right from another person on the grounds of a transaction while this right was entered in the public registry in the name of the alienator, the entry in the public registry shall be deemed to be accurate except when a complaint has been lodged against this entry, or when the acquirer knew of the inaccuracy of the entry."<sup>84</sup> The same rule applies in respect of real estate books, however, unlike Georgia, this principle is called as a principle of reliability and in content is the same as the presumption of veracity and completeness of entries in the public registry according to Georgian law. "Pursuant to German Civil Code, it is recognized that if a right is registered in the real estate book, it is presumed that this right exists."<sup>85</sup>

Presumption of veracity and completeness of entries in the public registry is another significant demonstration of the principle of trust and integrity established in the civil circulation. This legal

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<sup>81</sup> *Schöner H., Stüber K.*, Grundbuchrecht, Band 4, Handbuch der Rechtspraxis, 15. Aufl., "Verlag-C-H, Beck", München, 2012, Rdnr. 15.

<sup>82</sup> *Lazarevski A.* (Ed.), System of Registration of Rights on Real Estate. Experience of Foreign Countries, Moscow, 2000, 12 (in Russian).

<sup>83</sup> *Zoidze B.*, Property Law of Georgia, Tbilisi, 2003, 368 (in Georgian).

<sup>84</sup> Law of Georgia on Public Registry, Article 8, available (in Georgian) at: <<https://matsne.gov.ge/>>.

<sup>85</sup> *Lazarevski A.* (Ed.), System of Registration of Rights on Real Estate. Experience of Foreign Countries, Moscow, 2000, 16 (in Russian).

fiction is a meaningful guarantee for the protection of rights of partner in good faith.<sup>86</sup> This is a serious responsibility of the State with respect to the participants of circulation. However, this principle is not miraculous and it is possible that it could not ensure protection of interests of owners.<sup>87</sup>

In Sweden, veracity of registry data is ensured by the Stateto the extent that in case of damage as a result of inaccurate record compensation is guaranteed.<sup>88</sup> Person registering his/her right in the registry is no longer required to prove that the records are accurate. The whole burden of proof is on the person who attempts to reject the registered right.<sup>89</sup>

Based on interests of the acquirer in good faith, all records are considered to be accurate. The principle of reliability means the preference of those persons whose rights are registered in the public registry – real estate book – in relation to those persons whose rights (even if they are acquired beforehand) are not registered in the registry. Registered right does not to require evidences.<sup>90</sup>

### **13. Principle of Relations between Main Book and Land Cadastre**

This is a compilation of records about land which consists of two parts: maps and plans that provide measures and displays location of the plots with textual records describing quality of the plots of land.<sup>91</sup>

According to the modern cadastral systems, collection of all required cadastral information on each immovable object under examination is not required. Division of immovable objects is the layer that should be mentioned in the first place. This layer has its own independent informational value - after objects are fixed with boundaries, regardless of their ownership form, for internal development independently, for completing cadastral information.<sup>92</sup>

There is a widespread view that formation of the object is closely related to the actual officially recognized rights and unless anyone declares about his/her right on these objects, no one is entitled to fix boundaries. However, this view is not accurate. Any immovable object represents an integral molecule that must be seen as a separate object at the level of local governance, regardless the legal collision related to it. It is quite possible that there are no rights on the object, e.g. previous owner died and the successors have not drawing it up, but it would not be proper to deny existence of the immovable thing. In other words, the condition of the object does not depend on the nature of rights, any legal claims or othersubjective liabilities.<sup>93</sup>

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<sup>86</sup> Commentary to the Civil Code of Georgia, Volume II, Tbilisi, 1999, 325 (in Georgian).

<sup>87</sup> Zoidze B., Reception of Property Law in Georgia, Tbilisi, 2005, 261 (in Georgian).

<sup>88</sup> Lazarashvili L., Swedish System of Registration of Real Estate, Journal "Constitution and Human", No. 2, 2001, 44.

<sup>89</sup> See Lazarevski A. (Ed.), System of Registration of Rights on Real Estate. Experience of Foreign Countries 2000, 16 (in Russian).

<sup>90</sup> *Ib.*, 9.

<sup>91</sup> Management of Land Resources in Europe, UNDP, New York-Genève, 2005, 30.

<sup>92</sup> Nikonov P., Jyravski N., Real Estate, Cadastre and World Systems of Registration of Rights on Real Estate, Analytical Review, Sankt-Petersburg, 2006, 4 (in Russian).

<sup>93</sup> Nikonov P., Jyravski N., Real Estate, Cadastre and World Systems of Registration of Rights on Real Estate, Analytical Review, Sankt-Petersburg, 2006, 3 (in Russian).

Good system of land management provides a guarantee for protection of private property, as well as contributes to existence of effective system of land taxation and so on.

#### 14. Principle of Sequence of Rights

According to this principle, the rights on the plot of land registered in the real estate book, considering their legal significance, are determined in the consecutive order. In this system of rights, property rights are in the first place.<sup>94</sup>

#### 15. Principle of Absoluteness

Since in Georgia mainly property rights are registered in the public registry, it is recommended to discuss principles of absoluteness and *numerous clausus* of property rights.<sup>95</sup>

"Absolute relation is established on the basis of normative intention of law."<sup>96</sup> "All property rights are absolute and all of them demonstrate individual power, a form of domination on the property."<sup>97</sup> Each property right is considered as a right to rule on the thing (plot of land) of a person that is recognized and protected by all;<sup>98</sup> ownership should be outlined as an absolute right expressing "full domination" on the property.<sup>99</sup> "Every liable person is responsible before the person who is entitled to an absolute right."<sup>100</sup> Absolute right or "property demand" is directed and, thus, implementable in respect of any person.<sup>101</sup>

#### 16. Principle of Numerus Clausus

Participants of the relations are able use only those forms of domination on things that are established by law.<sup>102</sup> "There are as many property rights as recognized by law. These are: ownership, right to build, servitude, usufruct, mortgage, security interest."<sup>103</sup> Type of each property rights is

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<sup>94</sup> Chanturia L., Ownership on Immovable Things, Tbilisi, 2001, 167 (in Georgian).

<sup>95</sup> For the exception from this rule, see in the part of property rights.

<sup>96</sup> Zoidze B., Property Law of Georgia, Tbilisi, 2003, 4 (in Georgian).

<sup>97</sup> Gierke, Deutsches Pruvatrecht, Band II, 1905,1 (see: Kereselidze D., Most General Systemic Notions of Private Law, Tbilisi, 2009, 217 (in Georgian)).

<sup>98</sup> Chanturia L., Ownership on Immovable Things, Tbilisi, 2001, 167 (in Georgian).

<sup>99</sup> Puchta, Pandekten, 1877, § 141, 210 f.; §144, 216f., (see: Kereselidze D., Most General Systemic Notions of Private Law, Tbilisi, 2009, 220 (in Georgian)).

<sup>100</sup> Zoidze B., Property Law of Georgia, Tbilisi, 2003, 4 (in Georgian).

<sup>101</sup> Coing, Europäisches Privatrecht II, 19. Jahrhundert, 1985, § 64 II, 368 (see: Kereselidze D., Most General Systemic Notions of Private Law, Tbilisi, 2009, 217 (in Georgian)).

<sup>102</sup> Chanturia L., Ownership on Immovable Things, Tbilisi, 2001, 167 (in Georgian).

<sup>103</sup> Zoidze B., Property Law of Georgia, Tbilisi, 2003, 4 (in Georgian).

precisely defined by law<sup>104</sup> and is subject to determination based on individual's intention only within the limits prescribed by law. Accordingly, parties to the relations are unable to determine different legal property rights.<sup>105</sup>

## 17. Conclusion

Based on the abovementioned, it is possible to outline principles of registration of property rights on immovable things. These principles are: registration in the public registry (real estate book), application, publicity (openness), exhaustive list of rights, certainty (specialty), abstraction, subject-matter verification (legalite), preference (priority), registration, credibility of the real estate book entries, relations between main book and land cadastre, sequence of rights, absoluteness, numerus clausus. A review and study of these principles is important for both theoretical and practical points of view.

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<sup>104</sup> Principle of "*numerus clausus*". For comparison concerning meaning of this principle: *Merrill/Smith*, Optimal Standardization in the Law of Property: The *Numerus Clausus* Principle, *Yale Law Journal*, 2000-2001 (110), 1, 6 et seq.; see feedback on Article: *Hansmann/Kraakman*, Property, Contract, and Verification: The *Numerus Clausus* Problem and the Divisibility of Rights, *Journal of Legal Studies*, 2002 (31), 373, 374 et seq. (see: *Kereselidze D.*, Most General Systemic Notions of Private Law, Tbilisi, 2009, 219 (in Georgian)).

<sup>105</sup> For comparison, comparative law review, e.g. *Van Erp*, Comparative Property Law, in: *Reimann/Zimmerman* (eds.), *Oxford Handbook of Comparative Law*, 2006, 1053 (see: *Kereselidze D.*, Most General Systemic Notions of Private Law, Tbilisi, 2009, 219 (in Georgian)).

**Tamta Mamaiashvili\***

## **Settlement as the Basis for Concluding the Civil Case**

### **1. Introduction**

Concluding the civil case with the settlement is one of the important sections of Civil Procedural Code. Settlement is the effective mean for the overcoming of difficulties in civil relationships and resolution of disputes between the parties.

Legal relationships are diverse and multi-angle. Will of the parties is always directed towards the establishment of new, desired result for the parties. They enter negotiations, conclude agreements, conduct business meetings - during these relationships there are no "pure" legal relationships, they only include the legal regulation of social relationships.<sup>1</sup> The will of the parties is changing during the above process. They often find it difficult to determine the scope of relationships and behaviors, which may cause undesired results. Changes in some cases are caused by subjective factors and in other cases – by objective ones. Moreover, existence of objective factors in some cases forces the party to change his/her position. The above does not always result in results which are desired, beneficial and straightforward for all parties and therefore the signs of conflict in the relationship are created. The complexity of these events is established as a dispute between the parties. If parties are not able to find way out, usually, the dispute is brought to the court for the review and it is transformed into the court case (trial). Such development of relationships brings the issue of settlement between the parties.

Human being with his/her nature is agreeable and therefore, members of the society, sometimes even unconsciously, are trying to achieve agreement. In some cases this process is thought through, as it is consciously understood that negotiation is the only right way to achieve implementation of one's desires and achievement of desired results. Motivation of settlement – this is the desire of person to live based on their own decisions and achieve own objectives. The resistance of desires against the actual events is caused by differing attitudes of persons to those events; negotiations are the way for overcoming such differences.

Legal dispute is usually related to long and legally complex process; settlement is the legal event, which in a simple way and with the maximal consideration of will of the parties solves the existing dispute based on the legal ways. Trial at the court is also process, which has specific beginning and the end based on specific legal events. In particular, the beginning of such process is the claim, and one of the ways to end the process is – Settlement.

Some scientists are of the view that reviewing the case under settlement process was created before the State Justice. Alternative systems for the dispute resolution were developed in historic Georgia and

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<sup>1</sup> *Bichia M.*, Methodological Issues of Public Legal Relations, "Law Journal", No 1-2, 2010, 84.

settlement was considered as one of the ways for dispute resolution. Besides the legal system, the mediators' court played the significant role and it was effective body, sometimes solving the arguments, which could not be solved by the state.<sup>2</sup> For the solution of problematic issues the external person was invited, which was referred to as "Mediator", "middle man", "nemsgamezali" (in Svaneti).<sup>3</sup>

The debating parties prefer peaceful solution of the issues to the never ending revenge. The main objective of mediators was to achieve agreement between the parties. Therefore they were trying to achieve decision acceptable for both parties. The Georgian legal mind has opposed the habits of revenge, vendetta with mediation court as very effective means for the overcoming the hostility and achieving agreement between the parties.<sup>4</sup> "The main function of mediation court is to reconcile the parties."<sup>5</sup> The history proves that the Georgina legal system was aware of and supporting the above form of dispute resolution from the ancient times.

Statement from Ilia Chavchavadze, during his work as mediator judge (1864 year): "Local population must trust mediator judge. For getting such trust it is not required to know the laws, but the knowledge of mind, thinking of people, habits, and traditions is necessary. In summary it is necessary to have knowledge of everything which distinguishes local life and it is also required to have smart mind, honest nature and clean reputation."<sup>6</sup>

"The guaranty for the society stability lies in the implementation of rights of the society members. In order to ensure that each member of society can implement the rights granted by the law for the achievement of desired outcomes, it is necessary to create favorable environment at society as well as legislative levels. Civil code serves this purpose, when it considers the settlement as the way to review the case and resolve the dispute."<sup>7</sup>

The purpose of present work is to determine the legal nature of the settlement where it can be the basis for the termination of the case.

## **2. Legal Aspects of Settlement**

### **2.1 Place and Function of Settlement**

The norms related to the settlement are presented in general terms in the material and procedural laws and it is not defined in a systemic manner. Civil Code of Georgia (hereinafter referred to as CCG) discusses the errors in the basis of the Settlement. The code discusses the notion of settlement and mutual compromise. In particular, "the contract is void by which the dispute or un-decidedness

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<sup>2</sup> *Davitashvili G.*, Legal Organisation and Process in Georgian Customary Law, Tbilisi, 2004, 36 (in Georgian).

<sup>3</sup> *Khoperia M.*, The Role of Mediator in Family Separation according to Georgian Customary Law, "Law Journal", No 1, 2011, 46.

<sup>4</sup> *Davitashvili G.*, Mediation Court in Svaneti, Tbilisi, 2002, 3 (in Georgian).

<sup>5</sup> *Ib.*, 5.

<sup>6</sup> *Grigalashvili N.*, Accompanying Soul, Newspaper – 24 Saati, 2010, available (in Georgian) at: <<http://24saati.ge/index.php/category/culture/2010-03-01/4013.html>> [24.12.2012].

<sup>7</sup> *Gogishvili M., Sulkhaniashvili M., Meskhishvili K., Jinoria Kh., Gelashvili R.*, Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 63 (in Georgian).



between the parties is resolved by means of mutual concessions (agreement), if by the contents of the contract such agreement is based on the circumstances which are not relevant to the reality and there would not be argument or un-decidedness if the parties were aware of the real circumstances related to the matter."<sup>8</sup> In the above mentioned case, the indirect definition of notion settlement is provided; however the Civil Procedural Code of Georgia (hereinafter referred to as CPCG) does not define the term agreement at all.

The norms related to the settlement process are covered in various chapters of CPCG.<sup>9</sup>In this way it is not possible to discuss the systemic integrity of settlement, as independent process. For the regulation of the above area it is expedient to allocate specific chapter in the CPCG to the process of settlement, to systematically integrate and improve the existing norms in the form of general and special norms, as "only under the stabile legislation is the citizen able to act in line with the requirements of the law."<sup>10</sup>

Settlement is the integration of functions of complex nature and covers: functions of social management, control, legal justice and security, functions of freedom and economy. All other functions of settlement serve one purpose – "justice supports the agreement of differing interests and plays the function of regulation of conflicts."<sup>11</sup>

"Dispute" is the relationship burdened with negative emotions established between two or more persons. Legal dictionary defines term "dispute" as the conflict and dispute, which is the basis for initiating the specific trial.<sup>12</sup> "The most frequent are the disputes in the society relationships of complex structure, when the dispute is related to the relationship between more than two subjects, simultaneous set of disputable issues, especially high value of the subject for the dispute and the cases when the dispute between the parties continues for the long time period. The person who is emotionally neutral to the conflict is interested in its resolution."<sup>13</sup> However, the above person cannot become the guarantor for the dispute resolution, in such case the settlement should play the most important function – function of dispute resolution. All above mentioned ensures the stabile and consecutive development of the legal relationships, which more easily reaches its logical end via the settlement.

The social and legal protection function of settlement directs the behaviors of subjects participating in the relationship to the correct legal direction and by this way implements the legal and social control. Control function of settlement is reflected in the regulation of system of court case implementation. By means of settlement, on the one hand the functioning of court system is placed under the legal framework and on the other hand, the social management of the legal environment becomes easier. Settlement is the mean for ensuring the legal order and security, "As it establishes the sense of unity and social solidarity among the members of the society."<sup>14</sup> "Order is the relevant structural

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<sup>8</sup> Article 360 of CPCG.

<sup>9</sup> The following articles regulate the relationships related to the settlement in CPCG: 3, 49, 54, 83, 91, 98, 186, 187, 199, 205, 208, 217, 218, 272.

<sup>10</sup> *Khubua G.*, Theory of Law, Tbilisi, 2004, 49 (in Georgian).

<sup>11</sup> *Ib.*, 47.

<sup>12</sup> Black's Law Dictionary, 2004, 505.

<sup>13</sup> *Tsertsvadze G.*, Mediation, Alternative Form for Dispute Resolution, Tbilisi, 2010, 32 (in Georgian).

<sup>14</sup> *Khubua G.*, Theory of Law, Tbilisi, 2004, 46 (in Georgian).

complex of rules and laws, which consists of inter-depending elements."<sup>15</sup> "The main element of order is human being. There is an order, if human being acts with individual responsibility. The order should serve the establishment of worthwhile existence of human being."<sup>16</sup>

Freedom is the important function of settlement. There is no absolute freedom; however the settlement is the important mean for demonstration of freedom granted under the law. We can state that the legislator was human when he/she defined the place for the settlement in the legal system. By this way the legislator gave opportunity to the parties to demonstrate their free will despite the law and binding power of the court; by the above it confirmed that even law might have no power against the will of the human being.

In Georgia, the realization of rights of physical and legal persons is guaranteed in the following way – in case of possibility for voluntary execution of the above rights, the court authorities ensure their forced implementation and protection. The court is guarantor for the implementation of person's right.<sup>17</sup> In the modern State the individuals are prohibited to resolve and end legal disputes independently via so called self-trial, as monopoly over the justice is granted to the State Government;<sup>18</sup> settlement is the legal event, which demonstrates its legal perfection in the "self- trial."

## **2.2. Notion of Settlement**

"Interpretation of legal norm considers definition of its contents, in other words definition of the idea considered under the norm by the legislator."<sup>19</sup> Utilization of justice considers legal assessment of daily relationships. The above is achieved via the establishment of understandable connection between the abstract norm and specific life fact.<sup>20</sup>

Notion of settlement is encountered two time in CCG; first time – in relation to "the acknowledgement of existence of the debt",<sup>21</sup> and second time – in "error in the basis of the settlement."<sup>22</sup> In addition to term settlement CCG uses term "mutual- concession" for the expression of same legal meaning. In particular, "the contract is void by which the argument or un-decidedness between the parties is resolved by means of mutual concessions (settlement)."<sup>23</sup> The norm gives legislative priority to the term "mutual-concession" and separates the term "settlement" in brackets. The legal essence between the settlement and mutual-concession is identical. Moreover, "mutual-concession" together with other legal components is the necessary and unconditional mean for the achievement of settlement. However, it is still possible to draw boundaries between them. Term "mutual-concession" acknowledged by CCG is the component part of term settlement. Term "settlement" is universal notion

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<sup>15</sup> *Khubua G.*, Theory of Law, Tbilisi, 2004, 47 (in Georgian).

<sup>16</sup> *Ib.*

<sup>17</sup> *Ethical Issues of Legal Professions, Study Materials, ABA Rule of Law Initiative, Tbilisi, 2009, 90-91 (in Georgian).*

<sup>18</sup> *Hensel S.*, Methodic for Processing of Civil Cases, Tbilisi, 2009, 21 (in Georgian).

<sup>19</sup> *Intskirveli G.*, Theory of State and Law, Tbilisi, 1998, 171 (in Georgian).

<sup>20</sup> *Hensel S.*, Methodic for Processing of Civil Cases, Tbilisi, 2009, 39 (in Georgian).

<sup>21</sup> CCG, Article 341, Part 2.

<sup>22</sup> *Ib.*, Article 360, Part 1.

<sup>23</sup> *Ib.*, CCG does not provide definition for "way for settlement".

for the expression of its real content meaning and therefore it must be always used under its wide meaning.

The fact that CCG gives priority to term "mutual-concession", is derived from the material nature of the civil law. CCG determines the rules of behavior for the actors of social relationships at the stage, where the relationship is not yet transformed into the dispute. Term "mutual-concession" is relatively "light" demonstration of legal meaning of the settlement. Resolution of dispute via "mutual-concessions" is possible if the dispute is at its initial stage and it is still possible to resolve it without the court trial. Hence, "mutual-concessions" may take place at the initial stage of dispute (the same is indicated by the term "overcoming"<sup>24</sup>), and the term "settlement", used by CCG, is only possible via the dispute resolution using the court.

The terms expressing the meaning of the settlement process are the following: agreement, solution of issue, resolution, conclusion of peace, agreeing, consent, connection and compromise. However the term "settlement" the best reflects the process, which is provided by these terms together. It can cover all the above terms in itself, with retaining the contents and legal importance of each of the term. CPCG for the settlement process uses only one term – "settlement". The term "settlement" in the CPCG first time is related to the principle of dispositionality. In particular, "parties can end the trial with settlement".<sup>25</sup> Procedural legislation considers other terms related to the dispute settlement in terms of contents, such as: approval of settlement, settlement conditions, offer of ending the case with settlement, settlement act, purpose of settlement and etc.<sup>26</sup>

In a simple way, purpose of settlement is the resolution of dispute. The dispute can be interpreted as specific type argument, which is related to the facts, law or policy, where the statement and request from one party relates to the non-acknowledgement, counter-request or rejection of the other party. Dispute between the individuals is inevitable intra-state dispute. Under the existence of argument the parties may change their position, find relevant resources for the dispute resolution. The disputes between states, neighbors and siblings shall be considered as the part and problem of human relationships. The main requirement is that the dispute shall be discussed and resolved in a peaceful manner (dispute will only be pursued by peaceful means).<sup>27</sup>

"In USA – the alternative dispute resolution - ADR<sup>28</sup> covers any form of resolution except for the court process."<sup>29</sup> "Alternative Dispute Resolution" – dispute resolution without trial, via the arbitrage or mediation.<sup>30</sup> In the process of alternative dispute resolution (ADR) participation of professional third party is the constitutional sign distinguishing ADR from other negotiations.<sup>31</sup> Some authors give wider meaning to ADR and are of the view that it covers Negotiations, Mediation and

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<sup>24</sup> Term "overcoming" indicates to the lighter, non-court resolution method for disputes.

<sup>25</sup> CPCG, Article 3, Part 2.

<sup>26</sup> *Ib.*, Articles: 186, 208, 217, 218, 83.

<sup>27</sup> *Merrills J.G.*, International Dispute Settlement, New York, "Cambridge University Press", 2005, 1.

<sup>28</sup> Alternative Dispute Resolution.

<sup>29</sup> *Berger, Klaus Peter*, Private Dispute Resolution in International Business, Negotiation, Mediation, Arbitration, Volume I, Case Study, Alphen aan den Rijn, "Kluwer Law International", 2006, 157 (see: *Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 35 (in Georgian)).

<sup>30</sup> Black's Law Dictionary, 2004, 86.

<sup>31</sup> *Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 39 (in Georgian).

Arbitration. Moreover the scientists often talk about the methods and technologies developed on the basis of synthesis of listed forms.<sup>32</sup> "Conciliation" – gathering of arguing parties together with the purpose to achieve the agreement.<sup>33</sup> "Mediation" – mediation, intermediation.<sup>34</sup> In contrary to mediation there is no third person involved in the process of dispute settlement.<sup>35</sup> "Mediation is often referred to as "preparatory" initial and test stage preceding the court or arbitration process."<sup>36</sup> Mediation and court settlement differ from each other with the fact that settlement is directly related to the trial process and is implemented in the court, and mediation is the negotiation implemented with the help of third person. Both of them, at the end, are the alternative means for dispute resolution.<sup>37</sup> "Arbitration" – mediation court, arbitrage – resolution of dispute with the involvement of external person or persons, which are selected by the both parties.<sup>38</sup> "Negotiate" – holding negotiations, discussion of conditions, agreement, settlement, deal.<sup>39</sup> Moreover, communication with other party for the purpose of achieving agreement.<sup>40</sup> "Settlement" – regulation, solution, settling of the problem.<sup>41</sup> The latter has several meanings. According to the most common version, this is a process in which disputing parties (in case of case review at the court as well as review without court) achieve the agreement.<sup>42</sup> According to the second meaning the above mentioned term considers the contract between the disputing parties on the settlement.<sup>43</sup>

German scientist H. Prutting distinguishes four main groups for the means of dispute resolution: "negotiation – Das Verhandeln; mediation – Das Vermitteln; conciliation– Das Schlichten (conciliation, settlement); private and common justice – Das Richten (arbitration, litigation)."<sup>44</sup> "Notion "mediation" in German considers "settlement/agreement" (Der Begriff der Mediation bedeutet eigentlich nur "vermittlung"); however notion "mediation" was established in the speech of German legal advisors

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<sup>32</sup> *Friedrich, Fabian, M.* Das UNCITRAL – Medollgesetz über die internationale Gandelsschlichtund, Ein Kommentar, Aachen,"Shaker", 2006, 8 (see: *Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 35 (in Georgian)).

<sup>33</sup> *Kolin P.*, English-Georgian Legal Interpretation Dictionary, Tbilisi, 2004, 130.

<sup>34</sup> *Ib.*, 363.

<sup>35</sup> If we don't consider the court (the judge) in the "passive third party" status, which only plays "support" role in the settlement process and implements the duties assigned under the law in the process of approving the settlement act in accordance with the law.

<sup>36</sup> *Guillemin, Jean-Francois*, Reasons for Choosing Alternative Dispute Resolution, in: *Goldmith, J.C./Ingen-Housz, Arnold,/Point, Gerald H.* (Editors) ADR in Business, Practice and Issues across Countries and Cultures, "Kluwer Law International", New-York, 2006, 35 (see: *Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 34 (in Georgian)).

<sup>37</sup> There is also the form of legal mediation, so called court-annexed mediation, which was included in CPCG on 20 December, 2011 as an addition.

<sup>38</sup> *Kolin P.*, English-Georgian Legal Interpretation Dictionary, Tbilisi, 2004, 41.

<sup>39</sup> Available at: <<http://en.wikipedia.org/wiki/Negotiate>> [05.02.2014].

<sup>40</sup> Black s Law Dictionary, 2004, 1064.

<sup>41</sup> Available at: <[http://en.wikipedia.org/wiki/Settlement\\_\(litigation\)](http://en.wikipedia.org/wiki/Settlement_(litigation))> [05.02.2014].

<sup>42</sup> Available at: <[http://en.wikipedia.org/wiki/Settlement\\_\(litigation\)](http://en.wikipedia.org/wiki/Settlement_(litigation))> [05.02.2014].

<sup>43</sup> *Ib.*

<sup>44</sup> *Prutting, Hanns*, Mediation im Arbeitsrecht, in: *Haft, Fritjof/von Schlieffen, Katherina* (Hrsg.), Handbuch Mediation, 2. Auflage, "Beck", München, 2009, 516-517 (see: *Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 125-126 (in Georgian)).

and in general means mechanisms for dispute resolutions via non-court (alternative) means.<sup>45</sup> Russian procedural legislation considers conditions for changing the claim, rejecting the claim, acknowledging the claim and settlement.<sup>46</sup> In the Russian law settlement is expressed with the term "мировое соглашение" (amicable agreement) and it is based on term "мировое" (amicable) which stresses the peaceful nature of the settlement.

Law norm shall be established in understandable and clear manner, and the purpose of legislation shall be determined clearly. It must reflect the maximal reality of the area covered under regulation, clearly determine the behavioral rules, using the non-ambiguous and understandable language.

And finally, settlement can be interpreted as the agreement of parties for the purpose of ending the dispute discussed at the court; which is the alternative means for the dispute resolution based on the mutual concessions and the settlement.

### 2.3. Legal Meaning of the Settlement

There are tangible and legal contents distinguished in the legal relationships. The first is the factual relationship and represented with pure facts; the latter is the formal element of legal relationship, by which the formal relationship gains the legal form.<sup>47</sup> The legal meaning of the settlement is determined by two independent signs. The first – tangible, material or theoretical and second – procedural or practical (legal) sign.<sup>48</sup>

According to the interpretation from legal dictionary, settlement is the right of the parties to end the case with settlement.<sup>49</sup> However, settlement is not a right. Actually, not the settlement but ending the civil case with the settlement is the right of parties, demonstrating the dispositional principle. "Principle of disposition in the civil court trials is the ability of parties to freely use or dispose their material and procedural rights considered and guaranteed under the civil procedural legislation."<sup>50</sup> The difference in the civil rights is expressed in the fact that they are possessed by their owners. Each of them is authorized to use or not to use his/her right, retain or reject such right; request its acknowledgement or accommodate for its non-implementation, which is expressed with the aphorism: "Nobody can be forced to present the claim against his/her will" (Nemo invitus agree cogitur) or "there is no trial without plaintiff" (emo iudex sine actore).<sup>51</sup> Principle of disposition is considered as the true

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<sup>45</sup> Alexander, Martin, *Mediation in Family Disputes, Principles of Practice*, Third Edition, Padstow, "Ashgate", 2008, 7 (see: *Tsertsvadze G.*, *Mediation, Alternative Form of Dispute Resolution*, Tbilisi, 2010, 41 (in Georgian)).

<sup>46</sup> Russian Federation CC, Article 39, Part 1.

<sup>47</sup> *v. Savigni F.C.*, *System des heutigen Römischen Rechts*, I, 1840, 333 (see: *Bichia M.*, *Methodological Issues of Public Legal Relations*, "Law Journal", No. 1-2, Tbilisi, 2010, 98).

<sup>48</sup> Notion of settlement may contain such legal characteristics, which can be included in theoretical as well as practical signs.

<sup>49</sup> *Shushanashvili Al.*, *Law Dictionary*, 2000, 178 (in Georgian).

<sup>50</sup> Case No. as-531-764-08, Supreme Court of Georgia, 2008, available (in Georgian) at: <[www.supreme-court.ge](http://www.supreme-court.ge)>.

<sup>51</sup> *Collection of Works on Civil Code, Treushnikova M.K.* (Chief Ed.), Moscow, 1996, 58 (in Russian).

beginning of the court trial not because it cannot be violated by the law, but its rejection can't find the realization in practice without the will of interested parties.<sup>52</sup>

Settlement is a deal under the material sign. "Deal is expression of unilateral, mutual, and multi-lateral will, which is directed towards the creation, change or termination of legal relationship."<sup>53</sup> The most common form of deal is contract, which establishes changes or terminates the legal relationships between two or more subjects.<sup>54</sup>

"Settlement is contract by which the dispute or non-convictability is settled via the mutual-concession. The need for settlement is created in the event of dispute or ambiguity between the parties on the issues related to their rights. Settlement can be used for any legal relationships which are based on the liabilities of parties, if such relationship creates dispute or non-convictability."<sup>55</sup> The parties are liable to apply all efforts for the fair resolution of liability relationships (article 361, part 2, CC). Such liabilities can be referred to as protective liabilities.<sup>56</sup>

Two main and essentially significant factors determine consideration of dispute settlement as a contract. Settlement is the fact of demonstration of mutual or multi-lateral will. "Agreement of will of two (or more) persons is necessary for the contract conclusion; however contract does not consider any type of agreement between two (or more) parties, it considers the agreement which results in the generation, change or termination of certain rights and liabilities for participants."<sup>57</sup> However, settlement at some level differs from the deal considered under the article 50 of CCG. Namely, unlike deal, settlement cannot be result of demonstration of the unilateral will. It is impossible to demonstrate unilateral will in the settlement. Unilateral will, can be demonstrated in the civil procedural relationships by the way of acknowledgement of the claim or rejection of the claim, which is not a settlement, nonetheless providing the result of termination of civil case. "Parties can end the court trial by the settlement. Plaintiff can reject the claim, and the defendant – can acknowledge the claim."<sup>58</sup>

"The settlement shall not be directed towards the creation of legal relationship. It is usually the result of demonstration of mutual or multilateral will, which is directed towards the change or termination of legal relationship."<sup>59</sup> "As settlement results in creation of new liabilities for the parties, it can become the basis for generation of a new claim. Therefore settlement does not result in the termination of existing liability relationships or changing them with the new ones, but it regulates the relationships in a new way. Purpose of the settlement is not innovation, its purpose is change of liability relationships and determining them in a new way, and the parties desire to agree to such

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<sup>52</sup> Collection of Works on Civil Code, *Treushnikova M.K.* (Chief Ed.), Moscow, 1996, 59 (in Russian).

<sup>53</sup> CCG, Article 50.

<sup>54</sup> CCG, Volume 3, Section 1.

<sup>55</sup> Comments to CCG, Volume 3, Tbilisi, 2001, 263-264 (in Georgian).

<sup>56</sup> *Bioling H., Lutrinhaus P.*, Systematic Analysis of Basis for the Specific Requirements Envisaged under the Civil Code of Georgia, Bremen/Tbilisi, 2004 - 2009, 32 (in Georgian).

<sup>57</sup> *Akhvlediani Z.*, Liability Law, Tbilisi, 1999, 10.

<sup>58</sup> CCG, Article 3, Part 1.

<sup>59</sup> *Gogishvili M., Sulxanishvili M., Meskhishvili K., Jinoria Kh., Gelashvili R.*, Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 27.

way".<sup>60</sup> Settlement is the agreement of parties to new circumstances. In the event of settlement between the parties the court case is terminated, all decisions related to the case are annulled and the settlement is approved. Such settlement is a new will expressed between the parties, which consider entering the new deal.

Procedural settlement or settlement under the practical sign is a legal process and it considers two components: settlement as an independent process and settlement as the integral part of court trial or process of process.<sup>61</sup> Settlement as an independent process is independent legal event with its beginning, legal stages and the end. The basis for beginning of the settlement is the dispute between the parties. It consists of settlement attempts, offers, negotiation between the parties directed towards the completion of the court case with the settlement.<sup>62</sup> As for the settlement as the integral part of court case, it is important to note that the settlement is the legal event with accessory nature, which does not exist without court trial. "The right is accessory, if it is related to other right in the way that it cannot exist without it."<sup>63</sup> The right is accessory if it serves the purpose of main right, namely, purpose of its extension or reinforcement. The purpose of accessory right demonstrates that it is not generated without the main right.<sup>64</sup> Existence of settlement and its legal implementation depends on the process of civil case and does not exist without it.<sup>65</sup>

Settlement is not created without the main procedural right - right to trial. If there is no court trial, in other words the dispute to discuss, the settlement cannot be executed; in other words "if there is no dispute, there is nothing to settle." Settlement is the constituent part of the court trial and as it is process itself, it must be mentioned using the specific legal term "process of process." Hence, settlement under the "material sign" is "mutual concession" and "deal", and settlement under the procedural sign – is a "process" and "process of process."

### 3. Process of Settlement

#### 3.1. Principles of Settlement Process

Settlement has become especially important since 2007, after the changes were made to the CPCG with the purpose to effectively implement the above mentioned measure in practice. The parties can complete the court trial with the settlement.<sup>66</sup> Prior to each court hearing and trial the court reminds the parties their procedural right on the ending the trial with the settlement and asks them if they wish to end the court case with settlement.<sup>67</sup> For the settlement purposes the parties hold nego-

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<sup>60</sup> *Larenz, Schuldrecht, AT, 14. Aufl., 94* (see: Comments to CCG, Volume 3, Tbilisi, 2001, 264 (in Georgian)).

<sup>61</sup> Regarding the settlement process see chapter 3 of the present article.

<sup>62</sup> See chapter 3 of the article, paragraphs: 3.2. and 3.3.

<sup>63</sup> CCG, Article 153, Part 1.

<sup>64</sup> Comments to CCG, Volume 3, Tbilisi, 1999, 34-35 (in Georgian).

<sup>65</sup> It must be noted that Georgian procedural legislation acknowledges only the court settlement, confirming the inter-relationship between the settlement and the case.

<sup>66</sup> CPCG, Article 3.

<sup>67</sup> CPCG, Article 207, Part 1; Article 218, Part 1; Article 373, Part 2.

tiations and develop settlement offers. Settlement act is drafted with the consideration of number of parties and need of transferring one additional copy to the court; the settlement acts are handed over to the court for the further discussion and are attached to the case materials. Based on the above, the court leaves the trial for discussions and makes decision on the approval or rejection of settlement act. If court decides that settlement conditions are against or violate legislation or rights and interests of other persons, then it rejects the settlement act; if the court decides that settlement conditions are legal and they do not violate the rights of other persons, then it approves the settlement act and terminates the case. One copy of such decision is attached to the case materials, two copies are handed to the parties. Decision can be appealed via the private claim.<sup>68</sup> If within the defined time, none of the parties appeal the decision it becomes effective and assumes the power of legal decision, which is obligatory for execution for parties. The cases terminated via the settlement does not give the right to the parties to approach the court second time with the same subject of dispute between the same parties.

The principles which are the basis for the settlement can be divided into fundamental and auxiliary principles. The fundamental principles of the settlement are: settlements are implemented only under the court conditions, at the case discussion as well as decision execution stages; ensuring the legality of the settlement is the liability of the court; the settlement act is approved by the court decision; the settlement act itself becomes the integral part of the court decision text or becomes its attachment; the settlement terminates the court trial. The auxiliary principles of the settlement are: settlement is the procedural action of parties; settlement act considers agreement on the disputed conditions; if the settlement act is not subject to the court decision, the essential review of the dispute continues; it is prohibited to approach the court with request for the new review for the cases ended with the settlement; non-execution of settlement conditions are subject to the forced execution.

### **3.2. Conflict and Settlement Attempts**

All types of society relationships including legal relationships are characterized with systemic nature. Settlement process is based on systemic integrity and legal order. System consists of aggregate of specific stages. Stages ensure the structural integrity of the legal event. The systemic order of settlement process is ensured by the settlement stages.

Existence of conflict/dispute between the parties is considered as informal initial stage of the settlement. The conflict as an event has several stages. At the initial stage there are only few facts, which are understood differently by parties. The second stage starts when the parties make chaotic and emotional decisions, without understanding the purpose of such decisions – the situation becomes even more difficult. At the third stage "all connecting bridges are burnt." The parties stop communication. The open conflict situation is created. Generally at this stage the parties start looking for the procedures to resolve the dispute. Possible results: defeat, victory and compromise.<sup>69</sup>

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<sup>68</sup> CPCG, Article 187-e<sup>9</sup>.

<sup>69</sup> Heussen, Benno, Die Auswahl des richtigen Verfahrens-ein Erfahrungsbericht, in: *Haft, Fritjof/von Schlieffen, Katherina* (Hrsg.), *Handbuch Mediation*, 2. Auflage, "Beck", München, 2009, s. 221 (in: *Tsertsvadze G.*, *Mediation, Alternative Form of Dispute Resolution*, Tbilisi, 2010, 271-272 (in Georgian)).



In general conflict starts with the identification of violator and actually the parties never move to the next stage. Existence of conflict creates problems in business as well as personal relationships between the parties, deepens the basis for conflict and finally creates negative attitude towards each other. The search for ways for conflict resolution is not always legal. More specifically, such search does not start with legal processes. Often attempts for negotiations and some negotiations are implemented before taking the case to the court, however following the unsuccessful attempts, one of the parties makes decision to try the state and legislative ways for "quieting" the other party. Looking for violator does not bring parties to the desired result.

Settlement process starts with the settlement preparatory processes in other words with settlement attempts. The necessary pre-condition for settlement attempts is existence of contact. The constant communication between the parties is the type of contact,<sup>70</sup> which must be implemented in a correct form, not to lose the small chance of bringing the parties to the settlement decision.<sup>71</sup> It is important that communication is based on their free will, responsibility and attitude towards the subject of the dispute. Exchange of positions shall be directed towards the common benefit. Otherwise, the attempts will be never transformed into the actual negotiations. During the settlement attempts, it is important for the parties to find so called "golden middle" in the existing disputable relationships.

Judge is not the initiator of settlement attempts. "Mediator shall not convince the parties that he/she is neutral due to his/her moral principles, but convince them he/she does not need such sympathy or antipathy for the simple reason, that his independence to any party cannot result in completion of mediation process in favor of this party."<sup>72</sup> This is somehow the "support" provided to the settlement attempts from the judge. Often settlement attempts are backed with the quite heavy work implemented by the judge, such work can be as labor some as the trial itself. Judge must present the reasonable and effective offer on settlement, which will serve the dispute resolution and improve negotiations between the parties. Court shall "offer to parties few options for settlement, show the weaknesses and strengths of their positions, convince in the advantage of completion the case with settlement, and what is te most important indicate to the possible results of dispute resolution, which is somewhat innovative in civil court practice and supports the direct relationship between the judge and the parties and establishes closer relationships within the limits envisaged by the law."<sup>73</sup>

### 3.3. Communication and Achievement of Compromise

The science interprets communication as exchange of information, facts, comprehensions, ideas, assessments, feelings, perceptions, expectations and desires.<sup>74</sup> Communication is one integral parts of the process, integrity of which is created by the aggregation of certain circumstances, which considers:

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<sup>70</sup> See chapter 3, paragraph 3.3 of the article.

<sup>71</sup> The stage of negotiations is discussed separately; however we consider it as one of the forms and integrals parts of settlement attempts.

<sup>72</sup> *Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 226 (in Georgian).

<sup>73</sup> *Gogishvili M., Sulxanishvili M., Meskhishvili K., Jinoria Kh., Gelashvili R.*, Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 39 (in Georgian).

<sup>74</sup> *Ib.*, 8.

analytical listening – one of the pre-conditions of court process, meaning that parties understand what is said and what is meant by the plaintiff, defendant, lawyers, judges; verbal communication – simple talk, familiar words, short sentences; plan and order/ sequence – clear structure and leit-motif of talk; brief and specific talk – concentration on specific information and its delivery to the addressee; visual and interesting presentation of issues – it is the most important at which stage is the addressee at this moment with his/her thoughts; position should be delivered at a possibly visual way for him/her; enrich the speech with examples, pictures, jests;<sup>75</sup> non-verbal communication – body language considers the part and elements of communication, which is provided beyond the words. Non-verbal communication helps us to better assess our speech, statements of partner; Social perception – perception of events is not the photographic reflection of environment; this process depends on specific people, his/her personality. In this regards, first of all we are talking about how the person accepts certain events and how he/she processes them. Level of perception depends on the capabilities of perception, ability to percept, readiness.<sup>76</sup> Management of emotions – conflicts are created not only around the difference between the facts related to the subject of dispute, but also from the different positions, attitudes and feelings of the participants.<sup>77</sup>

The characteristics of communication capabilities of the judge have special importance for the settlement process. Judge must be equipped with the knowledge of procedural norms and high legal qualification as well as with the skills helping him/her in correct management of the whole process up to the making of correct decision; in other words judge should be equipped with professional competence and ability to lead the negotiations related to the settlement, personal competences. During the case review it is necessary to identify the opposing interests of the parties and establish successful communication via the balancing of such interests.<sup>78</sup>

The necessary pre-condition for compromise is existence of human and legal balance between the parties. Above mentioned balance, at certain stage of the case process shall create pre-condition for the adjustment of interests, which will become the basis for the completion of process with the dispute settlement. "It is less probable that party with the stronger positions and hoping to have success during the court or arbitrage trials, will sit at the negotiation table."<sup>79</sup> The constituent part of compromise achievement is discharging of situation; focus on the future resolution of the dispute, careful discussion of common interests. "Following the start of negotiations and discussion of possibility-standards for each issue, it is desirable to achieve consensus, which is based on the conclusions from the negotiations and reflects the interests of all parties in the best possible way."<sup>80</sup>

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<sup>75</sup> *Gogishvili M., Sulxanishvili M., Meskhishvili K., Jinoria Kh., Gelashvili R., Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 14 (in Georgian).*

<sup>76</sup> *Ib.*, 19.

<sup>77</sup> *Ib.*, 21-22.

<sup>78</sup> *Gogishvili M., Sulxanishvili M., Meskhishvili K., Jinoria Kh., Gelashvili R., Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 8 (in Georgian).*

<sup>79</sup> *Tsertsvadze G., Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 57 (in Georgian).*

<sup>80</sup> *Ib.*, 92.

### 3.4. Settlement Negotiations and Offers

Objective of the negotiations is achievement of agreement, however settlement negotiations are different from the normal negotiations. It is important to avoid "negotiations for negotiations." Settlement negotiations directed towards the ending the specific dispute and achievement of common benefits are based on general principles, such as human attitude among the arguing parties. Selection of correct way for leading negotiations depends on many important factors.

Leading negotiations and leading the case are quite different from each other. Leading negotiations is a process, where parties retain maximal control over the dispute; as for the leading the court case brings the dispute under its influence and finally makes court resolution on the dispute.<sup>81</sup>

The settlement negotiations give birth to the "truth" related to the subject of dispute,<sup>82</sup> the arguing parties try to better understand the negative and positive sides of the disputable issue, the weaknesses and strength of their position, assess the tendencies in the future development of the dispute and based on the exchange of positions attempt to develop possible "draft" for the settlement conditions.

Settlement negotiations may be conducted at any stage of the court trial. Negotiations are conducted within the procedural dispute and cannot go beyond the subject of the dispute. However in some cases, parties try to consider in the settlement act more than determined under the subject of dispute in order to avoid further complications.<sup>83</sup> In contrary, the settlement negotiations may not cover the subject of dispute completely. Accordingly, court shall terminate the dispute within the limits envisaged under the settlement, and the issues where the settlement was not achieved shall be reviewed in compliance with the general rules.

There is no time factor for settlement negotiations; the most important is the result. However, the time for holding negotiations depends on the essence of subject of the dispute, number of disputing parties, the process held at the court prior to the negotiations. "The practice confirms that the parties may agree in few days, maximum in one or two weeks' time, but the agreement usually is not reached if process is dragged on for months."<sup>84</sup> For the effective utilization of time, the parties can agree some dates and develop their positions within such dates and then with the support from the court correctly summarize and establish them in the form of settlement act.<sup>85</sup> Negotiations held during the determined time schedule must be focused on the possible and not inevitable results. The parties shall accept the possible results in the way to consider the dispute settled.

The judge is authorized to involve in the settlement process as the "third passive party" in accordance with the rule envisaged by the law, in order to implement the "free will" and the liabilities

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<sup>81</sup> *Merrills J.G.*, International Dispute Settlement, New York, "Cambridge University Press", 2005, 18.

<sup>82</sup> Development of certain subjective and objective position in relation to the dispute is implied.

<sup>83</sup> This type of problem is more related to the execution of settlement.

<sup>84</sup> *Guillemin, Jean-Francois*, Reasons for choosing Alternative Dispute Resolution, in: *Goldsmith, J.C./Ingen-Housz, Arnold,/Pointon, Gerald, H. (Editors)* ADR in Business, Practice and Issues across Countries and Cultures, "Kuwer law Internationa", New -York, 2006, 31 (*Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 247 (in Georgian)).

<sup>85</sup> At one of the court processes, attended by me personally, judge gave "assignment" to the parties to develop settlement offers and present them to the court in one week time for review to the court.

assigned by the law. In the process of discussion of attitude towards the case it is important to utilize correct approaches (by the court) to the possible results; the court should indicate to the law, practice, position of legal advisers and society; however court should indicate that all the above may change as a result of attitude of parties to the case.<sup>86</sup> It is also important to understand the mentality of the arguing parties, difference between such mentalities is basis for confusion and dispute. The art of settlement also considers management of emotions of parties, sometimes the feelings have more weight than the discussions.<sup>87</sup>

For the resolution of dispute by the way of negotiations it is necessary for the parties to believe that the benefits of the agreement outweigh the losses. If their interests differ radically, the agreement which requires from the one party to compromise everything or vast majority of positions – is not achievable. If the negotiations around the main topics of the disputes are hindered, then there is more possibility for parties to agree on the procedural resolution of the dispute, which does not consider the rejection of the above discussed principle.<sup>88</sup> It is also possible that during the discussions the dispute is resolved in the way that both parties can benefit. If the termination is possible procedural agreement can be used, where the compromising party will receive the compensation for the material case.<sup>89</sup>

There are four types of negotiations: light – person wishes to avoid personal conflicts and often decides to compromise, for the achievement of result in a peaceful manner;<sup>90</sup> heavy – during the negotiation the person holds radical position, he does not give up positions and tries to justify his/her position;<sup>91</sup> "medium settlement" – the issue is solved in accordance with high standards and principles, based on the law and morale and not according to the desires of the parties;<sup>92</sup> "settlement in principle" – aims to achieve results for parties in accordance with their contribution.<sup>93</sup>

There is possibility that initially the positions to be achieved are not distinguished clearly; however the essence of dispute resolution is identified and such resolution can be improved and elaborated as a result of time and further negotiations. For the above it is expedient to preliminarily develop framework agreement. Development of draft will support concentrated negotiations, moreover, it will support identification of issues which would be missed otherwise, and will enable the parties to avoid any further misunderstandings.<sup>94</sup>

In the process of development of settlement offers, it is necessary for each party to clearly and correctly express their positions, analyses the essence of the dispute, desirable result and the benefits

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<sup>86</sup> *Gogishvili M., Sulxanishvili M., Meskhishvili K., Jinoria Kh., Gelashvili R., Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 35, (in Georgian).*

<sup>87</sup> *Ib.*, 58-59.

<sup>88</sup> *Merrills J.G., International Dispute Settlement, New York, "Cambridge University Press", 2005,12.*

<sup>89</sup> *Ib.*, 13.

<sup>90</sup> *Gogishvili M., Sulxanishvili M., Meskhishvili K., Jinoria Kh., Gelashvili R., Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 52 (in Georgian).*

<sup>91</sup> *Ib.*

<sup>92</sup> *Ib.*

<sup>93</sup> *Ib.*

<sup>94</sup> *Ib.*, 92.

that he/she should compromise.<sup>95</sup> The settlement offers must be fair; they should not violate the law, must regulate the relationships, become the intermediary part for the existing case circumstances and importantly, serve the aim to end the dispute in the form and with the result beneficial for the both parties.

#### **4. Role of Parties to the Court Trial and Judge in the Settlement Process**

##### **4.1. Status and Role of Parties to the Case in the Settlement Process**

Equipping of participants with the defined subjective rights and liabilities in the process of civil-legal regulation of social relationships determine their further behavior within the limits of relevant legal relationships.<sup>96</sup> Leading the case and ending the trial with the settlement is the right of parties. Material-legal interest in the result of the case considers that as a result of the case one of the parties may acquire material benefit, and other party – may lose such benefit. The situation in the event of the settlement is different. In this case the interest and utilization of legal benefits is simultaneous and mutual.

The trial process and settlement have two parties; each party can consist of different number of persons. However, the number of persons for each party does not have any meaning; there are only two parties in the trial – plaintiff and defendant.<sup>97</sup>

The case is taken to the court by one of the parties and it is against the other party. In old Roman civil justice the subject of the justice could be person, citizen as well as corporation.<sup>98</sup> In the civil case, the bodies and officials, leading the case, persons having the personal procedural interests and persons not having direct procedural interest are considered as parties to the Civil case.<sup>99</sup> Term "participant of the process" is wider and considers in itself the party too. The court trial has the plaintiff and the defendant; following the essential review of the case and its completion the parties change their status and become – winning and losing parties. Other status is assigned to the parties in the event of ending the trial with the settlement. There are no winning and losing parties in the dispute settlements; the parties are assigned the status which can be referred to as "intermediary status of the parties" – the mutual concessions puts them under the equal conditions.

During the dispute parties are confronted subjects; however being equal, the conflict cannot be avoided by means of creation of interest for one party and his/her desire. Settlement can be achieved only via the joint efforts. Taking case to the court by one party might be related to the fact of indoubtful court proceedings. Therefore, one person cannot agree with him/herself. "Legal relationship is the relationship defined between the two or more parties in line with the legal norms. Legal

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<sup>95</sup> In proprietary (related to money) disputes the settlement offers may consider the most suited payment schedule, which is key for credit relationships. In such cases, it is important to have settlement conditions close to the essence of the case and proceeding from the case circumstances.

<sup>96</sup> *Todua M., Willems H.*, Liability Law, Tbilisi, 2006, 7 (in Georgian).

<sup>97</sup> *Kurdadze Sh.*, Review of Civil Cases at First Instance Courts, Tbilisi, 2012, 118 (in Georgian).

<sup>98</sup> *Nadareishvili G.*, Civil Law of Rome, Tbilisi, 2001, 134-135 (in Georgian).

<sup>99</sup> *Shushanashvili Al.*, Law Dictionary, Tbilisi, 2000, 219 (in Georgian).

relationship is the relationship between the individuals (e.g. family justice), or between the individuals and objects (e.g. family justice, partial inheritance justice) regulated via the legal norms."<sup>100</sup>

The process is initiated, motivated by the parties to the process and not by the court. The right and liability of each party are relevant to the right and liability of the court and is determined based on such convergence.<sup>101</sup> Court does not lead the court trial without initiative from the interested parties. Court starts the trial only based on the claim from the interested parties and should not exceed the requests of the parties; should not look for the facts and evidences, which were not presented and stated by parties. The court is not authorized to look for and obtain evidences. Court in its decision is based on the evidences presented by the parties. Court actions follow the requests, initiatives from the parties and the disputable issues are reviewed based on the facts presented to the court by the parties.<sup>102</sup> Court as a body granted with the public authority, has no interest towards any party, it is interested with the basis for the correct resolution of the dispute, which is held by the court. Both parties must be equal for the court.<sup>103</sup>

"The legal interests of the parties to the court case are conflicting, as for the parties to the settlement – they are already led by the legal interests directed towards the mutually beneficial results. Everything is based on the "principle of disposition – right of the party to manage his/her material legal or procedural legal rights based on his/her desire, in other words act according his/her legal procedural interests."<sup>104</sup> We can distinguish the party initiating the settlement in the settlement process, which expressed the desire and demonstrated the initiative to end the case with the settlement. Legal interest in the result of the case differs for settlement and court trial cases. "Procedural interest considers the capability of the party to protect his/her rights; it also considers the desire of the party to get favorable decision and execute it."<sup>105</sup>

## **4.2. Status and the Role of the Judge in the Settlement**

The legal encyclopedia interprets the judge as the person which under the constitution has authority to execute the justice and implements his/her liabilities in the professional manner.<sup>106</sup> "The status of judge is first of all related to the high responsibility. There must be two determining factors in the conscious of the judge: his/her internal desire to be decent judge and high sense of responsibility. Judge must have feeling of the fairness and what is the most important, he/she must not make unforgivable mistake."<sup>107</sup> The function and goal of the court and the judge accordingly is to execute

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<sup>100</sup> *Khubua G.*, Theory of Law, Tbilisi, 2004, 200 (in Georgian).

<sup>101</sup> *Chechina N.A.*, Selective Works Devoted to Civil Processes, 2004, 44 (in Georgian).

<sup>102</sup> Collection of Works on Civil Process, *Treushnikova M.K.* (Chief Ed.), Moscow, 1996, 63 (in Russian).

<sup>103</sup> *Ib.*, 64.

<sup>104</sup> *Gabisonia I.*, Courts of Juries, Magisters and Mediators, Tbilisi, 2008, 101 (in Georgian).

<sup>105</sup> *Kurdadze Sh.*, Review of Civil Cases at First Instance Courts, Tbilisi, 2005, 120 (in Georgian).

<sup>106</sup> *Tezelashvili S.*, Legal Encyclopedia, Tbilisi, 2008, 376 (in Georgian).

<sup>107</sup> *Shavliashvili G.*, Civil Court will Become Accessible and Effective for the Citizens, Supreme Court of Georgia, Journal "Justice", No 1, 2006, 66 (in Georgian).

justice in given time and area with the correct utilization of the law. Court executes this function as the right granted by the god – "to execute true justice."<sup>108</sup>

The term "arbitrary judge" with its meaning fits the above status of the judge in the best way, who supports the parties to end the court case with the settlement with the purpose to end the trial. However, at present there is difference between the literal and legal meaning of the term. The Georgian legal system does not consider the status of "arbitrary judge"; however, the Georgian legal system uses the term "magistracy judge" which is adequate to the judge implementing the arbitrary functions in completely different legal area and with the different meaning.<sup>109</sup> The institute of magister or arbitrary judge is the important part of English legal culture. The court of magisters was established in the fourteenth century England.<sup>110</sup> "Under present conditions "Magister" ("Magister judge") and "arbitrary (court of arbitrary judges) court" are similar or even identical terms; in other cases "are different sides of one medal."<sup>111</sup> "It is not difficult to notice that the term magister judge "the arbitrary judge" indicates to the priority objectives and goals of such court, and its methods, directed towards the dispute settlement between the parties and generally considers their reconciliation and by this way regulation of conflict."<sup>112</sup>

The "Main and priority goal of arbitrary judges is to achieve settlement between the parties and accordingly, to "peacefully" resolve the dispute in a maximally prompt (hastened) manner with the possibly least consumption of time, energy and resources, in other words to achieve the maximal effect (results) under the maximal "procedural economy" (!). Generally the above is mainly related to the quantitative aspects(!)."<sup>113</sup> The comparative analysis of the above two statuses bring us to the conclusion that in some countries there is only institute of magisters (in terms of title) and relevant courts (New Zealand, Sweden, India and etc), the vast majority of countries have only arbitrary courts (judges) (in terms of the title) (Russia, Italy, Greece, Belgium, Israel, Turkey and etc), and in some countries the above is encountered in the form of "combination" (Malta, Canada, Malaysia, England).<sup>114</sup>

The number of cases with the alternative ways of resolution sharply increases; the legal system started introduction of specific rules, covering the guidance/management of specialists (especially for the mediators) leading the disputes via the alternative means. Often the judges remove their robes and put on the cap of the mediator. The legal system started provision of the lawyers with the mediation processes, however the regulation does not often provide the special instructions – for judges to act as mediators. For the centuries the Judges were acknowledged for their knowledge of the justice system and controlling the justice. It is paradox, but judges often face problems in the process of mediation related to giving up their wide authority, legal behavior, complex of diplomatic skills and ability to

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<sup>108</sup> *Lazarashvili L.*, Society Must Believe that the Court Is Able to Fulfill Its Real Function – Execute the Justice, Supreme Court of Georgia, Journal "Justice", No 1, 2006, 58-59 (in Georgian).

<sup>109</sup> CPG, Article 13, Part 2 and Article 14.

<sup>110</sup> *Gabisonia I.*, Courts of Juries, Magisters and Mediators, 2008, 342 (in Georgian).

<sup>111</sup> *Ib.*, 98.

<sup>112</sup> *Ib.*, 100.

<sup>113</sup> *Ib.*, 109.

<sup>114</sup> *Ib.*, 102.

convince. The judges are under the similar influence, however many groups of mediators consist of retired judges. The above is a problem characterizing the main directions of the mediation.<sup>115</sup> Despite the fact that the parties have right to manage subject of the dispute and apply the methods of combat (proceeding from the disposition principle), the main position in the process is held by the court, as it represents the State Authority and the parties are subordinated to the court. Actions of the parties are directed towards the creation of basis for starting the court activities and basis for making the relevant decision.<sup>116</sup>

The court is instructed by the law to offer to the parties, to support parties and use all efforts to achieve the dispute settlement. In this case the minimal measure is provision of consultations. The practical value of consultation is transfer of useful information at the correct time before the implementation of any actions. Such action implemented later might have the nature of pressure.<sup>117</sup> Moreover, the judge must be independent from the society and from the relationship with the parties to the case under discussion.<sup>118</sup>

If the judge is involved in the process of negotiations, generally he/she leads the confidential process of dispute settlement, during which "the parties, their representatives and attorneys are required to be completely candid with the settlement judge." The negotiations are not recorded and it is closed. The judge may request the parties to attend the settlement conference organized by the judge, the meeting might be conducted via the lawyers or mediators. The majority of lawyers are of the view that involvement of the judge in the negotiations confirms the prospects for the achievement of the agreement, even if the parties have not requested such agreement.<sup>119</sup>

"Pre-condition for the offer of settlement is the fundamental analysis of subject of the case and factual circumstances, not different from the process required for the judge related to the development of final decision."<sup>120</sup> "The court must support and implement all measures envisaged by the law to achieve the ending of the case with settlement."<sup>121</sup> The judge must apply all efforts to achieve the settlement. "All efforts" considers the attempt of the judge to convince the parties in the advantages of ending the case with settlement. The settlement requires a good mediator, and the judge is the best person and advisor in these terms. "In ancient Rome the judges were assigning the legal norms, as well as explaining/interpreting legal norms, in some exceptional cases the judges were legislators too."<sup>122</sup>

In the process of implementation of the above measures the judge must separate notions "involvement" and "interference." Involvement into the settlement process is implemented based on

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<sup>115</sup> See: *Certilman S.A.*, Judges as Mediators: Retaining Neutrality and Avoiding the Trap of Social Engineering, "The International Journal of Arbitration, Mediation and Dispute Management", Volume 73, No. 1, February 2007, 24.

<sup>116</sup> Collection of Works on Civil Process, *Treushnikova M.K.* (Chief Ed.), Moscow, 1996, 62 (in Russian).

<sup>117</sup> *Merrills J.G.*, International Dispute Settlement, New York, "Cambridge University Press", 2005, 3.

<sup>118</sup> International Ethical Standards for Judges, Bangalore Principles of Behavior at Court, Tbilisi, 2002, 6 (in Georgian).

<sup>119</sup> *Llevin A.L., Shuchman P., Yamnb C.M.*, Civil Procedure, Cases and Materials, Successor Edition, New York, "The Foundation Press", 1992, 549.

<sup>120</sup> *Chanturia L., Boeling H.*, Methodology on Making Decisions on Civil Cases, Tbilisi, 2003, 92 (in Georgian).

<sup>121</sup> Case №as-1269-1527-09, Chamber of Civil Cases, Supreme Court of Georgia, 2010, available (in Georgian) at: <[www.supremecourt.ge](http://www.supremecourt.ge)>.

<sup>122</sup> *Nadareishvili G.*, Civil Law of Rome, Tbilisi, 2001, 37 (in Georgian).



the voluntariness of parties and consideration of the law. In particular, the court shall apply all efforts to achieve the settlement between the parties.<sup>123</sup> Initiative of the judge to end the court trial with the settlement shall be considered as the form of such attempt. As for the "interference", it is implemented by unauthorized person in the irrelevant form and is against the law. It is prohibited for the judge to demonstrate the preliminarily established position or biased view towards certain person or group of persons founded on irrelevant basis through his words or behavior during the implementation of his/her duties.<sup>124</sup>

Some of the judges have skeptical view on the utilization of alternative means for the dispute resolution. They are of the view that the court processes have already approved their effectiveness. Hence there is no more need to look for novelties in this area. More so, as the court is never against the settlement and can approve the results achieved via the agreement between the parties.<sup>125</sup> Georgian legal systems puts more emphasis on the settlement between the parties; the above is supported by the fact that the implementation of disposition principle and the judge play the special role; and Georgian legal system is characterized with the flexible mechanism for the regulation of legal will of the parties.

## 5. Court Settlement and Its Legal Results

### 5.1. Ending the Court Proceedings with the Court Settlement

Settlement is one of the bases for termination of court proceedings in line with the rules envisaged by the law. In general, settlement considers agreement of parties and resolution of conflict by this way. The resolution of dispute (result) is normal, accepted practice for the civil cases, as for the criminal law cases – the above is considered as the exceptional method used in rare cases, as settlement, mediation and arbitration is rarely achieved for the criminal cases.<sup>126</sup>

According to the German civil procedural code, which is considered as "mother of procedural laws," the civil cases are divided into two parts: making legal decisions (*Erkenntnisverfahren*) and execution of legal decisions. German legal processing covers several principles, including the principle of disposition.<sup>127</sup> Private Justice is based on the principle of individual's self-determination to regulate his/her legal relationships. Right to apply or not to apply to the court is the basis for the above principle. The court cannot become the initiator of the court proceedings, the above is reflected in the statement: "If there is no plaintiff, there is no court trial" (there is no plaintiff, there is no judge).<sup>128</sup>

There are many reasons for utilization and spreading of dispute resolution procedure. Development of human rights in Europe created the fundament for the adoption of number of laws, which

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<sup>123</sup> CPCG, Article 218.

<sup>124</sup> International Ethical Standards for Judges, Bangalore Principles of Behavior at Court, Tbilisi, 2002, 10 (in Georgian).

<sup>125</sup> *Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 168 (in Georgian).

<sup>126</sup> *Gabisonia I.*, Courts of Juries, Magisters and Mediators, Tbilisi, 2008, 100-101 (in Georgian).

<sup>127</sup> *Ebke W.F., Finkin M.W., Beck Kluver C.H.*, Introduction to German Law, The Hague/London/Boston, 1996, 357.

<sup>128</sup> *Ib.*, 359.

was followed by the establishment of court institutions for the purpose of resolution of disputes related to the human rights. The above facilitated the increase of number of mechanisms for the dispute resolution in the area of human rights' protection as well as other areas of justice.<sup>129</sup> Dispute resolution via the alternative means provides solution to the legal problem through certain methods different from the general court process; as a result the court proceedings are avoided. However it is not always expedient to apply the alternative dispute resolution methods. For some type of disputes and purposes the court hearing is the best process, as in some situations only the court decision can ensure the correct indications for the parties; in cases where the alternative dispute resolution methods are well probed, it is desirable to use such methods optimally without rejecting the use of court decision.<sup>130</sup>

In some cases processing the case at the court may not result in the court resolution. One of the forms of the court processes without the court resolution is the termination of court proceedings.<sup>131</sup> Parties can reach agreement, settlement at the court and following the approval of such settlement at the court terminate the court hearing. The advantage (psychological) of the settlement approved by the court – none of the parties is a winner or loser (no parties wins or loses case). Moreover, parties can regulate all their legal relationships until such regulation is possible via the court process.<sup>132</sup>

"According to the article 3 of Civil Procedural Code of Georgia, parties are equipped with their rights and authority to manage their freedom. For the realization of this authority parties are in free possession of all procedural means: it depends on the will of the plaintiff to start the case, not to start the case or terminate the case at any moment; the defendant shall decide to accept or not to accept the claim; the conclusion of the case with settlement depends on the ability of parties to reach the reasonable compromise."<sup>133</sup> Conclusion of the case with settlement is the voluntary choice of parties. Namely, parties can end the case with settlement.<sup>134</sup> Moreover, then conditions of settlement act should not conflict with the law and rights of other persons.

For the purposes to conclude the case with settlement, the judge is authorized under his/her initiative or in line with the appeal from the party to declare the break at the court hearing and listen to the parties or their representatives without presence of other persons. The judge can indicate to the results of the dispute resolution and offer to the parties the settlement conditions.<sup>135</sup> If provided written materials creates the basis for the judge to assume that it is possible for the parties to conclude the case with settlement, and if according to the Judge's view the above is required for the interests of proper preparation of the case for hearing, the judge during 5 days following the receipt of written materials from the parties, is authorized to fix the preparatory meeting.<sup>136</sup> Namely judge can explain to the parties

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<sup>129</sup> *Buergenthal Th.*, The Proliferation of Disputes, Dispute Settlement Procedures and Respect for the Rule of Law, Journal "Arbitration International", Volume 22, Number 4, 2006, 495.

<sup>130</sup> *Llevin A.L., Shuchman Ph., Yamnbon C.M.*, Civil Procedure, Cases and Materials, Successor Edition, New York, "The Foundation Press", 1992, 543

<sup>131</sup> CPCG, Article 272.

<sup>132</sup> *Ebke W.F., Finkin M.W., Beck Kluver C.H.*, Introduction to German Law, The Hague/London/Boston, 1996, 369.

<sup>133</sup> Case №as-1232-1491-09, Chamber of Civil Cases, Supreme Court of Georgia, 2010, available (in Georgian) at: <[www.supremecourt.ge](http://www.supremecourt.ge)>.

<sup>134</sup> CPCG, Article 272, Sub-paragraph "d".

<sup>135</sup> CPCG, Article 218.

<sup>136</sup> CPCG, Article 205.

the settlement rules, conditions under which such settlement can be reached, convince the party to compromise, explain to the parties the difficulties related to the implementation of court hearings, indicate to the real probability for the creation of problems; and importantly provide time for settlement and etc. Despite such efforts court cannot force the parties to conclude the case with settlement. If parties are not able to agree on settlement, the court must continue the court process in a normal way.

According to CPCG the settlement is implemented by the court. The above is demonstrated by the term "court settlement". "Court settlement" considers the settlement which is executed under the court resolution.<sup>137</sup> It is important and interesting to review the parallel between the terms "court settlement" and "settlement court." "Settlement court" (in English World Court, Russian - Мировой суд) is defined as the lowest level court system in many countries, which under the simplified procedures reviews the trivial civil and criminal cases.<sup>138</sup> "In some countries the settlement court is operating at the lower level of the system, which at a first instance reviews the cases of low importance. The case is reviewed under the simplified procedure at the settlement court; the case is reviewed by the settlement judge unilaterally. There is no such court in Georgia at the moment."<sup>139</sup>

Case processing considers the review of the legal relationship which became disputable according to the court procedural rules. Therefore, the case can be only concluded with the court settlement. The decisions made for the cases devoted to the settlements are not implemented outside the court and are made by the court. The above is reinforced by the fact that the judge plays one of the most important roles in the court settlements. If the case is beyond the court, then the above is not considered as the court process. Hence the court proceedings may only end with the court settlement.

It is possible to conclude the case with settlement at any stage of the legal case review, including the stage preceding the essential review of case, avoiding the complex and long term court processes. The settlement can be approved at the stage of review of the claim for the decision without presence. For the above cases, court is not limited with the specific procedural actions, which excludes the essential review of the case and there is a possibility to approve the illegal settlement. The court should consider and avoid the above.<sup>140</sup> For the above purpose the court goes beyond the claim and requirements of private claim; court should study the case and only afterwards approve the settlement.<sup>141</sup>

The settlement can also be reached at the stage of renewal of court case hearing, court hearing based on the newly identified circumstances and in the event when the court hearing is terminated due to the newly identified circumstances, all court decisions are annulled and the settlement is approved. If the execution paper has been already issued, the different settlement procedure is envisaged in line with the law on "Execution processes."<sup>142</sup> Namely, in the event of settlement in the process of

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<sup>137</sup> Marsh S.R., Current Issues in Court Annexed Mediation, available at: <<http://adrr.com/adr2/essayq.htm>> [24.07.2012].

<sup>138</sup> Gabisonia I., Courts of Juries, Magisters and Mediators, Tbilisi, 2008, 100 (in Georgian).

<sup>139</sup> Shushanashvili Al., Law Dictionary, Tbilisi, 2000, 258-259 (in Georgian).

<sup>140</sup> Gogishvili M., Sulxanishvili M., Meskhishvili K., Jinoria Kh., Gelashvili R., Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 29 (in Georgian).

<sup>141</sup> Supreme Court of Georgia, Recommendations on Problematic Issues in Court Practice for Civil Law, XXX, Generic Practice of Supreme Court of Georgia related to the Civil Cases, Tbilisi, 2007, 38-39 (in Georgian).

<sup>142</sup> Law on Execution Activities, 1999, Article 18(e).

execution, creditor and debtor hand over written agreement to the court executor; court executor will send the agreement to the court during three days for making decision on approval of settlement.<sup>143</sup>

At the stage of legal processing, when reviewing the security and the claim has not yet been started, it is not possible to approve the settlement due to absence of parties and subject of the dispute.<sup>144</sup> The results of settlement approval differ depending on whether the legally effective decision is transferred for execution or not. If the case is transferred for execution, then based on the appeal from the executor the court approves the settlement, however court does not annul the court decision which is already legally effective. If case is not transferred for execution, in other words execution paper has not been issued, court is authorized to approve settlement and annul all decisions related to the case, in order to execute only one decision.<sup>145</sup>

Therefore judge must review each specific case with attention, without hurry, with high sense of responsibility and must be patient, attentive and convincing towards the parties.<sup>146</sup> "The court must support and implement all measures considered by the law in order to achieve the settlement between the parties."<sup>147</sup> The judge can temporarily delay the case and allocate reasonable time for the parties for reaching the settlement. Judge can suggest to the parties to better understand their positions, prospects for further development of case and possible results. Judge shall offer settlement in the clear form directed towards the settlement. Sentences to the parties shall demonstrate the purpose of settlement and results in case if such settlement is not reached.

## **5.2. Legal Results of Concluding the Civil Case with Settlement**

"Legal effectiveness" of settlement is demonstrated in the legal results achieved via the conclusion of civil case hearing with the settlement. Settlement brings the specific legal results, which on the one hand is demonstrated via the dispute resolution and on the other hand – via the ending of case processing at the court. Following the submission of settlement act by the parties, they approach the court with the request to approve submitted settlement act and terminate the court hearings.<sup>148</sup> Such request is the appeal implemented in accordance with rules envisaged under the law,<sup>149</sup> which may or may not be approved by the court. The court following the study of the case materials, examination of settlement act submitted by the parties makes decision to approve the settlement act and terminate the processing of the case, which is conveyed in the resolution based on the circumstances provided.<sup>150</sup>

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<sup>143</sup> Supreme Court of Georgia, Recommendations on Problematic Issues in Court Practice for Civil Law, XXX, Generic Practice of Supreme Court of Georgia related to the Civil Cases, Tbilisi, 2007, 39 (in Georgian).

<sup>144</sup> *Ib.*, 41.

<sup>145</sup> Supreme Court of Georgia, Recommendations on Problematic Issues in Court Practice for Civil Law, XXX, Generic Practice of Supreme Court of Georgia related to the Civil Cases, Tbilisi, 2007, 40 (in Georgian).

<sup>146</sup> Issues of Ethics for Legal Professions, Study Materials, ABA Rule of Law Initiative, Tbilisi, 2009, 94.

<sup>147</sup> CPCG, Article 218, Part 1.

<sup>148</sup> Case №as-1003-1278-09, Chamber of Civil Cases, Supreme Court of Georgia, 2010, available (in Georgian) at: <[www.supremecourt.ge](http://www.supremecourt.ge)>.

<sup>149</sup> *Ib.*

<sup>150</sup> *Ib.*

Ending the case processing via settlement is the alternative way of dispute resolution, which has several advantages compared with the case hearing process: avoiding dragged and long court procedures; resolution of dispute within the time required for the parties to develop settlement conditions; termination of court process with the results desirable by parties reducing the work load in the court system; prompt and final resolution of dispute reviewed at the court; simple execution; development of conditions by parties which are acceptable and easily executable; reduction of costs; avoiding all costs related to the execution.

The advantage of settlement is somehow related to its economic value – expressed in the reduction of losses (financial costs) as well as saving time (especially in entrepreneurial, family and work related relationships) and energy. Advantage of settlement is also expressed in prompt completion of court processes and avoiding long processes, related to court expenses.<sup>151</sup> "One of the problems of present justice is related to the huge number of cases resulting in overloaded judges, which naturally influences the quality of justice and causes justified dissatisfaction of society with the slow court processes. The above problem is faced by all instance courts; however it must be considered that activities of judges are creative ones. Such activities require time. The mind of judge should not be occupied with worries related to the violation of terms due to "old" cases and should not worry that the ministry of justice requests explanations on the above; on contrary judge should be concentrated on the correct interpretation of the law and provision of correct solution to the case."<sup>152</sup>

In case of settlement the dispute is resolved peacefully using the non-conflict ways. The above supports development of new relationships between the parties and achievement of peace. Via settlement it is possible to consider the possibility for future partnerships between the partner parties,<sup>153</sup> and their relationships may become better regulated and improved. As a result of such regulation of relationships there are no winners and losers. The reached settlement assigns to them the equal "intermediary status". Accordingly the "parties will not leave the court hall as winning or losing parties."<sup>154</sup> It can be noted that both parties are winners in case of settlement; none of them leaves the court hall "with empty hands. "As a result of settlement it is possible to restore the "justice" in a sharper way compared with the decision made over such disputes, as often such decisions are based on formal criteria. Therefore, it is possible to achieve the results via settlements which would not be achievable as a result of court decision..."<sup>155</sup>

The parties are equal for the court. The plaintiff as well as defendant has equal rights against the court. In the process of court hearings the interests of parties are equalized, their rights and liabilities are derived from the essence of the case, objectives of parties and liabilities of the court.

Settlement is a process, which is accepted and implemented by parties voluntarily. The desire of parties on the conclusion of case with settlement is achieved via the agreement of their wills, ensuring

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<sup>151</sup> Chanturia L., Boeling H., Methodology on Making Decisions on Civil Cases, Tbilisi, 2003, 89 (in Georgian).

<sup>152</sup> Lazarashvili L., Society Must Believe that the Court as is Able to Fulfill Its Real Function – Execute the Justice, Journal "Justice", No 1, 2006, 56 (in Georgian).

<sup>153</sup> Glenewinkel, Werner, Mediation als außergerichtliches Konfliktlösungsmodell, Am Beispiel der Trennungs- und Scheidungsmediation in der Bundesrepublik Deutschland, Stuttgart, 1999, 60-61 (*Tsertsvadze G.*, Mediation, Alternative Form of Dispute Resolution, Tbilisi, 2010, 48 (in Georgian)).

<sup>154</sup> Chanturia L., Boeling H., Methodology on Making Decisions on Civil Cases, Tbilisi, 2003, 90 (in Georgian).

<sup>155</sup> *Ib.*, 90.

the final resolution of dispute. As a result of settlement we are getting the "executed decision" and at the same time avoiding one more "undecided decision" imposed via the court processes.

"In the process of settlement, the attention is directed towards the possibility which is beyond the process. This is less relevant for the court decision making process."<sup>156</sup> By this way there is high possibility for the restoration of justice. Restoration of justice is not demonstrated via decision made in line with the rules envisaged under the law and execution of justice only, it is also demonstrated via the revealing the will of parties, fairness of which is confirmed by the fact that will of parties is agreed and acceptable for the final resolution of dispute.

"Settlement is equally important form of court case completion compared to the resolution made on the case. In some cases settlement is the better alternative with the condition that the offer of settlement does not only consider the reducing work load for the judge, but serves the purpose of fair resolution of conflict between the parties related to the subject of dispute."<sup>157</sup> The effect of conclusion of court case with settlement over the conducting civil cases is positive for the disputing parties as well as for the whole court system.

## **6. Settlement Act**

The settlement act, written document about the management of civil rights and liabilities of parties – is the concessional contract. There is a condition established in the contract law – the contract is concluded if parties agree to all essential conditions of such contract. Following the agreement of parties over the settlement, their rights and liabilities are determined according to the conditions envisaged under such settlement and not according to the liabilities considered before such settlement.<sup>158</sup>

The settlement shall be concluded in the written form. Moreover the court may indicate that "settlement act drafted by parties has to be attached to the case materials."<sup>159</sup>

Settlement act or in other words contract on settlement must consider all conditions related to the resolution of disputable issue. Contents of the settlement act shall be derived from the factual circumstances of the case and directed towards the dispute resolution. Moreover, conditions presented by each party must satisfy the interests and requirements of other party. Settlement act consists of the following provisions: conditions of the contract, special conditions, costs related to the process and concluding provisions.<sup>160</sup>

Settlement act is not an act issued by the court authority; adoption of court act by which the case is terminated is considered as the execution of justice.<sup>161</sup> "Notion of justice execution does not include such court acts which are although received (or will be received) for the court proceeding purposes, but the essential review of such cases is not implemented and the material legal condition of the

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<sup>156</sup> *Chanturia L., Boeling H.*, Methodology on Making Decisions on Civil Cases, Tbilisi, 2003, 89 (in Georgian).

<sup>157</sup> *Ib.*

<sup>158</sup> Comments to CCG, Volume 3, Tbilisi, 2001, 264-265 (in Georgian).

<sup>159</sup> Case №as-1105-1369-09, Chamber of Civil Cases, Supreme Court of Georgia, 2010, available (in Georgian) at: <[www.supremecourt.ge](http://www.supremecourt.ge)>.

<sup>160</sup> Case No. as-1269-1527-09, Chamber of Civil Cases, Supreme Court of Georgia, 2010, available (in Georgian) at: <[www.supremecourt.ge](http://www.supremecourt.ge)>.

<sup>161</sup> *Kurdadze Sh.*, Review of Civil Cases at First Instance Courts, Tbilisi, 2005, 13 (in Georgian).

parties is not determined (defined)."<sup>162</sup> According to the above logic concluding the case with settlement is not considered as execution of justice and it is only the procedural issue related to the concluding the case hearing.

Settlement act is not a document bearing the legal power. Settlement act is concluded for settlement and settlement is reached for the termination-completion of case processing, it is not possible to appeal the settlement act. Practice of Supreme Court demonstrated that if the party does not agree with the conditions of settlement act, the party shall appeal the decision of the approval of settlement act and not the settlement act itself. The above confirms the fact that the court decision grants the legal power and meaning to the settlement act.<sup>163</sup>

It is necessary to implement the settlement within the requirements of the law. Contents of the settlement act shall fully comply with the requirements of the law. Condition for satisfaction of the above condition is relevant as the parties determine all conditions, and there is a possibility that parties do not or could not consider the law requirements. Settlement conditions, by contents should not conflict with the moral and public order. The court is required to control the legality of settlement act and if it concerns the interests of state or the person not participating in the process, limits the rights or legal interest of the parties then it is not allowed to approve the act.<sup>164</sup>

"The court, in the process of evaluation of fairness and legality of settlement conditions, shall consider the following material-legal aspects of the act: the liabilities considered under the settlement act must be executable, which is necessary for issuing the execution paper and its execution without problems. The volume of liabilities, terms and conditions for their implementation shall be provided in detail for avoiding the confusion; settlement conditions should not violate the interests of third party; settlement conditions should not be in conflict with the imperative requirements of the law,<sup>165</sup> the subjective composition of settlement participants shall be fully given, especially in the event of procedural co-participation.<sup>166</sup> Settlement act may consider sanction for the violation of settlement act,<sup>167</sup> the court resolution on approval of settlement act should precisely reflect conditions agreed under the settlement, including volume of funds and terms defined for the implementation of undertaken liabilities. Approving the will expressed by the parties is the prerogative of the court. It can be stated that the judge approving the settlement act is implementing the function of "procedural notary", and the act itself is "the procedural settlement."<sup>168</sup>

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<sup>162</sup> *Kurdadze Sh.*, Review of Civil Cases at First Instance Courts, Tbilisi, 2005, 13 (in Georgian).

<sup>163</sup> Supreme Court of Georgia, Chamber of Civil, Entrepreneurial and Bankruptcy cases has resolution from the practice of year 2008, which is based on the request from the cassation party on the nullification of resolution of the same court dated 2004 due to the newly identified circumstances. One can read in the text of resolution: "The appealed resolution approved the settlement between JSC Post Bank of Bank of Georgia and etc..." see (in Georgian): <<http://www.supremecourt.ge/files/upload-file/pdf/03-2008.pdf>> [05.02.2014].

<sup>164</sup> Available (in Russian) at: <<http://divorces.ru/faq/osobennosti/mirovoe.htm>> [05.02.2014].

<sup>165</sup> Implies – persons involved as official persons not only in the specific case processing

<sup>166</sup> *Gogishvili M., Sulxanishvili M., Meskhishvili K., Jinoria Kh., Gelashvili R.*, Relationships at the Court Hall, Communication and Legal Aspects of Court Hearing Management and Settlement of Parties, Supreme Court of Georgia, Tbilisi, 2010, 39 (in Georgian).

<sup>167</sup> Resolution of Supreme Court of Georgia on Civil, Entrepreneurial and other Category of Cases, Civil Process, Termination of Court Process due to the Settlement between the Parties, №1, 2010, 20, available (in Georgian) at: <<http://www.supremecourt.ge/files/upload-file/pdf/kr20101.pdf>> [05.02.2014].

<sup>168</sup> Term "procedural deal" should not be confused with the procedural deal used in the criminal law.

## **7. Conclusion**

Legal regulation of conflicts created in the public relationships is related to the long and complex process. Settlement with maximal consideration of parties' will resolves the existing dispute and terminates the case processing at the court in an easy and legal way.

The legal norms related to the settlement are not defined systematically in the material and procedural legislation. Material law defines the notion of the settlement in an indirect way; it covers the error in the basis of the settlement. CCG uses the term identical to the settlement – "mutual concession." The term "settlement" itself is universal for the expression of its real contextual meaning. We must always use this term with its wide meaning. Actually "mutual concession," together with other legal components, is the constituent part of the settlement notion and the necessary mean for reaching the settlement. It must be noted that term used in CCG is related to the stage of the regulation of the behavior of public relationship when the relationship is not yet developed to the case processing stage; term "settlement" used by CPCG – covers the resolution of dispute which has already been transformed into the court case.

The norms related to the process of concluding court case with the settlement are provided in various chapters of CPCG, which makes it impossible to have the settlement as the systemically integral process. Moreover, Civil Procedural Law does not provide the definition of settlement as the integral part of case processing. It is expedient to devote separate chapter to the "settlement process", to integrate and improve existing norms in the form of general and special norms for settlement, which will ensure the systematic nature of the legislation and practical effectiveness of norms.

Settlement as an independent process is based on fundamental and auxiliary principles. The informal beginning of the process is the conflict between the parties, requiring settlement attempts, communication among the parties, and intensive implementation of negotiation processes. It is key to avoid "negotiation for negotiation." The judge is authorized to involve in the settlement attempts and via the implementation of his/her duties envisaged by the law support the settlement. Settlement as an independent process is the integral part of case processing. The above indicates to the accessory nature of the settlement, indicating that settlement cannot serve its purpose without the processing of civil case. Hence "if there is no dispute, there is nothing to settle about".

The status of parties and judges in the settlement process is very important. During the court processing the parties are conflicting subjects, in case of settlement they are motivated by the legal interests directed towards the common goal. We can distinguish the party initiating the settlement process; the above party expresses his/her desire to end the case with settlement. There are two parties to the case processing – plaintiff and defendant. They, following the case processing, essential review of the case and its completion change their status and become winning and losing parties. In the event of settlement they achieve the status which can be referred to as "intermediary status of parties".

The judge plays special role in the settlement process. The judge must use all efforts to achieve settlement of parties. "Applying all efforts" consider the attempts of the judge to convince the parties in the advantages of settlement and act within the authority granted by the law. In this process it is important to distinguish between the "involvement" and "interference" from the judge. Involvement is implemented based on the voluntary actions of the parties and the law and is related to the position that the court should support the parties in all possible ways and implement all measures envisaged under the law to achieve the settlement between the parties. As for the "interference" – it is



implemented by unauthorized person in an irrelevant way and is against the law. The contents of the settlement are included in the court decision via the approval of settlement act. In this case judge confirms the will expressed by the parties and equips the act with the legal power. Judge approves the act following the examination of its legality.

Concluding the case court processing with the settlement is the voluntary choice of parties and it is possible at any stage of case processing, including prior to the essential review of case, by this way we can avoid complex and long court process. There are exceptions at the stage of court processing, when the security for the claim is discussed and the civil action has not been yet defined. In this case approval of settlement is not allowed due to the absence of the dispute.

Settlement processes for civil cases and settlement agreement are divided into two groups based on the place of their conclusion and execution – court and non-court settlements. Georgian legislation envisages only "court settlements". "Court settlement" is a process, when the settlement is implemented according to the court decision (resolution) indicating that settlement is one of the basis for the completion of case court processing.

Settlement act, as the consensual contract on the management of civil rights and liabilities is an important document. The contract is concluded between the parties in a written form depending on which liability is subject of the act. Conditions of settlement act are directed towards the agreement of mutual interests of parties to the dispute and termination of court case. For the real and proper implementation of the above it is important to have settlement act which is based on free and thought-through will of parties, law and morale. Existence of all three conditions is necessary pre-condition for act approval. The parties are free in developing their will, the legality and morality of the will is controlled by the court.

Concluding the civil court case with the settlement is the dispositional authority granted to the parties by the law, which results in the deal based on the free expression of their will and reaching agreement; the above is approved by the court based on the control over the legality. The court processing of the case is terminated and completed via the discussed legal instrument. The influence of the settlement over the processing of civil cases is evidently positive for the disputing parties as well as the court, as the court is well aware of the difficulties related to the case processing faced by the parties in case of reviewing the case under the court rules – how long is the way towards the achievement of the desired victory.

**Sophio Machavariani\***

## **Liability in the Corporate Group According to the US and the German Laws and Perspectives of Integrating its Principles in Georgia**

### **1. Introduction**

Consideration and establishment of the modern corporate law achievements in Georgian legislative framework is preconditioned by the development of international economic relations and the process of integration of the Georgian economy in the world economy. One of the most important directions for the legal regulation of the corporate sphere is related to the responsibility in the corporate governance.<sup>1</sup>

Liability is considered as an instrument for corporate management, which includes issues related to the responsibility of the management towards the partnership and also those related to the responsibilities among the partners/shareholders of the corporation.

The legislations of the different countries, which regulate the corporate groups and belong to the continental or common law systems, are different from each other. But American and German systems are especially distinguished. The legislations of almost all developed countries originate from these two countries' laws. Therefore, the topic of liability is reviewed with regard to legislative principle recognized by the US or German legislation, considering the details of the corporate groups in the US (called in the US as holdings) and German concerns (as the unions of the enterprises are called as "concerns" in Germany).<sup>2</sup>

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<sup>1</sup> See further reading on this topic: *Chanturia L.*, Corporate Management and Responsibility of the Corporate Managers in the Law, Tbilisi, 2006 (in Georgian); *Burduli I.*, Basics of Joint Stock Law, Volume I, Tbilisi, 2010 (in Georgian); *Jugheli G.*, Protection of Capital in Joint Stock Company, Tbilisi, 2010 (in Georgian); *Dine J.*, The Governance of Corporate Groups, Cambridge, "Cambridge University Press", 2003; *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, New York, "LexisNexis", 2005; *Hopt K.J., Wymeersch E.*, Comparative Corporate Governance, Berlin, "Walter de Gruyter", 1997; *Emanuel S., Emanuel L.*, Corporations, New York, "Aspen Publishers Online", 2009; *Schuk-Amend A.*, Liability of Holding Companies, A CMS Corporate Publication, 2004, available at: <<https://www.google.scholar.com>>; *Zumbansen P.*, Liability Within Corporate Groups (Bremer Vulkan), Federal Court of Justice Attempts the Overhaul, "German Law Journal" No. 3, 2002; *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009; *Schmidt K., Lutter M.* (Hrsg.), Aktiengesetz Kommentar (AKtG), II. Band, "Verlag, Dr. Schmidt O.", Koln, 2008; *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010.

<sup>2</sup> *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 17.

The legislative changes which took place in Georgia in 2008 established so called mixed model, which considers specifics of the both (American and German) systems. It is possible to recognize in this sphere a system which was obtained from joining the both models and which will be in compliance with Georgian legislation and actual reality.

Thus, it is interesting to analyze the norms and the practice of the two most stable systems of the world – German and the US considering Georgia's relevant legislative context and factual reality.

Different themes are characteristic to the corporate management system for the enterprises integrated within the corporate group. The majority of the big corporations in Georgia<sup>3</sup> are united in corporate groups and managed by one corporate center. Respectively, this has special relevance for Georgia. Managing a corporate group, unlike managing a single enterprise, involves more participants and more relationships, which need smooth and consecutive regulation. Its idea goes beyond the notion of the corporate management, which often considers only faultless leading of the partnership by the managers.

All big reforms in the sphere of the corporate management in the world were implemented after the financial scandals, which were negatively reflected on the economies of some of the countries.<sup>4</sup> Therefore, it would be reasonable for Georgia to refine this sphere without any problems and mistakes and approach to the possible extent the world practice and principles improving the regulations by considering the mistakes made by others. This will give the possibility to the entrepreneurs of Georgia have a valid position for attracting the foreign investors and getting involved in the world economy.

## **2. Internal Duties among the Corporate Group Participants**

### **2.1. Fiduciary Duties of the Managers**

The managers of the partnership and the members of the Supervisory Board are responsible to lead the affairs of the partnership with the good faith and believing that their action is the most suitable for the interest of the partnership. These duties in the US law are called fiduciary duties,<sup>5</sup> though it is already a well-established term in all legal sciences.<sup>6</sup>

The concept of the fiduciary duty in the US law comes from the institute of trust (Law of Trusts). It was modified from the point of view of the corporate law, but the trust institute is still considered as its precursor.<sup>7</sup> It is recognized that the interest of the corporation must be dealt by the manager as by the trusted fiduciary body. A person is considered as fiduciary<sup>8</sup> if he took the

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<sup>3</sup> e.g. JSC "Bank of Georgia", JSC "Liberty Bank", JSC "VTB Bank", JSC "TBC Bank", JSC "Privat Bank", JSC "Bank Republic", LLC "GMC Group".

<sup>4</sup> *Rajak H.*, Corporate Groups and Cross-Border Bankruptcy, "Texas International Law Journal", Vol.44, 2009, 541.

<sup>5</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 199 (in Georgian).

<sup>6</sup> *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 486- 487.

<sup>7</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 4.

<sup>8</sup> *Jugheli G.*, Protection of the Capital in the Joint Stock Company, 2010, 178 (in Georgian).

responsibility to act in the interests of the other party in the circumstances which create the relationship established on the basis of the trust.<sup>9</sup>

In the US law, the issues which give rise in the corporate management, apart from the Case Law, are regulated by The Sarbanes Oxley Act.<sup>10</sup> Its new regulation is given also in The Dodd-Frank Act.<sup>11</sup> In Germany, these issues are defined by the Law of Germany on Stock Corporation.

The functions of corporations' management and control are distributed among: the shareholders common union, board of the directors and the managers. The board of the directors has also the functions of the Supervisory Board. In the German system the board is called "Supervisory Board". The main details of the duties of the board are practically same in the German and the US systems.<sup>12</sup>

The managers of the company are following their fiduciary duties when they act in the good faith and take relevant decisions, implement the action for the benefit of the partnership, stay uninvolved (in case of the conflict of interest, they give priority to the interest of the partnership); provide opportunities for an easy development of the company etc.<sup>13</sup>

The manager does not become liable if he could not achieve the success. But he becomes liable if the failure to follow the duties negatively affects the partnership.<sup>14</sup>

In Germany, the liability in capital partnership is regulated by the law and it does not depend on the conditions of the agreement which is made between the partnership and the manager.<sup>15</sup> Therefore, this liability is called legal liability. In the US, despite quite good regulation of this sphere, the contractual responsibilities prevail (mainly mentioned in the Charter); e.g. according to the US law, the directors are responsible towards the partnership if they exceed their rights or legal duties.<sup>16</sup> But unlike the German system, it is possible to exclude the directors' responsibility in case of breach of the Duty of Care in the US. The same is excluded for the breach of the Duty of Loyalty or/and for the damage made purposefully.<sup>17</sup>

Sarbanes-Oxley considers solid penalties for the directors in case of the breach of the concrete statements; in particular, in case of incomplete or inaccurate financial accounting, the director has to pay 5 million US dollars or face 20 years prison charge.<sup>18</sup> According to the same act, to ensure the

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<sup>9</sup> *Dine J.*, The Governance of Corporate Groups, Cambridge, "Cambridge University Press", 2003, 190.

<sup>10</sup> The Sarbanes-Oxley Act (SOX), 2002.

<sup>11</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), 2010.

<sup>12</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 10.

<sup>13</sup> *Sheikh S., Rees W.*, Corporate Governance & Corporate Control, London, "Routledge", 1995, 25.

<sup>14</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 65 (in Georgian).

<sup>15</sup> *Ib.*, 66.

<sup>16</sup> *Cioffi J.W.*, Corporate Governance Reform, Regulatory Politics and the Foundations of Finance Capitalism in the United States and Germany, "German Law Journal", Vol.07, No.06, 2006, 547-549; *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 32-35 (in Georgian).

<sup>17</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 124-126 (in Georgian).

<sup>18</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 33 (in Georgian).

independence of the management and the board members, it is prohibited to the corporation to give them credits.<sup>19</sup> To avoid the conflict of interest, it was considered necessary to choose board members and audit committee from invited directors and make deals among the group members for the commercial price and not for the favor of the managers or/and dominant shareholders interests.<sup>20</sup> This proves how big state interests in the good faith management is. For this reason, the contractual statements in this sphere were replaced by the imperative legal regulations.

In the US law, when talking about the duty of the corporate managers, managers' (executive director) responsibility is also considered together with those of the board members'.<sup>21</sup> In the US corporate practice, in the closed corporation, where the number of the shareholders is small, the partnership is practically manager by the shareholders. They are the members of the board and also the manager, while in the open partnerships with many shareholders, the managers have the real power.<sup>22</sup> Therefore, they are obviously subject to liability.

Fiducial duty principle, according to the German system, refers also to the Supervisory Board. It has the responsibility to control the directors' performance and also has the burden of proof in case of disagreements.<sup>23</sup>

According to the German legislation, apart from managers and the members of the board, any big or small shareholders or partners also have fiduciary duties.<sup>24</sup> In the US law, fiduciary duties are responsibilities of only dominant partners towards the partnerships or other partners; and this is the main difference between the dominant and small partners.<sup>25</sup>

The fundamental principle of the duty of care and the duty of loyalty of the board in the US are: prudence and honesty. Duty of care considers that he has to use his authority honestly, carefully and professionally and that all decisions should be taken based on the complete information obtained. The duty of loyalty is reflected in the monitoring of deals that were made or that will be made in the future.<sup>26</sup> As there is no Supervisory Board in the US, the functions of control and management are not clearly distinguished. Here the board involves the internal managers and so call invited directors.

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<sup>19</sup> *Kenny P.*, Corporate Governance in the U.S: Post-Enron, "German Law Journal", Vol.04, No.01, 2003, 53-59, 56.

<sup>20</sup> *Baums T., Feddersen D.*, Corporate Governance Rules for Quoted German Companies – Code of Best Practice for German Corporate Governance, German Panel on Corporate Governance, 2000, 7; *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 5.

<sup>21</sup> *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 517.

<sup>22</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 32-33, 118-121 (in Georgian).

<sup>23</sup> *Hopt K.J., Wymeersch E.*, Comparative Corporate Governance, Berlin, "Walter de Gruyter", 1997, 18.

<sup>24</sup> *Stefan G., Florian M.*, European Corporate Law Study Group Germany, 2008, 36; *O'Kelley R.T., Thompson B.*, Corporations and Other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 260.

<sup>25</sup> *Dine J.*, The Governance of Corporate Groups, Cambridge, "Cambridge University Press", 2003, 60; the terms different from those by *Chanturia L.* are established by *Jugheli G.* in the book: Protection of Capital in Joint Stock Company, Tbilisi, 2010, 246 (in Georgian).

<sup>26</sup> *Adamia N.*, The Structure of the Supervisory Board and Two-level Supervisory Board, IFC, "Quarterly Bulletin", 2010, 30-35.

Generally, managers are like directors in the German system, and invited ones are like board members. Unlike the US model, German model makes emphasis at prevention of the wrong decision.<sup>27</sup>

A member of the board is at breach of the duty of loyalty, if in case of the conflict of interests, he does not notify about it the common group or the board. The members of the board are responsible for the loss caused by the concrete action or inaction or/and the result of the mistake; but the member of the board will not be responsible if he did not vote for the damaging action or was absent during the discussion.<sup>28</sup>

The responsibility of the board during the corporate governance is discussed in OECD Principles of Corporate Governance.<sup>29</sup> According it, the members of the board must act in the best interest of the company and the partners. The truthfulness of a member of the governing body becomes doubtful if he has or was obliged to have the information, which would make reliance of the conclusion unreasonable.<sup>30</sup> If the decision of the board is about the rights of the partners, the action should be fair for all partners. The board has to be guided by the high ethical norms considering the interests of the partnership's stakeholders (company employees, customers, suppliers, creditors and partnership).<sup>31</sup>

The duties of the corporate management are divided into two groups: Duty of Care,<sup>32,33</sup> (Duty of Diligence, Sorgfaltspflicht) and Duty of Loyalty (Treuepflicht).<sup>34</sup>

## **2.2. Duty of Loyalty**

Duty of Loyalty (Treuepflicht) comes from the US law.<sup>35</sup> The German law does not know its legal definition. A part of the German scientists assign it to the category of the unwritten competences, the others consider it separately or perceive it as a part of the Duty of Diligence or Duty of Silence. However, the fact is, that it works at the level of legal principles and influences essentially the issues related to the corporate governance.<sup>36</sup>

In the US law, the main defining statements of the Duty of Loyalty and the Duty of Diligence of management are given in the Model Business Corporation Act (M.B.C.A) 2002, which is based on the

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<sup>27</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 32-33, 143, 71-72 (in Georgian).

<sup>28</sup> *Janjalia B.*, Corporate Management Research in Companies, IFC, 2008, 78.

<sup>29</sup> This refers to the German and also to the US corporate management.

<sup>30</sup> *Jibuti M., Korghanashvili K.*, Comment on the Law of Georgia on Securities Market, Georgian Securities Industry Association, Tbilisi, 2004, 215.

<sup>31</sup> OECD Principles of Corporate Governance, OECD, Paris, 2004, 24-25, 58-62.

<sup>32</sup> The alternative term used by *Jugheli G.*, in the book: Protection of Joint Stock Company, 2010 is "Duty of Empathy".

<sup>33</sup> *Emanuel S., Emanuel L.*, Corporations, New York, "Aspen Publishers Online", 2009, 25-31

<sup>34</sup> *Jugheli G.*, Protection of Capital in a Joint Stock Company, Tbilisi, 2010, 249 (in Georgian); *Carney W.J.*, Mergers and Acquisitions, Cases and Materials, New York, "Foundation Press", 2000, 66-229.

<sup>35</sup> *Jugheli G.*, Protection of Capital in a Joint Stock Company, Tbilisi, 2010, 304 (in Georgian).

<sup>36</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 4.

court practice<sup>37</sup> in this sphere and measures the Duty of Loyalty by truthfulness and by serving for the best of the corporations' interest (requiring special loyalty to the interests of the partnership).<sup>38</sup>

The dispute about Duty of Loyalty occurs in case of disregarding the common goal of an enterprise, while breach of this duty occurs when neglecting the actions towards the common goal's direction. The Duty of Loyalty is the responsibility of not only the managers of the partnership, but also of the shareholders/partners. The Duty of Loyalty is measured against the actions that are taken by the shareholder; considering if he protects only his own interest while damaging the partners or the partnership, or if his priority is the interest of the enterprise.<sup>39</sup>

The most common types of the breach of the Duty of Loyalty are: self-dealing,<sup>40</sup> disclosure of the confidential information, Usurping Corporate Opportunity, trading inside information etc.<sup>41</sup> An important definition of Self-Dealing is made by the Delaware Supreme Court in *Sinclair Oil Corp. v. Levien* (Supreme Court of Delaware, 280 A. a. 2d 717 (1971)) case and declared that self-dealing occurs when dominant is on the both sides with the participation of its subsidiary (meaning that there is dominant's interest on the both sides), although the deal was made by means of influencing the subsidiary.<sup>42</sup>

As it was mention one of the breaches of Duty of Loyalty is Usurping Corporate Opportunity. An example of this is so called "Pepsi-Cola Case", where the director bought himself the receipt of

<sup>37</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 302 (in Georgian).

<sup>38</sup> *Ib.*, 404.

<sup>39</sup> *Jannot D., Hagemann M.*, Hdb. Des Aktienrechts, 2009, 81 (see: *Burduli I.*, Basics of Joint Stock Law, Volume I, Tbilisi, 2010, 371); on duty of loyalty in concern management see: *Emmerich V., Habersack M.*, Konzernrecht, München, "Verlag C.H. Beck", 2005, 98-99; *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 5; Judgments made by the Supreme Court of Germany on this issue: BGHZ 103, 184 ff; BGHZ 14, 25 (38) (see: *Burduli I.*, Basics of Joint Stock Law, Vol. I., Tbilisi, 2010, 372);

<sup>40</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 4-5; *Gillooly M.*, The Law Relating to Corporate Groups, Centre for Commercial and Resources Law, "The Federation Press", 1993, 21-22; *Emmerich V., Habersack M.*, Konzernrecht, München, "Verlag C.H. Beck", 2005, 418-419; *Maisto G.*, International and EC Tax Aspects of Groups of Companies, IBFD, 2008, 7.

<sup>41</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 320-359 (in Georgian); *Balotti R.F., Finkelstein J.A.*, The Delaware Law of Corporations & Business Organizations Statutory Deskbook, New York, "Aspen Publishers", 2010, 8-3-98; *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 5; *Gillooly M.*, The Law Relating to Corporate Groups, Centre for Commercial and Resources Law, "The Federation Press", 1993, 21-22; *Emmerich V., Habersack M.*, Konzernrecht, München, "Verlag C.H. Beck", 2005, 418-419; *Maisto G.*, International and EC Tax Aspects of Groups of Companies, IBFD, 2008, 7.

<sup>42</sup> *Sinclair Oil Corp. v. Levien*, Supreme Court of Delaware, 280 A. a. 2d 717 (1971) (see: *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 626); *Robert F. Broz and RFB Cellular, Inc. v. Cellular Information Systems, Inc.*, Delaware Supreme Court, 673 A 2d 148 (1996) (see: *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 360); *O'Kelley R.T., Thompson B.*, Corporations and other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 342-345.

Pepsi and established a new company. The Court concluded that the Duty of Loyalty was breached and the director was obliged to give to the partnership the shares from the newly established company.<sup>43</sup> This proves that the Duty of Loyalty is so important in the US that the Court considered it reasonable to intervene in the private property – obligation to give the shares from the new company (the property of the defendant) is the seizure of the property.

"Indirect conflict of interests" is separately considered in the legal literature. It occurs when e.g. the transaction is made not by the interested parties themselves, but at first glance by the independent companies in which the partners are the directors of the parties or the persons associated with them.<sup>44</sup> Thus, so called "directors different interests notion" is established in practice.<sup>45</sup>

There are many disputes around Duty of Loyalty. It often become more obvious in the relationship (corporate group) between the parent and subsidiary companies when the director is having multiple mandates (the same person is the member of the board at the parent and subsidiary companies).

According to the Article 309 of the Law of Germany on Stock Corporation, the directors of the subsidiary company are obliged to refuse implementation of an instruction from the parent company, if implementation of this instruction will cause permanent damage to the subsidiary company<sup>46</sup> Thus, the German system obliges the managers of each company (subsidiary) in the corporate group to give priority to its own company's concrete interests.

According to the Case Law of the US, if the parent corporation owns 100% of the subsidiary, then the directors of the subsidiary should manage the corporation considering the interests of the parent corporations and its shareholders.<sup>47</sup>

It is fact that this diminishes the status of the subsidiary. It will be right to mention that in the US system the priority is given to the interests of the shareholders and company can be considered only as a mean of fulfilling this interest. Additionally, the US has a law-court practice different from the above mentioned one, which states that a director is assigned equal Duty of Loyalty towards the both corporations and compliance with the Duty of Loyalty towards one corporation cannot become the basis for rejecting the duty towards another corporation. Besides this, if the conflict of interests is inevitable, the Court advises the director not to participate in the transaction. Such kind of the necessity arises, when it becomes impossible to protect the best interest of the both corporations.<sup>48</sup> Thus, it is fact, that the US practice established a different approach to this matter.

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<sup>43</sup> *Schuk-Amend A.*, Liability of Holding Companies, 2004, 35, available at: <<https://www.google scholar.com>>; *Zumbansen P.*, Liability within Corporate Groups (Bremer Vulkan), Federal Court of Justice Attempts the Overhaul, "German Law Journal" No. 3, 2002, 42.

<sup>44</sup> *Emanuel S., Emanuel L.*, Corporations, "Aspen Publishers Online", New York, 2009, 29.

<sup>45</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 314 (in Georgian).

<sup>46</sup> *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 455; *Schmidt K., Lutter M.* (Hrsg.), Aktiengesetz Kommentar (AKtG), II. Band, Köln, "Verlag, Dr. Otto Schmidt", 2008, 2867-2877.

<sup>47</sup> *Ib.*, 333-334.

<sup>48</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 58.



On the basis of the judgment made by the Supreme Court of Delaware, the US justice established a principle that Duty of Loyalty is not limited only to the financial interests, but also refers to the general attitude of a director to the entire corporation, regardless of the interests that he may have. The result of the breach of the Duty of Loyalty is not only compensation of the loss caused by the breach, but also returning the profit that he obtained from self-dealing or using a commercial opportunity.<sup>49</sup>

There are many other judgments made in the US on the Duty of Loyalty.<sup>50</sup> Based on these judgments it can be concluded that to prove a breach of the Duty of Loyalty there should be an evidence that during decision-making a manager considered and gave priority to his own interests and not to those of the corporation. Apart from this, based on the management principles, the managers have the burden of proof to show that their actions were favorable for the partnership.<sup>51</sup> It is concluded based on the judgment made for the case of *Oberly v. Kirby, Delaware Supreme Court, 592 A.2d 445 (1991)*, that the managers are obliged to take decisions considering the complete information. When deciding about the liability of the management of the enterprise or members of the Supervisory Board, it is also considered if based on the internal documentation of the corporation (charter or an agreement etc.) a member was personally responsible to fulfill this responsibility. This rule is not used when a responsibility is solitarily assigned to several managers.<sup>52</sup>

### 2.3. Duty of Care (Duty of Diligence, Sorgfaltspflicht)

Duty of Care (Duty of Diligence, Sorgfaltspflicht) is an independent obligation of the corporate managers.<sup>53</sup>

According to the Duty of Care, a director or a manager has an obligation to fulfill his functions honestly, reasonably and believing that he acts based on the best interests of the corporation and with the prudence which would be used by an ordinary prudent person at the similar position and in the similar circumstances. According to the legal science, the Duty of Care established the standard of conduct, while Duty of Loyalty distinguishes the spheres of interests of the partnership and its units.<sup>54</sup>

The Sarbanes-Oxley Act (SOX) (Congress of USA, 2002) comprehensively covers the issues related to the Duty of Loyalty in the US. Since the mentioned law increased the obligations of the

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<sup>49</sup> *Brophy v. Cities Co.*, 70 A2d 5 (Del. Ch. 1949) (see: *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 353).

<sup>50</sup> *Lewis v. S.L. & E., Inc.*, United States Court of Appeals, Second Circuit 629 F. 2d 764 (1980); *In re The Walt Disney Co.*, Delaware Court of Chancery, 825 A. 2d 275 (2003) (see: *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 578).

<sup>51</sup> Principles of Corporate Governance, May 13, 1992 (see: *Soderquist L.D., Smiddy L.O., Cunningham L. A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 621).

<sup>52</sup> *O'Kelley R.T., Thompson B.*, Corporations and other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law&Business", 1999, 360-373.

<sup>53</sup> *Emanuel S., Emanuel L.*, Corporations, New York, "Aspen Publishers Online", 2009, 25-31.

<sup>54</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 319.

directors, respectively unfulfilling these obligations is considered as a breach of the Duty of Care. The mention terms can literally be translated as obligation of taking care and being cautious.<sup>55</sup> The notion of the Duty of Loyalty is reflected in *Principles of Corporate Governance* May 13, 1992 and in *Model Business Corporation Act* (M.B.C.A) 2002.<sup>56</sup>

The Duty of Care includes also "business care" called Business Due Diligence and Legal Due Diligence. The first of them considers keeping the format of diligence for taking economic/financial decision. The second case refers to the necessity of legal regulation of the decisions.

The managers of the partnership are obliged to follow the above mentioned duties for the partnership's and not for the shareholders' interests; but they have to make it considering the interests of the shareholders and also other stakeholders.<sup>57</sup> An incapacity or a lack of qualification do not release the manager from the responsibility.<sup>58</sup>

In Germany, a Supervisory Board member has to have "ordinary surveillance" diligence and responsibility and not the diligence of a manager of an enterprise.<sup>59</sup> Thus, in Germany, approach to the Supervisory Board member is more loyal, while diligence requirement is more strict for the directors.

One of the good examples of management liability in the US law is the judgment made by the Delaware Supreme Court in the case of *Smith v. Van Gorkom*, (1985 488 A.2d 858),<sup>60</sup> This case was about the managers' precaution and keeping the Duty of Diligence.<sup>61</sup> This judgment became the basis to increased role of so called invited directors in the US corporations management. The invited directors use the other information also apart from what was given by the internal management.<sup>62</sup>

Prohibition of returning the authorized capital is listed under the Duty of Diligence; prohibition of promising interests rate and dividend to the shareholders; prohibition of giving shares before payment of their full values; prohibition of distributing the property of the partnership; prohibition of payment while being insolvent; prohibition of making unjustified and unneeded social expenditures

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<sup>55</sup> *Jugheli G.*, Protection of Capital in Joint Stock Company, Tbilisi, 2010, 168 (in Georgian).

<sup>56</sup> Principles of Corporate Governance, May 13, 1992 (see: *Soderquist L.D.*, *Smiddy L.O.*, *Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 620-621).

<sup>57</sup> *Plessis J.*, *Jacques H.*, *Bagaric A.M.*, Principles of Contemporary Corporate Governance, 2<sup>nd</sup> Edition, Cambridge, "Cambridge University Press", 2011, 50; *Baums T.*, *Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 49-53.

<sup>58</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 205 (in Georgian); *Andenas M.*, *Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 301.

<sup>59</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 211.

<sup>60</sup> *Smith v. Van Gorkom*, Supreme Court of Delaware 488 A. 2d 858 (1985) (see: *Soderquist L.D.*, *Smiddy L.O.*, *Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 536); *Holland R.J.*, Delaware Director's Fiduciary Duties: The Focus on Loyalty, *University of Pennsylvania Journal of Business Law*, No. 11, 691, 2009 (see: *Jugheli G.*, Protection of Capital in Joint Stock Company, 2010, 189 (in Georgian)).

<sup>61</sup> *O'Kelley R.T.*, *Thompson B.*, Corporations and other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 287.

<sup>62</sup> *Cahn A.*, *Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 360-410.

and charities; prohibition of not presenting a requirement of the partnership to the third party etc. A breach of the Duty of Care (diligence) results in compensation of the loss caused by the breach. But in case of the breach of the Duty of Loyalty, a person who breached his duty apart from the compensating the loss will have to return the profit that he obtained through self-dealing or using commercial opportunities.<sup>63</sup>

In the US law, there is one more group of obligations – Duty of Obedience, but it is practically encompassed by the Duty of Care. In German law, there is a separate Duty of Silence (*Verschwiegenheitspflicht*).<sup>64</sup>

Neither in Germany nor in the US, despite an extensive court-law practice, there are no unified precedents of bringing management liability for the breach of the Duty of Care. For this reason it is difficult to bring a case to the court with this matter.<sup>65</sup> The main basis for this is a Business Judgment Rule<sup>66</sup> principle about the duties of the managers, which is well-established worldwide and protects the rights of the managers.

## 2.4. Business Judgment Rule Principle

In case of breach of the fiduciary duty, the bases for release from liability is Business Judgment Rule principle of the US law, which protects the directors from fiduciary liability.<sup>67</sup> But as the Business Judgment Rule was created by the Case Law, its definition does not exist.<sup>68</sup>

This institute was created in the beginning of the 19<sup>th</sup> century. The decision made by the Supreme Court of Louisiana made in 1829<sup>69</sup> is considered to be its basis. This judgment established a principle in the corporate law stating that a director cannot be made liable for a loss caused by a mistake which can be made by any diligent director. The directors become liable for those mistakes,

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<sup>63</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 199 (in Georgian).

<sup>64</sup> *Ib.*

<sup>65</sup> *Francias v. United Jersey Bank*, Supreme Court of New Jersey, 432 A.2d 814 (1981); *Joy v. North*, United States Court of Appeals, Second Circuit, 692 F.2d 880 (1982); *Shlensky v. Wrigley*, Appellate Court of Illinois, 237 N.E.2d 776 (1968); *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919); *Arnold v. Society for Savings Bancorp, Inc.*, Supreme Court of Delaware, 650 A.2d 1270 (1994); *Malpiede v. Towson*, Supreme Court of Delaware, 780 A.2d 1075 (2001); *WIR Foods, Inc. v. Tyson Foods, Inc.*, United States Court of Appeals, Fourth Circuit 65 F.3d 1172 (1995) (in: *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 508).

<sup>66</sup> *Emanuel S., Emanuel L.*, Corporations, New York, "Aspen Publishers Online", 2009, 25-31.

<sup>67</sup> *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 369-415; *Balotti R. F., Finkelstein J.A.*, The Delaware Law of Corporations & Business Organizations Statutory Deskbook, New York, "Aspen Publishers", 2010, 135; *O'Kelley R.T., Thompson B.*, Corporations and other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 261.

<sup>68</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 65, 216-218 (in Georgian).

<sup>69</sup> *Jugheli G.* relates the same fact to judgment made in 1827 (see *Jugheli G.*, Protection of Capital in Joint Stock Company, Tbilisi, 2010, 187 (in Georgian)).

that cannot be made by an ordinary diligent person with a common sense. The liability occurs in case of a wrong decision.<sup>70</sup>

In 2005, the introduction of so called Business Judgment Rule<sup>71</sup> in Germany from the US was made by the Law on Modernization of the Inaccessibility of Enterprises and Right to Complaint. Although this rule had already existed before based on the legislative norms or scientific statements.<sup>72</sup>

Business Judgments Rule was also reflected in the article 93 of the Law of Germany on Stock Corporation.<sup>73</sup> But it is considered to be a modified version of the US system. It is impossible to copy the US principle directly to the German system, because Germany system does not space free from legal control, which in the US is called as "safe harbor". Therefore, there is a certain difference between these two systems. This difference is in the scope of checking the contents of the business decisions.

The court is checking three main elements when there is complaint for the breach of the fiducial duties. These are: the personal impartiality of the director, availability of enough information and truthfulness of his action for the best interests of the corporation.<sup>74</sup> If after so call formal review it is proved that, there existed the mentioned preconditions, the control of the court becomes stricter and it will refers to the contents also, therefore from this moment the burden of proof will be transmitted to the management.<sup>75</sup>

The different between use of Business Judgment Rule in the US and in Germany is that in the US, usually, the contents of the business decision is not checked. But this does not mean that above principle can protect an obviously unclear and unreasonable decision. This principle is established in Germany in a way that no judgment can be made on the breach of duty when the member of the board could reasonably assume when taking the decision that he was acting based on the appropriate information for the benefit of the partnership. Germany does not protect clearly illegal decision either<sup>76</sup> and the scope of subjective judgment of the likelihood gets wider considering objective possibility principle.

This principle of releasing the directors from the liability works only for the decisions of the directors. It does not refer to the surveillance or control decisions.<sup>77</sup> There is a simple reason for it – so

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<sup>70</sup> *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 486- 487.

<sup>71</sup> This principle in Germany is compared to the notion of "Business Instinct" – *Luter M.*, Corporate Governance in Germany and the US in the book: *Chanturia L., Kniper R., Zemler I.*, Problems with Development of Corporate Law in Georgia, German-Georgian Symposium, GTZ, Tbilisi, 7-8 March, 2000, 21-32.

<sup>72</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 65, 42-43 (in Georgian).

<sup>73</sup> *Schmidt K., Lutter M.* (Hrsg.), Aktiengesetz Kommentar (AKtG), II. Band, "Verlag, Dr. Schmidt O.", Koln, 2008, 56.

<sup>74</sup> *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 370-375.

<sup>75</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 13.

<sup>76</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 65, 205(in Georgian).

<sup>77</sup> *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 312-314.

called business decisions, which are based on certain commercial risks and which are protected by the mentioned principle, can be made only the managers.

In Germany recognition of Business Judgment Rule<sup>78</sup> principle was based on the most influential case in the German joint stock law– the decision of the German Supreme Court made on April 21<sup>st</sup>, 1997 in *ARAG v. Garmenbeck (BGHZ 135,244)* case. It once again clarified the necessity to established the scope of the managers subjective and objective attitude when taking a decision.<sup>79</sup>

According to Business Judgment Rule, plaintiff has the burden of proof at the Court suit.<sup>80</sup> One of the examples of this is the decision made by the Court of Delaware in *Crane Co v. Harsco Corp. 511 FSupp 294 (D Del 1981)*<sup>81</sup> case.<sup>82</sup>

## 2.5 Responsibility of the Governing Company

In the legal sciences special attention is given to the creation of a governing company in a corporate group system based on an agreement. A governing company is created based on the decisions made at the common reunion of the defined subsidiaries and it act as their personal executive body. This activity does not require any kind of a license of a permit.<sup>83</sup>

The governing organizations considers the given form of governing the subsidiaries as an adequate and a suitable mean. It is widely accepted in practice. But in terms of the legal regulation, it's the most complex form of governing.<sup>84</sup> The most important aspect of it is the responsibility of a governor – manager of the companies. In such case responsible is a company as a governing unit. But then the governing company with the regression address a concrete person in charge who on behalf of the governing company actually took a decision which was damaging to the subsidiary.

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<sup>78</sup> This principle is called reasonable commercial decision presumption, *Jugheli G.*, Protection of Capital in Joint Stock Company, Tbilisi, 2010, 185 (in Georgian).

<sup>79</sup> *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 373-381; *Jugheli G.*, Protection of Capital in Joint Stock Company, Tbilisi, 2010, 113 (in Georgian).

<sup>80</sup> *Chanturia L.*, Corporate Management and Management Responsibility in Corporate Law, Tbilisi, 2006, 219 (in Georgian).

<sup>81</sup> *Balotti R.F., Finkelstein J.A.*, The Delaware Law of Corporations & Business Organizations Statutory Deskbook, New York, "Aspen Publishers", 2010, 4-15-10.

<sup>82</sup> *O'Kelley R.T., Thompson B.*, Corporations and Other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 398-407, 417-425; *ARAG v. Garmenbeck*, High Federal Court, Second Civil Division, April 21, 1997/ BGHZ 135 244; *Aronson, et al. v. Lewis*, Supreme Court of Delaware, 473 A 2d 805 (1984), *Unocal Corp. v. Mesa Petroleum Co.*, Supreme Court of Delaware, 493 A 2d 946 (1985) (see: *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 373-381); *Rosenblatt v Getty Oil Co* 493 A2d 929 (1985) and *Moran v. Household International Inc.*, 500 A2d 1346 (1985), *Scattered Corporation v. Chicago Stock Exchange, Inc.*, Delaware Supreme Court, 1997 701 A.2d 70 (see: *Balotti R.F., Finkelstein J.A.*, The Delaware Law of Corporations & Business Organizations Statutory Deskbook, New York, "Aspen Publishers", 2010, 4-15-10).

<sup>83</sup> *Shitkina I.S.*, Legal Regulation and Corporate Governance, "Wolters Kluwer", 2008, 303.

<sup>84</sup> *Osipenko O.V.*, Governing Company in the System of Governing Joint Stock Company, "Journal for Shareholders", No. 6(7), 2003, 15; *Dine J.*, The Governance of Corporate Groups, Cambridge, "Cambridge University Press", 2003, 190.

An agreement made with a governing company sometimes is compared to the agreement with an agent, when an agent acts on behalf of the principal and on its expenses. There is also a similarity with an agreement on trusting for the property, but it is not acceptable to compare civil relationship representation with a representation of an enterprise, because corporation's representation has entirely different specifics and the scope of its fulfillment and responsibility should be regulated only by a special entrepreneurial legislation.<sup>85</sup>

In legal literature "governing company" and "head office" notions are used with identical meaning. But this is not correct, because a head of a corporate group may create an independent legal unit – a governing company for successful management and holding's head office can be separately or the head office can implement management by itself. The management undertaken by a head office legally is not the same as management carried out by a governing company, because head office governs in an indirect way through integrating its decisions in the decisions made by the subsidiary companies. Respectively, the responsibility for ineffective management is different for a governing company and for a head office. The governing company in case of a damage caused by a breach of fiduciary duties becomes liable as legal body. But when management is carried out by a head office, the decisions made by the subsidiary companies are taken by the managers of these companies. Thus, a body which is different from the head office will be having corporate liability. But the head office may face a charge related to taking advantage of its dominant position.

## **2.6 Protecting the Rights of Shareholders**

It is true that protection of the rights of the shareholders is a common and general principle in any legal system or court practice. But belonging of the law of a concrete country to a particular law group (Common Law – Civil Law) makes certain differences in the issues related to the protection of the shareholders rights.<sup>86</sup>

Rights of the shareholders has always been a special theme for the scientific research, respectively, already during 18501-1933, Carl Fuerstenberg declared: "the shareholders are stupid and impudent: stupid because they buy the shares and imprudent because they ask for the relevant compensation".<sup>87</sup>

The doctrine implies an idea that the German law is the most complete in terms of regulating shareholders rights, while the US law deserves in this sphere the most original and extraordinary status.<sup>88</sup>

Unlike the US concept, German corporate law says that the primary goal of the management activity is not the protection of the shareholders' interests but protection of the interests of the

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<sup>85</sup> *Schuk-Amend A.*, Liability of Holding Companies, 2004, 35, available at: <<https://www.google.scholar.com>>; *Zumbansen P.*, Liability Within Corporate Groups (Bremer Vulkan), Federal Court of Justice Attempts the Overhaul, "German Law Journal", No. 3, 2002, 42; *Dine J.*, The Governance of Corporate Groups, Cambridge, "Cambridge University Press", 2003, 190.

<sup>86</sup> *Braendle U.C.*, Shareholder Protection in the USA and Germany, Law and Finance Revisited, "German Law Journal", Vol. 07, No.03, 2006, 260.

<sup>87</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 1.

<sup>88</sup> *Siems M.M.*, Shareholder Protection Around the World (Leximetric II), Centre for Business Research, University of Cambridge, "Working Paper", No. 359, 2007, 42.

partnership. To demonstrate the difference we have to mention that according to assessment the protection of the shareholders rights in the US gets 5 scores out of 6 and in Germany it gets only 1.<sup>89</sup>

In the corporate group the principle of protection of the rights of small shareholders of the subsidiary company is based on the general statements, among them: protection of the equality of the shareholders (Gleichbehandlung der Aktionäre),<sup>90</sup> existence of fiduciary duties towards other shareholders<sup>91</sup> and the right to control the partnership.<sup>92</sup> The proof of this principles is the obligation of the corporation to have open relationship with the shareholders, which means that the corporation should help the shareholders "understand, perceive" the business, probable risk, financial conditions, exiting status of affairs in the corporation and trends of the development of the partnership.<sup>93</sup>

There have been discussion around the doctrine for yeas regarding giving real opportunity to the shareholders to participate in the management of the company.<sup>94</sup> Protection of the rights of the shareholder is discussed in "Modernising Company Law and Enhancing Corporate Governance in the European Union" (EU Action Plan: 21.05.2003)<sup>95</sup> which was adopted by the European Commission on May 21, 2003. This action plan is an attempt to implement protection of the shareholders rights with a concrete mechanism. The following is listed among them: implementation of the director's duties by a shareholder personally instead of the directors (derivative claim),<sup>96</sup> knowing the personalities of the big shareholders, obtaining a possibility to dismiss the director etc.<sup>97</sup>

In the US law, the principle of protection of the shareholders rights originates from the case of *Dodge v. Ford Motor Co.*, Michigan Supreme Court, 1919, 204 Mich. 459, 170 N.W. 668 in 1919, which proved that corporation is created and runs primarily for the profit of the shareholders and the obligation of the management is implementation of the activities for obtaining this outcome.<sup>98</sup>

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<sup>89</sup> Siems M.M., Shareholder Protection Around the World (Leximetric II), Centre for Business Research, University of Cambridge, "Working Paper", No. 359, 2007, 2.

<sup>90</sup> "One share – one vote" principle is the demonstration of what was mentioned, Cahn A., Donald D.C., Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 564; Payne J., Takeovers in English and German Law, Oxford/Portland, "Hart Publishing", 2002, 30; Burduli I., Basics of Joint Stock Law, Vol. I, Tbilisi, 2010, 330-331 (in Georgian).

<sup>91</sup> About Fiducial Duties see further in O'Kelley R.T., Thompson B., Corporations and other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 259-453; Butcher B., Directors' Duties: A New Millennium, A New Approach? Fiduciary Duties, "Kluwer Law International", 2000, 155.

<sup>92</sup> Andenas M., Wooldridge F., European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 487.

<sup>93</sup> Principles of Corporate Governance, May 2002, the Business Roundtable, an Association of Chief Executive Officers Committed to Improving Public Policy, 25, available at: <<https://www.google.ge>>.

<sup>94</sup> Siems M.M., Shareholder Protection around the World (Leximetric II), Centre for Business Research, University of Cambridge, "Working Paper", No. 359, 2007, 2.

<sup>95</sup> Development of Corporate Governance in Georgia, IFC, 2008, 12.

<sup>96</sup> On derivative claims see: Emanuel S., Emanuel L., Corporations, New York, "Aspen Publishers Online", 2009, 46-78.

<sup>97</sup> Siems M.M., Shareholder Protection Around the World (Leximetric II), Centre for Business Research, University of Cambridge, "Working Paper", No. 359, 2007, 5-6; Kuchava K., Problems Related to Corporate Governance in Georgia, IFC, 2009, 3 (in Georgian).

<sup>98</sup> O'Kelley R.T., Thompson B., Corporations and Other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 267-269; Baums T., Scott K.E., Taking Shareholder

The judgment of the Supreme Federal Court of Germany made in *In Re Holzmuller* case in 1982 is about the protection of the rights of the subsidiaries - small shareholders by the parent company. The subject of the dispute was transfer of the property without the consent of the shareholders. But it was not considered as revoked because the breach of the duty from the management was not proved.<sup>99</sup> The protection of the shareholders rights in the corporate group is the subject of the decisions made by the Supreme Federal Court of Germany in *In Re Gelatine* case in 2004. And it is considered that this case renewed the case of *In Re Holzmuller* and supported the same principles.<sup>100</sup>

The right of a dominant shareholders to transfer the properties of subsidiaries to the other subsidiaries creates serious danger for the small shareholders. To avoid this there are different means in the corporate management, which vary deepening on the subject. Respectively, there are derivative claim and dominant responsibility institutes.<sup>101</sup>

### 2.6.1. So Called "Derivative Claim"

In the legal science derivative (indirect) claim<sup>102</sup> is a request initiated by the shareholder which he presents for the benefit of the corporation and which is against the management of the corporation.<sup>103</sup> This has been permitted in some states since the mid of 19<sup>th</sup> century.<sup>104</sup> It was established in Germany legislation also, but the right to present this kind of a claim has only the shareholder who possesses 1% of the authorized capital or 100, 000 Euro.<sup>105</sup>

The legislation of Germany did not have concrete regulation for a claim before the adoption of the Law on Inaccessibility of the Enterprise and Modernization of the Right to Appeal in 2005. Before that only the Supervisory Board had the right to bring the case against the board on the basis of the decision made at the common reunion.<sup>106</sup> The shareholders got the right to present a claim only about the

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Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 1.

<sup>99</sup> *In Re Holzmuller*, 1982, BGHZ 83,122 (in: *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 695-709).

<sup>100</sup> *Ib.*, 710-721; *In Re Gelatine*, 2004, Doc.No II ZR 154/02, Der Konzern 2004, 421.

<sup>101</sup> *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 680.

<sup>102</sup> *Jugheli G.*, Protection of Capital in Joint Stock Company, Tbilisi, 2010, 175-177 (in Georgian).

<sup>103</sup> *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 318-319.

<sup>104</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 9; *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 751-784.

<sup>105</sup> *Chanturia L.*, Corporate Management and Responsibility of the Corporate Managers in the Law, Tbilisi, 2006, 424 (in Georgian); *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 318-319.

<sup>106</sup> *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 318; *Braendle Udo C.*, Shareholder Protection in the USA and Germany, Law and Finance Revisited, "German Law Journal", Vol. 07, No.03, 2007, 272-273, 468.



requirements that the partnership has towards the board or the Supervisory Board (thus, German law rejected the possibility of introducing claim against any third part, while it is permitted in the US law).<sup>107</sup>

A person can introduce a derivative claim if he has been a shareholder by the time when the company suffered the damage; and he must be a shareholder of the company for the moment of presenting a claim.<sup>108</sup> Additionally, before presenting the claim he has to show it to the board. Permitting a claim is a complex procedure described in details by the legislation in Germany<sup>109</sup> as well as in the US.<sup>110</sup> The derivative process may not be maintained and might get terminated by the Court if it turns out that the plaintiff is trying to protect the partnership or/and its partner's interests unfairly and inappropriately.<sup>111</sup>

The need for having a derivative claim is admitted by the scientist, who define necessity of a complex procedure of permitting it. There is an opinion that if a shareholder addressed the board and got the refusal for presenting the claim, the shareholder does not lose the right to present the claim.<sup>112</sup> Some scientists think that addressing the common reunion should not be the precondition for permitting, if he initially assumes that it may not have a result.<sup>113</sup>

The scientists in the US also discuss that a derivative claim can be presented not only for the actual damage that occurred but also for avoiding the expected loss. However, in the US law, a classical and successful form of the derivative claim is related to the loss that actually happened, rather than disputes about the future loss.<sup>114</sup> The Courts primarily clarify the type of the claim (derivative or direct) and on its basis they request to follow the conditions of permissibility.<sup>115</sup>

The US experience of tens of years practice with regard to the derivative claim established some defining factors – the preconditions of permissibility of this type of a claim, which is important for any country undergoing the stage of the legislative development.

## 2.6.2 Responsibility of Dominant

One more effective means of protecting the rights of the shareholders in corporate governance in Germany as well as in the US is dominant responsibility principle.<sup>116</sup>

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<sup>107</sup> Law of Germany on Stock Corporations and Parallel Russian-German Texts, Moscow, "Wolters Kluwer", 2009; Emanuel S., Emanuel L., Corporations, New York, "Aspen Publishers Online", 2009, 46.

<sup>108</sup> Soderquist L.D., Smiddy L.O., Cunningham L.A., Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 753.

<sup>109</sup> Jugheli G., Protection of Capital in Joint Stock Company, Tbilisi, 2010, 175-179, (in Georgian).

<sup>110</sup> Soderquist L.D., Smiddy L.O., Cunningham L.A., Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 755-756.

<sup>111</sup> *Ib.*, 753.

<sup>112</sup> *Ib.*

<sup>113</sup> Jugheli G., Protection of Capital in Joint Stock Company, Tbilisi, 2010, 175-179 (in Georgian).

<sup>114</sup> Soderquist L.D., Smiddy L.O., Cunningham L.A., Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 755.

<sup>115</sup> *Grimes v. Donald*, Delaware Supreme Court, 673 A.2d 1207 (1996); *Aronson v. Lewis*, Delaware Supreme Court, 473 A.2d 805 (1984); *In re The Limited, Inc.*, Delaware Court of Chancery, 2002 Del. Ch. Lexis 28 (March 27, 2002) (see: Soderquist L.D., Smiddy L.O., Cunningham L.A., Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 754-784); *Shlensky v. Wrigley*, Illinois Appellate Court, 95 Ill. APP. 2d 173, 237 N.E. 2d 776 (1968) (in: *O'Kelley R.T., Thompson B.*, Corporations and Other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 262).

<sup>116</sup> Law of Germany on Stock Corporations and Parallel Russian-German Texts, Moscow, "Wolters Kluwer", 2009; *Dine J.*, The Governance of Corporate Groups, Cambridge, "Cambridge University Press", 2003, 61.

Control of corporation using dominant position is defined as an opportunity of a person, based on an agreement or otherwise, to implement the management and strategy of the enterprise directly or indirectly due to processing enough shares for voting.<sup>117</sup> Dominant can be also those groups of the shareholder who do not possess majority of shares but have different practical possibility to influence the results of voting. A shareholder can be considered as dominant and having decisive influence when he is in a dominant economic position. Thus, in some cases a dominant can be a shareholder, which is an important borrower of the enterprise, a main supplier of a product or a customer.<sup>118</sup>

The topic of the dominant partners' rights and responsibilities implies the responsibilities in the corporation towards the subsidiary and also the problem of so called *Piercing the Corporate Veil* (direct responsibility) when a dominant is responsible towards the third part – a creditor.

The topic of dominants responsibility is especially acute in the corporate groups where holding company is considered as dominant of the subsidiary.

The actions take by the parent company for its own interests which damage the subsidiary can be: use of the corporate property, parent company's status or information or/and appropriating the advantages of the subsidiary by competing with it.<sup>119</sup> Apart from this, when a head office governs the entire group using common economic tools, in the context of its dominant interests, it becomes difficult to create real mechanisms for protecting the small shareholders.

A dominant shareholder, which can define a decision of a subsidiary, becomes liable towards a creditor only in case of a serious blame. An ordinary mistake in business caused by neglecting is not considered here and this is the risk of the creditor. The seriousness of blame should be assessed separately for every concrete case.<sup>120</sup>

The practice of Supreme Court of Delaware distinguishes two main tendencies in terms of this. In *Sinclair Oil Corp. v. Levien*, Delaware Supreme Court, 280 A.2d 717 (1971)<sup>121</sup> case the plaintiff was arguing that managers of the subsidiary were not independent from the holding company (dominant) and it was implementing its control and for this reason he also had the fiduciary duties towards the subsidiary and the burden of proof.

But according to the decision Business Judgment Rule principle was used towards the dominant and the burden of proof was transferred to the subsidiary – plaintiff. It had to prove that the parent company profited due to unfair action.<sup>122</sup> The Supreme Court of Delaware supported different approach

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<sup>117</sup> *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 626-639.

<sup>118</sup> *Jugheli G.*, Protection of Capital in Joint Stock Company, 2010, 248 (in Georgian).

<sup>119</sup> *Gillooly M.*, The Law relating to Corporate Groups, Centre for Commercial and Resources Law, "The Federation Press", 1993, 22.

<sup>120</sup> *Nestor S.*, General Principles of Company Law for Transition Economies (English Version), "The Journal of Corporation Law", Vol. 24, № 2, 1999, 225; *Hamilton R.W.*, The Law of Corporations, St. Paul, "West Publishing Company", 1991, 93.

<sup>121</sup> This is considered as one of the most important judgments in the sphere of protecting the rights of the small shareholders of the subsidiaries, see more information in the book: *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 626.

<sup>122</sup> *Sinclair Oil Corporation v. Francis S. Levien*, 280 A. 2d 717 (Del. 1971) (see: *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 691-695).

in *Weinberger v. UOP, Inc* case.<sup>123</sup> The Court explained that the dominant should not necessarily benefit and the fairness of the transaction should be proved by the dominant.<sup>124</sup> Thus, this issue is so complex and specific that the justice finds it difficult to establish a unified approach.

When speaking about the dominant responsibility it is important to mention the judgment of Federal Court of Germany taken in 2001 in *Bremer Vulkan* case. This judgment spread the responsibility within the corporate group dominant in such a way that corporate group responsibility was not overlapping with it. The reason for it is that, proceeding from the attitude of the participants in the corporate group, the justice is directed towards establishing management liability primarily on so called "corporate architecture"/structure and not on the action of a particular manager. In the above case a decisive importance was having the fact that the parent company was possessing 100% of shares from the subsidiary and had unlimited authority over it.<sup>125</sup> This became subject for criticism for many German scientists and had many opponents.

According to the general practice of the Court, when a holding company controls its subsidiary and gives to it obligatory instructions, then during the dispute (about taking advantage of dominant position) the parent company (holding) has the burden of proof. This mean that it has to prove that its decision was not followed by loss. According to the Business Judgment Rule an ordinary prudence is sufficient. But in case of an instruction from holding company (dominant) the requirements are stricter.<sup>126</sup>

In modern science special attention is given to the *Piercing the Corporate Veil* (direct responsibility) of the dominant partner towards the third party creditors.

### 3. Responsibility of Corporate Group Members towards the Third Parties

#### 3.1 Protection of the Creditors' Rights, Piercing the Corporate Veil

*Piercing the Corporate Veil* (Ger. - Durchgriffshaftung) means literally a piercing responsibility.<sup>127</sup> It is developed by the US Case Law and is used mainly in limited liability companies. It is not used for open partnerships.<sup>128</sup> The term implies the direct responsibility principle in a way that a

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<sup>123</sup> *Weinberger v. UOP, Inc.*, Supreme Court of Delaware, 457 A.2d 701 (1983) (in: *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 639).

<sup>124</sup> *Jugheli G.*, Protection of Capital in Joint Stock Company, 2010, 247 (in Georgian).

<sup>125</sup> *Zumbansen P.*, Liability within Corporate Groups (*Bremer Vulkan*), Federal Court of Justice Attempts the Overhaul, "German Law Journal" No. 3, 2002, 45.

<sup>126</sup> *Sinclair Oil Corp. V. Levien* 280 A. 2d 717 (1971) (see: *Hurst Th.R., Gregory W.A.*, Cases and Materials on Corporations, "Anderson Publishing Co.", 1999, 442).

<sup>127</sup> *Burduli I.*, Authorized Capital and its Functions, in: Theoretical and Practical Issues of the Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 236; *Burduli I.*, Basics of Joint Stock Law, Vol. I, Tbilisi, 2010, 165 (in Georgian); *O'Kelley R.T., Thompson B.*, Corporations and Other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 584-635; *Hamilton R.W.*, The Law of Corporations, 5<sup>th</sup> Edition, St.Paul, 2000, 134-163.

<sup>128</sup> *Burduli I.*, Authorized Capital and its Functions, in: Theoretical and Practical Issues of the Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 241 (in Georgian).

partner, despite his limited liability, may become liable individually towards the creditors for the caused loss.<sup>129</sup>

According to the US Case Law,<sup>130</sup> *Piercing the Corporate Veil* in corporate law ensures protection of the third parties – creditors from being deceived.<sup>131</sup> For the sake of protecting this very principle in some situation it is acceptable to let the creditors pierce so called "corporate veil".<sup>132</sup>

To activate *Piercing the Corporate Veil* principle it is necessary to make the following factual investigation within the scope of "three stage test"<sup>133</sup>: 1) The parent entity entirely controls and dominates the subsidiary; 2) Dominant action towards the subsidiary is unfair and based on fraud; and 3) The action of dominant is followed by the loss of plaintiff.<sup>134</sup> According to the Corporate Justice of Delaware, the parent entity can become responsible toward the creditor of its subsidiary, following *Piercing the Corporate Veil* principle, only if the parent and subsidiary companies had the same management and shared the income and responsibilities.<sup>135</sup>

Regardless the fact that so called *Piercing the Corporate Veil* principle is quite widely used by the court, it does not mean that generally the principle of capital limited liability companies has changed. It remains the same. *Piercing the Corporate Veil* principle is an exception and depends on verification of many details.

*Piercing the Corporate Veil* principle can also be met in German law practice. According to it parent entity becomes directly responsible towards the creditors of its subsidiary if interventions from the parent entity effectively undermines future independence of the subsidiary and its action cause bankruptcy of the subsidiary.<sup>136</sup>

From the first sight this contradicts the principle of the corporate law about the legal individual's limited liability, but from the judicial point of view, it is considered as obedient action that can be used by the Court to avoid injustice.<sup>137</sup>

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<sup>129</sup> *Pfeiffer G., Timmerbeil S.*, US-American Company Law - An Overview, available at: <www.zjs-online.com>, 598.

<sup>130</sup> Case Law.

<sup>131</sup> *Miller S.K.*, Piercing the Corporate Veil among Affiliated Companies in the European Community and in the U.S: A Comparative Analysis of U.S., German and U.K., Veil-piercing Approaches, "American Business Law Journal", No. 36, 1998, 117-118; *Burduli I.*, Authorized Capital and Its Functions, in: Theoretical and Practical Issues of the Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 237-240 (in Georgian).

<sup>132</sup> *Burduli I.*, Authorized Capital and its Functions, in: Theoretical and Practical Issues of the Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 242 (in Georgian).

<sup>133</sup> *Burduli I.*, Basics of Joint Stock Law, Volume I, Tbilisi, 2010, 165 (in Georgian).

<sup>134</sup> *O'Kelley R.T., Thompson B.*, Corporations and Other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 584.

<sup>135</sup> *Balotti R.F., Finkelstein J.A.*, The Delaware Law of Corporations & Business Organizations Statutory Deskbook, New York, "Aspen Publishers", 2010, 4-17-00; *Burduli I.*, Authorized Capital and its Functions, in: Theoretical and Practical Issues of the Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 254 (in Georgian).

<sup>136</sup> *Reich-Graffe R.*, Changing Paradigms: The Liability of Corporate Groups in Germany, "Connecticut Law Review", Vol. 37, 2004-2005, 801.

<sup>137</sup> *De Witt Truck Brokers v. W., Flumming fruit Company*, 540 F. 2d 681 (Cir 1976) in the book: *Burduli I.*, Authorized Capital and its Functions, in: Theoretical and Practical Issues of the Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 246 (in Georgian); *Emmerich V., Habersack M.*, Konzernrecht, "Verlag C.H. Beck", 2005, München, 144-147; 419.

In the legal science the issues related to *Piercing the Corporate Veil* principle are divided as contractual and delict. In case of contractual piercing, the dispute is caused by the fact that the creditor itself had selected the debtor (legal body, corporation) and it is not permissible to let the creditor address *Piercing the Corporate Veil* principle. However, in certain situations it is permitted by the Court in contractual relationships, when there is a fact of an intentional deception like e.g. if a parent entity management let a creditor have an incorrect impression about the property of the entity and deceived it.<sup>138</sup>

The responsibility originated from delict is more loyal to the plaintiff, because the creditor did not select the party by itself and thus cannot be obliged to follow the precautionary principle.<sup>139</sup>

Various court decisions are related to this principle and from this point of view to the protection of the rights of the creditors.<sup>140</sup> These decisions have different justifications for *Piercing the Corporate Veil* liability and make different interpretations. This additionally proves that, the mentioned institute is still subject of discussion not only for the scientists but also for the practitioners at the court; and that there is no common approach established. The main principle that can be mentioned as a explanation is that, it is permitted when parent (in the US holding) company entirely controls the subsidiary and this control because the cause of the damage, although there are different approaches when verifying these factual circumstances.

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<sup>138</sup> *Emmerich V., Habersack M.*, Konzernrecht, "Verlag C.H. Beck", 2005, München, 255-256.

<sup>139</sup> *Burduli I.*, Authorized Capital and its Functions, in: Theoretical and Practical Issues of the Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 259 (in Georgian); *Merkt H., Gothel R.*, US-amerikanisches Gesellschaftsrecht, 2 Aufl., Frankfurt am Main, "Verlag Recht und Wirtschaft", 2006, 242; *Baatz v. Arrow Bar*, Supreme Court of South Dakota, 452 N.W. 2d 138 (1990) (see: *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005, 517).

<sup>140</sup> *In Re Rave Communications, Inc. v. Entertainment Equities, Inc.*, United States Bankruptcy Court, Southern District of New York, 138 BR 390 (1992); *In Re Oil Spill by the "Amoco Cadiz" of the Coast of France*, US District Court, Northern District of Illinois Eastern Division, 1984 US Dist, LEXIS 17480; 20 ERC (BNA) 204; *Re Polly Peck International plc* (in administration), Chancery Division (Companies Court), [1996] 2 All ER 433, [1996] 1 BCLC 428; [1996] BCC 486 (see: *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 732-737); *Consumer's Co-op v. Olsen*, Wisconsin Supreme Court, 1988 142 Wis. 2d 465, 419 N.W. 2d 211; *K.C. Roofing Center v. On Top Roofing, Inc.*, Missouri Court of Appeals, 1991, 807 S.W. 2d 545; *United States v. Bestfoods*, Supreme Court of the United States, 1998 118 S. Ct. 1876 (see: *O'Kelley R.T., Thompson B.*, Corporations and Other Business Associations, Cases and Materials, 3<sup>rd</sup> Edition, New York, "Aspen Law & Business", 1999, 623-639); *Baatz v. Arrow Bar*, Supreme Court of South Dakota, 452 N.W. 2D 138 (1990); *Walkovszky v. Carlton*, Court of Appeals of New York, 233 N.E. 2d 6 (1966); *Sea-Land Services, Inc. v. Pepper Source*, United States Court of Appeals, Seventh Circuit, 941 F. 2d 519 (1991) (see: *Hurst Th.R., Gregory W.A.*, Cases and Materials on Corporations, "Anderson Publishing Co.", 1999, 636); *Soderquist L.D., Smiddy L.O., Cunningham L.A.*, Corporations and other Business Organizations: Cases, Materials, Problems, 6<sup>th</sup> Edition, "LexisNexis", 2005.

### **3.2. Joint Liability of the Group Members toward the Creditor, Responsibility during Bankruptcy**

One of the fundamental aspects of holdings is joint liabilities of the group members towards the creditors.

Holding company is liable for the debts of the subsidiary company in two cases: the first case is when a subsidiary was acting according to the mandatory instructions from holding company (when it is declared that holding can give instructions to the subsidiary) and the second case - when subsidiary becomes liable because the parent company's mistake caused bankruptcy of the subsidiary.<sup>141</sup>

Joint liability is often created by the conditions mentioned in the agreement or/and charter of the subsidiary company about the fulfillment of obligatory instructions. In order to avoid the joint liability (when needed), holding companies are trying to hide their controlling participation in subsidiary companies and do not acknowledge in written form their right to give the instructions.<sup>142</sup>

The concrete basics of the joint liability are described in the Article 15 of the Law of German on Stock Corporation. According to it the parent entity is liable for the debts of the subsidiary or the other group member, if there is an agreement made on domination or sharing the profit and loss; if the rules for protection of the property of the entity were broken; the damaging instructions were given to the subsidiary company without giving relevant and appropriate compensation; or an fundamentally destructive intervention was made from the parent company.<sup>143</sup> In such cases the holding company, the controlling entity and also a concrete manager from controlling entity or the subsidiary, a member of the Supervisory Board; or partner/shareholder of the controlling entity can be liable.<sup>144</sup> Also, according to the general principle, any member of the corporate group, which benefited from the damaging action, can become liable towards one of the group members to compensate the loss.<sup>145</sup>

According to the general principle, based on German of the US practice, parent entity<sup>146</sup> of one of the companies from the group can be considered liable for the debts if: 1) the conditions of the transaction are stipulated in a way that the parent entity gets the income, while the subsidiary becomes liable for the damage; 2) the subsidiary enterprise is presented as a part of the parent enterprise; 3) certain corporate formalities of the dependent enterprise are not protected and followed; 4) dependent and parent entities carry out practically the same business; 5) it is not clarified which transaction was made with the parent entity and which one was made with the dependent entity.<sup>147</sup>

The modern science separately discusses the liabilities inside the corporation group - when one of its member becomes bankrupt. In particular, it happens if bankruptcy of a legal body is caused by its founders

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<sup>141</sup> *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 457; *Shitkina I.S.*, Holding and Legal and Governance Aspects, Moscow, "Gorodets – Publishing House", 2003, 63.

<sup>142</sup> *Shitkina I.S.*, Holding and Legal and Governance Aspects, Moscow, "Gorodets – Publishing House", 2003, 240.

<sup>143</sup> *Schmidt K., Lutter M.* (Hrsg.), Aktiengesetz Kommentar (AKtG), II. Band, Köln, "Verlag, Dr. Schmidt O.", 2008, 2631-2650.

<sup>144</sup> *Schuk-Amend A.*, Liability of Holding Companies, 2004, 33, available at: <<https://www.google.scholar.com>>.

<sup>145</sup> *Baums T., Scott K.E.*, Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, European Corporate Governance Institute (ECGI), "Law Working Paper", No. 17, 2003, 45; *Andenas M., Wooldridge F.*, European Comparative Company Law, Cambridge, "Cambridge University Press", 2009, 470.

<sup>146</sup> Scientific researches in English call parent corporation as "holding companies", which are called in Germany as "mother partnerships".

<sup>147</sup> *Hamilton R.W.*, The Law of Corporations, St. Paul, "West Publishing Company", 1991, 93.

or "other persons", which have the right to give the obligatory instructions to this legal body (which became bankrupt); or if they have different means for determining this legal body's actions; than they will have subsidiary liability for the debts caused by the bankruptcy of this legal body, if it has not enough property. These can be founders or "other person", which has the right to give to the legal body an obligatory instructions or have some other means to determine the actions of this legal body.<sup>148</sup>

The German court made a judgment on this topic in 2004 in *Autohandler* case. The Court decided that indirect shareholder, which possessed the shares of the insolvent private company, could be liable for causing the insolvency, if without providing the appropriate compensation, he transferred all the shares from this company to himself or to the other company in which he had shares. Apart from this the Court decided that the shareholder could have limited his responsibility if it had been possible to prove that company suffered only the minor loss. It was also concluded by the Court that the shareholder would not have been liable, if the Court had decide that the liability for the insolvency was not based on incorrect management.<sup>149</sup>

#### **4. Integration of the Corporate Responsibility Principles in the Georgia Law**

The corporate responsibility include many factors. Many of their key principles can be observed in the Georgian legislation. But generally, they are neither combined nor systematized and cannot be perceived as a united normative basis. It is also important that some norms where were known for Georgia legislation (and now are revoked, e.g. Article 17 of the Law on the Entrepreneurs ) still exist in German and the US law and have essential importance for regulating the corporate groups.

As of 1994, Article 17 of the Law of Georgia on Entrepreneurs was about the main regulations for the relationship among the enterprises (corporate group). In particular, the Article 17.3-17.4 considered that if the enterprise held at least 50% of the share from another enterprise located in Georgia, in such case the main enterprise would have been liable for: a) compensating the annual loss of the minor enterprise; b) compensating those losses of the property of the minor enterprise, which were caused by the transactions made by the main enterprise or by the other measures; c) also compensating appropriately the external partners; d) making a statement about participating in the minor enterprise etc. This Article corresponded to the basics of the corporate group joint liability. Presently, it is annulled and is not replaced by any other norm. Since the principle of joint liability is one of the specific issues of the corporate group responsibility, it should be again regulated at the legal level. It should not be depending on the contractual conditions of the parties. It must be an appropriate mean for ensuring protection of the rights of the creditors of the corporate group.

The same Article stated that if an enterprise held at least 75% of the shares from another company located in Georgia, the main enterprise would be liable for the loss of the minor enterprise or

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<sup>148</sup> *Shitkina I.S.*, Holding and Legal and Governance Aspects, Moscow, "Gorodets – Publishing House", 2003, 221; *Zumbansen P.*, Liability within Corporate Groups (Bremer Vulkan), Federal Court of Justice Attempts the Overhaul, "German Law Journal", No. 3, 2002.

<sup>149</sup> *Cahn A., Donald D.C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge, "Cambridge University Press", 2010, 737-751.

that of the third party, which were caused by the transactions or other arrangements. In such case, the persons mentioned in Article 9.1 would also be liable as joint debtors. Liability would not arise if the honest manager of the independent enterprise acted also in this way. Thus, the Law on Entrepreneurs (1994) from the very beginning considered so called Business Judgment Principle. This principle was also integrated in Article 9.7 of the Law on Entrepreneurs (1994). It stated that persons mentioned in Article 9.1 had to lead the entity with the real truthfulness and prudence. If they had failed to fulfill this duty, they would have become jointly liable for the damage caused to the partners. The managers of the entity have to prove that they did not violate their duty. By that time the fiduciary duties were not referring to the Supervisory Board.

The Article 9.6 of the Law on Entrepreneurs which is effective currently states that "the managers of the entity and members of the Supervisory Board must lead the entity honestly, in particular, the should care as any other person with the common sense would do at the same position and in the same circumstance and act with the faith that their action is the most suitable for the entity". Thus, it is obvious that unlike previous legislation, present legislation makes liable towards the entity also the members of the Supervisory Board. The second important difference is that if with previous legislation the manager was required to have diligence of a "real businessman", today legislation speaks about "an ordinary person with a common sense". The general statements of the old law also defined the issue of the burden of proof. The diligence of an ordinary person is not sufficient for a manager of an enterprise and when he managers the property interests of the other people (shareholders/partners), he should be required to show special/real businessman's diligence. It is true that, proceeding from the principle of representation, it is the risk of the owner/partner to whom he delegates the management of his own property, but as success or failure of each company, generally, affects the economic situation and also the public interest emerge, the law has to give strict requirements for the qualification of the managers.

Article 56.4 of the Law on Entrepreneurs, which is currently effective, is about the responsibilities of the directors of the joint stock companies and it says that managers and the Supervisory Board members have the burden of proof. Thus, it is true that the burden of proof is discussed in the norm regulating joint stock companies. It should also be returned in the general statements. These general statements can be also used for the limited liability companies, if needed, because limited liability companies, practically, have no legal regulation of this issue.

The most common type of the breach of the duty of loyalty is self-dealing and not notifying about it. To prevent this kind of situations, there used to be legal notice on the entrepreneurs in Article 17 of the law. This notice stating about the responsibility of internal communicate (the analog exist nowadays in Germany, Law on Stock Corporation) is now revoked. From economic standpoint it might not be necessary, because it is not determining for creation or existence of holding relationships, but it is needed for the control, because it is one of the mechanisms for avoiding self-dealing. This is especially important for indirect participation in shares, when direct interest cannot be seen.

Following the obvious changes of main principles in the Law on the Entrepreneurs has and after it approached significantly to the US system about the corporation

On March 14, 2008, after amendments in to the main principles of Law on the Entrepreneurs when it became much closer to the US system on corporations, the Article 17 of the law was entirely removed. It should be mentioned that in the US (unlike Germany) the concrete statements may not be



written as notions, but normative acts on corporate group management and responsibility are subjects of research and court judgments and improve daily. This sphere was left in an absolutely chaotic condition in Georgia after the entire removal of the relevant regulations from the Georgian law. This is a basis for serious problems from the point of view of the legal regulation.

One of the instruments for the corporate responsibility mentioned in the doctrine is possibility of presenting a so called derivative claim. Article 53.5 of the Law on the Entrepreneurs is about it, although it requires to have some preconditions met. It should be mentioned that the law does not consider at all the same possibility for limited liability companies. By the scientist and also by the US and German Court practice, derivative claim is permissible for limited liability companies. There is no court practice in Georgia on the mentioned issue. At present, at the Appeal Court there is a dispute about it and this fact represents the first step of establishing the court practice (we mean the case of GMC LLC., where the partners brought a claim against the company management and dominants for the damage that was caused to the company and the partners. Due to the complexity of the subject and factual circumstances, this case integrates practically all those institutes that are associated with the issue of the corporate responsibility: burden of proof, liability of the dominants and the members of the Supervisory Board, permissibility of the derivative claim in case of limited liability company etc).<sup>150</sup> Tbilisi City Court decided for this dispute that only the entity and not an individual partner had the right to present a claim and practically excluded the existence of a derivative claim. This position is incorrect and does not comply to the theme in the world legal doctrine that a derivative claim should be also permissible in case of limited liability company; apart from this there should not be a requirement to meet the formal primary conditions which are mentioned in the regulation of the joint stock company, if it is obvious that it will not have any result.<sup>151</sup> The court has to be more careful with this novelty in Georgia and should protect the partnership rights appropriately, following modern recognized principles for the protection of partners rights, which is quite problematic in Georgia.

The essence of a derivative claim is that the claim is presented by a partner for the interests and benefits of the entity, although the company does not participate in the dispute as the plaintiff (future creditor). According to the Georgian legislation the parties of the dispute/execution are people reflected in the decision (the creditor and the debtor). But since the derivative claim is a type of indirect claims and the obtained interest will be received by the entity and not by the partner, respectively, the legislation or the court practice should be suggesting how to execute the decision and who should be the authorized person - creditor to request the "interest" which had been appropriated by the decision

One of the interesting topics of the corporate responsibility is dominant's responsibility, which is regulated by Articles 3.8 and 53.4 of the Law on Entrepreneurs. In Georgia there is not court practice in dominant's responsibility issues. The above mentioned case with GMC Group LLC is one of the first attempts of requesting compensation of damages from the dominant partners (case № 2/952-10).<sup>152</sup> The court incorrectly considered this as a type of indirect claims and said that the entity

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<sup>150</sup> Cases No. 2/952-10 and No. 2/951-10, Tbilisi City Court, 2011 (in Georgian).

<sup>151</sup> *Jugheli G.*, Protection of Authorized Share Capital, Tbilisi, 2010, 354 (in Georgian).

<sup>152</sup> Cases No. 2/952-10 and No. 2/951-10, Tbilisi City Court, 2011 (in Georgian).

was authorized to present it. Corporate management and the responsibility in this process is not only the legal institute, it also integrates issues of economic theory. For this reason the attitude to his issue should not be plain or/and limited to the definitions.

The statement of the Law on Entrepreneurs about taking advantage of dominant position is perceived in science as if it's implementation is related with the decision of the common reunion. But this norm refers to much wider spectrum and considered all forms and means of dominant influence; as apart from taking a decision at the common reunion, there are many other ways by which dominant can actually take advantage of the position. Especially, in the conditions, when it united all kind of feature of holding; meaning that the above mentioned is a general definition, because basis for having practical influence can be any of the three types of holding relationships (based on shares, contractual and factual). Thus, concrete event of influence should be verifies according to the concrete circumstances.

In dominant's responsibility sphere one of the important institute is *Piercing the Corporate Veil* principle(direct responsibility). The Court practice became basis for its common use in foreign countries. In Georgian reality there is neither practice nor enough scientific research in this sphere. One of the first cases on this issue is the civil case of *N Tour*, which was heard at the Tbilisi City Court based on the claim from JSC VTB Bank Georgia. The legal basis for the claim was Article 3.4 of the Law of Georgia on Entrepreneurs. According to it the partners of the entity are personally liable towards the creditors, if the take advantage of the legal forms for limiting liability. Despite the fact that the definition given in the law entirely corresponds to the regulation of *Piercing the Corporate Veil* in the international practice, based on the judgment №2/9095-11 of the Tbilisi City Court dated January 22, 2013 and judgment №2b-2822-12 of Chamber of Civil Cases at the Court of Appeal the claim/appeal complaint was denied on the ground that the factual bases have not been identified for its admission.<sup>153</sup>

This case represents an attempt of having grounds for establishing in Georgia justice system so called *Piercing the Corporate Veil Principle*, which very important. At the given stage the case is heard by the Court of Cassation.

The Georgian legislation (the Law on Entrepreneurs, Article 55.8) considers so called fiducial responsibility for the members of the Supervisory Board. Although it would have been reasonable to have different extents of the requirements for the members of the Supervisory Board and for the directors. As a member of the Supervisory Board is a controlling unit, it is possible to require him have more qualification compared to what the directors are required. The directors, as a rule, can carry out only ordinary activities without a consent from the Supervisory Board or shareholders. If a manager or a member of Supervisory Board agree to manage the entity without having relevant qualification and this brings about negative results, this will be considered as a breach of fiduciary duties and can become the basis for compensating the loss.

Georgian Court has very little practice related to the breach of fiduciary duties. Among these few cases we have to mention the judgment made by the Georgian Court in *3M Georgia Autoservice LLC* case. In this judgment it was decided that the partner who had 50% of the shares could dismiss the director because of unfulfilling his duties from his position and appoint a new one without a

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<sup>153</sup> Case No. 2/9005-1, Tbilisi Appeal Court, 2012; case No. 2b-2822-12, Tbilisi Appeal Court, 2013 (in Georgian).

consent from the partner who held another 50% of the shares (and was the director at the same time). Thus, in this case as a result of breach of fiduciary duties, apart from standard liability for the damage, a different not typical legal solution was found. This was caused by the fact that the director of the entity had not been managing the company – he went abroad from Georgia and abandoned management of the company. He did not make payment to the budget, which probably caused some tax sanctions.

Remedies due to the breach of fiduciary duties were the topic of judgment №2/4877-08 made by the Tbilisi City Court on December 18. With this judgment the Court established a general principle that the managers of the entity and the members of the Supervisory Board were jointly liable with regard to the entity for the amount of fine fixed by the tax inspection due to the breach of the tax payment rules. However, the complaint against the defendant were not admitted because by the time when the entity had to make payment, the defendants were not the managers. The plaintiff refused to require the relevant defendants.<sup>154</sup> The Court generally recognized that in this type of dispute the members of the Supervisory board. But when making the decision the had to have considered also which of the actions of the manager caused the loss: an ordinary activity: of the enterprise which is daily performed by the director or a activity requiring special authority which had to be controlled by the Supervisory board.

In the doctrine the joint liability principle of the corporate group is considered as one of the main bases for creation of a corporate group. Although in Georgian legislation this causes certain ambiguity.

Based on the theories of holding company, the subsidiary and the head organization may become jointly liable if the preliminary agreement was made by the subsidiary, but based on the instructions of the parent company. When speaking about the joint liability, we have to consider compliance of internal legislation of the country with other norms, because in case of a dispute, the agreement among the holding participants cannot solely regulate the case. According to the Georgian legislation, joint liability occurs when a party of a concrete agreement is the parent entity or a separate agreement is to be made with joint liability debtor and the subsidiary will remain as the main debtor. This is also possible, if this will be considered by the law. The grounds for holding's liability were covered by Articles 17.3 and 17.4 of the law, which are currently annulled. Respectively, the legal formulation of this topic does not exist any more.

Subsidiary liability of the holding company for the debts of the subsidiary, which is discussed in the scientific literature is also important for the concept of the group responsibility in holding. It should be permitted by the legislation of the concrete country in case of bankruptcy. When dealing with a case of insolvency, the general principle of the Georgia law is that in all cases the debtor is the party which has the creditors and which is insolvent (the subsidiary company). If the property of the company is not sufficient to satisfy the creditors and cover the debts, the only legal means to involve the holding company in this process for subsidiary liability is to move to the rehabilitation regime of the process.

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<sup>154</sup> Case No.2/4877-08, Tbilisi City Court, 2009 (in Georgian).

## 5. Conclusion

The current legislation of Georgia contains some aspects and elements of corporate liability, but they are presented in a chaotic way and do not give the impression of an integrated legislative sphere.

Taking this into consideration, it would be reasonable to establish the above mentioned main principles of the corporate management including clear division of authorities among the governing bodies, which would make ground of creation of an effective management system. Apart from this, it is important to reflect in details the issues of liability characteristic to the corporate groups. This includes the liabilities within the corporation and also liabilities with regards to the third parties. This can be supported by the legal practice at the Court. The first precedent has been heard at the Court already.

It also should be mentioned that a model of corporate management is considered effective if the loss can be prevented. And this remains one of the most complex problems in the law. Along with the improvement of the legislations, it is important to create the legal practice in this field. The small number of such cases cannot regulate this issue. For the prevention of loss it is especially important to distinguish the functions of the corporation management and the corporation control, based on the distribution of the duties and elaborate the principles of the liabilities of the responsible persons in case of the breach of their duties.

A special attention is given to the protection of the rights of the small shareholders when a dominant is taking advantage of its position. This can be implemented with different legal means, but creation of actual tools and their execution still remains a considerable problem, because the actual application of the principles mentioned in the doctrine depend on many factual circumstances. And with the current practice the small shareholder has the burden to prove it.

To improve the legislation on the above mentioned institutes and give the right direction to the practice, these legal institutes have to be well studied considering the scientific doctrine, legislations of the developed countries and the practice. This will assist the companies operating in Georgia to establish the principles of corporate governance which are recognized in the world.

The mentioned issues are especially problematic because there are many enterprises in Georgia which are parts of so called transnational corporation groups.<sup>155</sup> The issues related to the governance and liability of the transnational corporation groups are not defined only with existing legislation of Georgia and the corporate liability institutes recognized in the world intervene in the corporate space. The Georgian companies have to be prepared for this with their internal documentation and also with the existing legislative basis. Otherwise it will be difficult to maintain the increasing interests of foreign investments in Georgia and the finally the common economic indicators will be negatively affected with this. Legislative regulation of the corporate liability at the international level is important for development of any country and certainly for Georgia's economic development also. Thus, these public interests make the corporate liability issues especially important.

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<sup>155</sup> The majority of Georgia banks are the corporations created with the foreign capital.

**George Makharoblishvili\***

## **Acquisition of Target Company at the Organized Capital Market – Acquisition Via Tender Offer and its Forms**

### **I. Introduction**

Corporate legal rules have their distinctive characteristics. Its regulatory spectrum is under the thesis area of organizational structure of entrepreneurial subjects and provides the systemic preferences for corporate law. Implementation of corporate governance is considered as the tool for the accumulation of large capital. The essence of corporate law covers the existential nature of organizationally governed subjects and provides the legal forms for the management of mega capital. Teleological and target definition of management is the basis for the present article. Management strategy shall be interpreted via two differing abstracts. First – corporate legal dimension covers the inter-organizational spectrum of management of invested capital by dealer and regulates the principle-agent relationships under the interaction dimension. Second stigma of management considers the norms-provisions for the capital market, in other words secondary capital market organized for the securities. One is the form for the concentration and management of large capital, and the second one is the operation via such legal forms in the dimension of capital attraction. The latter is under the regulatory area of securities law. It is used for the maximal utilization of all advantages of the organizational form which are the characteristics of capital type entrepreneurial entities. In parallel with the advantage, the above creates the increased danger for the manipulation with the procedural rules for the capital concentration and unfair competition. Accordingly the possible dissonance shall be overcome via the preventive or repressive actions.

The article covers the public mechanism – tender (bid) offer for the acquisition of enterprise operating at the organized capital market. Tender offer is related to the distribution of capital of all parties participating in the transaction and establishment of new "governance". Therefore, the above is subject to the special supervision under the securities law. In parallel with the rules established at the capital market, the property manipulations and violation of the above rules are opposed by the preventive corporate legal actions, supporting the establishment of balance of interests among the subjects functioning at the market. Precondition for existence of balanced interests ensures the stability of participants of capital market and accordingly the economic stability and dynamics. The anthology of the research covers the existential demonstration of interest imbalance and major tactical legal tools (mainly of corporate nature) for their prevention.

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## II. Definition of Takeover

There are two different mechanisms for acquisition of corporations: holding private negotiations without limitation in time and place and at the organized regulated market of shares<sup>1</sup> with fulfillment<sup>2</sup> of relevant procedural requirements.<sup>3</sup> "Organizations" of market shall be defined in two directions. First, legislative regulatory regulation of turnover of securities, which is general for all accountable companies operating at the organized secondary market. Second, relatively close regulation among the sub-types of organized markets under the standard criteria determined by the statutes and internal guidelines of entrepreneurial entities organizing the stock exchange. Conjunction of both directions is produced in the form of organized capital market. Subtype demonstration of forms of organized capital markets is the organized secondary market, which are divided into the stock market and over-the-counter market. In this regard, capital market is the most important segment for the acquisition of control over the corporation.<sup>4</sup> Gaining control is executed via the transaction of acquisition of controlling number of shares in the target company. Securities market defines the achievement of control in the enterprise via the purchase of more than 10% of votes in the company.<sup>5</sup> Dealer can attain control or purchase via the private negotiations as well as tender offer.<sup>6</sup>

Organized market as the area for implementation of transactions is the definitive substantive sign for the takeover of the corporation via the tender offer. The motives differing from each other are the preconditions for the above. Taking over the corporation<sup>7</sup> shall ensure the increase of value of the aggregate.<sup>8,9</sup> Stagnation of value which is caused by the informational vacuum, in other words

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<sup>1</sup> *Hazen T.L.*, Broker-Dealer Regulation, St. Paul, "Thomson/West", 2011, 3-13.

<sup>2</sup> *Steinberg M.*, Understanding Securities Law, 5<sup>th</sup> Ed., St. Paul, "Matthew Bender & Company", 2009, 115-143.

<sup>3</sup> Previous chapter analyzed forms of share purchase as the existential case of private negotiations. Visavi to the above the public bid offer, is the thematically similar however procedurally different mechanism for acquisition. Analysis of public form of acquisition is provided in the present chapter and following paragraphs.

<sup>4</sup> *Betton S., Eckbo B., Torbun K.*, Corporate Takeovers, "Tuck School of Business Working Paper", No. 2008-47, 2008, 1, available at: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1131033](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1131033)>.

<sup>5</sup> Article 2, Para. 20, Law on Securities Market, 1996.

<sup>6</sup> Article 15, Para. 1 of Law on Securities Market deems it possible to acquire control ("... can make") via bid offer; article 18, paragraph 1 considers the conclusion of secondary deal at the stock exchange and outside the exchange, and considers it under the category of ordinary activities.

<sup>7</sup> Georgian equivalents of English "takeover" – takeover, get possession of. As for the "hostile takeover", it is more appropriate to consider "absorption" as Georgian equivalent.

<sup>8</sup> "Aggregate" is the income of target and bidder company shareholders. *Schuster E.P.*, Efficiency in Private Control Sales – The Case of Mandatory Bids, "LSE Legal Studies Working Paper", No. 8/2010 2, available at: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1610259](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1610259)>. There is theory on the increase of shareholders' value "implicit contract theory". Economically beneficial results of the takeover for the shareholders are achieved via the changes to the structure of Target Company. Changes include replacement of the employees starting from the ordinary labor and including the executive management. According to the "implicit contract theory" the above enables the acquirer to reduce the operational costs and increase of value received from the target company. See: *Klein W.A., Coffee J.C.*, Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 200-201. Compare: *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 667-668.

informational asymmetry, value of transactions, absence of technological development at relevant level or other reasons, stimulates the acquisition or sale<sup>10</sup> of corporation. In any case, offer is already profitable for the shareholders of Target Company.<sup>11</sup> There might be various motives for corporation takeover; however each specific takeover has one specific motive. The following preconditions - the objective to achieve monopolist or oligopolistic status, informational advantage, in other words the situation when not all the participants of the functioning market have access to information on the value and prospects of target company,<sup>12</sup> achievement of synergy effect, change of management, financial view (tax advantages and reduced liquidation value)<sup>13</sup> and personal interest of the management are leading among the diverse preconditions for takeover.<sup>14,15</sup> In parallel to the above the heterogenic characteristics of takeover are: value of the offer,<sup>16</sup> scale of competition (*single-bid versus multiple-bid contests*),<sup>17</sup> level of success, type of agreement (*merger versus tender offer*), method of financing (cash or share), approach of target company towards the combination (*hostile versus neutral or friendly*), intersection of areas of market products: is it horizontal or vertical<sup>18</sup> and etc.<sup>19</sup>

Acquisition of full control over the target company via the tender offer is the regulated and probed technical tool for the prompt takeover. It can be implemented before the achievement of control limit envisaged under the law,<sup>20</sup> following which the rules for the *mandatory takeover bid* become effective.<sup>21,22</sup> As mentioned above, acquisition of control package of shares is possible via the private negotiations or public bid offer on the acquisition of voting shares.<sup>23</sup>

<sup>9</sup> Gilson R., *The Law and Finance of Corporate Acquisitions*, New York, "Foundation Press", 1986, 259.

<sup>10</sup> Hall B.H., *Effects of Takeover Activity in Corporate Research and Development*, in: *Corporate Takeovers: Causes and Consequences*, Auerbach A. (Ed.), Chicago, "University of Chicago Press", 1988, 72.

<sup>11</sup> Roll R., *Empirical Evidence on Takeover Activity and Shareholders Wealth*, in: *Knights, Raiders, and Targets*, Coffee J., Lowenstein L., Rose-Ackerman S. (Eds.), New York, "Oxford University Press", 1998, 241-242.

<sup>12</sup> Compare: Davies P., Hopt K., *Control Transactions*, New York, "Oxford University Press", 2009, 174.

<sup>13</sup> Klein W.A., Coffee J.C., *Business Organization and Finance*, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 200.

<sup>14</sup> Gilson R., *The Law and Finance of Corporate Acquisitions*, New York, "Foundation Press", 1986, 257 et seq.

<sup>15</sup> Roll R., *Empirical Evidence on Takeover Activity and Shareholders Wealth*, New York, "Oxford University Press", 1988, 243-250.

<sup>16</sup> So called "takeover bid", where the bidder is the potential subject of the takeover.

<sup>17</sup> Competition in the scale considers the set of bids. Generally, the shareholders of the target company do not agree with the bid offer until the expiration of legal validity of the offer in expectation of the better offer. See: Gevurtz F., *Corporation Law*, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 704 - selection of mechanisms for the bid offer places the offerer within the conjunction framework: he cannot hold negotiations in other way and purchase the securities included in the bid offer. See: Article 15, Paragraph 7, Sub-paragraph a of the Law on Securities Market, 1996.

<sup>18</sup> Klein W.A., Coffee J.C., *Business Organization and Finance*, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 199.

<sup>19</sup> Betton S., Eckbo B., Torbun K., *Corporate Takeovers*, "Tuck School of Business Working Paper", No. 2008-47, 2008, 2.

<sup>20</sup> According to the Article 53<sup>2</sup>, Paragraph 1 of Law on Entrepreneurship, 1994 – purchase of more than half of voting shares causes the activation of obligatory bid tender.

<sup>21</sup> Hertig H., McCahery J., *Company and Takeover Law Reforms in Europe: Misguided Harmonization Efforts or Regulatory Competition?*, in: *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US*, Armour J., McCahey J. (Eds.), Oxford, "Hart Publications", 2006, 564-565.

Takeover is the attempt of bidder to acquire the control in target company via the partial and full purchase of its placed shares.<sup>24</sup>

The basis for practical utilization of existence of takeover preconditions is associated with the achievement of limit percentage indicator of voting shares in the company.<sup>25</sup> This indicator varies for various legislations. However its essence is unchanged.<sup>26</sup> Gaining the control package of shares in the target company is generic and depends on the specific normative regulation.<sup>27</sup> Procedural development of takeover does not only include the mandatory tender offer.<sup>28</sup> Under the existence of final, specific conditions for the takeover (absorption) it is regulatively imperative and one of the composing elements. Its second, key element is bid offer, which is self-regulated but quo warranto action of

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<sup>22</sup> There are ways to avoid the mentioned rule. One of such ways is initial purchase of shares under the controlling package indicator. In this case investor willing to acquire the corporation, purchases such number of shares in the company which will help him to avoid mandatory bid offer and enable him to purchase the certain percentage of company shares only at market price.

<sup>23</sup> *Brudney V., Chirelstein W.*, Corporate Finance, Westbury, "Foundation Press", 1979, 709-710.

<sup>24</sup> *Lipton M., Steinberger E.*, Takeovers & Freeze Outs, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 1, p. 10.

<sup>25</sup> *Bradly M.*, Interfirm Tender Offer and Market For Corporate Control, "Journal of Business", Vol. 53, No. 4, 1982, 268.

<sup>26</sup> However the opposite view is more justified. The mandatory tender offerer and takeover shall be distinguished from each other: the takeover process may start before achieving the controlling package by the tender offer on purchase of major part of the target company, which depends on the will of offerer and can be the first step from the chain of actions. For example, the USA act regulating the tender offer - Williams Act, considers the purchase of 5% of target company to be the subject of the regulation. Law on securities of Georgia regulates the tender offer under the dispositional provision (article 15.1). However if the dispositional provision is used, it will consider only the tender offers made for more than 10% of voting shares. See: Williams Act, Sec. (13)(d). 5% and 10% are not the control limits envisaged under the corporate law and do not generate the obligation to make tender offer. However, it may be the pre-condition for the hostile takeover or serve hostile takeover implementation, in other words be the first step in the absorption process. See: *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, 2010, 197-211; *Haas J.J.*, Corporate Finance, New-York, "Thomson/West", 2011, 634-644; ABA Section of Antitrust Law, The Merger Review Process: A Step-By-Step Guide To U.S. And Foreign Merger Review, 4<sup>th</sup> Ed., 2012, 154-157. It has to be noted that takeover does not start at the stage of purchase of controlling package as envisaged under the corporate law; it starts with the first attempt to gain the control as envisaged under the securities law. Gaining the controlling number of shares under the corporate law enable the acquirer to fully absorb the target company, in other words the bidder makes bid offer (liability) or utilizes the normative right on mandatory sale. One of the requirements of Williams Act - the acquirer must distinguish the objective of acquisition of target company – does the acquirer intends to gain control over the company (takeover) or purchase of shares are used as the mechanism for investment. See: *Gaughan P.A.*, Mergers, Acquisitions and Corporate Restructurings, 5<sup>th</sup> Ed., New Jersey, "John Wiley & Sons", 2011, 76-78; *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 207-210. For delimitation, compare: *Hertig H., McCahery J.*, Company and Takeover Law Reforms in Europe: Misguided Harmonization or Regulatory Competition? In: After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US, *Armour J., McCahey J.*, (Eds.), Oxford, "Hart Publications", 2006, 559-565.

<sup>27</sup> *Klein W.A., Coffee J.C.*, Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 190.

<sup>28</sup> *Burduli I.*, Mandatory Tender Offer, Mandatory Sale of Shares, Journal "Justice", No 2, 2007, 11-29 (in Georgian).



corporation.<sup>29</sup> Analysis of the first element between the mentioned elements is not covered under the research, the second one – is the connecting element to the continuation of implemented research, following which the mentioned segment of the research will be completed via the classification of takeover forms and analysis of the means for defense from the takeover.

### III. Bid Offer under the Takeover Context

Bid offer is specific legally regulated event characteristic to the organized trade in the capital market.<sup>30,31</sup> It regulates the bid offers which are made to the voting shares of corporation functioning at the organized secondary market of capital.<sup>32</sup> The addressees of the offer are shareholders of joint stock company.<sup>33</sup>

Based on its regulative nature, subject to anti-monopoly legislation, due to the prevention of monopoly status via the legislative regulations, the practical implementation is conducted not via the horizontal combination (when both companies carry out the same entrepreneurial activities) but via the vertical combination for the execution of conglomerate acquisition.<sup>34</sup>

The bid offer with the purpose to acquire shares in target company is especially effective, when the share participation in the company is significantly *dispersed*<sup>35</sup> and there is no one shareholder (*block holder*), who possesses the number of shares required for direct implementation of effective control over the company.<sup>36</sup> The minimum precondition for the implementation of the above is at least the belief of the offerer that the management of target company will like the offer or at least will not be against such offer<sup>37</sup> in other words will be neutral.<sup>38,39</sup> The motivator for activation of Bid offer –

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<sup>29</sup> Cox J., Hazen T.L., Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 1, New York, "Aspen Publisher", 2010, 243-244.

<sup>30</sup> Its legal regulation is covered in many anti-monopoly legislations (Williams Act, Security Exchange Act 1934,). In terms of law, it is subject of law on securities. Steinberg M., Understanding Securities Law, 5<sup>th</sup> Ed., St. Paul, "Matthew Bender & Company", 2009, 285. Under the Georgian legislation purchase of JSC shares via the bid offer is regulated under the Article 15, Paragraph 1, Law on Securities Market of Georgia, 1996.

<sup>31</sup> Despite its legally regulated contents, there are no direct definitions given in majority of legislative acts. Cox J., Hazen T.H., Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 211-212.

<sup>32</sup> Oesterle D.A., Mergers and Acquisitions, St. Paul, "West Publishing", 2006, 130.

<sup>33</sup> Easterbrook F., Fischel D., The Economic Structure of Corporate Law, Harvard, "Harvard University Press", 1991, 162.

<sup>34</sup> Clark R., Corporate Law, St. Paul, "AA Balkema", 1986, 537.

<sup>35</sup> Brudney V., Chirelstein W., Corporate Finance, Westbury, "Foundation Press", 1979, 709.

<sup>36</sup> Sepe S., Rogers J., Private Sale of Corporate Control: Why the European Mandatory Bid Rule is Inefficient, 2010, 7, available at: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1086321](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1086321)>.

<sup>37</sup> Brudney V., Chirelstein W., Corporate Finance, Westbury, "Foundation Press", 1979, 710.

<sup>38</sup> Hertig H., McCahery J., Company and Takeover Law Reforms in Europe: Misguided Harmonization or Regulatory Competition? In: After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US, Armour J., McCahery J. (Eds.), Oxford, "Hart Publications", 2006, 562-564.

<sup>39</sup> Fleischer A., Mundheim R., Corporate Acquisition by Tender Offer, "U. of Pa.L.Rev.", No. 115, 1967, 317-321.

impossibility to carry out transaction subject to the negotiations with the enterprise as the legally existing subject, such as merger or acquisition of property.<sup>40</sup> Bid offer is a term which reflects the existence of complex events. This determines its dichotomy – the result of absence of straightforward definition. The determination of its essence in terms of contents is possible at legislative<sup>41</sup> and doctrinal levels.<sup>42</sup> According to the capital market regulatory rules, bid offer, is the public statement of the offerer on the purchase of securities placed by the owner at the depositary bank at determined price.<sup>43</sup> In other words, bid offer considers public offer made to all shareholders of target company with the purpose to purchase their shares placed in the publicly traded market. Generally offer is made by person or group of persons (investors)<sup>44</sup> on the partial or full purchase of class, or classes or all shares of the company.<sup>45</sup> Via the bid offer, the essence of acquisition unlike the merger of property acquisition is reflected in the possibility to purchase shares of the company directly from the shareholder avoiding the management of the company.<sup>46</sup> The difference lies in the subjectivism of persons participating in the transaction.

Definition of price<sup>47</sup> is another sign of complexity of bid offer. The price is generally determined based on the economically prospective view on the corporation.<sup>48,49</sup> Potential buyer is ready to pay premium amount,<sup>50</sup> as the price for the bid offer and acquisition of control.<sup>51</sup> Premium price is much higher than the market price.<sup>52</sup> Economic projection of Bid offer and premium price paid depends on economic prospects related to the securities,<sup>53</sup> capital market and the company.<sup>54</sup>

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<sup>40</sup> *Brudney V., Chirelstein W.*, Corporate Finance, Westbury, "Foundation Press", 1979, 709.

<sup>41</sup> *Hazen T.L.*, The Law of Securities Regulation, 6<sup>th</sup> Ed., St. Paul, "West", 2009, 388-393.

<sup>42</sup> It may cover elements of private negotiations and elements of public trade of shares. See: *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 212-213.

<sup>43</sup> *Oesterle D.A.*, Mergers and Acquisitions, St. Paul, "West Publishing", 2006, 130.

<sup>44</sup> *Aranow E.R., Einhorn H.A.*, Tender Offers for Corporate Control, New-York, "Columbia University Press", 1973, 83-94.

<sup>45</sup> *Kanter C.*, Tender Offers Making and Meeting Them, New York, "PLI", 1979, 12.

<sup>46</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 704.

<sup>47</sup> In the process of adoption of Williams Act, and during the debates in the congress the definition for the bid offer was developed (definition was not included in the final draft), where the price should be much higher compared with the market price (... *price substantially above the current market price* ). See: *Aranow E.R., Einhorn H.A.*, Tender Offers for Corporate Control, New-York, "Columbia University Press", 1973, 71-82; *Kanter C.*, Tender Offers Making and Meeting Them, New York, "PLI", 1979, 8-14.

<sup>48</sup> *Easterbrook F., Fischel D.*, The Economic Structure of Corporate Law, Harvard, "Harvard University Press", 1991, 162-163.

<sup>49</sup> *Klein W.A., Coffee J.C.*, Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007,190.

<sup>50</sup> *Betton S., Eckbo B., Torbun K.*, Corporate Takeovers, "Tuck School of Business Working Paper", No.2008-47, 2008, 17-18.

<sup>51</sup> *Haas J.J.*, Corporate Finance, New-York, "Thomson/West", 2011, 637.

<sup>52</sup> *Sepe S., Rogers J.*, Private Sale of Corporate Control: Why the European Mandatory Bid Rule is Inefficient, 2010, 8-34, available at: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1086321](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1086321)>.

<sup>53</sup> *Booth R.A.*, Financing the Corporation, Chicago, "West", 2010, 685-692.

<sup>54</sup> Compare: *Dyck A., Zingales L.*, Private Benefits of Control: An International Comparison, 2001, 8-9, available at: <<http://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2004.00642.x/pdf>>.

Security has two dimensions: *Risk and anticipated income*. Acquirer diversifies the risk based on the investment, change of management and utilization of possibility to gain the liquid market. However the main factor for the price determination can be the anticipated income. If the bidder anticipates at least 1% increase in the revenues from the shares, then payment of premium price for the bid offer might become profitable for him/her.<sup>55</sup>

Bid offerer legally binds himself by the offer.<sup>56</sup> In case of acceptance he will purchase the specific number and class of shares at the determined price.<sup>57</sup> Offer is made to all shareholders, which essentially excludes the possibility to purchase all shares offered for acquisition.<sup>58</sup> Tactical<sup>59</sup> view<sup>60</sup> of the buyer is the following: to purchase the maximal number of voting shares at the first stage of the bid offer<sup>61</sup> and if he achieves the mandatory sales level, to implement the "short-form" merger to exclude the minority shareholders.<sup>62</sup> It has to be noted that such bid offer is executed in case of hostile (towards the shareholders) acquisition.<sup>63</sup>

In addition to doctrinal and legislative definitions, there is court case practice, which provides the specific definition of essence as well as substantive elements of bid offer.<sup>64</sup> These elements are provided in the list of factual circumstances, under existence of which the purchase of shares will be qualified as bid offer and will be subject to the special anti-monopoly regulations.<sup>65</sup> In the case against *Wellman Dickinson* the court determined eight factual circumstances for definition of bid offer. Corporate action of subject is qualified as bid offer if: it is made to (1) wide circle of shareholders, which is (2) directed towards the request to purchase of substantial percentage of issued shares; (3) the price is higher compared with the price dominating at the market; (4) the conditions of the offer are strictly defined and are not subject to change via negotiations; (5) aimed to acquire the fixed bidding

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<sup>55</sup> Posner R., *Economic Analysis of Law*, 4<sup>th</sup> Ed., New York, "Aspen Publisher", 1992, 429.

<sup>56</sup> The mandatory power of the tender offer is reinforced at legislative level. It is based on the specific limitations. Following the statement on public bid offer made by the acquirer, within the validity of the offer he is prohibited to hold private negotiations with the shareholders of Target Company and purchase the shares. See: Rule 14e-5(a), Security Exchange Act, 1934, Article 15, paragraph 7, Law on Securities Market, 1996.

<sup>57</sup> Cox J., *Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 213.

<sup>58</sup> *Gevurtz F.*, *Corporation Law*, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 704. Bid offer made by the offerer does not consider the mandatory acceptance. Estimation made by the acquirer is hypothetic and potential: he via the payment of premium price provokes acceptance from the shareholders of target company. Of course all shareholders have right on will autonomy and property – sale of shares is the act of their will.

<sup>59</sup> Generally, for the tactics for implementation of bid offer see: *Brudney V.*, *Chirelstein W.*, *Corporate Finance*, Westbury, "Foundation Press", 1979, 712-716.

<sup>60</sup> *Betton S.*, *Eckbo B.*, *Torbun K.*, *Corporate Takeovers*, "Tuck School of Business Working Paper", No.2008-47, 2008, 20-25.

<sup>61</sup> *Gilson R.*, *The Law and Finance of Corporate Acquisitions*, New York, "Foundation Press", 1986, 816.

<sup>62</sup> *Haas J.J.*, *Corporate Finance*, New-York, "Thomson/West", 2011, 682.

<sup>63</sup> *Depamphilis D.*, *Mergers, Acquisitions, and Other Corporate Restructuring Activities*, 5<sup>th</sup> Ed., Oxford, "Academic Press", 2010, 21.

<sup>64</sup> *Wellman v. Dickinson*, 475 F.Supp. 783, 823-824 (S.D.N.Y. 1979); *SEC v. Carter Halway Hale Stores, Inc.*, 760 F.2d 945 (Cir. 1985).

<sup>65</sup> *Haas J.J.*, *Corporate Finance*, New-York, "Thomson/West", 2011, 639-640.

number of shares; (6) during the specifically determined time; (7) the accepters are convinced to make decision on selling of shares and (8) the offer is made publicly, facilitating the fast accumulation of shares.<sup>66</sup>

In summary, bid offer is legally regulated mechanism for the purchase of company shares established at the procedural, instrumental capital market<sup>67</sup> and is key inter-structural, static element for practical demonstration of acquisition.<sup>68</sup>

#### **IV. Acquisition via Takeover: Forms and Their Demonstration**

##### **4.1. "Friendly" Takeover<sup>69</sup>**

There are many types of bid offers.<sup>70</sup> Typological difference between these forms is based on the classification of participating entities and offer motives.<sup>71</sup> Differentiation of entities is qualifying factor for the acquisition motive. Based on the acquisition motive the nature of acquisition is

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<sup>66</sup> Cox J., Hazen T.L., Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 213-215.

<sup>67</sup> Its regulation is provided in article 15, law on Securities Market, complimented by various regulations issued by National Bank

<sup>68</sup> Klein W.A., Coffee J.C., Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/ Foundation Press", 2007, 189-190.

<sup>69</sup> So called. "friendly takeover", see: Lipton M., Steinberger E., Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 1, 10-11.

<sup>70</sup> There are partial tender offers – the offer indicates the maximal limiting number of shares to be purchased; Any of all tender offer – the unlimited number of shares to be purchased is defined; Bid offer is classified in terms of financing based on type of financing – transaction financed with cash tender offer or shares; self-tender offer – company makes offer on re-purchase of its own shares, see: Haas, Corporate Finance, New-York, "Thomson/West", 2011, p. 637-638. Offer which is made by third, non-emitting Corporation is referred to as the tender offer from the third party. See: Oesterle D.A., Mergers and Acquisitions, St. Paul, "West Publishing", 2006, 135-136. If so called "looter" acquirer implements the acquisition of target company through the two-stage price and by this way manipulates with the difference in prices, then we are dealing with coercive tender offer. In the event of "Coercion" the "looter" acquirer at the first stage of acquisition buys the 51% of company shares at high price. For example, if the market price for the share is 50 USD, then at the first stage the acquirer offers to shareholders USD 80 in cash for 51%, the remaining 49% is purchased using the debt securities at USD 60. In total, the average price for sold shares equals to USD70.2. If the actual value of the company is USD 75, then at the first stage everyone agrees with the offer based on 80\$ > 75\$ principle. The investor was "forced" to sell the shares worth of USD75 at USD 70. See: Easterbrook F., Fischel D., The Economic Structure of Corporate Law, Harvard, "Harvard University Press", 1991, 179, 220. It has to be mentioned, that the ways for avoiding such manipulations are not considered under the legislation on securities (Georgian legislation tries to define "manipulation" in the legislation on securities, according to which the deals are considered as manipulation which do not cause changes in the registered data and it is implement for deceiving purposes. See: Law on Securities Market, Article 44). Such manipulation is covered under the ISA SEC regulations, under which the standard of the "best price" for the tender offer is only covered at the stage of bid offer implementation and does not have regulations in case of two-stage mechanism for the acquisition of target company. See: Cox J., Hazen T.L., Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 224-226.

<sup>71</sup> Depamphilis D., Mergers, Acquisitions, and Other Corporate Restructuring Activities, 5<sup>th</sup> Ed., Oxford, "Academic Press", 2010, 21.

determined: if the purposes of takeover are getting rid of the competitor, changing management, diversification of risk or avoiding responsibility then the takeover is considered as disciplinary or "hostile". If the target of bid offer is the legal entity and the purpose is to achieve higher benefits or increasing market power, in other words achieve synergy via the consolidation, then we are dealing with the elements of so called "synergetic"<sup>72</sup> "friendly" takeover.<sup>73</sup> The second classifier for the determination of takeover type is the attitude of the target company management to the transaction. If the management agrees to hold negotiations, then we are dealing with the elements of "friendly" takeover. Therefore, friendly takeover is also referred to as "negotiated takeover transaction."<sup>74</sup>

Negotiations are possible in two cases. If the management of target company believes that acquisition of the company by the acquirer is desirable in marketing and management terms, then the target company starts negotiations to agree on the transaction provisions. In the second case, additional participant enters the takeover transaction. If the target company does not want to implement the first transaction method of acquisition, then it looks for the competitor bidder (*white knight*),<sup>75</sup> starts negotiations with the new bidder in order to avoid hostile takeover.<sup>76</sup> As a result, any type of acquisition offer determines the selling of the company. And it does not matter which bidder – first bidder or the competitor providing better offer – is the winner. If the competitor company can be found within the potential diapason of possibilities, then the fiduciary duty and doctrine on increase of "shareholders" value makes obligatory for the management to direct its actions towards the attraction of better offer.

In the event of merger or proprietary acquisition, when the board (directors) of both parties to the combination achieve the mutually agreed decision on the acquisition, in other words the target company management (board and shareholders) are not against the transaction, we have the classical form of so called "friendly takeover".<sup>77</sup> In this case, the board of target company approves the transaction before convening the general shareholders' meeting, and the shareholders state their consent to such decision.<sup>78</sup> "Friendly takeover" is also used as a mechanism for avoiding the strict anti-monopoly regulations, when it is implemented via the corporational combination of merger.<sup>79</sup>

In terms of corporate structure, friendly takeover is the causal condition for the changes similar to the proprietary acquisition. Friendly takeover is identical to the proprietary acquisition or merger in

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<sup>72</sup> Morck R., Shleifer A., Vishny R., Characteristics of Targets of Hostile and Friendly Takeovers, in: Corporate Takeovers, Auerbach A. (Ed.), Chicago, "University of Chicago Press", 1988, 101-102.

<sup>73</sup> Depamphilis D., Mergers, Acquisitions, and Other Corporate Restructuring Activities, 5<sup>th</sup> Ed., Oxford, "Academic Press", 2010, 21.

<sup>74</sup> Gilson R., The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 817.

<sup>75</sup> *White knight* differs from *white squire*. In the first case, "white knight" is the subject which comes onto the scene as the alternative buyer to the hostile acquirer of the target company and gains control in the target company. Unlike the above discussed, *white squire* is the ordinary investor buying the shares, who is interested in the investment and its objective is not gaining the control over the target company. See: Radin S., The Business Judgment Rule, Vol. II, New York, "Wolters Kluwer Law & Business", 2009, 2662.

<sup>76</sup> Gilson R., The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 817.

<sup>77</sup> Clark R., Corporate Law, St. Paul, "AA Balkema", 1986, 532.

<sup>78</sup> Klein W.A., Coffee J.C., Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 190-191.

<sup>79</sup> Clark R., Corporate Law, St. Paul, "AA Balkema", 1986, 537.

terms of results of the transaction. The difference lies in the teleological analysis of procedural part (management consent) of the combination, having more technical or financial nature than contents' or substantive nature.

Any acquisition, including "friendly" acquisition requires legally correct technical implementation. However in some cases, court does not consider some corporate combinations as "friendly" acquisitions.<sup>80</sup> Among the strategic mechanisms for the execution of transactions according to the management consent we shall distinguish *leveraged buyout* and *management buyout*. Their theoretical-synchronic analysis will provide us with the additional spectrum for the perception of schematic picture of acquisition combinations.

#### **4.1.1. Leveraged Buyout, as the Methodic Demonstration of "Friendly" Takeover**

In the corporate law the *leveraged buyout (LBO)* is distinguished with its characteristic specifications among the various legal forms of acquisition. This is a specific case of control transfer (change),<sup>81</sup> the main aspects of which are financial provision of the transaction and method for execution.<sup>82</sup> *LBO* does not cover the corporate combination with the participation of other companies. *LBO* is purchase of shares by investors of the corporation.<sup>83</sup> The purchase of shares is made with cash; investor or group of investors purchase shares of the target company from its shareholders via the bid offer and pay the cash.<sup>84</sup>

For the procedural execution of acquisition, investor generally establishes the "fictive" "acquirer" corporation<sup>85</sup> in the private sector (*private equity firm*) functioning in the form of commendatory Organisation; the above corporation is used for execution of *LBO*. The full capitalization of the established corporation is done in cash. Newly established corporation attracts the principle amount required for the acquisition of shares from institutional investors or through selling the short-term debt securities to the bank. Moreover the corporation retains small portion of funds in cash. This form of financing structuring is referred to as, so called, "*leveraged*". Accordingly the capital structure of the "acquirer" corporation is formed via the leveraging the increased loan funds through the internal equity financing.<sup>86</sup> So called *Junk Bonds* are used as debt securities.<sup>87</sup>

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<sup>80</sup> Radin S., *The Business Judgment Rule*, Vol. II, New York, "Wolters Kluwer Law & Business", 2009, 2675-2685.

<sup>81</sup> Williamson O.E., *Mergers, Acquisitions, and Leveraged Buyouts: An Efficiency Assessment*, in: *Corporate Law and Economic Analysis*, Bebchuk L. (Ed.), New York, "Cambridge University Press", 1990, 11.

<sup>82</sup> Haas J.J., *Corporate Finance*, New-York, "Thomson/West", 2011, 609.

<sup>83</sup> Klein W.A., Coffee J.C., *Business Organization and Finance*, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 191.

<sup>84</sup> Haas J.J., *Corporate Finance*, New-York, "Thomson/West", 2011, 609.

<sup>85</sup> "Fraudulence" is determined by its only objective purpose in the process of acquisition of Target Company.

<sup>86</sup> Oesterle D.A., *Mergers and Acquisitions*, St. Paul, "West Publishing", 2006, 27.

<sup>87</sup> Same "high-yield bond". See: Taggart R., *The Growth of the "Junk" Bond Market and its Role in Financing Takeovers*, in: *Mergers and Acquisitions*, Auerbach A. (Ed.), Chicago, "University of Chicago Press", 1988, 5-24.

At the next stage the "acquirer" corporation uses the attracted funds for the acquisition of controlling package of public shares from the shareholders of target company. After the purchase of desired number (within the limit) of shares, "fictive" corporation is merged with the target company. As the debt securities were secured securities, as a result of merger the part of the target company's property is used for securing the debt, as the merger is characterized with the eventual combination of liabilities. On the other hand, "fictive" corporation becomes the owner of voting shares of the target company in return for the debt liabilities.<sup>88</sup> The payment of debt for the debt securities issued by the "fictive" corporation is assigned to the target company property.<sup>89</sup> The above meaning that the investor or group of investors has taken over the target company avoiding the target company management; and the initial stated "intention" was not the absorption.<sup>90</sup> As a result of transaction, the absorption of liabilities of "fictive" corporation by the target company facilitates the transformation of "open" joint stock company into the "closed" joint stock company;<sup>91</sup> the capital structure of the above company is formed in the form of increased debt capitalization.<sup>92</sup>

The above discussed analysis is done based on the financial "leverage". "Leverage" is determinant of capital structure. Leverage terminologically is used for description of financial results of debt and internal capitalization.<sup>93</sup> Debt securities issued for the above method of financing are secured by the property of issuing company. Such debt is considered as debt based on the property<sup>94</sup> or secured debt.<sup>95,96</sup> Investment turnover of the borrowed funds is the financial tool, "leverage" of internal financing; in other words it facilitates the achievement of beneficial results for the company.<sup>97</sup> Definition of "leverage" is main determining factor of *LBO*. Financial-economic empirical research on corporate combinations distinguishes the exchange of debt securities with the shares as the key characteristic of the above.<sup>98</sup>

In addition to the execution of second stage of *LBO* acquisition of the company via the merger, the second stage can be implemented via proprietary selling of acquired company or the legal possibility to dispose the business activities. If the acquirer, instead of partial selling of company property, decides to pay the debt taken for the transaction financed by *leverage* by selling the whole

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<sup>88</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 709.

<sup>89</sup> *Haas J.J.*, Corporate Finance, New-York, "Thomson/West", 2011, 609.

<sup>90</sup> *Klein W.A., Coffee J.C.*, Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 190.

<sup>91</sup> *Pay'N Pak Stores v. Court Square Capital LTD* (9th Cir. 1998).

<sup>92</sup> *Williamson O.E.*, Mergers, Acquisitions, and Leveraged Buyouts: An Efficiency Assessment, New Haven, "Yale Law School", 1990, 11-14.

<sup>93</sup> *Klein W.A., Coffee J.C.*, Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 8.

<sup>94</sup> So called "Asset-based lending".

<sup>95</sup> So called "Secured lending".

<sup>96</sup> See: *Depamphilis D.*, Mergers, Acquisitions, and other Corporate Restructuring Activities, 5<sup>th</sup> Ed., Oxford, "Academic Press", 2010, 499.

<sup>97</sup> *Klein W.A., Coffee J.C.*, Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 9-11.

<sup>98</sup> *Williamson O.E.*, Mergers, Acquisitions, and Leveraged Buyouts: An Efficiency Assessment, New Haven, "Yale Law School", 1990, 15.

property of the company or its full business, as thinks that the target business cannot be any more the indicator of its success and it exhausted all potential possibilities, the typical destruction or *Bust-up LBO* is formed.<sup>99</sup> The latter is used in cases, when the acquisition of target company is made for the diversification of investment and generation of profits in some time period. The main essence of the above is related to the source of transaction financing and the method of payment the debt. If acquirer sells the significant part of the target company to cover the debt and the disposal of the assets results in the termination of activities by the target company, we are dealing with the *Bust-up Takeover*.<sup>100</sup> In parallel, following the improvement of acquired company's management, entrepreneurial activities and business strategies, the investor may register the target company at the organized capital market; and the company will be finally sold at that market.<sup>101</sup>

#### **4.1.2. Management Buyout, as the Methodic Demonstration of "Friendly" Takeover**

*Management buy-out* is the schematically idio-sincrate demonstration of takeover executed with the participation of corporate management; this is local but complex type of transaction opposite to the debt financing, different from the acquisition panacea. Qualification of *Management buyout* (abbreviation - *MBO*) as a method of "friendly" takeover is determined by its objective, which is reinforced by many court resolutions.<sup>102</sup> If target company is against the takeover transaction, management can use this method of share buyout as the mechanism for defense.<sup>103,104</sup>

*MBO*, by its contents has the same type of transaction scheme as *LBO*.<sup>105</sup> This is one of the options of financing the shares of the target company via the debt,<sup>106,107</sup> with the difference that instead of group of investors or part of investors are represented by the company management.<sup>108</sup> Based on the management estimation the current price of the company shares is not relevant to the real value (is *undervalued*) and it has significantly higher value.<sup>109</sup> This is reflected in real estimation of future, potential cash inflows. The main precondition of the above is generally transformation of "open" corporation into the "closed" company (*going private*),<sup>110,111,112</sup> and the buyers of placed shares are the

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<sup>99</sup> In other words: "breakup". See: *Haas J.J.*, Corporate Finance, New-York, "Thomson/West", 2011, 609-610.

<sup>100</sup> *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 1, 25.

<sup>101</sup> *Macey J.*, Corporate Governance, Princeton, "Princeton University Press", 2008, 241-244.

<sup>102</sup> *Radin S.*, The Business Judgment Rule, Vol. II, New York, "Wolters Kluwer Law & Business", 2009, 2663-2675.

<sup>103</sup> The analysis for the means of defense against the undesired takeover is presented below.

<sup>104</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 709.

<sup>105</sup> *Haas J.J.*, Corporate Finance, New-York, "Thomson/West", 2011, 610.

<sup>106</sup> Relationship of capital structure under the loan financing is at 6:1 or 12:1. See: *Shleifer A., Vishny R.*, Management Buyouts as a Response to Market Pressure, Chicago, "University of Chicago Press", 1998, 87.

<sup>107</sup> *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 913.

<sup>108</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, Chap. 14, New York, "Aspen Law & Business", 2000, 3.

<sup>109</sup> *Depamphilis D.*, Mergers, Acquisitions, and other Corporate Restructuring Activities, 5<sup>th</sup> Ed., Oxford, "Academic Press", 2010, 498.

<sup>110</sup> *going private* – transaction generally is implemented through the re-purchase of own shares, when the company makes tender offer on the shares of public shareholders (self-tender offer). See: *Haas J.J.*,



managers.<sup>113</sup> The mechanism for debt financing does not exclude creation of other basis for de-listing, as transaction involves the company board. Namely, it is possible that for the transaction the target company, within the authority of the board, issues the specific number of shares without consent from the meeting of the shareholders (from the allowed quota of shares). If the above takes place, according to the rules established at the capital market, the corporation is subject to de-listing.<sup>114,115</sup> As a result of transaction completion, the managers of the target company mainly own the package, generally over the controlling percentage limit, of the target company.<sup>116</sup>

In terms of changes to corporate structure, in addition to the changes to capital structure,<sup>117</sup> the changes to such strategic organizational segments as control and ownership shall be mentioned. Debt financing of management buyout goes beyond the Burn definition of separation of ownership and control in the acquired company and creates the classical conflict created between the "principle and agent".<sup>118</sup> In this case, group of directors become the owners of the controlling shares in the same company.<sup>119</sup> Via the questioning the fairness of ownership in the "own" company by the management, the control over the company is acquired; the above generally is related to the creation of number of problematic issues in the company (established as a result of transaction) functioning under the capitalization form with increased liabilities.

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Corporate Finance, New-York, "Thomson/West", 2011, 662-664; compare: *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 121.

<sup>111</sup> *going private transaction* implemented by the management is the sub-type of freezing out the minority shareholders from the company; see: *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 913-914; *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 140.

<sup>112</sup> *Oesterle D.A.*, Mergers and Acquisitions, St. Paul, "West Publishing", 2006, 254.

<sup>113</sup> It is necessary to distinguish the classes of acquisitions implemented with the participation of management (MBO and Interfirm (cash) tender offer). In case of MBO the management of target company is the acquirer when it carries out purchase of shares from the shareholders of public company. The opposite of the above is Interfirm (cash) tender offer. In this case, management participates in the purchase of shares of shareholders of target company, moreover, the target company management participates in the transaction on behalf of the shareholders and what is more important, the target company is different legal entity. See: *Bradly M.*, Interfirm Tender Offer and Market for Corporate Control, "Journal of Business", Vol. 53, No. 4, 1982, 270-271.

<sup>114</sup> *Radin S.*, The Business Judgment Rule, Vol. II, New York, "Wolters Kluwer Law & Business", 2009, 2662-2663.

<sup>115</sup> Demonstration of the above case can be used as one of the examples explaining the *going private*.

<sup>116</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 14, p. 5.

<sup>117</sup> *Depamphilis D.*, Mergers, Acquisitions, and Other Corporate Restructuring Activities, 5<sup>th</sup> Ed., Oxford, "Academic Press", 2010, 507-509.

<sup>118</sup> This conflict includes the collision relationship between the company management and shareholders. See: *Armour J., Hansmann H., Kraakman R.*, Agency Problems and Legal Strategies, New York, "Oxford University Press", 2009, 21.

<sup>119</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 136.

### 4.1.3. Discussion of Problematic Issues Related to the Acquisition via Debt Financing

The both forms of debt financing are the types of financial restructuring of the corporation. Assigning "friendly" nature to the transaction is related to the avoiding of the undesired changes,<sup>120</sup> as the management was controlling body of the company even before the acquisition.<sup>121</sup> In exchange, we are getting two other problems.

First – in the period of bid offer for the acquisition of shares by the management, equaling at least 20 business days,<sup>122</sup> the competitive bidder may come to the scene.<sup>123</sup> This offer is somehow the challenge for the management, as if the competitive offer is made at better conditions,<sup>124</sup> then the management will face the choice.<sup>125</sup> The "principle-agent"<sup>126</sup> *ex ante/ex post* conflict is created,<sup>127</sup> which finds its development in terms of protection of fiduciary liabilities.<sup>128</sup> Bid offer, with its essence, considers offering of the best price.<sup>129</sup> When the competitor bidder enters the scene, naturally the shareholders expect the better offer.<sup>130</sup> The management shall use the mechanisms of control over the target company – information about its present value and prospective value – for blocking the competitor.<sup>131</sup> However, the essence of competitive bid is in the increase of purchase price for the shares, which is profitable for the owners of target company.<sup>132</sup> At the same time, accepting the offer made by the management might not reflect the actual position of shareholders about the fair price for the shares for sale.<sup>133</sup> One of the factors preventing the definition of fair price for shares is the impossibility to achieve the agreement on the financing of bid offer and payment forms.<sup>134</sup> It is

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<sup>120</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 704-705.

<sup>121</sup> *Klein W.A., Coffee J.C.*, Business Organization and Finance, 10<sup>th</sup> Ed., New York, "Thomson Reuters/ Foundation Press", 2007, 192.

<sup>122</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 223.

<sup>123</sup> *Clark R.*, Corporate Law, St. Paul, "AA Balkema", 1986, 518.

<sup>124</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 14, p. 40.

<sup>125</sup> As a result of better offer from the competing offerer the MBO implementers may face the dilemma. See: *Revlon, Inc. v. MacAndrews & Forbers Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986).

<sup>126</sup> For the inter-relationship between the principle-agent in the business transactional and commercial case, see: *Bradgate R.*, Commercial Law, New York, "Oxford University Press", 2005, 176-207.

<sup>127</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 14, p. 9. The problem of principle-agent is evident from the transaction construction: the fundamental principles of corporate law and corporate management are violated – the ownership and control face the problem of separation, as the board of director can become the owner of the controlling package of shares. See: *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 136.

<sup>128</sup> *Radin S.*, The Business Judgment Rule, Vol. II, New York, "Wolters Kluwer Law & Business", 2009, 2315-2319.

<sup>129</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 224.

<sup>130</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 704.

<sup>131</sup> As it was for the classic MBO case: *Mills Acquisition Company v. Macmillan, Inc.*, 559 A.2d 1261 (De. 1989).

<sup>132</sup> *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 816.

<sup>133</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 137.

<sup>134</sup> There is a precedent court decision, where the Delaware court stated the criteria for determining the fairness of contract and price, based on which the transactions with the management participation shall be implemented. See: *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

difficult to achieve the agreement, if the directors giving recommendations to shareholders are the acquirers at the same time.<sup>135</sup>

Second problem – problem of information<sup>136</sup> asymmetry,<sup>137</sup> personal interest<sup>138</sup> and accordingly fulfillment of fiduciary liabilities.<sup>139</sup> Liability to have open information and prohibition to use information for the personal interests<sup>140</sup> is regulated at legislative level.<sup>141</sup> However, the above is regulated based on the liability to dispose information to public on annual or quarterly basis; the above information can be outdated for the given transaction.<sup>142</sup> The personal interest and fiduciary liabilities are synchronically related. If all information<sup>143</sup> related to the transaction to be executed is symmetric, it is not difficult to avoid the personal interest.<sup>144</sup> However, determination of adequacy of offered price and recommendation of best value offer to the shareholders<sup>145</sup> complicates the fulfillment of fiduciary liabilities. The above creates the founded doubt on the existence of personal interest. Court decision on *Revlon MacAndrews & Forbers Holdings* determined the best price for two main cases. The situations were described for the circumstances resulting in normal change of corporation control or corporation becoming part of such combination transaction, which resulted in *break-up of the corporate entity*.<sup>146</sup> However, at the same time the court made exemption: *Revlon* criteria do not cover the transactions considering the replacement of one controlling shareholder by another controlling shareholder.<sup>147</sup>

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<sup>135</sup> Cox J., *Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 137.

<sup>136</sup> Lee R., *What is An Exchange?*, New York, "Oxford University Press", 2000, 97-117.

<sup>137</sup> Davies P., *Hopt K.*, Control Transactions, New York, "Oxford University Press", 2009, 174.

<sup>138</sup> Cox J., *Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 137.

<sup>139</sup> Fleischer A., *Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 14, pp. 9-14.

<sup>140</sup> *Hazen T.L.*, The Law of Securities Regulation, 6<sup>th</sup> Ed., St. Paul, "West", 2009, 406-407.

<sup>141</sup> Fleischer A., *Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 14, pp. 22-25; compare: Williams Act, Sec. 13 (d), 1968.

<sup>142</sup> Davies P., *Hopt K.*, Control Transactions, New York, "Oxford University Press", 2009, 175.

<sup>143</sup> Information can be classified into two types: information that might be exchanged between the parties at the stage of conclusion of the deal, the retrospective and prospective view on the company activities, results and etc; the other type of information – right of the business entity as the *sue generis* to protect information about it which might be disclosed in any context. In the first instance protection of information is generally based on the contract agreement and the value of compensation in case of violation is determined; the second case is regulated by the legislation *ex ante*. Unlike USA, continental Europe has 1996 year directive regulating the above, under which *sue generis* right on information protection is considered under the guarantee context. See: Lee R., *What is An Exchange?*, 2000, 147-149.

<sup>144</sup> Cox J., *Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 137. For the definition of "Uninterested Director" see: *Radin S.*, The Business Judgment Rule, Vol. II, 2009, New York, "Wolters Kluwer Law & Business", 2314-2315.

<sup>145</sup> Similar type recommendations shall be made according to the rules determined by the National Bank. See: Article 15, Paragraph 3, Law on Securities Market, 1996.

<sup>146</sup> *Radin S.*, The Business Judgment Rule, Vol. II, New York, "Wolters Kluwer Law & Business", 2009, 2320-2325.

<sup>147</sup> *Ib.*, 2534.

Buyout price generally varies between the 30-50% of price of share to be purchased, which would be received by the shareholder in the form of premium value<sup>148</sup> as an additional payment.<sup>149</sup> Together with the fair determination of price the issue related to the reforming the capital structure often becomes the basis for the claim of the company creditors at the court.<sup>150</sup> Creditors, owners of debt securities (bondholders), protest against the formation of capital with the extraordinary amount of borrowed funds.<sup>151</sup> Protest is based on the speculative reduction of investment value of the bonds owned by the plaintiffs.<sup>152</sup> Accordingly, the above issues are related to the fraud deals<sup>153</sup> and violation of fiduciary liabilities.<sup>154</sup>

In addition to violation of fiduciary liabilities, creditor can start court process covering other directions too.<sup>155</sup> Creditor, instead of claiming against the violation of fiduciary liabilities in the process of capital structure formation, can qualify the mechanism of debt financing as hypocritical/fraudulent deal. There are two ways for qualification of the purchase as fraudulent deal. First – intention to cheat/deceive creditors. In the process of claim review the evidence for the above will be looked in the objective of acquisition of company via debt. Namely, if it is proved that the mandatory financing instead of improvement of entrepreneurial activities and satisfaction of creditors was directed towards the "transfer" into the ownership of shareholders, then the court will at a high probability qualify such action as fraudulent.<sup>156</sup> Second – if creditor justifies that it is bankrupt and the bankruptcy is unavoidable proceeding from the results of the transfer and as a result of exchange of securities it has not received fair equivalent and the principle of fairness was violated in the process of transfer procedure implementation, the deal is considered as fraudulent.<sup>157</sup>

As conclusion, we can state that absence of marginal boundaries between the forms of "friendly" takeovers causes the discrimination of their complex demonstrations. The general result of takeovers in terms of change in corporate structure does not go beyond the general framework. These forms, under the same circumstances and utilizing the positive characteristics of various procedural-

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<sup>148</sup> According to the economic analysis, payment of premium price to the shareholders at the stage of loan financing is "illusory". See: *Easterbrook F., Fischel D.*, *The Economic Structure of Corporate Law*, Harvard, "Harvard University Press", 1991, 138-139.

<sup>149</sup> *Wright M., Renneboog L., Simons T., Scholes L.*, *Leveraged Buyout in U.K. and Continental Europe: Retrospect and Prospect*, *Journal of Applied Corporate Finance*, Vol. 18, No. 3, 2006, 8-10, available at: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=934939](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=934939)>.

<sup>150</sup> *Haas J.J.*, *Corporate Finance*, New-York, "Thomson/West", 2011, 610-611.

<sup>151</sup> *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*, 716 F.Supp. 1504 (S.D.N.Y. 1989).

<sup>152</sup> *Haas J.J.*, *Corporate Finance*, New-York, "Thomson/West", 2011, 611; compare: *Klein W.A., Coffee J.C.*, *Business Organization and Finance*, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 192; *Fleischer A., Sussman A.*, *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 14, pp. 39-4.

<sup>153</sup> *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 60-63.

<sup>154</sup> *Ib.*, 137-140.

<sup>155</sup> *United States v. Tabour Court Realty Corp.*, 803 F. 2d. 1288 (3d Cir. 1986).

<sup>156</sup> There are many court decisions on this issue, e.g: *Protocomm Corp. v. Novell Advanced Serv., Inc.*, 171 F.Supp.2d 459 (E.D.Pa. 2001); *Pay N Pak Stores, Inc., v. Court Square Capital, Ltd.*, 141 F.3d 1178 (Cir. 1998).

<sup>157</sup> *Cox J., Hazen T.L.*, *Business Organizations Law*, 3<sup>rd</sup> Ed., New York, "Aspen Publisher", 2011, 630.

combinational mechanisms establish different relations in the process directed towards the implementation of fundamental changes in the corporate structure.<sup>158</sup>

#### 4.2. "Hostile" Takeover / Absorption<sup>159</sup>

Bid offer on purchase of shares is alternative and popular option for purchase of corporations.<sup>160</sup> The advantage for its implementation is related to the limited time required, caused by the fact that the management of the target company<sup>161</sup> is not participating in the process and the mechanisms for the protection of rights of minority shareholders is not guaranteed. There are several types of bid offer tactics,<sup>162</sup> which on its own represents the first or second stage in the several stage acquisition processes;<sup>163,164</sup> it is aimed at the exclusion of minority shareholders or transformation into the

<sup>158</sup> Despite the many MBO elements to be analysed, theoretical review of these elements, is beyond the subject of the research in two directions. First- for the purposes of corporate law, the demonstration MBO under debate is the relationship between the fiduciary liabilities and the interests of shareholders, as principles. Second, utilization of insider information and blocking the better offer based on the asymmetric information is classical example of limitation of effectiveness of *business judgmentrule*. Accordingly none of the above is subject of our research.

<sup>159</sup> Lipton M., Steinberger E., Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 1, pp. 25-27.

<sup>160</sup> Cox J., Hazen T.L., Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 145.

<sup>161</sup> In the definition of takeover it is unavoidable to define the substantial contents elements (and not etymological) of "target" company. The corporation is identified as "target" if: a) it has "weak" management; b) shares are dispersed among the shareholders and not held by one controlling party; c) the large portion of shares are held by the institutional investors; d) the shareholders are geographically spread, e.g. representing different regions or countries, which complicates attendance of majority at the general meetings; e) has very low debt liabilities; f) book value or the liquidation value is over its market value. See: *Troubh R.*, Characteristics of Target Companies, "Bus. Law. Rev.", No. 32, 1977, 1301; compare: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 14, pp. 3-4.

<sup>162</sup> Bid offer technique is diverse. Among the various techniques the following should be mentioned: 1. Saturday night specialoffer – no special notification is made to the management of target company and offer is valid for very short period of time; 2 Classic bear hug – the notification is forwarded to the management of target company, the offer to purchase shares at fixed price is made, however it does not contain the elements of publicity; 3. Strong bear hug – notification to the management of target company and public statement of the offer is made simultaneously; offer contains the clause on negotiations on the share price with the corporation or the management; 4. Super-strong bear hug – is identical to Strong bear hug with the difference that if the target company opposes or rejects the offer, the offer contains provision on the reduction of initially offered price for the share; 5. Block purchase – purchase of large number of shares is made in preparation of foundation for the next tender offer. See: *Freud J., Easton R.*, The Three-Piece Suit: An Alternative Approach to Negotiated Corporate Acquisitions, "Bus. Law Journal", Vol. 34, No. 4, 1979, 1679; *Gilson R.*, The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept, "Stan. Law. Rev.", No. 34, 1982, 775; *Hazen T.L.*, The Law of Securities Regulation, 6<sup>th</sup> Ed., St. Paul, "West", 2009, 379-380; *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 1, p. 36.

<sup>163</sup> Several stage acquisitions generally contains three main phases. First – purchase of large package of shares from group of shareholders or large institutional investors who do not hold the controlling package of shares. Stage two – acquirer makes the tender offer to the target company shareholders within the "friendly"

"closed" (private) corporation.<sup>165</sup> This is the legally regulated technical tool for the implementation of "hostile" takeover.

Potentially all companies are target companies for acquisition.<sup>166</sup> The dichotomy among the forms of takeover can be considered in two dimensions, separating the sub-types of such takeovers. The first is qualified with the motive for the acquisition of target company. If the objective of takeover is removal of competitor, change of management, partial or complete selling of businesses of target company or avoiding direct responsibility over the liabilities, it is qualified as "hostile" takeover in terms of motive of acquisition.<sup>167</sup> Second element – "cognitive" approach of target company towards the acquisition transaction, the above qualifies the target company as the subject of the takeover.<sup>168</sup> Based on the above the sub-type of takeover can be determined. Combination of motives, objectives of acquisition transaction, attitude of target company towards the deal is the basis for the development of takeover sub-types. If the motive and objective of target company acquisition is neutralizing the competitor, sale of specific segment or products produced by the target company, removal of target company from the geographically favorable market,<sup>169</sup> change of management, exclusion of minority shareholders and company destroying; If the management of target company is of the view that the acquisition transaction brings undesirable results and does not support or is against of such transaction, in other words has negative attitude towards the change of control in the company and does not recommend the shareholders to sell the shares, then such corporate combination directed towards the gaining the control over the target company is potentially viewed as "hostile" takeover or absorption.<sup>170</sup> In other words, the acquirer requires the gaining of control over the target company for the purpose of its "absorption"; such absorption is carried out under the conditions of resistance from the management and avoiding the management. "Hostile" takeover is especially effective when the distribution of shares between the target company shareholders is significantly dispersed.<sup>171</sup>

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takeover on purchase of shares. At this stage, due to the "friendly" nature of transaction, board of target company makes recommendation to the shareholders to sell the shares. Stage three – acquirer merges with the target company, as a result shareholders of target company receive cash, and the acquirer becomes owner of 100% of target company. See: *Gilson R.*, *The Law and Finance of Corporate Acquisitions*, New York, "Foundation Press", 1986, 820-821.

<sup>164</sup> As it was given in case against *Radol Toma*. See *Radol v. Tomas*, 534 F.Supp. 1302 (S.D. Ohio 1982).

<sup>165</sup> *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 146.

<sup>166</sup> *Fleischer A., Sussman A.*, *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 14, p. 3.

<sup>167</sup> *Vishny R.*, *Characteristics of Targets of Hostile and Friendly Takeovers*, Chicago, "University of Chicago Press", 1988, 101.

<sup>168</sup> *Betton S., Eckbo B., Torbun K.*, *Corporate Takeovers*, "Tuck School of Business Working Paper", No.2008-47, 2008, 2.

<sup>169</sup> ABA Section of Antitrust Law, *Mergers and Acquisitions*, 3<sup>rd</sup> Ed., New York, "American Bar Association", 2008, 97-101.

<sup>170</sup> *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 146.

<sup>171</sup> The separation of shareholders supports the hostile takeover, however it also has negative aspects for the acquirer. Following the tender offer, it is natural that all shares will not be purchased under one agreement. Number of individual transactions is required between the acquirer and shareholders of target company. The

Management is *ab initio* in relation to the decision on selling of shares.<sup>172</sup> However the management has *ex ante* mechanisms preventing the undesirable acquisition granted by the corporate law, such mechanisms are limited with the standards of fiduciary liabilities as in the process of implementation of controlled transaction.<sup>173</sup>

In brief, any attempt to "change" economic relationships, which starts by the collaborative analysis of marketing prospects by two or more corporations, causes the resistance of the management of one (target) company to "collaborate" with the potential acquirer. Regulation of relationships established under the economic-financial spectrum is achieved based on the corporate-commercial-tax (entrepreneurial) regulations. Based on the transfer of regulatory definitions into the doctrinal dimension the legal qualification of mentioned above economic-financial relationship is "hostile" takeover or absorption.<sup>174</sup> Mechanisms for neutralizing or avoiding its results logically are covered under the legal rules of corporations and capital markets,<sup>175</sup> with their informal technical capabilities.<sup>176</sup> Accordingly, any type of undesired change of the control is opposed by the defense tools deductible from the normativism.

#### **4.3. General Strategies for the Defense against Takeover and Reflection of their Results in the Structural Elements of Joint Stock Company**

Corporate law does not include the legal mechanisms for protection from the intended acquisition. Drafting the acquisition agreement against the management will, selling the shares of the

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other demonstration of complexity – remaining minority shareholders of target company; which results in the increased costs related to the "hostile" takeover. For example, if at the first stage of acquisition acquirer purchases controlling package of shares and moves to the implementation of second stage, in other words decides to freeze out minority shareholders, then he shall pay shareholders higher price compared with the price paid at the first tender offer. Fair price of shares held by minority shareholders is the highest price paid by him/her for the company shares for the specific period of time. This with the high probability is the price paid by acquirer for the controlling package of shares during the first two stages of takeover. See: *Depamphilis D.*, *Mergers, Acquisitions, and Other Corporate Restructuring Activities*, 5<sup>th</sup> Ed., Oxford, "Academic Press", 2010, 21. Compare: *Massari M., Monge V., Zanetti L.*, *Control Premium in the Presence of Rules Imposing Mandatory Tender Offers: Can It be Measured?* "IAFC Universita Bocconi Working Paper", 2004. 5-8, available at: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=683277](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=683277)>. However there are exceptions considered under the federal legislation. If acquisition was from the beginning implemented through two stage tender offer, so called Two-Tiered Offer and in the process of implementation of first stage the information was available on its general intention and plans including the information that he planned at the second stage to complete the transaction via the merger, then according to the federal legislation, it is possible at the second stage to purchase shares at a lower price compared with the price paid at the first stage. Offer made at this stage is so called Two-Tiered front-end loaded offer. See: *Hazen T.L.*, *The Law of Securities Regulation*, 6<sup>th</sup> Ed., St. Paul, "West", 2009, 409.

<sup>172</sup> Compare: *Oesterle D.A.*, *Mergers and Acquisitions*, St. Paul, "West Publishing", 2006, 273.

<sup>173</sup> *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 147.

<sup>174</sup> *Hazen T.L.*, *The Law of Securities Regulation*, 6<sup>th</sup> Ed., St. Paul, "West", 2009, 378.

<sup>175</sup> *Ib.*

<sup>176</sup> *Gevurtz F.*, *Corporation Law*, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 704.

company and hostile bid offer requires existence of mechanisms for their neutralization, as opposing the management body might be based on the preliminarily determined view on the corporate capabilities and prospects of the company,<sup>177</sup> which is not within the interests of the shareholders and the company. In the similar situation, there are various defense mechanisms held by the company management, *quo warranto* utilization of which is ensured by the implicit norms of the corporate law.<sup>178</sup> Utilization of anti-acquisition mechanisms by the management are reinforced by the court practices, however only in cases when such offer is reviewed within the fiduciary liabilities and checks if such offer is within the best interests of the corporation and shareholders.<sup>179</sup>

The essential utilization of defense mechanisms is related to two opposite however thematically similar issues. If the company management is given the opportunity to oppose, the management will reduce the net potential income of the offerer.<sup>180</sup> Delaware corporate law gives the direct mandate to the directorate by the granting the permission to "simply reject the transaction",<sup>181</sup> if the board believes that it is more appropriate to retain the independence and existence of legal entity.<sup>182</sup> In contrary to the above all target companies become the subjects to the wide monitoring due to the acquisition process if the implementation of defense is not possible.<sup>183</sup> In parallel, granting the defense authority to the management can be used as the mechanism for retaining their positions in the company.<sup>184</sup>

The economic paradigm of the market opposes the legal realities. Seller or his/her representative, as the fiduciary entity is liable to achieve the highest price for the sale as a result of bargaining. The seller will not be able to bargain if he/she does not have right to reject the offer. And the above is the postulate given beyond the corporate law area.<sup>185</sup> Therefore, the defense means relevant to each specific acquisition shall be selected under the marginal differentiation of economic paradigm and legally determined fiduciary liabilities.

There are several important tools held by the management for avoiding the acquisition or making right decision, under the collision of the best offer and interests of corporation/shareholders.<sup>186</sup>

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<sup>177</sup> This is a principle "management knows best". See: *Gilson R.*, *The Law and Finance of Corporate Acquisitions*, New York, "Foundation Press", 1986, 756-765.

<sup>178</sup> *Hazen T.L.*, *The Law of Securities Regulation*, 6<sup>th</sup> Ed., St. Paul, "West", 2009, 408-411.

<sup>179</sup> This the best known court resolution made by the Delaware supreme court in 1985: *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953-954.

<sup>180</sup> *Easterbrook F., Fischel D.*, *The Proper Role of Target's Management in Responding to a Tender Offer*, "Harv. L. Rev.", 1981, 94-1161.

<sup>181</sup> *Radin S.*, *The Business Judgment Rule*, 6<sup>th</sup> Ed., Vol. III, New York, "Wolters Kluwer Law & Business", 2009, 3244-3258.

<sup>182</sup> *Betton S., Eckbo M., Torbun K.*, *Corporate Takeovers*, "Tuck School of Business Working Paper", No.2008-47, 2008, 44-46.

<sup>183</sup> *Haddock D., Macey J., McChesney F.*, *Property Rights in Assets and Resistance to Tender Offer*, in: *Corporate Law an Economic Analysis*, *Bebchuk L.*, (Ed.), New York, "Cambridge University Press", 1990, 118.

<sup>184</sup> *Easterbrook F., Fischel D.*, *The Proper Role of Target's Management in Responding to a Tender Offer*, "Harv. L. Rev.", 1981, 1175.

<sup>185</sup> *Haddock D., Macey J., McChesney F.*, *Property Rights in Assets and Resistance to Tender Offer*, "Va. L. Rev.", 1987, 119.

<sup>186</sup> Compare: *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 147.



Such mechanisms are classified under two directions. The first – these are defense strategies based on the property<sup>187</sup> and second – defense means against the acquisition based on the liabilities.<sup>188,189</sup> We'll focus on several mechanisms of defense against the hostile acquisition. Among such mechanisms we must mention<sup>190</sup> such strategies based on the property as "shark repellent" tactics, "golden parachute" tactics "greenmail" tactics and "poison pill" tactics.<sup>191</sup>

#### 4.3.1. "Shark Repellent" Tactics

Defense against the acquisition is under the fiduciary liabilities of the directors; the above enables the management to protect the "rule" in the company using the material resources freed up from the corporation. Defense means are divided into two categories: response to the acquisition and acquisition prevention means.<sup>192</sup> The common characteristic of both tactics is implementation of such tactics, which are only under the competence of the board and does not require consent or decision of the general meeting of shareholders.<sup>193</sup>

The "Shark repellent" tactic is essentially different type of tactics among the diverse forms of defense; this is preventive defense mechanism.<sup>194</sup> According to its legal basis, this is corporate-legal method of defense against the takeover, which is reflected in the statutes of the company, forming and regulating the organizational structure of the company.<sup>195</sup> Under this tactics, the structural changes are entered in the statutes, which change the organizational basis of the company and structure of the management.<sup>196</sup> In general, reflection of defense mechanisms in the statutes is made until the stage, when the shares are placed at the securities market for the public trade or as soon as the company is transformed into the "open" company or at least before the "hostile" bid offer is made.<sup>197,198</sup> Decision of the general meeting of shareholders is required for the changes to the statutes; however such

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<sup>187</sup> So called "asset-based defensive strategies".

<sup>188</sup> So called "liability-based defensive strategies".

<sup>189</sup> See: Haas J.J., Corporate Finance, New-York, "Thomson/West", 2011, 709-717.

<sup>190</sup> We shall distinguish the leveraged capitalization among the defense tactics based on the liabilities, when the target company takes large amount of loan secured by its own assets.

<sup>191</sup> Thomson S., Business Planning For Mergers and Acquisitions, 2<sup>nd</sup> Ed., Durham, "Carolina Academic Press", 2001, 977.

<sup>192</sup> Cox J., Hazen T.L., Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 147.

<sup>193</sup> *Ib.*, 148.

<sup>194</sup> "Shark repellent" tactics is also referred to as "porcupine".

<sup>195</sup> Haas J.J., Corporate Finance, New-York, "Thomson/West", 2011, 702.

<sup>196</sup> Lipton M., Steinberger E., Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 6, pp. 26-28.

<sup>197</sup> *Ib.*, Chap. 6, p. 26.

<sup>198</sup> Here the "Breakthrough rule" becomes effective; this is innovative term introduced by the group of high level experts of EU legal reforms in the area of corporate law. See: Hertig G., McCahery J., Company and Takeover Law Reforms in Europe: Misguided Harmonization or Regulatory Competition? In: After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US, Armour J., McCahery J., (Eds.), Oxford, "Hart Publications", 2006, 565-568.

decision is not required for implementation of such changes.<sup>199</sup> Combined decision at the stage of prevention of potential takeover, in case of attempt of takeover gains the nature of aggressive defense.<sup>200</sup>

There are three forms of demonstration of changes to the statutes based on "*Shark repellent*" tactics.<sup>201</sup> First, corporate-legal type of changes to the statutes prevents the change of control right in the corporation.<sup>202</sup> The above relates to the mechanisms prohibiting the change of board of directors. At the stage of potential takeover, management analyses the danger to its position (*staggering*). Tactics consider the establishment of classified board.<sup>203</sup> Existence of classified board increases the period of full re-election of the management and complicates the procedure. Namely, first of all, the dismissal of the director requires the legal basis; however if the director is dismissed, then the board retains the authority to fill up the vacant position.<sup>204</sup> According to the deductive definition of the classified board, re-selection of elected board, which is generally elected for up to three years period,<sup>205</sup> cannot be made at higher than 1/3 proportion. The re-election of classified board is not possible without legal basis,<sup>206</sup> if not otherwise considered by the statutes.<sup>207</sup> Moreover, the statutory provisions limiting the increase of number of the board/directorate are also considered.<sup>208</sup> In the event of first type "*shark repellent*" the procedures for the initiating and convening the general meeting of shareholders becomes more complicated in the process of acquisition. The purpose of the above is to avoid initiation of general meeting of shareholders by the majority shareholders within the specific time-period<sup>209</sup> or to avoid the dismissal of directors based on the written consent from the

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<sup>199</sup> Haas J.J., Corporate Finance, New-York, "Thomson/West", 2011, 702-703.

<sup>200</sup> Fleischer A., Sussman A., Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 6, p. 9.

<sup>201</sup> *Ib.*, Chap. 6, p. 4.

<sup>202</sup> Gilson R., The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 633.

<sup>203</sup> Lipton M., Steinberger E., Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 6, pp. 28-29.

<sup>204</sup> Cox J., Hazen T.L., Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, p. 149.

<sup>205</sup> In Georgia this term (timeframe) is under the charter and contract autonomy and is equivalent to results fitted to each specific case.

<sup>206</sup> However in one of the decisions, Delaware court has not taken into account existence of classified board and deemed the shareholders as authorized persons to make changes to the statutes on the annulation/termination of classified directors and then to dismiss directors from their positions without groundings. Moreover, it was noted that defense of classified board at charter level is possible via the establishment of requirement for qualified majority for the changes to statutes. See: *Roven v. Cotter*, 547, A.2d 603 (Del. Ch. 1988). Also see: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 6, pp. 28-30; *Thomson S.*, Business Planning For Mergers and Acquisitions, 2<sup>nd</sup> Ed., Durham, "Carolina Academic Press", 2001, 1018-1019.

<sup>207</sup> Lipton M., Steinberger E., Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 6, p. 29.

<sup>208</sup> Haas J.J., Corporate Finance, New-York, "Thomson/West", 2011, 703.

<sup>209</sup> In the process of takeover, it is possible that convening of special/extraordinary shareholders meeting for changes to the statutes has specific time limitations. In one of the court decisions, it was noted that such meeting cannot be convened earlier than 90-100 days. (from the start of takeover process). See: *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25, 40-41 (Del. Ch. 1988).

shareholders.<sup>210</sup> The management under the conditions of prevention from the potential takeover and "looking after" their own position can convince the general meeting of shareholders to establish the provisions on decision making on the above mentioned changes based on the qualified majority.<sup>211212</sup>

The second package of statutory changes comprise of such artificial barriers, as quantitative indicator of votes for voting at the second stage of two-stage acquisition transaction. Namely if the target company decides following the bid offer to create the subsidiary company instead of target company, as a result of the merger, then the merger adaptation will require the consent from the qualified majority.<sup>213</sup> Definition of maximal number of qualified votes generally is calculated based on the shareholders who systematically attend the ordinary or extraordinary general meetings.<sup>214</sup> Precondition for establishment of such provision is the lot of shares held by the management (jointly), which is sufficient for blocking the decision on merger based on qualified majority.<sup>215</sup> Corporate combination of merger, based on the legislative regulations, requires the decision from the shareholders' meeting. Therefore, if at the second stage of takeover the acquirer decides to dismiss the minority shareholders, and the management is able to block the decision,<sup>216</sup> then such tactical move will temporarily hinder the achievement of objective by the acquirer via the successful bid offer.<sup>217</sup>

And finally, third type of changes to the statutes considers provisions on fair price. Such changes differ from the above two.<sup>218</sup> Statutory precondition on fair price differs from the above discussed measures based on the prevention purposes. The main purpose of the above discussed two sub-types was protection of interests of the target company board; however the latter considers the protection from the "rider"<sup>219</sup> as well as creation of more value for the shareholders.<sup>220</sup> Fair price provisions may relate to the approval of merger based on the qualified majority at the second stage of two-stage acquisition.<sup>221</sup> Changes related to the fair price and provisions related to the merger intersect,<sup>222</sup> when

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<sup>210</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 705.

<sup>211</sup> *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 6, pp. 30-31.

<sup>212</sup> *Thomson S.*, Business Planning For Mergers and Acquisitions, 2<sup>nd</sup> Ed., Durham, "Carolina Academic Press", 2001, 1012-1014, 1021-1027.

<sup>213</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 148-149.

<sup>214</sup> *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 633-634.

<sup>215</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 150.

<sup>216</sup> Only under condition when the acquirer company does not have competence to replace "old" board (again proceeding from the same statutes) which was formed before the bid offer to the target company.

<sup>217</sup> *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 634.

<sup>218</sup> Compare: *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 634.

<sup>219</sup> Same as acquirer entity, company implementing acquisition. See: *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 1, p. 10.

<sup>220</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 150.

<sup>221</sup> *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 6, p. 32.

<sup>222</sup> They are also referred to as Lock-in provision. See: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 6, p. 50.

the implementation of merger of the target company with the *related person*<sup>223</sup> starts.<sup>224</sup> Decision on such merger shall be made by qualified majority, which must compensate the shareholders to be "dismissed" at least with the volume determined under the provision on fair price.<sup>225</sup> "Price" determined under the statutory provision is often quite high. It is close to the highest price, which was paid by the acquirer to the shareholders holding the shares with voting rights or the price which was fixed during the last few years of trading with shares of the target company or is based on the estimation of future potential revenues.<sup>226</sup> Precondition for execution of provisions on the qualified majority and fair price is acquisition of majority of voting shares or controlling package of shares by the acquirer and its objective must be the completion of second stage of two-stage takeover.<sup>227</sup> In brief, the statute covers the procedures complicating the two-stage acquisition process.

The third type of "Shark repellent" changes to the statutes is the right on share buyout.<sup>228</sup> This tactic following the bid offer protects the interests of those shareholders who did not sell their shares to the acquirer. The above type provision ensures the liability of any person participating in the second stage of share purchase, to purchase the shares at fair and preliminarily determined (in the statutes) price owned by the shareholders, despite the fact whether the implementation of merger combination has started or not.<sup>229,230</sup> The above mentioned provisions belong to the category of mechanisms of defence against the takeover allowed at the legislation level.<sup>231</sup>

#### **4.3.2. "Poison Pill" Tactics**

The evolution of "Poison pill" tactics made this type of tactics as the most popular and widely spread tactics among the means of defense against the takeover. Despite the stronger "fatal" effect of other protection mechanisms, which are at some level reinforced by the court decision,<sup>232</sup> "poison pill" remains as the effective mean for the protection against the takeover. This is tactical response against the forced takeover and gives the board of target company the means to give the relevant response to the "hostile" purchase offer.<sup>233</sup> However it is not panacea for stopping the takeover process.<sup>234</sup>

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<sup>223</sup> So called related person. According to general definition, this is a person holding the certain number of shares in the company. See: *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 705. Definition of related party is given in article 2, paragraph 11 of law on Securities Market, it relates the fact of owning of controlling package of shares to the relative relationship.

<sup>224</sup> *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 680-681.

<sup>225</sup> *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 6, 34.

<sup>226</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 705-706.

<sup>227</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 6, pp. 48-52.

<sup>228</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 150-151.

<sup>229</sup> *Gevurtz F.*, Corporation Law, 2<sup>th</sup> Ed., St. Paul, "Thomson Reuters", 2010, 706.

<sup>230</sup> Comp. Article 53<sup>1</sup>, Paragraph 1, Law on Entrepreneurs.

<sup>231</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 718-725.

<sup>232</sup> *Thomson S.*, Business Planning for Mergers and Acquisitions, Durham, "Carolina Academic Press", 2001, 987-992.

<sup>233</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 5, p. 5.

<sup>234</sup> *Ib.*, 15.

"Poison pill" tactics has undergone the long development period. Still its general formula at court or doctrinal levels has been developed.<sup>235</sup> This is *ex ante* mean for the prevention of takeover. The term "poison pill" describes the management granting to the shareholders such rights,<sup>236</sup> which in the event of creation of specific circumstances related to the rejected acquisition grants the special economic value to the significant positions of the company owners.<sup>237</sup> Following the establishment of economic value of the right, which considers the receiving of property or cash from the company or the "rider", the completion of acquisition without using this mechanism becomes impossible and the "rider" is not able to "absorb" the target company without swallowing the "economic pill" (economic value) of the company which shall be transferred to the shareholders as a result of implementation of above mentioned right.<sup>238</sup>

"Rights' plan" is the most widely spread form of the "poison pill" tactics reinforced by the court precedents.<sup>239</sup> Rights' plan does not include the transactions subject to the negotiations.<sup>240</sup> It influences the final results of the acquisition offer rejected by the board. Moreover it ensures the achievement of agreement between the target company board and the acquirer company management.<sup>241</sup> The result is

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<sup>235</sup> Thomson S., *Business Planning For Mergers and Acquisitions*, 2<sup>nd</sup> Ed., Durham, "Carolina Academic Press", 2001, 998-1009.

<sup>236</sup> Target company directorate using the defence mechanism acts within so called "blank stock" authority, which proceeds from the implicit provisions of the statutes giving directors the ability to issue new class preference shares or make rights' restructuring for this type of share, from time to time. Essence of "blank stock" is the mechanism of share issue. Prior to the placement of shares by the company, either ordinary, preference or hybrid ones, such placement shall be authorized at the statutes level, in other words the maximum permitted number of shares to be issued shall be determined. The above can be carried out in two ways. The first option - the statutes considers the catalogue of rights of the shares. For issuing of any additional shares the necessary requirements for the adherence to the formal procedure is defined, which includes the decision of shareholders on the increase of capital via the share issue and amendments to the statutes. At the following stage the directorate becomes competent to issue authorized additional shares to third party. Second option – the statutes defines the specific boundaries for the competences of directorate. Director is given authority to determine on unilateral basis type, rights and class of new shares. In the latter case, directorate does not have requirement for the shareholders' meeting, making the issue of new shares as flexible mechanism and increasing the mobility of corporation actions. Therefore, this is one of the most important methods for the implementation of "poison pill" tactics. See: *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, 2010, 406-408; *Fletcher W.*, *Fletcher Cyclopedia of the Law of Corporations*, Rev. Ed., Vol. 11, 2011, 466-467. Authority of "blank stock" is defined under article 59, paragraphs 4, 5 and 6 of Law on Entrepreneurs.

<sup>237</sup> *Fleischer A., Sussman A.*, *Takeover Defense*, Vol. I, Chap. 5, New York, "Aspen Law & Business", 2000, 6.

<sup>238</sup> Compare: *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 165-167.

<sup>239</sup> *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985). According to this decision, Delaware supreme court considered "Poison pill" "*flip-over*", as the analogue to the provisions against the devaluation, which are used for the protection of owners of securities in the process of merger. This resolution specifically reinforces the provisions/ principles listed in well-known decision on *Unicol*. See: *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 168. On the principles of *Unicol* see: *Fleischer A., Sussman A.*, *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 3, pp. 6-9.

<sup>240</sup> At least at the first stage of transition execution.

<sup>241</sup> *Lipton M., Steinberger E.*, *Takeovers & Freezeouts*, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p. 59.

payment of higher price to the target company shareholders<sup>242</sup> compared with the regular premium price paid for the control achievement.<sup>243</sup> The essence of "poison pill" is in the simplified procedure for its issuing. For the above the management shall make decision on the plan.<sup>244,245</sup>

For the acquirer company it causes the increasing price of the acquisition transaction via the devaluation of shares for the company shareholders. Devaluation covers two segments. First, it causes the reduction of voting right of the target company owned by the acquirer company, in other words, the legal type influence will be in place. The second – it causes increase of economic value via the increase of share price for the potential buyer. Accordingly, structure of "poison pill" can be divided into "voting pill" and "economic pill". In the first instance, which is referred to as a plan on the dividend of convertible preferential share,<sup>246</sup> the voting right proceeding from the shares changes in the way that<sup>247</sup> the obstacles are created for the "invader" in convincing the shareholders to accept the acquisition transaction, which was not accepted by the board.<sup>248</sup> On the other hand, the economic pill, defining the "financial fines" for the acquisition can be divided into two groups.

First - *stock purchase pill* or *share purchase rights plan*,<sup>249</sup> which gives the shareholder right to additionally purchase shares at a significant discount after the takeover is declared and it is not positively accepted by the board of target company.<sup>250</sup> The other demonstration of the "economic pill" is so called "*put pill*" or "*back-end pill*",<sup>251</sup> which equips the shareholder with the right to receive the cash or high value securities for the goods owned by him/her if the acquisition transaction "rejected" by the board *failed to meet price goals*.<sup>252</sup>

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<sup>242</sup> Thomson S., *Business Planning for Mergers and Acquisitions*, 2<sup>nd</sup> Ed., Durham, "Carolina Academic Press", 2001, 1002-1006.

<sup>243</sup> Lipton M., Steinberger E., *Takeovers & Freezeouts*, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p.58.

<sup>244</sup> Gevurtz F., *Corporation Law*, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 706. Compare: Fleischer A., Sussman A., *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 6, 33-49; Klein W.A., Coffee J.C., *Business Organization and Finance*, 10<sup>th</sup> Ed., New York, "Thomson Reuters/Foundation Press", 2007, 185-189.

<sup>245</sup> Competence of directors in relation to the adaptation of shareholders' rights plan is under their fiduciary liabilities, violation of which was subject to many court cases. See: Radin S., *The Business Judgment Rule*, 6<sup>th</sup> Ed., Vol. III, New York, "Wolters Kluwer Law & Business", 2009, 3125-3203.

<sup>246</sup> Lipton M., Steinberger E., *Takeovers & Freezeouts*, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p. 60.

<sup>247</sup> The demonstration of voting right pill is issuing the new preferential shares and their distribution among the shareholders, excluding the acquirer. Distribution is implemented on *pro rata* basis. The newly issued preferential shares will have special voting rights. Fleischer A., Sussman A., *Takeover Defense*, Vol. I, Chap. 5, New York, "Aspen Law & Business", 2000, 38-39.

<sup>248</sup> Fleischer A., Sussman A., *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 5, p.38.

<sup>249</sup> Lipton M., Steinberger E., *Takeovers & Freezeouts*, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p. 61.

<sup>250</sup> Fleischer A., Sussman A., *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 5, pp. 40-41, 49-50.

<sup>251</sup> Lipton M., Steinberger E., *Takeovers & Freezeouts*, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 6, p. 96.

<sup>252</sup> Fleischer A., Sussman A., *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 5, pp. 34, 41-48.

At present the most popular form of "poison pill" is "flip-in" or "flip-out" status of catalogue of shareholders' rights,<sup>253</sup> which is especially often used in case of two-stage acquisition.<sup>254</sup> Despite the fact that there is no unified model version of the above, conceptually it consists of several stages. At the first stage, prior to any projection on any type of takeover transaction, the board of directors makes decision to issue the right to purchase one share for each ordinary share.<sup>255</sup> The granted right does not have any economic value until the "rider" attains the controlling indicator of voting shares in the target company<sup>256</sup> avoiding the board involvement. At this stage, the "rider" gets the status of "owner rejected by the board" which triggers the special authority of remaining shareholders. Under the activated authority the shareholder can purchase additional voting package of shares at 50% discount compared with the market price of the share.<sup>257</sup> Finally, if following the "flip-in" the target company starts participation in corporate combination with any person or involves itself into the sale of substantial part of the property, all shareholders of the target company (except for the "rider") are automatically granted the authority to purchase the packet of shares with the "strongest" voting rights from the corporation established as a result of the transaction at 50% discount price compared with the market price.<sup>258</sup> The precondition for utilization of *flip-over* are the realized results of *flip-in*.<sup>259</sup> *Flip-over* covers the corporate combination, when the target conversion or exchange of target company's shares is implemented, or the substantial portion (generally 50%) of the property or up to 50% of property producing the largest portion of company's revenues is sold. Despite the fact that the precondition for utilization of *flip-over* is *flip-in*, which (*flip-in*) was activated by the acquirer company via the declaration of bid offer, it is not necessary to have it as a the party to the *flip-over* transaction.<sup>260</sup> The transaction opens to the shareholder with the right to use the "poison pill" to utilize the remaining part

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<sup>253</sup> Compare: *Radin S.*, The Business Judgment Rule, 6<sup>th</sup> Ed., Vol. III, New York, "Wolters Kluwer Law & Business", 2009, 3136-3182.

<sup>254</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 706.

<sup>255</sup> In the Georgian legislation decision requires consent from the general shareholders' meeting, as it is realized in terms of dividend issue. Issue of dividends is implemented by the management. However if otherwise considered by the statutes the authority to distribute profits may be given to the board of directors. See article 8 and article 54, paragraph 6, sub-paragraph d) and the last paragraph (sentence), law on Entrepreneurs

<sup>256</sup> Usually, this is 15% or 20%. In Georgian legislation controlling package considers passing the minimum 10% indicator.

<sup>257</sup> This is classical "flip-in". For illustration, if the initial price of company's ordinary share was USD100, and 30 business days before the "flip-in" its average trade price equaled to USD25, the shareholder's right allows him to purchase ordinary share with the value of USD 200 at USD 100; as a result he will become owner of 8 shares (200 : 25), and the purchase price for one share will be – 12.50\$ (100\$ : 8). See: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 5, p. 61; *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p. 86.

<sup>258</sup> The latter is so called "flip-over".

<sup>259</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 707.

<sup>260</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 5, p. 62.

of the right. The shareholder is given the right to buy at 50% discount<sup>261</sup> the securities with the best voting rights in the mother corporation which was established as a result of transaction.<sup>262,263</sup>

The tactical nature of "*dead hand*" tactics<sup>264</sup> has to be also mentioned.<sup>265</sup> After the acquirer reaches the specific percentage indicator of target company, he may start gradual replacement of target company board and establish new management.<sup>266</sup> The provision determined under the "*dead hand*" tactics limits the authority of newly established board of directors to buyout the rights plan approved by the previous board and the securities determined under such plan.<sup>267</sup> Utilization of such tactics of creation of new board (members of the board are candidates from the acquirer) by the acquirer is directed towards the attempt to convince the shareholders who will later buyout shares determined under the "*poison pill*" provision and make the procedural execution of bid offer easier.<sup>268,269</sup>

Despite the fact that the range of defense means under the "*poison pill*" is diverse, their concept is demonstrated in the preventive actions against the takeover. Prevention is not directed towards the avoiding the takeover, but towards the gaining the maximal revenue.<sup>270</sup> It also influences the market value of the share.<sup>271</sup> More importantly, its adaptation does not require consent from the shareholders meeting<sup>272</sup> and its implementation, generally, is carried out in the period preceding the start of takeover process without substantial changes made to the capital structure.<sup>273</sup>

#### **4.3.3. "*Golden Parachute*" Tactics**

Post-transactional period following the company takeover has substantial impact over the employment conditions of company employees.<sup>274</sup> Often, as a result of takeover, dismissal of employees is

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<sup>261</sup> As it was calculated at the *flip-in* stage. See the present article, reference 257.

<sup>262</sup> We have the typical "reverse – triangle" merger: acquirer forms so called "shell" corporation which is the intermediary unit of the acquisition. At the following stage, "shell" corporation merges with the target corporation, and the target corporation becomes the 100% subsidiary company of mother company/ acquirer company. Above mentioned right on purchase of voting rights considers the mother JSC formed as a result of transaction. See: *Oesterle D.A.*, Mergers and Acquisitions, St. Paul, "West Publishing", 2006, 25-26.

<sup>263</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 5, pp. 61-62.

<sup>264</sup> *Haas J.J.*, Corporate Finance, New-York, "Thomson/West", 2011, 706-708.

<sup>265</sup> *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p. 92.

<sup>266</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 169.

<sup>267</sup> *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 707.

<sup>268</sup> *Thomson S.*, Business Planning For Mergers and Acquisitions, 2<sup>nd</sup> Ed., Durham, "Carolina Academic Press", 2001, 1001-1006.

<sup>269</sup> Compare: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 5, pp. 108-125.

<sup>270</sup> *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p. 67.

<sup>271</sup> *Ib.*, Chap.6, pp. 68-69.

<sup>272</sup> *Ib.*, 63-64.

<sup>273</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 168.

<sup>274</sup> "Employees" consider not only the labour of the enterprise but also directors working in the management and executive officers and etc. See: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 7, p. 11.



expected grounded by their surplus quantity, or as a result of changes in the management, or for the reduction of costs for the acquirer corporation, in other words with the objective to increase its revenues. Under the condition of undesired takeover potential, the management of Target Company usually tries<sup>275</sup> to consider the effect of change in control in the remuneration plan for employees.<sup>276</sup> The plan adaptation does not require decision from the general meeting of shareholders unless for exceptional cases, when the company does not want to avoid the securities regulations or requirements of stock exchange.<sup>277</sup>

In general, it is possible to protect company employees via the agreement of benefits and compensation. Well planned and developed remuneration protection plan serves and protects value creation for the shareholders in several ways. First, via the encouragement and protection of retention of employees on the positions; second – "calming" the employees regarding the concerns on reduction of remuneration and their dismissal, supporting the continuation of usual business in the company; third – future work prospects for the talented management of the company, or if the company will be taken over – paying the promised remuneration; and finally fourth – allowing the employees to act in the best interest of the company and shareholders in the event of bid offer made on the company takeover, however excluding the inclination towards the personal interests.<sup>278</sup> It has to be mentioned that definition of such type general benefits is not the mean for defense against or avoiding the takeover.<sup>279</sup> It mainly protects the grounded expectations of the employees; protects the promises regarding the agreed remuneration made based on the agreement provisions; prevents acquirer from the frustrating established practices related to the remuneration and income generation and protects employees from the results of unplanned termination of agreements following the takeover.<sup>280,281</sup>

The specific demonstration of the above is the main power working at the management level, actions of whom determine the correct corporate and marketing management of target company,<sup>282</sup> and whose interests are somehow insured via the conclusion of specific agreement with the corporation (in other words with the employer). Such agreement is the method of remuneration<sup>283</sup> which might be

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<sup>275</sup> If, of course, its corporate management is in accordance with the best practice standards.

<sup>276</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 7, p.5.

<sup>277</sup> *Ib.*, 12.

<sup>278</sup> *Ib.*, 5.

<sup>279</sup> Whether the "golden parachute" is defense means – is the subject of debate in the legal doctrine. There is a view that this is a way to avoid conflict of interest of shareholders and management of Target Company at the stage of takeover. For the illustration of method for avoiding conflict of interests the diversification of investment portfolio is used. If the target subjects of such tactics are large number of employees then it will significantly increase the costs related to takeover for the acquirer. See: *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 670-671.

<sup>280</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 7, p. 6.

<sup>281</sup> Listed circumstances cover the resigning from work and are positively referred to as "*parachute*", which describes the secure landing with the parachute.

<sup>282</sup> Case when the key personnel of the management are insured against the results of takeover is referred to as "*golden parachute*". See: *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap. 6, p.13.

<sup>283</sup> This method of remuneration in terms of tax is taxable. This type of compensation is ordinary income, accordingly comes under the taxable categories. See: *Thomson S.*, Business Planning For Mergers and Acquisitions, 2<sup>nd</sup> Ed., Durham, "Carolina Academic Press", 2001, 1035.

considered in the employment contract or separate<sup>284</sup> agreement.<sup>285</sup> Accordingly, it is legally effective for the specific time period.<sup>286</sup> The main determining factors of the above are the agreement provisions, according to which manager or executive director, in case of dismissal or termination of authority due to the expiration of specific time, as a result of takeover, must receive the remuneration envisaged under such provisions.<sup>287</sup> Such type of agreement is guarantee mechanism for protection of company employees with the objective to neutralize the results of change in control. Therefore it is referred to as "protection of benefits" or "benefit" plan.<sup>288</sup> The agreement provisions become effective following the change of control in the company.<sup>289</sup> Management via such agreement prevents the cases when he/she may not wish to continue management of entrepreneurial activities under the new owner/controller, at least due to the lack of trust and collaboration experience, unlike the relationship established with the previous owner.<sup>290</sup>

The latter mean of defense against the takeover, on the one hand, prevents the changes in organizational, strategic and structural units due to the higher price for the option to acquire the target company and in the mechanism for retaining these elements in the initial form, and on the other hand, provides the company employees with the possibility to receive some compensation due to the modifications in the established organizational units (management, employees) which were result of changes in the strategic structural elements of the company.

#### **4.3.4. "Greenmail" Tactics**

The list of defense mechanisms, due to the variety of composing elements, is quite long. Targeted definition of written or unwritten rights under the competence of the board<sup>291</sup> establishes the specific defense method. The method contents are determined under the condition of management of funds freed up from the company by the management and by this development of strategies protecting the company from undesired acquisition.<sup>292</sup>

The bid offer on purchase of controlling shares in the target company requires the "response", action.<sup>293</sup> There are two types of responses: self-defense tactics or neutralization of takeover attempts

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<sup>284</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 7, p. 14.

<sup>285</sup> *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p. 12.

<sup>286</sup> Typical example of effectiveness of agreement provisions is one to three years period. See: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 7, pp. 14-15.

<sup>287</sup> *Lipton M., Steinberger E.*, Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, p. 13.

<sup>288</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 7, pp. 9-10.

<sup>289</sup> *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 670.

<sup>290</sup> *Ib.*, 671.

<sup>291</sup> Compare: *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 3, New York, "Aspen Publisher", 2010, pp. 406-407.

<sup>292</sup> *Haas J.J.*, Corporate Finance, New-York, "Thomson/West", 2011, 709.

<sup>293</sup> It has to be mentioned that Target Company can develop anti-tactics to the "Greenmail" tactics at statutes level. Namely, the company statutes can envisage that the authority to purchase the voting shares owned by

and modified acceptance of offer.<sup>294</sup> "Green mail" tactics belong to the first category. Following the identification of bid offer for the target company, the directors of the target company have opportunity to make the response, to "attack" the "rider". Based on the board decision, company purchases at a premium price the shares of Acquirer Company in the company potentially implementing the "hostile" takeover.<sup>295</sup> The tactic is implemented using the funds created from company's free resources. As a result of share buyout, target company does not any more face the danger of takeover from the potential buyer, as the latter does not anymore own shares in the target company.<sup>296</sup> The problem related to the co-existence of the above conditions<sup>297</sup> is connected with the fulfillment of fiduciary liabilities by the directors and sharp reduction of target company share price following the transaction.<sup>298</sup> Board of directors must approve that buyout was implemented with the consideration of the best interests of the company.<sup>299</sup> In other case, they will be protected under the *business judgment rule*.<sup>300</sup> Moreover the negative aspect of the above method is taxation issues created.<sup>301</sup> The changes made to USA taxation legislation in 1986, prohibited the disposal of any amount of funds related to

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the acquirer is granted to the directors only based on the shareholders' decision. See: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap.6, pp. 52-54.

<sup>294</sup> "Golden parachute", "Poison pill" and partially "Shark repellent" are generally modified acceptances with the improved conditions.

<sup>295</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., New York, "Aspen Publisher", 2010, Vol. 4, p. 175.

<sup>296</sup> However, freezing out by purchase of shares of potential acquirer may create the temptation for takeovers in other corporations. See: *Gevurtz F.*, Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 708.

<sup>297</sup> For some problematic issues related to the given tactics see: *Gilson R.*, The Law and Finance of Corporate Acquisitions, New York, "Foundation Press", 1986, 736-738.

<sup>298</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 8, pp. 19-20.

<sup>299</sup> In the court case against Polk Good the court considered the "greenmail" payment implemented by the directors considered as the area considered under the *business judgment rule*. See: *Polk v. Good*, 507, A.2d 531 (Del. 1986).

<sup>300</sup> In one of the well-known court resolutions on "Greenmail" transaction, the court reviewed the re-purchase of own shares using the corporation capital as the "naked desire" to retain controlling positions in the company, as it did not serve the best interests of the corporation. See: *Heckman v. Ahmanson*, 214 Cal. Rptr. 177 (Ct. App. 1985).

<sup>301</sup> *Thomson S.*, Business Planning For Mergers and Acquisitions, 2<sup>nd</sup> Ed., Durham, "Carolina Academic Press", 2001, 1038-1039. Georgian tax code does not impose regulations on purchase of own shares. In order to cover the similar transfer under the taxation it is necessary to have taxable profit. Taxable profit is calculated based on the difference between the joint revenues and tax deductions; Joint income is calculated as the sum of income from Georgian sources and oversees sources. One of the segments of joint income is the income from economic activities. Among the incomes from economic activities the income generated from the sales of assets should be mentioned. As the financing of "Greenmail" tactics is done through the fund formed from corporation's free resources, and such funds are belonging to the tangible asset category, it is logical that via the buyout of own shares, for which the company uses its assets, the economic income in the form of shares is fixed. Despite the fact that actually nothing is added to the company, as it becomes debtor to itself, still we have the elements of joint income, in other words the transaction becomes taxable. Accordingly, in line with Georgian legislation, utilization of "greenmail" as defense mechanism is not beneficial in taxation terms. See Tax code of Georgia, Article 8, sections 2 and 15, article 97, section 1, article 100 and article 102, section 1, paragraph b).

the buyout of own shares<sup>302</sup> (of course in case of hostile takeover), in 1987 the congress introduced the tax liability over the 50% profit or other revenue, which is not paid to all shareholders under the same conditions, in the other word, if the target company of the buyout is not represented by all shareholders.<sup>303</sup> Despite the above, there is a view in the doctrine, that "greenmail" is the socially beneficial, which eventually increases the value of the company.

As a result of "greenmail" there are no changes made to the organizational structural units of the company. It is generally directed against such changes; on the contrary some adjustments are made to the strategic elements of the corporation, capital structure and relative balance among the properties. The shares issued to the third parties are purchased by the company itself (without structural changes to the capital). For the purchase of shares company uses special fund, formed from the freed resources of the company. In other words purchase is made in return for the reduction of company's property units, as the capital structure and number of placed shares is not changed, but substantial funds outflow from the company which eventually causes reduction of share price.

#### **4.3.5. Capital Restructuring as Defense Strategy against the Undesired Acquisition**

Inter-relationship between the defense tactics against the takeover reveals that elements of some of them are inter-supportive, intersecting or complimentary. The similar phenomenon is the capital structure.<sup>304</sup> Target company, sometimes, tries to defend itself against the undesired acquirer using its own resources, therefore it plays a role of "white knight". It tries to defend and increase shareholders' and company value via the effective implementation of business strategies. Restructuring<sup>305</sup> and re-capitalization are some of the most realistic options for the above purposes.<sup>306,307</sup> Possibility to implement the above depends on the existing condition of the company, its structure, statutes and regulating legislative norms. Depending on the above, decision is made on the type of changes required: establishment of requirement of shareholders' decision; possibility to accumulate specific volume of funds or reinvestment of excess funds; structural changes designed with the purpose to receive accountable results; consideration of legislative limitations related to the undertaking the

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<sup>302</sup> See *Jugeli G.*, Protection of Capital in the Company, 2010, 38-43 (in Georgian).

<sup>303</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4., New York, "Aspen Publisher", 2010, 176.

<sup>304</sup> One additional radical form of defense against takeover – re-incorporation of target company. Re-incorporation is implemented in the country of legal regulation (state) which has strict legislative norms against the takeover. See: *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, Vol. 4, 3<sup>rd</sup> Ed., New York, "Aspen Publisher", 2010, 251-258.

<sup>305</sup> Restructuring considers division of company, sale of one of the company's business lines or transfer to the subsidiary company, full or partial liquidation, buyout of shares and re-capitalization. See: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap.13, p.3.

<sup>306</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 174.

<sup>307</sup> However re-capitalization is not always considered as the mechanism of defense. For example, Delaware Supreme Court in 1996 has not qualified as defense action the decision on re-capitalization made with the support of 50% shareholders of Target Company. The above decision was increasing their control over the corporation. See: *Williams v. Geier*, 671, A.2d 1368, (Del. 1996).

liabilities; legislative existence of shareholders' right to protest; redirection to the tax factor-circumstances.<sup>308</sup>

Change to the strategic element of the corporation- the capital, in other words re-capitalization is widely spread tool. For the implementation of re-capitalization merger or re-classification structures are used.<sup>309</sup> In the event of re-capitalization via merger, the ordinary shares of Target Company are converted into cash (or combination of cash and debt) and ordinary shares of new ("survived") company. The reverse version of re-capitalization is re-classification. Capital restructuring via re-classification means that via the changes to the statutes of target company, the ordinary shares are re-classified into preferential shares, which are gradually re-purchased using the cash (or its equivalent e.g. debt or property) and new ordinary shares. Management often abstains from receiving the debt fund flows or cash and prefers to receive new shares. The share exchange rate is based on the estimated market value of the new shares and is calculated in the way that the total reimbursement (consideration) received by the management of target company is equivalent to the revenues received by the (public) shareholders of the same company. Such structural changes generally require decision of general shareholders' meeting,<sup>310</sup> generally under the condition of qualified majority.<sup>311</sup>

Source of re-capitalization financing is "leverage"; accordingly, new company established as a result of merger mainly has the debt<sup>312</sup> capitalization form. On the other hand, taking loan is the best way for changing the capital structure.<sup>313</sup>

Capital restructuring is the important defense tool against the takeover in the event, if the profile of shareholders owning the capital formed via the debt financing is changed. Namely, if the target company for the financing of re-capitalization sells the main portion of voting shares to so called "friendly" party ("*white square*"), then this will neutralize potentially "hostile" acquisition.<sup>314</sup>

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<sup>308</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap.13, p. 4.

<sup>309</sup> In the event of "brief merger" and corporation re-classification, the shareholders' right for protest is utilized at a limited level. More exactly, in the first case it is used at a limited level, and for the second case – the appealing on rights is not done at all. The same situation in the event of tender offer on the purchase of own shares made by the target company, as from its perspective such offer is not transaction. Accordingly the rights of the shareholders are not protected. See: *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 4, 72-76.

<sup>310</sup> This is the way to avoid requirement for decision from the shareholders' meeting if the shareholders of target company receive the extraordinary dividend in the form of cash or debt. They become owners of relatively low price ordinary shares in a new "leveraged" company. Above mentioned restructuring serves the purpose of value creation for shareholders by the way of increase of their annual income at limited indicator, the above is achieved via the conversion of debt into equity. In exchange to the reduction in shares the income generated from one share is increased. See: *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap.13, pp. 5, 13-14.

<sup>311</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap.13, p.5.

<sup>312</sup> Loan is required for the financing of issue of new shares. See: *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 176-178.

<sup>313</sup> *Cox J., Hazen T.L.*, Treatise on the Law of Corporations, 3<sup>rd</sup> Ed., Vol. 4., New York, "Aspen Publisher", 2010, 174.

<sup>314</sup> *Fleischer A., Sussman A.*, Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap.13, pp. 25-36.

Finally, as a result of re-capitalization, the debt liabilities of target company are increased and it is transformed into high leveraged company, Finally, as a result of re-capitalization, the debt liabilities of Target Company are increased and it is transformed into the company with high "leverage". The above is closely related to the outflow of cash funds for the satisfaction of debt liabilities. Funds are sourced via the reduction of operational and capital costs and in some cases, by means of disposal of property. Moreover, the chances for several time increase of share indicator of the management of re-capitalized company become realistic.<sup>315</sup>

#### **4.3.6. Discussion of other Means of Defense against the Takeover**

In addition to main defense strategies, selection of which is under the competence of directors – and which is implemented with the consideration of fiduciary liabilities and synthetic analysis of adequacy of defense mechanisms – there are several other defense forms.

One of the trendy defense tactics is "*Pac man*" tactics. Under this tactics, the shares of acquirer company are purchased before the acquirer company finalizes "hostile" purchase of target company shares.<sup>316</sup> Implementation of counter-purchase is again made via the "hostile" offer.<sup>317</sup> If both companies successfully complete the purchase of controlling package of shares in the other company, then none of them will have right to use the voting right for the shares owned in other company. Rithorics for the above is the following: "the small fish turns to the big fish and tries to swallow it before the big fish swallows the small fish."<sup>318</sup>

Following the receipt of "hostile" bid offer, if the directors do not have effective defense means and it is clear that target company will not be able to protect itself from the undesired acquisition the target company management starts looking for the competitor acquirer, so called "*White knight*". The latter starts negotiations with the target company to purchase shares; hence the "hostile" acquisition is replaced with the "friendly" acquisition. The objective of the above defense method is not to retain the independent existence of Target Company. Despite the fact that the result is the same – the target company terminates its existence – the corporation is not acquired by undesired third party.<sup>319</sup>

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<sup>315</sup> *Fleischer A., Sussman A., Takeover Defense, Vol. I, New York, "Aspen Law & Business", 2000, Chap.13, pp. 6-7.* This is achieved when the management in turn for the re-capitalization receives new shares instead of cash. For example: Company A has 1000 placed shares, out of which 75 is owned by the management. According to the re-capitalization conditions, public shareholders owning 925 shares are authorized to exchange each share for USD8 cash, debt of USD2 and one new share with the planned market price of USD 2.5. As result value for one share is USD12.5. Management holding 75 shares can receive 5 new shares (price of old shares is USD12.5 and price for new share – USD2.5) with the condition that shareholders will be paid in cash or debt, and management only receives new shares. As a result the number of shares in re-capitalized company equals 1300, where management owns 375 shares. Change in number of shares is reflected in the share indicators, at 21,5% increase: before re-capitalization management owned 7.5%, following the re-capitalization the same indicator reached 29%.

<sup>316</sup> *Gevurtz F., Corporation Law, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 708.*

<sup>317</sup> *Lipton M., Steinberger E., Takeovers & Freezeouts, New York, "Law Journal Seminar-Press, Inc.", 2002, Chap.6, pp. 239-245.*

<sup>318</sup> *Haas J.J., Corporate Finance, New-York, "Thomson/West", 2011, 711.*

<sup>319</sup> *Ib., 710.*

Target company can issue quite a large number of shares by which it will reduce the percentage share of acquirer. Moreover the target company will transfer the issued shares to relatively "friendly" third parties, so called "*White square*"-s. The "*standstill agreement*" is concluded with the third party with the main conditions: (a) acquirer party is limited in selling of shares in future; (b) agreement prohibits utilization of controlling rights for influencing the entrepreneurial activities of target company; (c) the target company retains the right to unanimously terminate the agreement if the buyer decides to sell the shares; (d) under the agreement, acquirer is liable to use the voting rights of the held shares in the way instructed by the target company. In exchange the acquirer gets the representation rights to the board of target company.<sup>320</sup>

The preventive combinational defense method is so called "*lock-up*" tactic. The most popular form of the method is "*crown jewel*".<sup>321</sup> For the prevention of undesired acquisition management of target company may offer to the third party to buy the main property or business line at the price agreed if the target company is forced to "run away" from the "hostile" acquisition.<sup>322</sup> "Lock-up" agreement can be reached with the "*White knight*", which will be offered to acquire the whole company by the target company. As a result, target company becomes less attractive for the acquirer. Therefore such agreement is referred to as "*lock-up*" agreement.<sup>323</sup>

And finally, instead of finding acquirer company competing with the "rider", the target company may make the bid offer on the buyout of own shares from the capital market.<sup>324</sup> The above tactic is not the methodic approach aiming at the full avoiding of takeover; however by this way the economic value of synergism created as a result of takeover is lost for the acquirer. Acquirer can still make the bid offer on the purchase of shares remaining with the target company.<sup>325</sup> Using the above method the target company management hopes to create competitive environment for the "rider" and sell remaining shares at a higher price. Despite the above, the number of placed shares of the target company are down to minimum indicator as a result of buyout of own shares.<sup>326,327</sup>

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<sup>320</sup> *Gilson R.*, *The Law and Finance of Corporate Acquisitions*, New York, "Foundation Press", 1986, 672.

<sup>321</sup> Compare: *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., Vol. 4, New York, "Aspen Publisher", 2010, 178-180.

<sup>322</sup> *Haas J.J.*, *Corporate Finance*, New-York, "Thomson/West", 2011, 709.

<sup>323</sup> *Gevurtz F.*, *Corporation Law*, 2<sup>nd</sup> Ed., St. Paul, "Thomson Reuters", 2010, 710; compare: *Fleischer A., Sussman A.*, *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 13, pp. 23-24.

<sup>324</sup> Purchase of shares owned by the "rider" by the target company must have rational purpose; see: *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, (Del. 1985).

<sup>325</sup> *Cox J., Hazen T.L.*, *Treatise on the Law of Corporations*, 3<sup>rd</sup> Ed., New York, "Aspen Publisher", 2010, Vol. 4, 173.

<sup>326</sup> *Fleischer A., Sussman A.*, *Takeover Defense*, Vol. I, New York, "Aspen Law & Business", 2000, Chap. 13, pp. 36-41.

<sup>327</sup> There are many other forms of corporation takeovers starting with the "Share plans for the shares owned by the employees" (Esop) and ending with the lock-up option; it is impossible to discuss all of them in the present work, further analysis of the above forms would inappropriately change the structure of the work.

## **V. Conclusion**

The contents definition of takeover is determined by the level of willingness to participate in the transaction by one of the parties out of two or more legal entities participating in the corporate combination. "Friendly" takeover belongs to undesirable but acceptable categories. Therefore, the activity with low level of will is evident. The "hostile" takeover is atypical to the "friendly" takeover; in this case the will of the target company is directed towards the rejection of the transaction. The common segment of analysis completed for both cases lies in the action dimension. Namely, practice of takeover takes place at the organized secondary capital market.<sup>328</sup> The area for practical implementation belongs to the area regulated under the regulations on securities. The discussed analysis was conducted using the dogmatics of two conjunctive laws (corporate and capital market). The inter-disciplinary form of the implemented research is derived from the additionality of tax aspect analysis. As a result of research the actions implemented in the practical utilization of takeover were structurally established and analytically reviewed. The advantages and disadvantages of strategies have been distinguished. The practical application of research is determined by the benefits of the results: the research gives opportunity to make reasonable choice between the forms of takeover and to determine the strategic view on the achievement of control. The simple deduction makes it evident that target company management can choose, plan and implement diverse combinational tactics for defense purposes. The final section of the work covers the non-popular, however potentially usable defense strategies.

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<sup>328</sup> *Pinto A., Branson D.*, Understanding Corporate Law, 3<sup>rd</sup> Ed., New York, "Matthew Bender & Company", 2009, 368.



**Roin Migriauli\***

## **Legal Status of Bankruptcy Manager Based on the Comparative Analysis of the 1996 Law on Bankruptcy and the 2007 Law on Insolvency**

### **1. Introduction**

The concept of a bankruptcy manager is one of the most important concepts in bankruptcy law. Origins of the mentioned concept date back to the Roman law.<sup>1</sup> Precursor of a bankruptcy manager is *magister* that was appointed by a pretor from among creditors and a *curator* appointed by the magistrate.<sup>2</sup> Both individuals would initially be elected by the creditors and they were invested with the functions of management and sale of a debtor's assets. "Magister" would sell entire assets of a debtor to one buyer and would distribute the earnings among creditors. While a "Curator" could sell single items of assets although it was court that distributed earnings among creditors.<sup>3</sup>

As a result of the reception of the Roman law different systems of the Roman law have also come to be reflected in other European countries. Respectively, many concepts of law, with some variations was introduced in the legal system of the majority of European countries as well. This was the case with the bankruptcy law as well. As a result, Europe's bankruptcy law was founded on the systems established in the Roman law.<sup>4</sup> The same can be said about the Georgian Bankruptcy Law the grounds for which was laid by the 1996 Law<sup>5</sup> on Bankruptcy Proceedings. In turn, the latter was the result of the reception of the German Law on Bankruptcy and Insolvency.<sup>6</sup> In 2007 the Law on Bankruptcy Proceedings entered into force;<sup>7</sup> it fully replaced the Bankruptcy Law after the expiration of the transitory period. The comparative analysis of both laws clearly demonstrates that the Law on Insolvency is clearly far from the recognized standards of the bankruptcy law.<sup>8</sup>

The distance from standard bankruptcy law was especially reflected on the legal status of a bankruptcy manager and the competencies of a bankruptcy manager. Under the Insolvency Law the concept of a bankruptcy manager underwent serious modification: bankruptcy manager acquired not only other legal status but his/her functions were formed in a different manner as well.

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<sup>1</sup> *Migriauli R.*, Introduction to the Bankruptcy Law (Handbook), 2<sup>nd</sup> Revised Edition, Tbilisi, 2006, 167-168 (in Georgian).

<sup>2</sup> Magistratus was a state position in ancient Rome and a consul, pretor, tribune, etc. would hold this position

<sup>3</sup> *Migriauli R.*, Introduction to the Bankruptcy Law (Handbook), 2<sup>nd</sup> Revised Edition, Tbilisi, 2006, 168 (in Georgian).

<sup>4</sup> *Migriauli R.*, The Matters of the Georgian Private Law, 1<sup>st</sup> Edition, Tbilisi, 2011, 23.

<sup>5</sup> Shortened: Law on Bankruptcy (in Georgian).

<sup>6</sup> *Migriauli R.*, The Matters of the Georgian Private Law, 1<sup>st</sup> Edition, Tbilisi, 2011, 21 (in Georgian).

<sup>7</sup> Shortened: Law on Insolvency.

<sup>8</sup> *Migriauli R.*, The Matters of the Georgian Private Law, 1<sup>st</sup> Edition, Tbilisi, 2011, 132 (in Georgian).

According to the Insolvency Law of the European countries bankruptcy manager is such a powerful and independent individual that he/she is considered as a "central figure" in the bankruptcy proceedings. The same was case under the 1996 Law of Georgia on Bankruptcy.<sup>9</sup> Central role of the bankruptcy manager In the entire proceedings was conditioned also by the fact that the bankruptcy proceedings was regarded as main proceedings under the entire proceedings for insolvency, because it was in the mentioned proceedings where the bankruptcy mass would be fully formed, debtor's demands were implemented, creditor's claims would be finalized, bankruptcy mass would be protected against unfair encroachment, its realization would take place and creditors' claims would be satisfied, etc.

The 2007 legislation of Georgia on Insolvency shifted main burden to the trusteeship regime, while bankruptcy proceedings was transformed into formal proceedings. Moreover, the Law on Insolvency distributed the competencies falling within the insolvency proceedings to the Enforcement Bureau which enforcement officers sometimes act as trustees, and sometimes as bankruptcy managers in the insolvency proceedings. If the legislator continues to burden the insolvency legislation with public elements in such manner time may not be far when enforcement officers of the Enforcement Bureau will also act as rehabilitation managers.

It should be mentioned that such involvement of the state in insolvency proceedings is justified only in case when the insolvency mass is not sufficient for covering the insolvency proceedings expenses,<sup>10</sup> while keeping proceedings and its completion is necessary due to economic purposes.

## **2. Bankruptcy Manager – Central Player in Bankruptcy Proceedings or Just an Intermediary for an Auction**

According to the 1996 Law on Bankruptcy bankruptcy manager who had a leading role in bankruptcy proceedings was implementing the whole proceedings (from beginning to end) independently. According to the mentioned law bankruptcy manager would gain authority upon opening the proceedings, to manage and dispose the bankruptcy mass at his/her discretion. Disposal of the bankruptcy mass – this was one of the main objectives of a bankruptcy manager. Under the mentioned competence he/she was able not only to alienate the items of assets of the mass separately also sell them collectively; In the realization of the bankruptcy mass items bankruptcy manager was not limited by the methods of alienation, and was free in their selection. Namely, he/she could sell items of the mass through an auction as well as without an auction. Especially effective was selling of assets through a competition. None the less effective was also direct sale of property that implied independent selection of a buyer.<sup>11</sup>

Bankruptcy manager would take decisions independently as part of the management of the debtor's enterprise and also perfumed its representational authorities as a debtor. Bankruptcy manager

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<sup>9</sup> *Migriauli R.*, Introduction to the Bankruptcy Law (Handbook), 2<sup>nd</sup> Revised Edition, Tbilisi, 2006, 36 (in Georgian).

<sup>10</sup> *Schnitger H., Migriauli R.*, The Law of Georgia on Insolvency, Description and Comparison of the Georgia Law on Bankruptcy and International Standards, Tbilisi, 2011, 71(in Georgian).

<sup>11</sup> *Migriauli R.*, Introduction to the Bankruptcy Law (Handbook), 2<sup>nd</sup> Revised Edition, Tbilisi, 2006, 44-45 (in Georgian).

was able to strike disposal contracts or terminate existing contracts at his/her own discretion, in case such actions on his/her part would be useful for the bankruptcy mass; bankruptcy manager was able to decide at his/her own discretion the matter of effective arrangement of personnel in a debtor's enterprise, end unproductive productions at the enterprise; bankruptcy manager was able to keep judicial proceedings beneficial for the mass. Importantly, for boosting the bankruptcy mass a bankruptcy manager was vested with such legal lever as contesting.<sup>12</sup> Namely, bankruptcy manager was able to challenge legal actions harmful to the mass and creditors performed by an insolvent debtor within 3 years from the launch of bankruptcy proceedings.<sup>13</sup>

Bankruptcy manager would take active part in pre-conciliation procedures as well that might end with the salvation of a debtor's enterprise or even rehabilitation. Namely, he/she would submit a conciliation application, design a conciliation proposal, etc.

The 2007 Law on Insolvency created an absolutely different situation; especially through the 2011 amendments to the mentioned Law. Although bankruptcy manager retained this name but due to his/her functions he/she cannot be referred to as a manager of a debtor's property. He/she is just a shadow of a real bankruptcy manager and he/she cannot claim to be "in charge of bankruptcy proceedings" and/or a "central figure in the bankruptcy proceedings". This subject can only be referred to as "a formal bankruptcy manager".

It seems that the Law on Insolvency vested a formal bankruptcy manager with enterprise management and representational functions in the bankruptcy process, it seems that the Law on Insolvency vested formal bankruptcy manager with the authority to manage and represent a debtor.<sup>14</sup> Although, if we analyze the entire performance period of a bankruptcy manager we will be convinced that such manager not only lacks interest to perform the mentioned tasks but also does not have enough time for implementing those. For example, immediately upon election (or appointment) a bankruptcy manager starts preparation for the first auction, namely, he/she has to determine market value of a debtor's assets and apply to the National Enforcement Bureau for auction services within 25 days from appointment.<sup>15</sup> It is compulsory that the first auction is performed within at least 30 days and no more than 40 days from the election (or appointment) of bankruptcy manager.<sup>16</sup> Therefore, all attention of a formal bankruptcy manager is directed towards holding an auction, more precisely, he/she got vested with the role of an intermediary between a debtor's creditors and the National Enforcement Bureau; the Law fully deprived the bankruptcy manager of the prerogative to sell debtor's assets and it was fully given to the National Enforcement Bureau. While the latter entirely marginalized the formal bankruptcy manager from auction relations. Nothing to say about the selection of methods of realization of property by bankruptcy manager – a debtor's property is sold

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<sup>12</sup> *Migriauli R.*, Introduction to the Bankruptcy Law (Handbook), 2<sup>nd</sup> Revised Edition, Tbilisi, 2006, 129-131 (in Georgian).

<sup>13</sup> Article 17 of the Law of Georgian on Bankruptcy Proceedings, "Newsletter of Parliament of Georgia", N 19-20, 1996.

<sup>14</sup> Article 37.1 of the Law of Georgia on Insolvency Proceedings, "Newsletter of Parliament of Georgia", 31/03/2007.

<sup>15</sup> *Ib.*, Article 38.5.

<sup>16</sup> *Ib.*, Article 38.9.

only by means of an auction, and solely through the National Enforcement Bureau.<sup>17</sup> Following all this it is no surprise why the formal bankruptcy manager no longer has the interest to actively get involved in contracts concluded by a debtor or "swaying judicial proceedings" or take measures to somehow increase the debtor's property. Even the worse, the Law on Insolvency explicitly took away from the bankruptcy manager the legal obligation of finding a debtor's property. Such obligation can be imposed on a formal bankruptcy manager only by means of a contract concluded with creditors;<sup>18</sup> further, neither is the possibility of contesting a powerful tool in the hands of a formal bankruptcy manager. First of all, the Law on Insolvency has brought the timeframes for exercising the right of contesting down to 6 months, and secondly, the Law avoided in-depth regulation of the concept of contesting and limited itself to describing just its formal characteristics;<sup>19</sup> under the new Law the formal bankruptcy manager lacks interest to start reorganization activities in the debtor's enterprise or economize on production costs, etc.

Therefore, in the Law on Insolvency the functions of the supposed bankruptcy manager of enterprise managing, leading of a debtor's enterprise and representation just formally.

### **3. About the Interests of a Bankruptcy Manager in the Insolvency Proceedings**

What interests may a formal bankruptcy manager have in insolvency proceedings, i.e., what may attract a private individual into the proceedings to give consent to a creditor or creditors to the appointment as a bankruptcy manager. In my opinion two main interests can be identified here: professional and material.

Professional interest is demonstrated in its implementation. Therefore, serving as a bankruptcy manager is a good example for the realization of professional capacity and gaining experience. The 1996 Law on Bankruptcy emphasized the relevant experience of an individual for the appointment as a bankruptcy manager<sup>20</sup> although it did not specify the field in which a candidate to be elected (appointed) should have had relevant experience. The concept of a bankruptcy manager was new and respectively no one would have the experience of working as a bankruptcy manager. Therefore, judges mainly focused on two types of people with higher education: lawyer and an economist, while in practice on such professions as a lawyer and an auditor.<sup>21</sup> While in judicial and bankruptcy practice still mainly Lawyers would be appointed as bankruptcy manager, which was predominantly in conformity with European standards. Therefore, serving as a bankruptcy manager would also provide the lawyers specific experience.

Such a professional standard of a formal bankruptcy manager is not prescribed under the Insolvency Law. Bankruptcy manager may be a person with any profession, even a legal entity. The

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<sup>17</sup> Articles 38.1 and 38.2 of the Law of Georgia on Insolvency Proceedings, "Newsletter of Parliament of Georgia", 31/03/2007.

<sup>18</sup> *Ib.*, Article 37.4<sup>1</sup>.

<sup>19</sup> *Ib.*, Article 35.

<sup>20</sup> Article 15.1 of the Law of Georgian on Bankruptcy Proceedings, "Newsletter of Parliament of Georgia", N 19-20, 1996.

<sup>21</sup> *Migriauli R.*, Introduction to the Bankruptcy Law (Handbook), 2<sup>nd</sup> Revised Edition, Tbilisi, 2006, 42 (in Georgian).

main thing is that such person/entity should not be performing the activity same or similar to that of a debtor.<sup>22</sup> To put it simply, an engineer should not be appointed as a bankruptcy manager of an engineering company, a teacher should not be appointed as a bankruptcy manager of a private school, etc. It should be mentioned that the tradition established through the Bankruptcy Law is still maintained and attorneys or auditors are invited as bankruptcy managers.

Material interest is the most decisive interest of an individual/entity to accept the appointment or selection as a bankruptcy manager. Naturally, bankruptcy manager should receive relevant remuneration. The law of all leading European countries regulate the matter of the remuneration of a bankruptcy manager under a separate law. There are various criteria for the calculation of remuneration of bankruptcy manager: there is remuneration on the basis of time spent and also remuneration that is calculated according to the quota of the insolvency mass.<sup>23</sup> According to Europe's international standards the amount of a bankruptcy manager's remuneration, in general is tied to the bankruptcy mass quota and is determined at the proportion relevant to its value, while this proportion is reflected in a special scale. Respectively, the higher the value of the bankruptcy mass the higher the amount of remuneration. The mentioned principle was also prescribed under the 1996 Law on Bankruptcy<sup>24</sup> that envisaged the enactment of a separate law. Although it did not get to the enactment of a separate law and the determination of remuneration of Georgian bankruptcy managers was fully entrusted to the bankruptcy judges. And judges would determine the size of remuneration at their discretion. Courts, of course, could not bypass the principle of the proportion of the mass established under the Law and would prescribe different percentages for remuneration to the bankruptcy managers, based on the volume of mass; with the exception of few cases when some bankruptcy managers would be assigned a monthly fixed rate as salary. The Law on Bankruptcy regulated also the matter of bonus payment to a bankruptcy manager, in case its/his/her performance was productive.<sup>25</sup> This position was more attractive also because a bankruptcy manager, in addition to remuneration could claim reimbursement of incurred costs which amount was determined by court.<sup>26</sup>

The 2007 Law on Insolvency deprived bankruptcy managers of this important material interest as well. The new Law entrusted the matter of remuneration of a bankruptcy manager entirely to a contract to be concluded with creditors.<sup>27</sup> This provision of the Law created some kind of conflict situation between the interests of creditors involved in the proceedings and the interests of a bankruptcy manager. Because the positioning of the table of claims in different orders there is conflict of interest among creditors as well. Creditors, in the first place strive to have maximum satisfaction of their claims. Creditor's claims are satisfied from the earnings from the realization of a debtor's assets.

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<sup>22</sup> Article 87.3 of the Law of Georgia on Insolvency Proceedings, "Newsletter of Parliament of Georgia", 31/03/2007.

<sup>23</sup> *Schnitger H., Migriauli R.*, Law of Georgia on Insolvency, Description and Comparison of the Georgia Law on Bankruptcy and International Standards, Tbilisi, 2011, 72 (in Georgian).

<sup>24</sup> Article 33.1 of the Law of Georgian on Bankruptcy Proceedings, "Newsletter of Parliament of Georgia", N 19-20, 1996.

<sup>25</sup> *Ib.*, Article 33.1.

<sup>26</sup> *Ib.*, Article 33.2.

<sup>27</sup> Article 37.4 of the Law of Georgia on Insolvency Proceedings, "Newsletter of Parliament of Georgia", 31/03/2007.

Bankruptcy manager should be paid out of these earnings as well, unless creditors agree otherwise. Given this diverse struggle of interests it should not be a surprise that creditors will try their best for a bankruptcy manager to receive as little remuneration as possible. If creditors granted high pay to a bankruptcy manager they would be acting to the detriment of their own interests.<sup>28</sup> Therefore, it is difficult to find a person who given the current regulation of the Law would accept the position of a bankruptcy manager easily, especially in the situation when the degree of his/her/its responsibility has clearly been increased and he/she/it may be asked to use a bank guarantee or the insurance of responsibility for securing the responsibility.<sup>29</sup>

Such ill-considered regulation of the Insolvency Law has resulted in the diminishing and devaluation of the mentioned concept which will end with its full elimination in the future. Although, this process has already been commenced: 2011 amendments envisage that if a bankruptcy manager is not elected at a creditors' meeting or the creditors do not submit the candidatures of a bankruptcy manager Court will appoint the National Enforcement Bureau as bankruptcy manager<sup>30</sup> that has a legal status of a legal entity of public law.<sup>31</sup> The National Enforcement Bureau will also be appointed as a manager in case they do not like the quality of discharging obligations by a bankruptcy manager elected by the creditors who is a private individual and one of the creditors applies to court demanding his/her replacement.<sup>32</sup> Therefore, in case of appointment by the National Enforcement Bureau the functions of the bankruptcy manager are performed by the enforcement officers of the National Bureau.

#### **4. Conclusion**

With the enactment of the 2007 Law on Insolvency that one year from the entry into force entirely superseded the Bankruptcy Law that was based on European Legal standards, Georgia effectively rejected the private law principles established under the Insolvency Law. The mentioned was proven by the amendments to the Insolvency Law in 2010 and 2011 that ignored accepted legal concept of a bankruptcy manager and this private subject significant for bankruptcy proceedings with the public officials performing the public functions.

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<sup>28</sup> *Schnitger H., Migriauli R., Law of Georgia on Insolvency, Description and Comparison of the Georgia Law on Bankruptcy and International Standards, Tbilisi, 2011, 78 (in Georgian).*

<sup>29</sup> Article 37.4 of the Law of Georgia on Insolvency Proceedings, "Newsletter of Parliament of Georgia", 31/03/2007.

<sup>30</sup> *Ib.*, Article 37.2.

<sup>31</sup> *Ib.*, Article 3.

<sup>32</sup> *Ib.*, Article 37.6.

**Levan Mosakhlshvili\***

## **Principles on Freedom of Information**

### **1. Introduction**

Information is the oxygen of democracy.<sup>1</sup> If people do not know what is happening in their society, if the actions of those who rule them are hidden, then they cannot take a meaningful part in the affairs of that society. But information is not just a necessity for people – it is an essential part of good government. Bad government needs secrecy to survive. It allows inefficiency, wastefulness and corruption to thrive. Information allows people to scrutinize the actions of a government and is the basis for proper, informed debate of those actions.<sup>2</sup>

Freedom of information allows the public to have an adequate view of, and to form a critical opinion on, the state of the society in which they live and on the authorities that govern them;<sup>3</sup> It can also be beneficial to governments themselves – openness and transparency in the decision-making process can improve citizen trust in government actions.<sup>4</sup>

Freedom of information, as well as any legal institution has its principles, i.e. the guidelines that define its essence.<sup>5</sup>

Principles of law in their essence are the generalized reflection of objective law of community development.<sup>6</sup> They provide homogeneous formulation of legal norms, influence the participants of legal relations and determine the guidelines for their action. In addition, principles of law – unique means of legal life of society – have their influence on all areas of law. Besides, in absence of specific norms regulating legal relations, they define the ratio of this relation with the nature of law, determining their legitimate or illegal nature.

Due to this and other reasons, in June 1999, the Authoritative NGO "Article 19" drafted the International Principles on Freedom of Information based on multiyear work. The Principles are based on international and regional law and standards, evolving state practice and the general principles of law recognized by the community of nations. They are the product of a long process of study, analysis

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<sup>1</sup> Principles of Law on Freedom of Information, Article 19, London, 1999, 1, available at: <<http://www.article19.org/data/files/pdfs/standards/righttoknow.pdf>>.

<sup>2</sup> International Standards on Freedom of Expression, *Subari S.* (Ed.), Tbilisi, 2004, 13.

<sup>3</sup> Recommendation adopted by Committee of Ministers of the Council of Europe towards Member States on Access to Official Documents, Rec. (2002) 2, 4, available at: <[http://www.coe.int/t/dghl/standardsetting/media/doc/H-Inf\(2003\)003\\_en.pdf](http://www.coe.int/t/dghl/standardsetting/media/doc/H-Inf(2003)003_en.pdf)>.

<sup>4</sup> *Banisar D.*, Freedom of Information around the World, London, 2006, 6.

<sup>5</sup> *Stott D.*, Principles of Administrative Law, London, 1997, 2.

<sup>6</sup> *Werhan K.*, Principles of Administrative Law (Concise Hornbooks Series), London, 2007, 12.

and consultation overseen by "Article 19", drawing on extensive experience and work with partner organizations in many countries around the world.<sup>7</sup>

Main goal of the elaboration of these principles is to improve management and raise responsibilities, ensure the spread of democracy around the world, and are intended for openness of national legislation on freedom of information and official information.

Principles on Freedom of Information constitute a certain standard to be introduced in internal legislation of the states. These principles allow discussing whether the legislation of any country is consistent with international standards.

## **2. Guidelines on Freedom of Information Legislation**

### **2.1. Principle 1. Maximum Disclosure.<sup>8</sup> *Freedom of Information Legislation Should Be Guided by the Principle of Maximum Disclosure***

Maximum disclosure is the main principle of Freedom of information legislation. The principle of maximum disclosure establishes a presumption that all information held by public bodies should be open, i.e. a presumption of disclosure should be in place, and the government should promote the development of the culture of maximum disclosure. As to this presumption, it may be overcome only in very limited circumstances that should be drafted in detail and included in national legislation. Where a public authority seeks to deny access to information, it should bear the onus of justifying the refusal and demonstrate primacy of nondisclosure on principle of disclosure.<sup>9</sup>

According to principle 1, "Information" includes all records held by a public body, regardless of the form in which the information is stored (document, tape, electronic recording and so on), its source (whether it was produced by the public body or some other body) and the date of production. The legislation should also apply to records, which have been classified, subjecting them to the same test as all other record.

The principle of maximum disclosure should apply to all public bodies with no exceptions, as the "public body" should include all branches and levels of government including local government, elected bodies, bodies which operate under a statutory mandate, nationalized industries and public corporations, non-departmental bodies, judicial bodies, and private bodies which carry out public function. Private bodies themselves should also be included if they hold information whose disclosure is likely to diminish the risk of harm to key public interests. Inter-governmental organizations should also be subject to freedom of information regimes based on the principles set down in this document.

It is important that the law on freedom of information apply to any persons and the right of information access should be exercised not only by citizens, but also by any person requesting information. A person interested in information is not obliged to have any special legal status or interest.<sup>10</sup>

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<sup>7</sup> *Chugoshvili T., Lomjaria N., Kordzakhia T.*, Freedom of Information in Georgia, Tbilisi, 2007, 8 (in Georgian).

<sup>8</sup> The Public's Right to Know Principles on Freedom of Information Legislation, Article 19, London 1999, 1.

<sup>9</sup> Article 19, Access to Information for Citizens, 2000, 2.

<sup>10</sup> Guidebook on Freedom of Information in South Caucasus, Tbilisi, 2012, 36.



## **2.2. Principle 2. Obligation to Publish. *Public Bodies Should Be under an Obligation to Publish and Disseminate Widely Documents of Significant Public Interest***

With the view of proper exercising the right to information access, it is not sufficient to oblige public bodies to issue requested information. Effectiveness of access to information for many people depends on intensive operation of public bodies and publishing the key information that has not been requested.

For instance, declaration on principles of freedom of expression of Africa states that "state bodies are under obligation, regardless of non-availability, to publish widely information of significant public interest."<sup>11</sup> However, the scope of this obligation to some extent is subject to reasonable limits based on resources and capacity, but the size of information to be published according to the law should increase from time to time as publication and dissemination of information is simplified thanks to latest technologies.<sup>12</sup>

Public bodies should, as a minimum, be under an obligation to publish the following categories of information:

1. operational information about how the public body functions, including costs, objectives, audited accounts, standards, achievements;
2. information on any requests, complaints or other direct actions which members of the public may take in relation to the public body;
3. guidance on processes by which members of the public may provide input into major policy or decision-making;
4. the types of information which the body holds and the form in which this information is held; and;
5. the content of any decision affecting the public, along with reasons for the decision and background material of importance in framing the decision.

Georgia assumed obligations under the Open Government Partnership (OGP) action plan to publish and disseminate widely key documents of significant public interest. To this end, site [www.data.gov.ge](http://www.data.gov.ge) has been created and is tested to post information of public interest, including the records concerning the state finances and budget.<sup>13</sup>

## **2.3. Principle 3. Promotion of Open Government. *Public Bodies Must Actively Promote Open Government***

In democratic society, the public bodies must actively promote open government. The law should make provision for public education and the dissemination of information regarding their right. The law should provide for a number of mechanisms to address the problem of a culture of secrecy within government.

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<sup>11</sup> Principle 4, Declaration of Principles on Freedom of Expression in Africa, African Commission on Human and Peoples' Rights, available at: <<http://www1.umn.edu/humanrts/achpr/expressionfreedomdec.html>>.

<sup>12</sup> Mendel T., Freedom of Information, London, UNESCO, 2008, 126.

<sup>13</sup> Recommendations of Civil Society Organizations on Open Government Partnership Action Plan prepared by the Institute for Development of Freedom of Information (IDFI), 2012, 3, available at: <<http://www.csb.gov.ge/uploads/recommendtion.pdf>>.

In the countries having no culture of openness between government and society, freedom of information legislation cannot provide the tool for success. Creation and practicing a mechanism depends on changing the culture of "secrecy".

Promotional activities are, therefore, an essential component of a freedom of information regime. Initiatives might include incentives for public bodies that perform well and impose sanctions for those hindering access to information. "Objective" reasons undermining open government should also be excluded, such as the key constraints to the disclosure of information held by public body, which relate to poor office work. Therefore, documents circulation is to be improved.

#### **2.4 Principle 4. Limited Scope of Exceptions. *Exceptions Should Be Clearly and Narrowly Drawn and Subject to Strict "Harm" and "Public Interest" Tests***

In every country having freedom of information legislation, there are constraints to the free disclosure of information, i.e. there is a public information, which should not be disclosed. Though in such case, presumption of disclosure should be in place unless the public body can show that the information falls within the exceptions. The exceptions should be clearly and narrowly drawn in order to minimize or eliminate discretionary powers of public bodies to limit access to information. Refusal to disclose information is not justified unless the public authority can show that the information meets a strict three-part test:

**a) the information must relate to a legitimate aim listed in the law.**

Legitimate aims, which may justify non-disclosure of information, should be provided in the law in the form of a complete list. This list should include only interests, which constitute legitimate grounds for refusing to disclose documents and should be limited to matters such as law enforcement, privacy, national security, territorial integrity, commercial and other confidentiality, public or individual safety, and the effectiveness and integrity of government decision-making processes, promoting unbiased and independent court etc.

**b) disclosure of the information must threaten to cause substantial harm to that legitimate aim.**

for instance, restrictions whose aim is to protect governments from embarrassment or the exposure of wrongdoing can never be justified.

**c) the harm to the aim must be greater than the public interest in having the information.**

For example, the exposure of corruption in the military may at first sight, appear to weaken national defense, but actually, over time, help to eliminate the corruption and strengthen the armed forces. For non-disclosure to be legitimate in such cases, the net effect of disclosure must be to cause substantial harm to the aim. Even if it can be shown that disclosure of the information would cause substantial harm to a legitimate aim, the information should still be disclosed if the benefits of disclosure outweigh the harm. For example, certain information may be private in nature but at the same time expose high-level corruption within government. The harm to the legitimate aim must be weighed against the public interest in having the information made public. Where the latter is greater, the law should provide for disclosure of the information.<sup>14</sup>

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<sup>14</sup> The Public's Right to know Principles on Freedom of Information Legislation, Article 19, London 1999, 6.

No public bodies should be completely excluded from the ambit of the law, even if the majority of their functions fall within the zone of exceptions. This applies to all branches of government (that is, the executive, legislative and judicial branches) as well as to all functions of government (including, for example, functions of security and defense bodies). Non-disclosure of information must be justified on a case-by-case basis.

**2.5.Principle 5. Processes to Facilitate Access - *Requests for Information Should Be Processed Rapidly and Fairly and an Independent Review of Any Refusals Should Be Available***

Requests for information should be processed rapidly and fairly."Rapidly" means that national law should provide for strict and adequate time limits for the providing information and an individual right of appeal to an independent administrative body from a refusal by a public body to disclose information. This may be either an existing body, or one specially established for this purpose. In either case, the body must meet certain standards and have special powers, and effective courts should exist within national legislation.

**2.6.Principle 6. Costs - *Individuals Should not Be Deterred from Making Requests for Information by Excessive Costs***

Individuals should not be deterred from making requests for information by excessive costs. The cost of gaining access to information held by public bodies should not be so high as to deter potential applicants.

Georgian legislation completely shares this principle. Access to information is free of charge in Georgia except for costs associated with providing copies of public information. Amount of this cost and payment conditions are set by the law on "charges for providing copies of public information."

**2.7.Principle 7. Open Meetings - *Meetings of Public Bodies Should Be Open to the Public***

Meetings of public bodies should be open to the public. This democratic principle establishes a presumption that decision-making process is objective. It provides guarantee for transparency and dispels suspicions among citizens concerning the secrecy of reviewing and decision-making.<sup>15</sup> Freedom of information includes the public's right to know what the government is doing and to participate in decision-making processes. Aarhus Convention covers the public participation in decision-making in certain fields including the environment (planning, elaboration of programs and policies, executive acts and/or legally binding normative documents to be universally recognized).

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<sup>15</sup> *Kopaleishvili M., Skhirtladze N., Kardava E., Turava P.*, Manual in Administrative Procedural Law, Tbilisi, 2008, 31 (in Georgian).

Freedom of information legislation should establish a presumption that all meetings of governing bodies should be open to public. Meetings may be closed, but only in accordance with established procedures and where adequate reasons for closure exist (e.g. state security and safety, health care etc.).

## **2.8. Principle 8. Disclosure Takes Precedence**

### ***Laws which Are Inconsistent with the Principle of Maximum Disclosure Should Be Amended or Repealed***

A commitment should be made by every state to bring all laws relating to information into line with the principle of maximum disclosure underpinning the freedom of information principles. Laws, which are inconsistent with the principle of maximum disclosure, should be amended or repealed. The legislative basis should be revised to ensure increased access to public information. With this view, a complex revision of the laws regulating freedom of information and access to public information is required. As for the exceptions - the regime of exceptions, provided for in the freedom of information law, should be comprehensive and other laws should not be permitted to extend it.

## **2.9. Principle 9. Protection for Whistleblowers**

### ***Individuals who Release Information on Wrongdoing – Whistleblowers – Must Be Protected***

According to this principle, individuals should be protected from any legal, administrative or employment-related sanctions through special mechanisms and procedures within national constitution for releasing information on wrongdoing. The states should encourage and promote whistleblowers acting within the legal public interests, establish effective, legal, unbiased and independent rules for considering whistle-blowing complaints and protect the whistleblower and a witness from wrongdoing. It should be taken into account that it is inadmissible to threaten, discriminate, exert pressure, start administrative or disciplinary proceedings, civil or criminal prosecution, inflict physical, moral or material damage to whistle-blower or his relatives.

## **3. Conclusion**

Therefore, these principles aim at measuring the national information disclosure legislation compliance with Principles of Freedom of information, ensuring their introduction into legislation, and stirring public interest in access to information that can be achieved only through their active participation in the institutional development of the freedom of information. The latter will greatly contribute to the transparency and good governance.

**George Rusiashvili\***

## **Competition of Vindication and Execution Claim in Reversing of the Outcomes of Invalid Deal**

### **I. Introduction**

Law on unreasonable enrichment is an integral part of codification of Continental Europe. What is transferred to a transferee unreasonably, e.g. on the basis of the invalid deal, shall be returned to the transferor, through the execution claim (Leistungskondiktion). Similarly, what is gained by a person through intervention into the other person's rights – using other person's property – shall be returned to the entitled person with the through the claim of unreasonably taken (Eingriffkondiktion). These two claims are the key instruments serving to conversion of the unreasonable movement of the property.

Obligation of returning of the gained is limited to the gains in possession of the transferee at a moment of the claim.<sup>1</sup> Though, how could be established whether the transferee is still enriched at a time of claim or not, is a disputable issue. For example, if a person has spent the unreasonable gains and hence, has not enriched but he has saved the money which he would have to pay from his own property, for achievement of the same purpose, he shall be regarded as enriched still.<sup>2</sup> This rule does not apply if a person has spent unreasonable gains for the purposes, for achievement of which he would not spend his own property (e.g. luxury articles). Creators of GBG based such decision on the proposal that the demand created from unreasonable enrichment is oriented towards correction of the unjust outcomes (Billigkeitsanspruch) and fulfills only supplementary function to certain extent. Therefore, it is unacceptable that bona fide transferee was damaged by the obligation of returning in any way.<sup>3</sup> Though, some disagree with such assumption. It is indeed hard to explain why a person wasting received property absolutely aimlessly should be in more favorable situation than a one using the gains for his own needs.<sup>4</sup>

Another case, where it is unclear, whether the transferee is still enriched or not, is an invalid bilateral agreement. Execution claim, similar to the other claims emerging from the unreasonable enrichment is of unilateral nature. For example, German law provides for only claiming back of the executed from the transferee, relevant scopes and excluding circumstances but it does not specify, how

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<sup>1</sup> *Honsell H.*, Drei Fragen des Bereicherungsrecht, Festschrift Schulin, 2002, 30; *Staudinger/Lorenz St.*, 1999, § 818 BGB, Rn. 33; *MüKo/Lieb M.*, 2004, § 818 BGB, Rn. 47; compare: § 818 BGB, Art. 65 OR and § 1437 ABGB.

<sup>2</sup> *Honsell H.*, Drei Fragen des Bereicherungsrecht, Festschrift Schulin, 2002, 30; compare also BGE 119 II 437 (442) et seq.; *Gauch P.*, *Schluemp W.R.*, *Schmid J.*, *Rey H.*, Obligationenrecht AT, I, 2003, N. 1437; *Schwenzer I.*, Obligationenrecht AT, 2009, N 58, 12; also *Honsell H.*, *Mader P.*, in Schwimann ABGB, 1987, §1437, N 22; *MüKo/Lieb M.*, 2004, § 818 BGB Rn. 73 et seq.

<sup>3</sup> Protokolle zum BGB II 706 et seq.

<sup>4</sup> *Honsell H.*, Drei Fragen des Bereicherungsrecht, Festschrift Schulin, 2002, 30.

the execution performed by the transferee should be provided, where the transferee, on his side, is an executor.

In this work, we shall attempt to clarify, how the gains actually possessed by the transferee and interests of the parties to the invalid agreement could be taken into consideration at full extent.

## **II. Interrelation of Vindication and Execution Claim in the Countries with Abstract and Causal Property Deals Law**

Similar to German, Swiss and Austrian law systems, Georgian law provides for the claims origination from the unreasonable enrichment. At the same time, there is vindication as well, as the main claim of the proprietor from the holder with no title. In the countries where the obligations' deals results in validity of the property deals, vindication could include the function of execution claim as well. Below we provide analysis of correlation of these two claims.

### **1. Interrelation of Vindication, Execution Claim and their Additional Legal Outcomes in German Law**

In German law, one of the most complicated problems is the issue of competition of the claims originating from the unreasonable enrichment with the claims originating from the other law institutes. As early as in the 19<sup>th</sup> century, when BGB was not developed, according to the dominating position, rei vindication excluded application of *condictio*.<sup>5</sup> Existence of preconditions of vindication implied that the preconditions of execution claim did not exist yet. It was questionable, whether the owner of a property who had no title was enriched or not. Function of the execution claim was to substitute the lost possibility of vindication, i.e. where in result of property loss, destruction or disposal, it was impossible to claim such property from the owner, execution claim<sup>6</sup> replaced vindication and consequently, while it was possible to regain the property through vindication, the execution claim was unavailable.<sup>7</sup> German law doctrine of that period did not strictly distinguish the property *condictio* (*condictio rei*) and ownership *condictio* (*condictio possessionis*),<sup>8</sup> though German civil law of that period was already providing for such difference. Reflection of this position was the assumption dominating in German literature of the past century that Paragraph 985 of BGB, regulating vindication, excluding claiming of the property through *condictio*, leaves untouched the ownership *condictio*.<sup>9</sup>

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<sup>5</sup> *Savigny F.C.*, System des heutigen römischen rechts, V, 1841, 565; *Schmitt R.*, Die Subsidiarität der Bereicherungsansprüche, 1969, 57.

<sup>6</sup> *Savigny F.C.*, System des heutigen römischen rechts, V, 1841, 515; *Wilburg W.*, Die Lehre von der ungerechtfertigten Bereicherung nach österreichischem und deutschem Recht, 1934, 33.

<sup>7</sup> bayr. ObLG, SeuffArch 35, 428; *Stadler A.*, Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion, 1996, 224.

<sup>8</sup> *Stadler A.*, Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion, 1996, 224.

<sup>9</sup> Compare, decisions of the court of Second Reich on ownership *condictio*; RGZ 98, 131 (135); RGZ 115, 31 (34); RGZ 129, 307 (311); also BGH NJW 1953, 58 (59); *Schmitt R.*, Die Subsidiarität der Bereicherungsansprüche, 1969, 104.

Currently, in German law, competition of these two claims is possible in case of claiming of the property from the unreasonable possession. Example is the case where both, the obligations deal and property deal is invalid (due to the same or different reasons), case of so called double invalidity (Doppelnichtigkeit). In such case the owner can claim the property through both, vindication and unjust enrichment.<sup>10</sup> Competition of these two claims causes difficulties as this issue arises not only with respect of the main claims (whether the property should be returned through vindication or *condictio* claim) but also with respect of the additional claims (Nebenansprüche), like, e.g. compensation of gains received from the property.

### a. Interrelation between Vindication and Execution Claim

German literature<sup>11</sup> clearly states that the institute of unjust enrichment shall not be given unambiguously subsidiary role with respect of all other claims, as recognized in many other law systems. Non-subsidiary nature of this institute is emphasized by its place in German Civil Code. Though it clearly rejects the opposite position<sup>12</sup> stating that unjust enrichment is the "supreme order", which bears the function of control and correction of all other institutes of the law and hence, in case of correlation between execution claim and other claims, we may have only relative subsidization<sup>13</sup> i.e. non-excluding competition.

In German Civil Code, vindication is regulated by Paragraph 985<sup>14</sup> and execution claim – by Paragraph 812 I 1, 1. Var.<sup>15</sup> Where both, the obligations and property deals are invalid, the property title owner may claim the property from the unjustly enriched through both, vindication and *condictio* claim. For example, a person's legal capacity is limited at a time of making both, property and obligations' deals or obligations' deal is made erroneously (a person made mistake in establishing contractor's identity) and in property deal, he erroneously transfers the other thing to the purchaser. In result of competition, both deals may be deemed invalid from the moment they were made.<sup>16</sup> Competition of claims may can take place also where more than two persons participate in the legal relations.<sup>17</sup> For example, where, in result of the chain of disposals,<sup>18</sup> each, whether property or obligations deal, between the owner and the first purchaser, as well as between the latter and the second purchaser is invalid. It is necessary that the second purchaser was unable to purchase the title through *bona fide* deal.

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<sup>10</sup> *Stadler A.*, *Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion*, 1996, 224.

<sup>11</sup> *Schmitt R.*, *Die Subsidiarität der Bereicherungsansprüche*, 1969, 96 et seq..

<sup>12</sup> *v.Caemmerer E.*, *Bereicherung und unerlaubte Handlung*, *Festschrift Rabel*, 1954, 339; *Waltjen D.*, *Das Eigentümer-Besitzer-Verhältnis und Ansprüche aus ungerechtfertigter Bereicherung*, *AcP* 175 (1975), 109 et seq.

<sup>13</sup> This is not caused by the fact that this institute is subsidiary, in relation with all other institutes.

<sup>14</sup> § 985: A person who, either intentionally or by mistake, pays the debts of another person may claim from this person compensation for his expenses.

<sup>15</sup> § 812 I 1: A person who gained something through other person's performance or in any way, without legal basis, on the other person's account, shall return it.

<sup>16</sup> The issue, whether the invalidity caused by competition of the obligations' deal is applicable to the property deal as well, is beyond the scopes of this work.

<sup>17</sup> *Stadler A.*, *Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion*, 1996, 225.

<sup>18</sup> *Veräußerungskette* – case where property is disposed off several times, in sequence.

## 1.1. Judicial Practice, Views Dominating in the Literature and Different Opinion

If the subject of claim is returning of the property into the possession, according to the judicial practices and dominating views, vindication and execution claim compete with one another and both rights of claim could be applied.<sup>19</sup>

The other, quite significant part of the authors of scientific literature has the opposite opinion. They state that claim related to unjust enrichment, as a special claim, in competition with vindication, excludes the application of the latter. This is based on the opinion of Siber,<sup>20</sup> stated as early as in the beginning of the century, that vindication, as a general claim originating from the property should be shifted back in competition with the special claims. Further this opinion was formulated as a theory<sup>21</sup> and covered interrelations between vindication and *condictio*.

Existence if the mentioned conception<sup>22</sup> is mostly due to the fact that vindication and *condictio* have different additional claims. For example, Paragraph 987 of German Civil Code regulates the claim of title owner to the unauthorized holder on returning the benefits gained from the property or the benefits, which the holder could gain from the moment of claim and did not accept wrongfully. Further paragraphs regulate compensation of the benefits gained by unauthorized holder, who has gained the property gratuitously, right of the unauthorized holder to compensate damages (§ 988 BGB) and number of other claims accompanying vindication. These regulations distinguish *bona fide* and non-*bona fide* holders and establish different responsibilities for them. Paragraph 993 and the further ones regulate the title owner's obligation to compensate costs made for the property by unauthorized holder. Set of opposing claims form so called "relations between the title owner and holder" (*Eigentümer-Besitzer Verhältnis*). Law of unjust enrichment regulates differently such claims in German law, though before the issue of competition between the additional claims, the issue of competition between the main claims should be discussed, i.e. competition between the claims oriented towards restitution of the property and not compensation of the benefits or damages.<sup>23</sup>

Unlike the additional claims, the main claims are oriented towards one and the same purpose – restitution of the property and there are no any contradictions in assessment of the legal benefits.<sup>24</sup> As

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<sup>19</sup> BGHZ 34, 122; *Staudinger/Gursky K.H.*, 2006, § 985 BGB, Rn. 24; compare also RGZ 170, 259.

<sup>20</sup> *Siber H.*, *Der Rechtszwang im Schuldverhältnis*, 1903, 114, 125 et seq.; also *Siber H.*, *Die Passivlegitimation bei der reivindicatio*, 1907, 249 et seq.

<sup>21</sup> *Raiser L.*, *Eigentumsanspruch und Recht zum Besitz*, *Festschrift Wolff M.*, 1952, 123, 140; *Raiser L.*, *Verwendungsansprüche des Werkunternehmers*, "JZ", 1958, 681, 683; *Baur F.*, *Stürner R.*, *Sachenrecht*, 1999, 97 et seq.; *v. Caemmerer E.*, *Bereicherung und unerlaubte Handlung*, *Festschrift Rabel*, 1954, 145 et seq.; Compare also *Waltjen D.*, *Das Eigentümer-Besitzer-Verhältnis und Ansprüche aus ungerechtfertigter Bereicherung*, *AcP* 175 (1975), 109 et seq.; *Honsell H.*, *Wieling H.J.*, *Fälle zum Besonderen Schuldrecht*, 1996, 98 not. 2.

<sup>22</sup> *Waltjen D.*, *Das Eigentümer-Besitzer-Verhältnis und Ansprüche aus ungerechtfertigter Bereicherung*, *AcP* 175 (1975), 109.

<sup>23</sup> Differentiation between the basic and additional claims is quite possible, Compare: *Staudinger/Gursky K.H.*, 2006, § 985 BGB, Rn. 24; *Köbl U.*, *Das Eigentümer-Besitzer-Verhältnis im Anspruchssystem des BGB*, 1971, 153 et seq.; *Emmerich V.*, *Nebenfolgen der Vindikation*, 1966, 42, 100 et seq.; *Medicus D.*, *Bürgerliches Recht*, 2011, Rn. 593.

<sup>24</sup> *Larenz K.*, *Methodenlehre*, 1991, 250.



opposed to the statement that the execution claim, in relation to vindication, should be given the preference, the following argument could be provided. Paragraph 986 of BGB states that of a property owner has so called ownership rights, than vindication from the side of title owner is unacceptable.

If contractual claims and those originating from unjust enrichment exclude possibility of vindication, than scopes of application of Paragraph 986 are very limited.<sup>25</sup> In any case, where there is no contractual ownership right, claiming of the property is possible on the contractual grounds or according to the regulations of unjust enrichment, as such, excluding the possibility of claiming of the property through vindication. Vindication was applicable in very limited cases as well, as always, when invalid contractual relations take place, reclaiming of the chattels would be provided according to the regulations of unjust enrichment. And the main sphere of vindication application would be the case where the title owner has lost ownership over the property unwillingly, though, in German law, there is the other, more specified claim for regulation of such relations.<sup>26</sup>

There is the following additional argument against exclusion of vindication in application of the *condictio* application: number of requirements, including vindication, provides the possibility of separation of an item from the property owned by debtor and its transfer to the title owner in case of the debtor's bankruptcy.<sup>27</sup> Though, where double invalidity takes place in relations between the title owner and unjustly enriched owner, such separation is provided by *condictio* as well,<sup>28</sup> but not where the unjustly enriched person has disposed the item to third party. Example: *I. A. sold the item and transferred it to B, who, on his side, disposed this item and transferred to C. All these circumstances, both, in obligation and property respect, are invalid. Further B got bankrupt.* Assuming that A's condition against B excludes possibility of vindication of the item from C, such solution apparently worsens A's situation as he will have no possibility to claim the item from C directly and *condictio* against B will not be helpful, as B does not own the item anymore and only value of the item could be claimed from him (§818I BGB). A will have to take place in B's creditors and be satisfied by the share remained after distribution of the bankrupt's property. Regarding these arguments, the position that vindication and *condictio* do not exclude one another but rather compete, in German law, see, quite well grounded.

## **b. Correlation between Vindication and Execution *Condictio* Accompanying Claims**

Correlation between the vindication (§§987 and further BGB<sup>29</sup>) and execution *condictio* accompanying claims (§§812, 818 BGB) is relatively complex issue. In both cases, outcome accompanying the claim for property is claim of the benefits gained from such property.

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<sup>25</sup> *Stadler A.*, *Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion*, 1996, 227.

<sup>26</sup> § 1007 II BGB or § 861 BGB; compare *Medicus D.*, *Bürgerliches Recht*, 2011, Rn. 593.

<sup>27</sup> *Stadler A.*, *Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion*, 1996, 229.

<sup>28</sup> *Böhle-Stamschräder A.*, *Kilger J.*, § 43 *Kostenordnung* Bem. 7.

<sup>29</sup> § 987 I BGB: Owner shall return to the title owner the benefits gained after submission of the claim to the court. § 988 BGB: owner, possessing the property as his own one or owns in on the basis of the right of use, which actually does not exist and the ownership is gained gratuitously, shall compensate to the title owner the benefits gained before submission of claim in accordance with the provisions on unjust enrichment. § 993 I BGB: if the preconditions specified in paragraphs 987-992 are not complied with, the owner shall return the gains which could not be regarded as the benefits from reasonable operation in accordance with

Bona fide owner, from whom the title owner regains his own item through vindication, could be obligated to compensate the benefits generated only after submission of vindication claim against him or the benefits gained through use of the item more extensively than allowed (Übermaßfrüchte).<sup>30</sup> Bona fide owner shall not be imposed the obligation of returning of any other benefits. Exclusion is the case where the owner has gained ownership gratuitously. In such case he has to return the benefits in accordance with the provisions applicable to unjust enrichment.

Returning of the benefits is regulated in the other way in the law on unjust enrichment.<sup>31</sup> In such case, paragraph 818, BGB competes with paragraphs 987, 988 and 993. Application of each of these regulations provides different outcome. Owner, who has gained ownership as a result of invalid obligations deal, shall return the benefits gained from the item in accordance with §818 I BGB, while the owner, who has not gained ownership as double invalidity has taken place, shall not return such benefits, according to §§988, 993 I BGB.

### **1.1. Preference of the "Relations between the Title Owner and Owner"**

According to German judicial practice, in competition of claims, the preference shall be given to the additional claims arisen from vindication. According to the opinion dominating in the judicial practice and in the literature, purpose of these additional requirements is privilege of the bona fide owner, who has gained the item through payment and no claim is brought against him yet. This purpose is particularly significant in relations between three persons, i.e. where the item received by the owner from the title owner was further transferred to the other owner. Second, unauthorized owner obliged to return the item to the title owner, and entitled to claim compensation from his contractor (the first owner) only, shall be entitled to the benefits gained from the item. To provide privileges to the above owner, according to the position dominating in the judicial practice, paragraph 987 of BGB and the further paragraphs thereof, provide the all-embracing provisions excluding possibility of originating of similar requirements from the other institutes of the law.<sup>32</sup> The general principle embedded in this opinion is often subject to certain modifications.

As mentioned above, the purpose of the institute regulating "relations between the title owner and owner" is to ensure that the bona fide owner gaining the item through paid deal maintained the benefits generated from such item as he is to return the item to the title owner and claiming of the payment (if relations between three parties take place) depends on solvency of his direct contractor, as well as the other complications created by such situation. In other words: in the relations between three parties, the title owner regains the item from the third party's ownership very simply, while the latter, having no

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the provisions on unjust enrichment; he shall not be liable to compensate any other loss or damage in any other way.

<sup>30</sup> Implies the gains generated on the account of wear and tear of the property's substance or use of the property is so extensive that it causes reduction of future productivity of the property (*MüKo/Baldus Ch.*, 2009, § 993 BGB, Rn. 5).

<sup>31</sup> § 818 I BGB: Gains obtained from the thing or right, as well as what was received by a person in result of the damage, breakage or encroachment of the thing.

<sup>32</sup> RGZ 163, 348 (35)2; RGZ 137, 206; *MüKo/Medicus D.*, 1997, §993 BGB, Rn. 11 et seq.

reason to propose that the item was not his property and using this item as his own one, loses the item and in his claim for payment, he is dependent upon solvency of the absolutely different person (and not the title owner).

In case of acquisition of ownership for free the provisions are different. Evaluative decision (Wertungseinschiedung) of German legislators that compared with the paid acquisition, gaining of the item gratuitously is much weaker basis for maintaining and avoiding additional claims (causa minor) is one of the key ideas of the entire institute of unjust enrichment.<sup>33</sup> This assessment is applied to the "title owner & owner relations" as well. Therefore, according to the provisions of § 988, an owner who has gained ownership gratuitously shall compensate the benefits similar to the provisions dealing with unjust enrichment. Law on unjust enrichment does not distinguish whether the ownership was gained through paid or unpaid deal. Hence, where the paid obligations' deal is invalid and the property deal is valid, the unjustly enriched shall return the property to the initial title owner, as well as the benefits gained from this item (§ 818 I BGB). Where, similar to the obligations' deal the property deal was invalid as well, unjustly enriched owner had to return the property, together with the gained benefits, according to the *condictio* provisions while in case of responsibility, originating from the vindication claim, he was not obliged to return the benefits. These two measures of responsibility are not comparable. Judicial practice<sup>34</sup> attempts to fit them to one another by means of the following method: gaining of ownership with no grounds or no payment is regarded equal, i.e. even where a person has made the paid obligations; agreement and at the same time the property deal providing ownership was invalid, it is regarded that the ownership was gained with no payment. Such solution allows that Paragraph 988 of BGB placing into the privileged situation only buyer who has made payment and pointing to unjust enrichment in all other cases of claiming benefits, was applicable to the double invalidity cases. Hence, in case of invalidity of property deal, unauthorized owner, in any case dealing with returning of the benefits, was responsible in accordance with the provisions of vindication relations.

## 1.2. Considerations Provided in the Literature and Competition of Claims

These considerations are quite strictly criticized in the literature.<sup>35</sup> In our opinion, the example would be useful to illustrate the arguments. *Example 2: A sold an item and transferred it to B, who, on his side, transferred it to C on the basis of unpaid deal. All these obligations' and property deals are invalid and C could not gain the property through bona fide acquisition.*

The basis for this difference between paying and non-paying buyer provided by Paragraph 988 of BGB, where only the latter shall return the benefits, is the fact that C, gaining ownership gratuitously, is not subject to the risk of repayment of the price from direct contractor B. He has gained the property

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<sup>33</sup> For comparison: § 816 I BGB: "If unauthorized person disposes off the thing and such disposal is valid, with respect of the authorized person, he shall transfer to the authorized person what was received in result of such disposal. If disposal takes place gratuitously, this obligation will be vested upon a person who actually gains the legal goods in result of such disposal."

<sup>34</sup> RGZ 163, 348 et seq.; BGHZ 32, 76 (94) et seq.

<sup>35</sup> *Baur F., Stürner R.*, Sachenrecht, 1999, 97; *Medicus D.*, Bürgerliches Recht, 2011, Rn. 600; *Emmerich V.*, Nebenfolgen der Vindikation, 1966, 94.

through unpaid deal and therefore, he could be obligated to return gained benefits directly to A. This issue is solved in the different way where B transfers the item to C through paid deal. C's interest, if he has to transfer the benefit gained from the item to the title owner, is in regaining of the payment. More exactly, C is interested not to return the item before reimbursement of the amount paid by the contractor.<sup>36</sup> In relations between two parties, C's such interest could be taken into consideration through obligating both parties to provide execution simultaneously (Zug-um-Zug Leistung),<sup>37</sup> allowing C, owning the item, not to return the benefit until the costs made for acquisition of the item are not compensated to him. The situation is different, where C returns the benefits to A, the title owner while he is entitled to claim repayment of the paid price from B, the direct contactor. In such case he is not entitled to claim for simultaneous execution and the risk of B's insolvency is born by him. This very outcome, regarded as unfair, is the main argument against the solution offered by the judicial practice. Therefore, the position dominating in the literature<sup>38</sup> is that irrespective of § 993 I 2 BGB, stating that the bona fide paying purchaser shall not repay the benefits, in case of double invalidity, unjust enrichment should be still applied. Though, as such, it induces new problem: the two institutes provide different outcomes to one and the same case.

### 1.3. Privilege of Execution Condictio

According to the third position considered in the literature,<sup>39</sup> the entitlement to the additional claims resulting from execution condictio supersedes the additional claims originated from vindication.<sup>40</sup> This position is based upon the assumption that unjust enrichment, in relation with vindication, is a special requirement, applicable to the interrelations of the additional outcomes of condictio and vindication. This theory is based on the argument that there is no difference, whether only obligations' deal is invalid or both, obligations' and property deals are invalid.<sup>41</sup> In addition, where the title owner claims his property based on vindication and its additional claims, instead of execution condictio, an unjustly enriched person loses the opportunity to oppose to this claim his own claim related to unjust enrichment.<sup>42</sup>

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<sup>36</sup> *Stadler A.*, Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion, 1996, 229.

<sup>37</sup> § 273 BGB.

<sup>38</sup> *Baur F., Stürner R.*, Sachenrecht, 1999, 97; *Medicus D.*, Bürgerliches Recht, 2011, Rn. 600; *Larenz K., Canaris C.W.*, Lehrbuch des Schuldrechts, II/2, 1994, § 74 I 1 a.

<sup>39</sup> *v.Caemmerer E.*, Bereicherung und unerlaubte Handlung, Festschrift Rabel, 1954, 145 et seq., 154 not. 42; *Waltjen D.*, Das Eigentümer-Besitzer-Verhältnis und Ansprüche aus ungerechtfertigter Bereicherung, AcP 175 (1975), 109 et seq.; *Emmerich V.*, Nebenfolgen der Vindikation, 1966, 102 et seq.

<sup>40</sup> *Staudinger/Eckpfeiler/Martinek M.*, 2009, § 818 BGB, Rn. 68; this rule is applicable only in case of competition between performance condictio and vindication and is not applicable with respect of the other conditiones.

<sup>41</sup> *v.Caemmerer E.*, Bereicherung und unerlaubte Handlung, Festschrift Rabel, 1954, 145 et seq., 154 not. 42; *Köbl U.*, Das Eigentümer-Besitzer-Verhältnis im Anspruchssystem des BGB, 1971, 275; *Reuter D., Martinek M.*, Ungerechtfertigte Bereicherung, 1983, 690; *Koppensteiner H.G., Kramer R.A.*, ungerechtfertigte Bereicherung, 1975, 207.

<sup>42</sup> *Larenz K., Canaris C.W.*, Lehrbuch des Schuldrechts, II/2, 1994, 338 et seq.; *Koppensteiner H.G., Kramer R.A.*, ungerechtfertigte Bereicherung, 1975, 198 et seq.; *Reuter D., Martinek M.*, Ungerechtfertigte Bereicherung, 1983, 667.

## 2. Correlation between Vindication and *Condictio* in Swiss Law

### a. Claim of Property Restitution through Vindication

In Swiss law, where the causality principle operates, compared with German law, the role of unjust enrichment is substantially lower. Invalid obligations' deal automatically invalidates the property deal and the title owner has the opportunity to claim the property through vindication (Art. 641 II ZGB).<sup>43</sup> Of course, material presence of the property in the possession of the unjustly enriched person is the precondition to the vindication claim. A person, who has disposed of the property, bears the risk of accidental destruction of this property being in holding of unjustly enriched person.<sup>44</sup> Claim of compensation of costs made for the property and losses caused by the reason of purchaser is provided by Art. 938 ZGB and further articles.

Law of property deals has its niche in the other countries as well. For example, we have mentioned above the cases there the object of enrichment is money, mixed with the money of the enriched person, intangible assets, which could not be vindicated or material items, which, for different reasons, are not present in the contractor's property and only compensation could be claimed.

In the other cases, in Swiss law competition between *condictio* and vindication and relevant outcomes are similarly problematic. Both, the literature<sup>45</sup> and judicial practice make attempts to adjust them. The main subject of discussions comprises of the case where the seller may vindicate his property based on invalid purchase and sale agreement and the buyer may claim the paid price through *condictio* only, as well as the circumstance that the additional claims originating from vindication (Art. 938, ZGB and further and/or Art. 329 ABGB and further) are not suitable for reversion of the property movement within the invalid deal.<sup>46</sup> For example, in the law on unjust enrichment, there is no provision made to regulate repayment of the benefits from the property in question. As for the vindication relations, obligation of returning of the benefits is imposed on non-bona fide owner only (Art. 940 ZGB). Initially, the judicial practice<sup>47</sup> made attempts to introduce the requirement of benefits' returning in the law dealing with unjust enrichment. In such case the additional problem was the fact that in Switzerland, the law on unjust enrichment did not differentiate the bona fide and non-bona fide owners. Along with the judicial practice, the literature,<sup>48</sup> emphasized this difference in the law on unjust enrichment to prevent discrepancies between the vindication and *condictio* relations in this respect and the obligation of compensation of the benefits, within the scopes of unjust enrichment did not exceed beyond the scopes of vindication. Though, finally, the supreme judicial practice followed the other way.<sup>49</sup> Currently, it is possible to claim the benefits, as unjust enrichment even where the property is recovered through vindication and the owner is a bona fide owner excluding the possibility of the same from vindication

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<sup>43</sup> *Bucher E.*, *Obligationenrecht AT*, 1988, § 34 I 3; *Keller M., Schaufelberger P.*, *Das Schweizerische Schuldrecht, III, Ungerechtfertigte Bereicherung*, 1990, 7 et seq.; *Grawehr P.A.*, *Die ungerechtfertigte Bereicherung*, 1991, 44; *Oftringer K.*, *Eigentumsübertragung an Fahrnis*, 1933, 128.

<sup>44</sup> *Giger H.*, *Rechtsfolgen norm- und sittenwidriger Verträge*, 1933, 132.

<sup>45</sup> *Oftringer K.*, *Eigentumsübertragung an Fahrnis*, 1933, 126.

<sup>46</sup> *Honsell H.*, *Tradition und Zession - kausal oder abstrakt? "FS Wiegand"*, 2005, 356.

<sup>47</sup> BGE 84 II 186; Compare also BGE 61 II 20.

<sup>48</sup> *Keller M., Schaufelberger P.*, *Das Schweizerische Schuldrecht, III, Ungerechtfertigte Bereicherung*, 1990, 72.

<sup>49</sup> BGE 110 II 244 (249).

relations. By this, the law of unjust enrichment has undertaken the function of additional vindication claim to certain extent, irrespective whether the owner is a bona fide owner or not. Such solution of the problem is justified by the principle of actual mutuality, detailed below.

## **b. Subsidiary Nature of Condictio in relation with Vindication**

In Swiss law, the claim conditioned by unjust enrichment and oriented towards regaining of the property is of subsidiary nature, if the same goal could be achieved through the other claim. Federal Court of Switzerland, in one of its decisions,<sup>50</sup> had almost made the conclusion that a person is unjustly enriched only where it is impossible to recover the legal goods from him by means of the norms of any other civil-law institute. To characterize the interrelation between vindication and condictio, the following example would be adequate. *Example 3: A sold to B the lorry and B regularly hired out this lorry. Later it turned out that the sale and purchase agreement was invalid from the moment of its execution and B did not and could not know this. At a time of returning of the lorry A demanded from him repayment of the benefits gained through hire.*

In this case, together with the causal obligations' deal, the property deal is invalid as well. For the entire period of operation, A was the title owner of the lorry and he can recover his property through vindication. This vindication claim excludes application of the regulations on unjust enrichment oriented towards regaining of ownership.<sup>51</sup> The problem is how the benefits generated from hire out of the lorry could be claimed. Vindication provides for recovery of the benefits as additional claim only from the non-bona fide owner (Art. 940 ZGB). And here the judicial practice<sup>52</sup> relies upon the claim originated from unjust enrichment, providing opportunity of claiming of the amount generated from the hire of lorry, irrespective of bona fide ownership.

In all other cases of competition, vindication excludes condictio<sup>53</sup> and therefore the latter has very limited function. It is applicable only in the above mentioned exclusive cases.<sup>54</sup> Such decision is justified by the argument stated in German literature of 19<sup>th</sup> century. According to this argument, only ownership of a property could not be regarded as enrichment, where the property remains with the disposing party.<sup>55</sup> I.e., based on operation of the casualty principle, in typical cases no key component of unjust enrichment, "enrichment"<sup>56</sup> is absent. Though this dogma<sup>57</sup> of subsidization is criticized in the legal

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<sup>50</sup> BGE 102 II 329 (338).

<sup>51</sup> *Guhl Th., Merz H., Kummer M.*, Obligationenrecht, 1980 203; *Tuhr A., Peter H.*, Allgemeiner Teil des Schweizerischen Obligationenrechts, 1974, 502.

<sup>52</sup> BGE 110 II 228, compare the literature cited.

<sup>53</sup> *Oftinger K.*, Eigentumsübertragung an Fahrnis, 1933, 126; BGE 110 II 234; *Gauch P., Schlupe W.R., Jäggi P.*, Schweizerisches Obligationenrecht Allgemeiner Teil, I, 1995, N. 1499 et seq.

<sup>54</sup> *Bucher E.*, Obligationenrecht AT, 1988, §34 III 2 a not. 29.

<sup>55</sup> *Grawehr P.A.*, Die ungerechtfertigte Bereicherung, 1991, 44.

<sup>56</sup> *Keller M., Schaufelberger P.*, Das Schweizerische Schuldrecht, II, 1991, 7; *Bucher E.*, Obligationenrecht AT, 1988, §34 III 2 a; *Gauch P., Schlupe W.R., Jäggi P.*, Schweizerisches Obligationenrecht Allgemeiner Teil, I, N. 1501; *Grawehr P.A.*, Die ungerechtfertigte Bereicherung, 1991, 51; *Oftinger K.*, Eigentumsübertragung an Fahrnis, 1933, 126.

literature,<sup>58</sup> particularly, because the German doctrine relies upon the other ideas, unified different opinion was not formulated yet.<sup>59</sup>

### 3. Correlation between Vindication and Condictio in Austrian Law

Austrian law knows both, vindication and condition claims. In addition, being the country of causal property deals, in Austria, similar to Switzerland, in case of invalidity of the obligations' deal. The issue of competition between vindication and condictio arises. Vindication claim is regulated by Paragraph 366 of ABGB and is applied for recovery of the property from unauthorized ownership in all cases of invalidity of the obligation' deal from the moment of its concluding. According to the prevailing opinion,<sup>60</sup> vindication claim is not given preference and it competes with the claim originating from unjust enrichment. Though in Austrian judicial practice the latter has relatively modest function,<sup>61</sup> the literature still makes attempts to fit the legal outcomes of these two claims. For example, according to §1432 ABGB, if a person fulfills the obligation under the deal invalid due to the age or improper form, fulfillment shall not be claimed back, even where the implementer knew about absence of obligation. This prevailing opinion in Austrian literature spreads this provision over the vindication as well and excludes possibility of property recovery through vindication.<sup>62</sup>

### III. Correlation of Vindication and Condictio in Georgian Law and Adjustment of the Provisions of Foreign Law to the Outcomes of Invalid Bilateral Agreements

Georgian law system where the property deal is not regarded valid without obligations' deal providing basis for it,<sup>63</sup> should be oriented towards Austrian and Swiss models of the law on unjust enrichment, though the structure of the institute for unjust enrichment in Georgian Civil Code is closer to German one. In this chapter we make attempt to fit the above problems and their solutions with Georgian law.

We regard that the position expressed in Georgian legal literature,<sup>64</sup> stating that in competition between condictio and vindication, in any case, preference should be given to vindication, is uncon-

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<sup>57</sup> BGE 110 II 228 (234); *Gauch P., Schlupe W.R., Jäggi P.*, Schweizerisches Obligationenrecht Allgemeiner Teil, I, Zürich, 1995, N. 1500; BGE 114 II 156 (159); *Keller M., Schaufelberger P.*, Das Schweizerische Schuldrecht, II, 1991, 4; *Schwenzer I.*, Obligationenrecht AT, 2009, 59.03.

<sup>58</sup> *Honsell H.*, Drei Fragen des Bereicherungsrecht, Festschrift Schulin, 2002, 33.

<sup>59</sup> *Tuhr A., Peter H.*, Allgemeiner Teil des Schweizerischen Obligationenrechts, 1974, 519 et seq.

<sup>60</sup> *Kozioł H., Welser R.*, Grundriss des bürgerlichen Rechts AT, 1988, 431; OGH SZ 57/44.

<sup>61</sup> *Honsell H., Mader P.* in Schwimann ABGB, 1987, § 1431 ABGB N. 2; *Grawehr P.A.*, Die ungerechtfertigte Bereicherung, 1991, 64.

<sup>62</sup> *Stadler A.*, Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion, 1996, 237 and literature specified there.

<sup>63</sup> Section 1, Article 186 of GCC establishes as precondition for gaining of the property that the title owner transferred it to the purchaser on the basis of valid rights.

<sup>64</sup> *Kereselidze D.*, Application of Provisions of Unjust Enrichment, "Georgian Law Review", Vol. 6, N4, 2003, 600; *Chachava S.*, Competition of the Bases for Claims and Demands in Private Law, 2010, 145 (in Georgian).

vincing. As we saw above, to solve competition between *condictio* and vindication claims, foreign law offers number of different solutions.

May be, for Georgian law, it is unreasonable assumption that vindication and relevant additional claims, in competition, exclude the *condictio* and relevant additional claims. Primarily, with this assumption, in cases where the property, as such, is still in the possession of unjustly enriched person, execution *condictio* would become similar and this would not correspond to the will of Georgian legislators, as they have regulated the scopes and additional claims of *condictio*. It should be also taken into consideration that vindication claim is applicable not only to the unjustly enriched but to all unauthorized owners. It is not only the main and most powerful but also most general claim. On the contrary, the execution *condictio* is applicable to certain cases only and this underlines the special nature of the institute of unjust enrichment and necessity of its application in case of competition. It is important, that this position does not mean that possibility of recovering of the transferred property, as such, implies existence of execution between parties. And this differentiates this case from all other ones within the area of applicability of vindication. The owner, who has transferred the property willfully, should not be equalized with the owner from whom the property was stolen.

Parties' opposing executions, within the scopes of agreement create mutuality. One party executes only because the other party executes as well. In all considered legal systems, institute of unjust enrichment, in one or another form, serves to transfer this principle into the relations originating from invalidity of agreement. A party performs if the other one does and is interested, in case of invalidity of execution return the received if the other party does.

Georgian legislators, taking into consideration the experience of the other countries, included this principle in Section 2, Article 980 of Georgian Civil Code. According to this provision, the obligations of compensation under articles 979 and 980 shall be fulfilled simultaneously. This position of the legislator would be senseless, if only vindication claim is taken into consideration in competition as within these scopes application of this principle would be impossible. German legal literature and judicial practice formed this principle into the theory and emphasized its dogmatic contours, with had changed significantly with time.

## **1. "Saldotheorie" in German Law**

Below we make attempt to explain why German judicial practice<sup>65</sup> had to develop Saldotheorie, how it operates in each specific case and why it should be introduced into Georgian law. We provide example and consider it initially based on the abstraction principle and further within the scopes of Georgian law.

German law on unjust enrichment does not provide any special provisions differentiating it from the other performance *condictiones* for the *condictio* relations originating from invalid bilateral agreement.<sup>66</sup> Direct use of the law text, in many cases, could even result in quite unfair outcomes.

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<sup>65</sup> BGHZ 53, 144 (145); BGHZ 57,137 (147).

<sup>66</sup> *Miko-Schwab K.H.*, 2009, § 818 BGB, Rn. 209; *Larenz K., Canaris C.W.*, Lehrbuch des Schuldrechts, II/2, 1994, 321; Compare for different opinion *Flume W.*, Die Saldotheorie und die Rechtsfigur der ungerechtfertigten Bereicherung, AcP 194 (1994), 433.



*Example 4: A, the car seller sold to B a lorry for GEL 30000 (real value is GEL 30000). In two weeks after the date of agreement, in the accident occurred not by the reason of B, the value of lorry reduced by GEL 15000. It turned out that the agreement was invalid from the moment of its conclusion and A demands to return the lorry, while B claims the paid money back.*

Irrespective of invalidity of the agreement, according to the principle of abstraction, B has gained the property right to the lorry but he has to return the lorry according to the regulations dealing with unjust enrichment (§812 I, 1, 1. Var, BGB). A shall return the price of the thing. Until both performances (lorry and money paid for it) are with the unjustly enriched, in the initial form, this outcome could be accepted without correction. A claims the lorry and B claims the money and both parties can delay fulfillment of their respective obligations until receipt of the performance from the other party (§273 BGB<sup>67</sup>).

If the lorry is damaged, A will have to return to B the purchase price in full, while B, instead of the undamaged lorry (received by him initially), would return the thing with half-value. He had not received any benefits as a result of reduction of the property value and hence, he is not liable to compensate the loss caused by damage of the property, as it is regarded that GEL 15000, as enrichment, is not present in B's property.<sup>68</sup> The outcome is unfair as the risk of damage (whether accidental or by the receiver's reason) of the property is born by a person, who is neither owner and nor title owner. To prevent such outcome, German judicial practice<sup>69</sup> has developed so called theory of balance ("Saldotheorie").

In dogmatic sense, justification of this theory is quite disputable. Initially, the theory of balance was based upon the substance of the claim oriented towards recovery of unjust enrichment remained after balancing of all goods (penalizing and netting) remained after *condictio*. The opposing performances should not be claimed independently from one another but rather they should be automatically netted and unjust enriching should be claimed only from the party with which the balance was left and to the extent of such balance after balancing. After balancing only one claim would remain and such balance is regarded as unjust enrichment (erlangtes "Etwas").<sup>70</sup> Provided statement still is the way of resolving similar cases in judicial practice up to present.<sup>71</sup> If the claims of unjust enrichment of both parties are uniform (e.g. presented in money), than netting of these performances is provided and

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<sup>67</sup> § 273 BGB: If a debtor, from the same legal relations, which obligates him, is entitled to claim against the creditor, he may, unless the obligation otherwise provides, delay fulfillment of his obligation until the creditor fulfills it (right on delay of performance).

<sup>68</sup> § 818 II BGB: If it is impossible to return the thing, regarding its condition or if the receiver is not able to return the thing for any other reason, he shall compensate its value. § 818 III BGB: Obligation of compensation of the thing's value does not exist, if the recipient is not enriched any more.

<sup>69</sup> This theory was first seen in the decisions of court of Second Reich - RGZ 54,137, 141ff., and in contemporary German judicial practice it is unanimously recognized in slightly changed form: BGH, NJW 1999, 1181 et seq.; BGH, NJW 1995, 454, BGHZ 126, 105, BGH, NJW 2000, 3562. Compare for consideration of the parties' interests *Larenz K., Canaris C.W.*, Lehrbuch des Schuldrechts, II/2, 1994, § 73 III 2 a. For detailed justification of the theory; compare: *v.Caemmerer E.*, Bereicherung und unerlaubte Handlung, Festschrift Rabel, 1954, 385; *Leser H.G.*, Von der Saldotheorie zum faktischen Synallagma, 1956.

<sup>70</sup> *Reuter D., Martinek M.*, Ungerechtfertigte Bereicherung, 1983, 596.

<sup>71</sup> BGHZ 147, 152 (157); BGHZ 145, 52 (54); BGH JZ 1995, 572 (573).

only one of the parties is charged to return the amount remained after netting. *Example 5: A bought from B the watch for GEL 120 (its actual value was GEL 140) and this watch was later destroyed. The purchase agreement was invalid.*

In such case, A shall have the obligation to repay the price, GEL 120, while B will have the obligation to return the actual value of the thing, GEL 140. But this thing is no more present in B's property in its natural form and he has not received any replacement or benefit and he will not be regarded as enriched (§ 818 III BGB). Hence, we would obtain the above mentioned unfair outcome, where one of the parties would recover performance to full extent, while the other party would recover nothing. Therefore, judicial practice, before application of § 818 III BGB, nets the opposing *condictio* claims. In result, the obligation of returning of the received will be imposed only on the party, with whom, in result of netting, the balance will remain. Thus, B would be liable to repay GEL 20. § 818 III BGB will be applied to the balance remained after netting and as the amount of GEL 20 is no more present in B's ownership, both parties will be exempted from the obligation of returning of the performances.

The case, where the *condictio* claims comprise of non-uniform performances, could be discussed using the initial example. B has paid GEL 30000 as in lieu he would receive the lorry of the same value. Further, being in ownership of unjustly enriched B, the lorry lost its value. Where both performances are in the natural form in the possession of the unjustly enriched, a person may claim restitution of his property if he returns the performance.<sup>72</sup> If one of the performances was destroyed in full or in part, than the subject of claim for B's unjust enrichment shall be not the total price paid for the lorry but performance value initially received by B less the value of destroyed performance.<sup>73</sup>

It should be taken into consideration that currently, significant part of the literature<sup>74</sup> justifies the "theory of balance" not by the principle providing basis for the law on unjust enrichment stating that *condictio* is intended for recovery of the positive balance but through transfer of mutuality into the *condictio* relations. Such solution is based on the following considerations. In the contractual relations, as it was specified above, performances of the parties are in mutual interrelation, i.e. any of the parties performs because the other party's performing (*do ut des*). To prevent the above unfair outcome, this mutual relation should be transferred to the relations of unjust enrichment – any party returns because the other party does the same and returns to the extent returned by the other party – *redo utreddas*. This is called factual mutuality. Actual, because, based on von Caemmerer's explanation,<sup>75</sup> though the agreement was invalid and no legal or valid mutuality was created, it is impossible to reject that the agreement was factually performed and hence, we have actual mutuality.<sup>76</sup> Such mutuality, i.e. a party's

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<sup>72</sup> BGH, "NJW", 1995, 454; BGHZ 147, 152 (157); BGH, "NJW", 1999, 1181 et seq.; BGH, "NJW", 2001, 1127, in such case two claims are linked and the counterclaim is submitted; useless, according to § 273 BGB.

<sup>73</sup> BGHZ 116, 251 (256); BGHZ 145, 52 (55); BGHZ 149, 326 (333); BGHZ 161, 241 (250); BGH JZ 1995, 572 (573); BGH, NJW 1999, 1181.

<sup>74</sup> Justification originates from *v. Caemmerer E.*, *Bereicherung und unerlaubte Handlung*, Festschrift Rabel, 1954, 385; Compare further *Leser H.G.*, *Von der Saldotheorie zum faktischen Synallagma*, 1956, 110; *Reuter D., Martinek M.*, *Ungerechtfertigte Bereicherung*, 1983, 592.

<sup>75</sup> *v. Caemmerer E.*, *Bereicherung und unerlaubte Handlung*, Festschrift Rabel, 1954, 386.

<sup>76</sup> *Reuter D., Martinek M.*, *Ungerechtfertigte Bereicherung*, 1983, 598.

opinion, that the agreement is valid, is the main motivation of performance<sup>77</sup> and its leaving without attention means rejection of protection of the parties' legal interests.

A may be obligated to return the amount equal to the quantity of performance returned to him. For example, in the provided case, not only B will return the lorry with GEL 15000 lower value but similarly, A will return the amount reduced by the same GEL 15000, as the price of the thing.<sup>78</sup> Symmetric correlation between the parties' performances within the scopes of contractual relations is transferred to the relations originating from unjust enrichment. According to §818 III BGB, A is not regarded as enriched by GEL 15000 anymore, as he returns the amount and receives, in lieu, an item devaluated by GEL 15000. Therefore, this amount proportionally reduces the amount to be repaid. This opinion is based on the assumption: §818 III BGB determining, whether a person may be deemed unjustly enriched, proportionally, in this case, by GEL 15000, reduces the claims of both parties. Unjustly enriched person may claim performance only to the extent of his repayment.

### a. Weaknesses of the "Theory of Balance"

"Theory of balance" is criticized<sup>79</sup> in German legal literature in many respects. In number of cases, this theory is limited,<sup>80</sup> modified<sup>81</sup> or the exceptions are assumed.<sup>82</sup> For example, automatic netting is impossible, where one of the parties provides advance performance, as well as in number of the other cases.<sup>83</sup> It is clear that the outcome achieved on the basis of "theory of balance" shall not contradict to the substance of the norm<sup>84</sup> relying on which the agreement was deemed invalid.<sup>85</sup> Therefore, this theory is not applied against the interests of a juvenile.<sup>86</sup> *Example 6: juvenile A, without consent of his parents, buys sweets from B and eats them there. When the parents finally reject his agreement, A claims from B repayment of the price paid for the sweets and B – compensation of the value of sweets.*

In this case, if A's *condictio* claim oriented towards regaining of the purchase price, was deducted the value of sweets he has eaten, we would obtain the outcome, against which the law regulation was intended – A would lose his claim. Regulation establishing invalidity of the deal made by juvenile against the will of his/her parents is intended to prevent juvenile's property loss. In this case, loss is impossibility of repayment of the purchase price and in case of purchase of the consumable goods this

<sup>77</sup> *Leser H.G.*, *Von der Saldotheorie zum faktischen Synallagma*, 1956, 110.

<sup>78</sup> *Ib.*, 54: "Ist also beim Empfänger die Leistung, zur Hälfte weggefallen, so kann er entweder nur die Hälfte der Gegenleistung herausverlangen oder muß die Differenz ausgleichen oder die Rückabwicklung unterbleibt."

<sup>79</sup> For comparison: *Larenz K., Canaris C.W.*, *Lehrbuch des Schuldrechts*, II/2, 1994, § 73 III.

<sup>80</sup> BGHZ 126, 105; BGHZ 57, 137; BGHZ 78, 216; BGH, "NJW", 2001, 1127.

<sup>81</sup> Dignatic justification of this theory is disputable and mentioned "doctrine on factual mutuality" is severely opposed. Compare e.g. *Larenz K., Canaris C.W.*, *Lehrbuch des Schuldrechts*, II/2, 1994, § 73 I 4a, § 73 III 1 d; *Medicus D.*, *Bürgerliches Recht*, 2011, Rn.228 et seq.; *Staudinger, Lorenz St.*, 1999, §818 BGB Rn. 44 et seq.; *Gernhuber J.*, *Bürgerliches Recht*, 1991, §46 VI 2 c.

<sup>82</sup> *Medicus D.*, *Schuldrecht BT*, 2004, Rn. 694 et seq.

<sup>83</sup> Compare *Larenz K., Canaris C.W.*, *Lehrbuch des Schuldrechts*, II/2, 1994, § 73 111 5a and references therein; also *Reuter D., Martinek M.*, *Ungerechtfertigte Bereicherung*, 1983, 607.

<sup>84</sup> Compare: Sec. 4, Art. 979, GCC.

<sup>85</sup> *Medicus D.*, *Bürgerliches Recht*, 2011, Rn. 230.

<sup>86</sup> BGHZ 126, 105 ff.; *Larenz K., Canaris C.W.*, *Lehrbuch des Schuldrechts*, II/2, 1994, § 73 III 5b, II 2a.

situation would always take place. Therefore, it is recognized unanimously that the theory of balance shall not be applied for the detriment of the juvenile's interests. In such cases, opposing *condictio* claims should be realized independently from one another.

## **b. Correlation of Vindication and Performance *Condictio* in Invalid Bilateral Agreements**

Irrespective of "theory of balance", in German law there was a problem, which could not be resolved. This case is particularly interesting for us, as it deals with the above mentioned double invalidity, outcomes of which could be adopted in Georgian law without any additional clauses. *Example 7: A exchanged with B a watch (value – GEL 50) for the bicycle (value GEL 70). Both, liabilities' deal and property transfer agreement were invalid. A's watch, being in B's possession was destructed. B claims returning of his watch and A – compensation of the value of destructed watch.*

In application of provisions on unjust enrichment with this case, through "theory of balance", it is possible to avoid unfair outcome. As we have mentioned above, according to the "theory of balance" and underlying principle of factual mutuality, the received performances would be netted and each party would be liable to return received performance in proportion with the returned to him. B returns the bicycle of GEL 70 value and hence, within the scopes of this amount, he cannot state the fact that he is not enriched any more (by the reason of the watch's destruction). He would be liable to compensate the value of the watch (§818 II BGB).

The case is problematic where B claims his watch not through *condictio* but rather through vindication. In such case, balancing of the claims is impossible<sup>87</sup> as, on one hand, B's vindication claim is intended for regaining of his watch and on the other – A's *condictio* is intended for compensation of the watch value. Hence, we are no more within the *condictio* relations only, where transfer of factual mutuality principle allowed to temporarily disregard §818 II BGB.

Transfer of factual mutuality into the law on unjust enrichment was based on the assumption that similar to real mutuality situation, where two contractual claims oppose one another, in factual mutuality case, there are two opposing *condictio* claims. Such mutuality relation could not be established between vindication and *condictio* claims, as it is impossible to offset vindication claim with the claim of any other type.<sup>88</sup> Owner cannot deduct from the title owner's vindication claim the value of his performance.<sup>89</sup> If we leave this claim unchanged, we shall obtain the situation, where B will be able to claim his watch via vindication and he will have the argument against the other party's *condictio* claim

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<sup>87</sup> *Staudinger/Lorenz St.*, 1999, §818 BGB Rn. 42; OIG Frankfurt, "JW", 1929, 791, et seq.; *Diesselhorst M.*, Die Natur der Sache als außergesetzliche Rechtsquelle verfolgt an der Rechtsprechung zur Saldotheorie, 1968, 64 et seq.

<sup>88</sup> *Staudinger/Eckpfeiler/Martinek M.*, 2009, § 818 BGB Rn. 68: "§818 Abs 3 nicht gegenüber § 985 bzw 987 ff wirkt".

<sup>89</sup> *v.Caemmerer E.*, Bereicherung und unerlaubte Handlung, Festschrift Rabel, 1954, 387; *Flume W.*, Der Wegfall der Bereicherung in der Entwicklung vom römischen zum geltenden Recht, Festschrift Niedermeyer, 1953, 164; *Diesselhorst M.*, Die Natur der Sache als außergesetzliche Rechtsquelle verfolgt an der Rechtsprechung zur Saldotheorie, 1966, 201; *Leser H.G.*, Von der Saldotheorie zum faktischen Synallagma, 1956, 61, 107.

that he is no more unjustly enriched as the watch was destructed and he had not received any other benefits in lieu (§ 818 III BGB).

Such outcome could not be regarded as the satisfactory one. Therefore, in part of the literature the other theory is developed and called it the "modified two *condictio* theory"<sup>90</sup> (modifizierte *Zwei-Konditionen-Theorie*) or "theory of opposing performance *condictio*" (*Lehre von der Gegenleistungskondiktion*).<sup>91</sup> According to this theory, the claims should be related not by factual mutuality but rather teleological reduction of § 818 III BGB. Receiver, who has caused destruction of a thing (maybe even not by his reason) or because of the other fact it is impossible to return the thing, has no right to rely on the fact that the value of the destructed item is no more in his possession, in a form of enrichment. Impossibility of returning of the item is regarded as caused by the receiver, if such action, in case of his unfairness, was regarded as his guilt.<sup>92</sup>

In other words, where any of the parties has the opportunity to claim back his performance, on one side, the other party shall have the opportunity of *condictio* of his performance on the other side, irrespective of whether such received performance is in his possession or not. This goal is achieved not by balancing of the opposing claims, where § 818 III BGB symmetrically reduces both claims, but simply, this provision is disregarded. The theory is based on the following considerations: protection of his interests should be provided to a person regarding that the agreement was valid and thinking that he can treat the item as his own one and in case of its destruction he would not be charged. Though in case of validity of the deals, he would not have the opportunity to claim back his performance and had to accept that it was lost for him. In case of invalid deal, he would have the opportunity to receive his performance back only if he repays to the other party the value of the performance by the latter. Otherwise, this action is *venire contra factum proprium*. In the provided example, B has the opportunity to reclaim his bicycle through both, vindication and *condictio* though, in both cases he will be liable to compensate the value of B's destructed watch.

## 1. Reversion of Performances within the Scopes of Invalid Bilateral Agreement in Swiss Law

It was mentioned above, that according to the dogma, effective in Swiss law, in competition with vindication, the *condictio* is superseded.<sup>93</sup> This dogma of subsidiarity operates also in case of reversion of the outcomes of invalid bilateral agreements, though it leads to quite inadequate results. For example, in case of invalidity of purchase the seller always claims his performance through vindication and the buyer – claims the price via *condictio*.<sup>94</sup> As a result, reversion of performances within one and the same legal relation is placed in two absolutely different legal modes.<sup>95</sup>

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<sup>90</sup> *Flume W.*, Die Rückabwicklung nichtiger Kaufverträge nach Bereicherungsrecht - Zur Saldotheorie und ihren "Ausnahmen", "JZ", 2002, 321.

<sup>91</sup> *Medicus D.*, Bürgerliches Recht, 2011, Rn. 227-229, and relevant references; *Wieling H.J.*, Bereicherungsrecht, 2004, 79, includes this case into the theory of balance.

<sup>92</sup> *Larenz K., Canaris C.W.*, Lehrbuch des Schuldrechts, II/2, 1994, § 73 III 4.

<sup>93</sup> *Honsell H.*, Drei Fragen des Bereicherungsrecht, Festschrift Schulin, 2002, 25 ff.

<sup>94</sup> *Honsell H.*, Tradition und Zession - kausal oder abstrakt? Festschrift Wiegand, 2005, 360. Money *condictio* should be provided not because it is mixed with the recipient's money and thus is in his possession but

This discrepancy was criticized in Swiss legal literature. Vindication and accompanying claims (Art. 938 ZGB et seq.) correspond not to reversion of property movement originating from invalid agreement but rather to returning of the property taken from the ownership of the title owner without the latter's will (Art. 934 ZGB).<sup>96</sup> Bona fide purchaser is not protected as the title owner can vindicate his own property from him, if the property was lost, stolen or taken from his ownership without his will in any other way (*ubi rem meam inveno, ibi eam vindico*). In addition, the bona fide purchaser, who was not aware in the legal blemish and believed that the property belongs to him, should not be obligated to compensate the benefits gained from such property and relevant losses very strictly. To compensate that the property owner was a bona fide owner and still, he is liable to return the property, he should not compensate the benefits gained from such property, with the exception of the benefits, still in possession of the owner and not spent yet.<sup>97</sup> He shall not bear responsibility for damage of the property and profits not generated by his reason,<sup>98</sup> as he would not be responsible, as in case of his own property - *quia quasi suam rem neglexit nulla querela subiecta est*.<sup>99</sup>

In German and Austrian law, the same principle provides basis for the additional claims from vindication.<sup>100</sup> These provisions are not intended to give preference to a party which received performance within (invalid) bilateral agreement.

In addition, in number of cases, Swiss law recognizes the link between opposing performances and based on factual mutuality, attempts to eliminate Art. 938 ZGB, for example, where awards to the lessor the claim for compensation of benefits from invalid lease agreement against this provision.<sup>101</sup> These considerations are brought to opposing vindication and *condictio*.<sup>102</sup> Vindication and *condictio* emerged from one and the same legal relation should not be considered separately and when the seller regains possession over the property through vindication, the buyer may delay performance of this obligation until the price claimed through *condictio* is not paid. Actually, this is adjustment of the "theory of balance" developed in German law to the causal law system.<sup>103</sup> This dogmatically not very clearly stated principle does not operate where the property possessed by the receiver is destroyed, as in Switzerland, similar to Germany, performance shall not be reclaimed if the receiver is not enriched any more.<sup>104</sup>

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because the money can not be regarded as the thing in general, as it is bearer of abstract value only and value could be reimbursed only via *condictio*.

<sup>95</sup> *Honsell H.*, Tradition und Zession - kausal oder abstrakt? Festschrift Schulin, 2005, 358.

<sup>96</sup> *Ib.*, 357.

<sup>97</sup> *Ib.*

<sup>98</sup> *Ib.*

<sup>99</sup> Ulp.D. 5.3.31.3. Art. 938 ZGB: 1. Who owns the thing in good faith, because he uses and consumes this thing on the basis of his proposed rights, shall not be obliged to compensate this costs to the title owner 2. He shall not be responsible for destruction and damage of the thing.

<sup>100</sup> Compare: §§ 987, 989 BGB; § 329 ABGB: "Ein redlicher Besitzer kann schon allein aus dem Grund des redlichen Besitzes die Sache, die er besitzt, ohne Verantwortung nach Belieben brauchen, verbrauchen, auch wohl vertilgen."

<sup>101</sup> BGE 110 II 244; Compare p. 26.

<sup>102</sup> BGE 83 II 25; BGE 111 II 195 (197).

<sup>103</sup> *Schwenzer I.*, Obligationenrecht AT, 2009, N 58.21.

<sup>104</sup> Art. 64 OR: reclaiming is unacceptable, if the recipient is not enriched at a moment of returning, unless he has disposed the enrichment not in good faith and should propose that he would have to return performance.

Unlike German law, in case of the property destruction, under invalid bilateral agreement, Swiss law leaves the outcome without correction. In the judicial practice and literature, it is unambiguously stated that the risk of accidental destruction of the property is born by the title owner even it is in the possession of the unjustly enriched owner.<sup>105</sup> Vindication has certain advantages, compared with the performing title owner should initially attempt to regain his property through such claim. Unauthorized owner can not oppose such vindication claim to the performance provided by him.<sup>106</sup> Though mutuality principle is applied in both, vindication and *condictio* relations, to the extent that the parties shall return the received performances simultaneously<sup>107</sup> and this principle is of no use, where performance of one of the parties was destroyed. Hence, in the conditions of valid and invalid purchase, the risk of loss is distributed in different ways,<sup>108</sup> as, procuring specific item, from the moment of concluding of the purchase agreement, irrespective, whether the buyer became the title owner and gained ownership or not, the buyer bears the risk of accidental destruction of the property. Generally, in case of valid and invalid purchase, different risk distribution is absolutely acceptable. Decision on who will bear the risk of destruction is of more or less evaluative nature but in bilateral agreement, posing the risk on the title owner us only one-sided understanding of the substance of such agreement and distribution of the parties' interests within the scopes of such agreement. Though the bona fide purchaser (who did not and could not know about invalidity of the deal), as the right to believe that the property belongs to him and not to compensate its value in case of its destruction. But, at the same time, he should accept the position that in case of valid purchase he "loses" the paid price forever.<sup>109</sup> Hence, if, in case of property's destruction, only title owner would lose his claim, this would be only one-sided and incorrect understanding of the interests' distribution.

Assumption that the risk of accidental destruction of item should be borne by the title owner – *casum sentit dominus* – in some cases could lead to even absurd outcomes.<sup>110</sup> *Example 8: juvenile A and adult B exchanged their watches. A's parents did not accept this deal and therefore, it is invalid from the outset. Before the parties returned the watches to one another, A's watch being in possession of B, was destructed.*

In such cases, in the countries where the principle of causality is accepted, B will have the right to use vindication, as well as *condictio*, to regain ownership of the watch, against A, as together with the obligations' deal, both property deals are invalid as well. A, due to destruction of his watch, may claim only compensation of the watch value though not on the basis of unjust enrichment as B is no more

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<sup>105</sup> *Bucher E.*, *Obligationenrecht AT*, 1988, § 34, VII 3 c; *Giger H.*, *Rechtsfolgen norm- und sittenwidriger Verträge*, 1989, 148 et seq.

<sup>106</sup> BGE 110 II 244 (247); *Gauch P.*, *Schluemp W.R.*, *Jäggi P.*, *Schweizerisches Obligationenrecht Allgemeiner Teil*, I, N. 1527.

<sup>107</sup> BGE 33 II 542; BGE 64 II 135; BGE 83 II 25; BGE 92 II 179; BGE 111 II 197.

<sup>108</sup> *Bucher E.*, *Obligationenrecht AT*, 1988, § 34, VII 3 c; *Giger H.*, *Rechtsfolgen norm- und sittenwidriger Verträge*, 1989, 148 et seq.

<sup>109</sup> *Larenz K.*, *Canaris C.W.*, *Lehrbuch des Schuldrechts, II/2*, 1994, § 73, III 4; *Medicus D.*, *Schuldrecht BT*, 2004, Rn. 696.

<sup>110</sup> Compare *Flume W.*, *Der Wegfall der Bereicherung in der Entwicklung vom römischen zum geltenden Recht*, *Festschrift Niedermeyer*, 1953, 171: "Von dem Satz *casumsentitdominus*, muß man sich im geltenden *Kondiktionsrecht*, das den Anspruch abstrakt am Vermögen des Empfängers orientiert, frei machen."

enriched. If such outcome is left without correction, we obtain quite inadequate picture. Exchange is invalid because of the regulations intended to protect juvenile A's interests. While he has no capacity to conclude valid deal, obligating him to transfer the title on the property to B, the property deal depriving A of the title on the property is invalid as well. Actually, together with destruction of the property, we have situation, where A has no any right to claim. The regulation, serving to protection of A's interests, in combination with the principle that the risk of accidental destruction of the property is born by the title owner, leaves the juvenile without the right on claim and in addition, he has to return the unjustly received. Without operation of this dogma, though the juvenile would lose the property, he would have opportunity to regain its value. Therefore, in Swiss legal literature there is expressed the opinion that for the deals with double invalidity, where one of the items is destroyed, only law on unjust enrichment should be applied<sup>111</sup> and "theory of balance" developed in German doctrine should find wider application in Swiss law. It is unacceptable to consider the *condictio* claims originating from invalid bilateral agreement (or, due to operation of the causality principle, of vindication and *condictio*<sup>112</sup>) separately.<sup>113</sup> Regarding all these arguments, Honsell<sup>114</sup> made conclusion that because of absence of any other way, the principle of abstraction should be introduced into Swiss law and in result, invalid purchase deals' reversion will be provided by means of two opposing conditions.

### **3. Elimination of Property Movement from Invalid Bilateral Agreement in Austrian Law**

According to the position prevailing in Austrian law, in invalid bilateral agreements, in case of destruction of the property, risk is born by the title owner and not by the owner.<sup>115</sup> Title owner is no more entitled to claim compensation of the property's value, while he is obliged to return the received performance (e.g. purchase price). Such solution of this issue, similar to Swiss law, is different from accidental destruction risk distribution in case of valid purchase, where together with the property the risk is transferred to the purchaser. Though provided considerations ensure uniform regulation of vindication and *condictio* relations,<sup>116</sup> still, there are the opponents stating that in any case, after transfer of the property, risk of its destruction shall be transferred to the purchaser.<sup>117</sup>

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<sup>111</sup> *Giger H.*, *Rechtsfolgen norm- und sittenwidriger Verträge*, 1989, 147; *Honsell H.*, *Tradition und Zession - kausal oder abstrakt?* Festschrift Wiegand, 2005, 362.

<sup>112</sup> Compare BGE 55 II 302; dazu *Honsell H.*, *Obligationenrecht BT*, 1995, § 6 I 2 d.

<sup>113</sup> BGE 110 II 244; *Honsell H.*, *Obligationenrecht BT*, 1995, § 6 I 2 d.

<sup>114</sup> *Honsell H.*, *Tradition und Zession - kausal oder abstrakt?* Festschrift Wiegand, 2005, 360.

<sup>115</sup> *Koziol H., Welser R.*, *Grundriss des bürgerlichen Rechts AT*, 1988, 433 and relevant references.

<sup>116</sup> This corresponds to the will of Austrian legislator § 1437 ABGB: "Recipient of performance of non-existing obligation should be deemed as bona fide or non-bona fide recipient, based on whether he knew or not and whether he could propose or not the performer's mistake." § 329 ABGB: "Bona fide owner is entitled, due to the fact that he owns the thing in good faith, use, consume or destroy the thing at his own will and he shall bear no responsibility for this" § 1447 ABGB: "With accidental destruction of the thing no any obligation related therewith exists, including the obligation of compensation of its value." I.e. after accidental destruction of a thing it impossible to claim it back not only through vindication but also through claim for compensation of losses sequential from vindication relations, as well as claiming of its value from



The main dogmatic problem, discussed in Austrian legal literature is as follows: whether performance *condictio* is the legal continuation of vindication claim (*Rechtsfortwirkung*) and replacement of the lost vindication? Answer to this question would contribute to solving of this issue –is it possible to transfer of the principles underlying to vindication relations, like *casum sentit dominus*, to the *condictio* relations. In his early comparative work, Wilburg<sup>118</sup> formulates the principle that in case of *condictio* of the encroached (*Eingriffskondiktion*), where unjust enrichment takes place not by performance by the title owner but through direct intervention into the title owner's rights, *condictio* is the continuation of vindication. Hence, if a title owner loses his property because the unjustly enriched person has processed the property or mixed it with his own possessions, than lost vindication is replaced by *condictio*. As for the performance *condictio*, i.e. the case, where the title owner has willfully transferred the property to the unjustly enriched person, principles regulating vindication shall not be applicable to these relations.<sup>119</sup> Though, in his following work, Wilburg states that *condictio* is the legal continuation of vindication.<sup>120</sup> According to Huber,<sup>121</sup> in the conditions of operation of causality principle, the question, whether the claim originating from unjust enrichment is legal continuation of vindication, is senseless. In this case, the title owner maintains both, the property right and vindication right and he has the ownership *condictio* as well. As for the countries of abstract property deals' countries, the title owner disposes the property himself and claims, with respect of unjust enrichment, originating from invalidity of the obligations' deal is due to absence of grounds of property movement and not by the fact that the performer loses the property. Performance *condictio* is not the replacement of the lost property and relevant vindication but rather the instrument for reversion of ungrounded property movement, continuation of not property but rather obligations' relations.

Currently, similar to Swiss law, Austrian law attempts to integrate the principle underlying to the "theory of balance" into the law on unjust enrichment,<sup>122</sup> or for correction of the unfair outcomes, to which the principle of *casum sentit dominus* could lead; for finding alternative solution.

#### 4. Transfer of the Outcomes of "Saldotheorie" into Georgian Law

For Georgian law system, the orientation of Swiss law and relevant problems could serve as an example. Unlike Switzerland, irrespective of operation of causality principle, Georgian Civil Code shares the factual mutuality underlying the theory of balance.

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the bona fide owner, according to the regulations on unjust enrichment. In replacement, the title owner, who has lost the thing and its value, has no any counter claim to balance the *condictio* of the other party and shall fully return the received (*Apathy P.*, *Kurzkommentar zum ABGB*, 2007, § 1051 Rn. 4). Hence, in Austrian law, similar to Swiss La, according to the general provisions, the risk of accidental destruction of a thing is born by the title owner.

<sup>117</sup> *Harrer F.*, Rückabwicklungsprobleme beim fehlerhaften Kauf, *JBl*, 1983, 238; also *OGH JBl*, 1984, 200.

<sup>118</sup> *Wilburg W.*, Die Lehre von der ungerechtfertigten Bereicherung nach österreichischem und deutschem Recht, 1934, 28 et seq.

<sup>119</sup> *Ib.*, 49.

<sup>120</sup> *Wilburg W.*, Zusammenspiel der Kräfte im Aufbau des Schuldrechts, *AcP* 163 (1964), 346 et seq., 349, 353.

<sup>121</sup> *Huber P.*, Wegfall der Bereicherung und Nutzen, 1988, 54.

<sup>122</sup> *Kerschner F.*, Der OGH auf dem Weg zur Saldotheorie? "*JBl*", 1988, 541, 624; *Rabl Ch.*, Die Gefahrtragung beim Kauf, 2002, 284, 288.

Section 4 of Article 979, Georgian Civil Code:

When the parties to a bilateral contract, on the grounds of its voidness, are bound to return everything they have received from the contract, but one of the parties cannot return it because of the grounds defined in paragraph (2) of this Article, then this party shall not be obligated to return the [monetary value] if it follows from the essence of the norm of law according to which the contract was voided.

If we apply this regulation to the above mentioned case,<sup>123</sup> we obtain that B could be exempted from the obligation of compensation of the watch value, if the purpose of Section 1, Article 63 of Georgian Civil Code was recognition of the agreement null and void, for protection of B's interests. In reality, the situation is just the contrary. Purpose of the specified article and its further provisions is protection of the interests of a person with limited effectiveness through invalidation of the agreements made by him, while protection of A's interests could be guaranteed through claiming of the value of watch destroyed by B.

Hence, in this case, irrespective that B was a bona fide owner (Section 1, Article 981 of Georgian Civil Code) and the property was destroyed not by his fault (Section 4, Article 981, GCC), according to Subsection a), Section 1, Article 976 and Section 4, Article 979 of GCC, he still shall compensate the value of watch to A.

#### **a. Theory of "Balance" or "Counter-performance Condictio"**

Section 4 of Article 979, GCC, regulates the case, where the receiver of groundless performance should be regarded as unjustly enriched, though the received property is no more in his possession. This article of GCC is structured as follows: 1. According to Section 2, where the thing can not returned in its natural form, the receiver shall compensate its value. 2. Section 3 establishes exception from this provision, when it is impossible to return the thing and in addition, its value is not in the receiver's property in any other form. 3. Section 4, on its side, establishes the exclusion from the mentioned exclusion. Though the subject of performance is not present in the receiver's property and he has not enriched either by performance or by its value, the receiver shall still compensate its value if the condictio relations originated on the basis of invalid bilateral agreement and this compensation does not contradict to the substance of regulation causing invalidation of the agreement.

BGB contains only two of these provisions: 1. § 818 II BGB states that if it is impossible to return the thing in its natural form, the recipient shall compensate its value. 2. Obligation of repayment of the value does not exist if the receiver is not enriched any more (§818 III BGB). The Law does not contain the third provision assuming exclusion from the second provision, i.e. the one, specifying the cases where the receiver may be imposed the obligation of compensation even if he is not enriched. The above two theories – "theory of balance" and "theory of counter-performance" serve to the purpose of making exclusions from §818 III BGB in number of cases; i.e. a person, who is not enriched, was obligated to compensate the received.

Section 4 of Article 979 of GCC is the legislative realization of the underlying principle of these theories. In addition, we regard that it should be discussed in more details, which of these theories were

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<sup>123</sup> Compare with Example 8.

formulated as regulation by Georgian legislators. These theories have common purpose – they are intended to eliminate § 818 III BGB for number of cases, though this is provided in different forms. Modern "theory of balance" relying in the factual mutuality principle, eliminates § 818 III BGB so that applies it to both opposing *condictio* claims. i.e. destruction or damage of one of the performances reduces not only performer's but also receiver's *condictio* claims. According to "counter performance *condictio* theory", if a person claims his performance, he shall return the received performance as well. I.e. this theory, in number of cases, simply does not apply § 818 III BGB.

Though both theories serve to one and the same purpose, regarding their dogmatic basis, their application may provide different outcomes. For example, as we have already mentioned, the factual mutuality principle cannot be directly applied to the case, where not two *condictiones* but rather one *condictio* and one vindication claims are opposing. "Theory of counter-performance *condictio*" eliminates § 818 III BGB without any problems. Therefore, it should be clarified, on which exact theory are based the provisions of Section 4, Article 979 GCC and which theory should be systematically implemented in Georgian legal system.

It should be noted that the regulation provided by GCC has reservation, providing basis to offer that in this provision the legislator established the principle of "factual mutuality" as in unambiguously states that the distribution of interests within the bilateral agreement should be transferred to the law on unjust enrichment and not simply makes exclusion from Section 3, Article 979 of GCC. The regulation is formulated as follows: "when the parties to a bilateral contract, on the grounds of its voidness, are bound to return everything they have received from the contract". Returning on the grounds of voidness of the agreement, per se, implies returning on the basis of opposing *condictio* claims and not though vindication, which is maintained by the title owner independently of the obligations' agreement. Void agreement gives rise to the *condictio* and not vindication claim. Hence, this regulation dealing with unjust enrichment regards, as the first precondition of its application that two *condictiones* are opposing one another, like, in case of validity of the agreement, two claims for performance would do. This is nothing else than application of the principle of mutuality in the *condictio* relations. Factual mutuality is the principle and the very precondition, for which a party is exempted from the obligation of returning of the received, though he is no more enriched by the received. Further, the law provides projection of the substance of regulation over the mutuality principle introduced in the *condictio* relations.<sup>124</sup>

This means that the mutuality principle does not operate if it contradicts to the substance of the regulation on the basis of which the agreement was invalidated. This solution of the legislators is realization of the "doctrine of factual mutuality principle" at the legislative level. And its accompanying outcomes are that this theory and the regulation formulated on its basis, regard, as precondition, opposition of not two *condictio* but *condictio* and vindication claims. Though it is possible that Section 4, Article 979 of GCC was applied to vindication by analogy, or interpretation of the wording – "on the grounds of its voidness, are bound to return everything they have received from the contract" – in such way that it covered the claim of returning via vindication, which would be opposed by the *condictio* of

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<sup>124</sup> ".... But one of the parties is not able to return because of the grounds provided for by Section 2 of this Article, than he shall not be obliged to accept back performance if this is provided for by the regulation on the basis of which it was deemed invalid."

the other party, still, there is no need in this. Much simpler is to recognize that the parties of invalid bilateral agreement should claim back their performances in accordance with the provisions on unjust enrichment, which, as we attempted to show, provide opportunity to take into consideration the aspects and interests of the parties which is not provided by vindication and accompanying claims.

## **b. Section 5, Article 979 of GCC**

Incompatibility of considerations about different distribution of risk in the valid and invalid agreements prevailing in the Swiss and Austrian laws can be seen from Section 5, Article 979, GCC.<sup>125</sup>

By these provisions the legislator unambiguously rejects the principle – *casum sentit dominus*, as the regulation is a general reference point to determine the extent of accidental destruction risk to be imposed on the parties within the *condictio* relations. Georgian legislator has made logical choice for the benefit of the contractual scale. The performer shall bear the risk to the same extent as in case of valid agreement. Opposing to this principle is *casum sentit dominus*, i.e. case, where the title owner bears the risk of destruction irrespective of distribution of interests within the scopes of the agreement, due to the mere fact that he is the owner. Though Georgian legislator establishes the minimal extent of risk to be imposed on the performer, i.e. provides regulation of case, where the performer always bears the risk of destruction and does not specify the limit of imposition of such risk (does not specify, when such risk shall not be vested in the title owner). But by means of *argumentum e contrario*, we can make conclusion that this provision of the law would become senseless, if the performing title owner would be subjected to the responsibility, as to the extent specified by the law, also at the extremely increased scale – *casum sentit dominus*.

Hence, according to GCC, the determinant of the destruction risk is not the fact, with whom was property left or to whom it was transferred but who would bear such risk if the agreement remained valid. Again, such solution is nothing else but transfer of the contractual mutuality in a form of factual mutuality to *condictio* relations. Results gained by Swiss law doctrine, according to which the risks' distribution should be different in the valid and invalid agreements, do not correspond to Georgian law as Georgian legislator establishes different scale for this. In addition, validity/ invalidity of the agreement, often unnoticed by the parties, can not be condition for risk transfer as such. Such function should be given to transfer of the property<sup>126</sup> as in the valid agreements this is the decisive factor.<sup>127</sup>

## **c. Competition of the Claims Accompanying Condictio and Vindication**

In competition of vindication and *condictio*, the issue of preference of their accompanying claims is considered by German literature according to the type of *condictio* one deals with.<sup>128</sup> Such

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<sup>125</sup> "Destruction or damage of the performance subject, for which the performer bears responsibility, in case of validity of the agreement, always releases the recipient from obligation of compensation".

<sup>126</sup> *Honsell H.*, *Drei Fragen des Bereicherungsrecht*, *Festschrift Schulz*, 2002, 30.

<sup>127</sup> E.g. § 446 BGB: Risk of accidental loss or damage of the thing is transferred together with the thing.

<sup>128</sup> See note 42.

differentiation is necessary in Georgian law as well as different conditions are structured according to the different principles. While, as we have discussed above, performance conditions continuation of the agreement and serves to transfer of the contractual relations and interests and expectations of the parties within the scopes of contract to the *condictio* relations, *condictio* of the encroached has nothing common with the agreement and in such cases the guiding principles are absolutely different. Based on the same considerations, in performance *condictio*, its accompanying claims should be preferential in relation with the claims accompanying vindication. Below we shall make attempt to justify, why such solution is necessary in Georgian law.

#### **d. Claiming of Benefits from the Unauthorized Owner**

According to Article 163 of GCC, unauthorized bona fide owner is not liable to return the benefits gained from the property. Section 1 of Article 979 of GCC establishes the different provision,<sup>129</sup> according to which, unjustly enriched person, irrespective of whether he is bona fide owner or not, shall return the property together with the gained benefits. This strict provision for claiming of the received via invalid deal has its justification and it is unacceptable to demand the benefits from the unjustly received property (more exactly, excluding of the claim) by means of Article 163 of GCC. Section 1 of Article 979 of GCC is based on the following considerations – the performances and gains from such performances shall be returned to the parties to ensure the situation maximally close to the initial one, i.e. the situation, which would take place if the parties have not provided their performances at all. Performers regain not only the performances provided by them but also the benefits to be gained from such performances. Stricter mode of returning is compensated by the fact that who returns his performance and benefits gained from there is entitled to claim from the other party his performance with the relevant benefits. Such mutuality, as we have mentioned above, is the cornerstone not only for setting of the extent of the performances to be returned but of the benefits gained from such performances. Of course, this principle does not operate for the benefit of a person, who has received the property gratuitously or through unilateral deal but placing of non-paying purchaser in the position less favorable than the paying purchaser is one of the underlying principle of unjust enrichment institute and intentional decision of German legislator. From a person who received performance gratuitously not only performance could be claimed but also returning of the benefits without any compensation as his lawful trust (related to permanent maintaining of the received) is less significant than the trust of paying purchaser.

On the contrary, vindication and its additional claims intend not to take into consideration the mutual link between the performances but, disregarding all other aspects, returning of the property to the title owner. For vindication claim, it is not substantial, whether the unauthorized owner received the property from the title owner, third person or simply found it in the street. Interests of a person require particular protection where he has purchased the property from the third party in lieu of payment and then has to return it to the title owner. In this case, the unauthorized owner returns the property to title owner and receives nothing in its stead and in addition, he bears the risk of regaining the paid price from

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<sup>129</sup> "Obligation of returning is applicable to the gained benefits, as well as everything gained by the recipient as compensation for loss, damage or confiscation of the thing".

the third person. Thus, we have the situation, where the bona fide purchaser returns the property and this returning is not compensated at all as vindication serves to restitution of the property to title owner and not two-sided reconstruction of the situation, which would exist if the parties have not made the invalid deal. Hence, within vindication, regarding its one-sided nature, it is impossible to take into consideration, whether the title owner has transferred the property through performance or not and whether he has received anything in lieu. Therefore, to protect the interests of bona fide owner, the additional claims should be relatively light.

Vindication and performance *condictio* serve to different purposes and existence of light and relatively strict provisions related to claiming benefits is absolutely reasonable. Provision dealing with unjust enrichment should claim not only property received via invalid deal but also the relevant benefits to maximally take into consideration the factual mutuality linking performances of the parties with one another. Even where there is no such link (as a party has received the property for free, for example, as a gift), the regulations of unjust enrichment should apply as placing of the enriched in lieu of payment into more favorable position than the enriched with no payment is one of the key principles of this institute. Its avoidance based on Article 163 of GCC, which a priori provides light responsibility, is unacceptable.

#### **e. Claiming of the Costs Made for the Property by Unjustly Enriched Owner**

In case of claiming of the costs made by the unjustly enriched owner, in competition of Section 2, Article 163 and Section 1, Article 980 of GCC, preference should be given to Article 980. Such solution to the issue is a logical continuation of the above arguments and corresponds to the substance of these two institutes. Difference between these provisions is as follows: based on Section 2, Article 163 of GCC a person may claim only the costs and improvements not received from the benefits of the compensated property; while section 1 of Article 980 entitles a bona fide owner to claim the costs made for the property at full extent. As we can see, the difference is unambiguous and results from the simple fact that an unauthorized owner, according to provisions on unjust enrichment, shall return the benefits from the property. Consequently, the costs and improvements made cannot be compensated by such benefits.

Second argument, why the provisions on unjust enrichment should prevail in relation with Article 163 of GCC was already considered in German literature.<sup>130</sup> To illustrate it, we provide a simple example. *Example 9: A. ordered B, on the basis of invalid contract, restoration of the antique table. Variant 1: B took the table to his workshop and there he started to restore it. Variant 2: the table remained in A's home where B used to come every morning and conduct restoration works.* In both cases B is entitled to claim reimbursement for his work according to the provisions of unjust enrichment, though, as for the costs made directly for the property and improvement of that property, it is unclear, why in the former case compensation should be claimed based on Article 163 (as the table was transferred into his possession), while in the latter case, as the table was not transferred to his possession – on the basis of unjust enrichment provisions. Different solutions to these variants would be hard to justify as in both cases, the main thing are the invalid contractual relations, performances of which

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<sup>130</sup> *Staudinger/Eckpfeiler/Martinek M.*, 2009, § 818 BGB Rn. 68.

should be returned to one another by the parties and not relations between the title owner and unauthorized owner.

According to sentence 2, Section 1, Article 980 of GCC, the bona fide receiver shall have the demand of reimbursement of the costs and other property deficiency emerged in relation with his belief that the property was acquired forever. Though this regulation shall not be applicable where the property does not provide basis to regard it as the one acquired forever. In this case the receiver can not claim compensation of costs or any property deficiency. Article 163 of GCC does not provide for compensation of property deficiency at all and it does not contain any different provision reflecting whether the property is regarded as acquired forever or not. Unreasonable nature of the considerations<sup>131</sup> provided in Georgian literature is apparent in this case. If in any case of competition, vindication and accompanying claims shall prevail, scopes of applicability of Article 980 would be very narrow as it is hard to imagine the case where the purchaser is not a title owner and nevertheless, regards that the received property is acquired forever. And if we still imagine such case – for example, leasing, why should the receiver be entitled to claim the costs and property deficiency from the lessor who is not a title owner in this specific case, while he is not entitled to the same if the lessor is a title owner?

There is one more argument, in favor of prevailing of the provisions on unjust enrichment, regulating compensation of the costs and benefits over the similar provisions of vindication institute.

According to Section 2 of Article 980, GCC, obligations of compensation, by virtue of articles 979 and 980 shall be fulfilled simultaneously. In other words, parties shall return to one another the property received through performance, benefits generated from such property and costs made thereon simultaneously and each of the parties is entitled to delay fulfillment of this obligation until the other party returns the received. Without this provision, in any bilateral obligations, any party would be exposed to unreasonable risks.

Though Section 3, Article 163 of GCC contains similar provision – "The possessor in good faith may refuse to return the thing until his claims are satisfied" – but difference between the legal outcomes of two provisions is apparent. Unauthorized bona fide owner, from whom the title owner regains the property via vindication, may delay returning of the property until the title owner pays the costs made for the property and relevant improvements. As soon as the compensation is provided, he immediately loses the right to delay returning of the property. Section 3 of Article 163 does not and can not provide for the person's interests not to return the unjustly received property not only until he receives compensation of the costs made but even until the property transferred to him as performance is returned. Vindication serves to unilateral retrieval of the property and consequently, within the scopes of additional claims, it is impossible to take into consideration the interests of the parties originated from invalid bilateral agreement. Where the bilateral agreement is invalid and the parties have to return the received, interests

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<sup>131</sup> *Chachava S.*, Competition of the Bases of Claims and Requirements in Private Law, 2010, 146. We cannot agree with the opinion that unlike Article 980 of GCC, Article 163 restricts its application. Applicability of provisions of Art. 980 was initially limited to the bona fide owner, as well as 9818 I-III BGB is applied to the bona fide owner. Case of unfair recipients is regulated by Section 1, Article 981 of GCC, like Para. 818 IV, 819, BGB. As for Art. 984 of GCC, this provision is applicable to the unjustly enriched due to encroaching of the other persons' legal goods (Article 982, GCC) and has nothing common with differentiating of the bona fide owner from the unfair one.

of each of the parties are oriented towards delaying of returning, until the other party does the same. Section 3 of Article 163 of GCC does not protect these interests. Only Section 2 of Article 980 allows delay of the property restitution by the unauthorized owner until not only costs made but also his own performance is returned.

All above clearly show that in competition, not only performance *condictio* shall exclude vindication but also claims accompanying performance *condictio* shall exclude the claims accompanying vindication.

## **IV. Summarization**

### **1. Vindication and Condictio**

We attempted to show that each of discussed foreign legal system has the problem and difficulties of vindication and *condictio* correlation problems due to their competition, as well as how the agreement mutuality should be transferred to the *condictio* relations. Giving preference to vindication leads us to the problems characteristic for Swiss law, which could not be solved by means of the instruments available in Georgian Civil Code Dogmatically, the Austrian judicial practices and considerations provided in literature are less clearly formulated.

It is unanimously recognized<sup>132</sup> that the principle of abstraction serves to protection of civil turnover and interests of the third parties but it is not intended to give preference to any of the parties within the scopes of agreement. Hence, presence of this principle in German law and its absence in Georgian legislation cannot be a point of dispute between these two legal systems and the basis to argue that it is impossible to introduce conclusions developed by German law theorists into Georgian doctrine. On the contrary, necessity of introduction of these results is conditioned by unambiguous provisions of the law (Section 4, Article 979, GCC), as well as balancing of the legal interests underlying these provisions. Though in Georgian law, the principle of abstraction does not operate, vindication claim is still a claim intended to regulate relations not between the performer title owner and unauthorized owner receiving this performance but rather between the title owner and the unauthorized owner who has not received the property through performance by the title owner.

Wilburg<sup>133</sup> in Austrian law, rejected the mutuality relations between opposing *condictio* claims, arguing that such relations do not exist where the property is reclaimed through vindication. Though, due to the above arguments, it is doubtful, how could reject this mutuality relations even in the conditions of causal property deals.<sup>134</sup> It is clear that Georgian law on unjust enrichment followed the different way. At the legislative or judicial practice levels, adjusting to one another of vindication and *condictio* legal institutes<sup>135</sup> is not solution to this problem, as they serve to different purposes and have different dogmatic grounds. According to Flume, subject of vindication is restitution of the specific property and *condictio* is

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<sup>132</sup> *v. Caemmerer E.*, Bereicherung und unerlaubte Handlung, Festschrift Rabel, 1954, 387 et seq.; *Flessner A.*, Wegfall der Bereicherung, 1970, 148.

<sup>133</sup> *Wilburg W.*, Zusammenspiel der Kräfte im Aufbau des Schuldrechts, AcP 163 (1964), 163, 346 et seq., 353.

<sup>134</sup> *Stadler A.*, Gestaltungsfreiheit und Verkehrsschutz durch Abstraktion, 1996, 340.

<sup>135</sup> *Ib.*



intended for eradication of unreasonable movement of property,<sup>136</sup> where the main thing is not returning of a specific thing but rather, its value. Therefore, German scientists make conclusion<sup>137</sup> that in competition, the solution is not adjusting the legal outcomes of vindication and *condictio* so that they matched one another but ensuring prevalence of *condictio*. Only within the scopes of the latter the fair decision could be made on the basis of balancing of the parties' property interests. Irrespective of criticism to the certain preconditions to this assumption,<sup>138</sup> German literature states quite unambiguously that vindication claim is not intended as the instrument for reversion of the property movement caused by invalid bilateral contractual relations and hence, it does not give consideration to the property interests of the parties.

## 2. Theory of Balance in Georgian Law

Georgian legislators have found reasonable solution to the problem persisting in German law. German judicial practice and legal literature attempt to improve this problem. § 818 III BGB (Section 3, Article 979, GCC), stating that a person shall not be responsible of he is not enriched any more, may be applied only unilaterally, against *condictio* of one person and this leads to elimination of the factual mutuality links between the performances within invalid bilateral agreements. To maintain this mutuality relation, German doctrine has developed two above mentioned theories and Georgian legislators clearly embedded them into the law. Hence, though the theory of balance is a conception described within German doctrine, where the abstraction principle is accepted, this theory might and should be introduced into Georgian law as it is introduced at the legislative level and now it is up to the judicial practice and legal literature, to provide adequately understand and explain it.

## V. Conclusion

As we attempted to show, application of regulations of unjust enrichment in reversion of performances within invalid bilateral agreements is inevitable. In case of application of the vindication regulations only, the problem will be that Section 4, Article 979 of GCC will be left off-side, finally leading to the unfair outcomes. As we have mentioned from the outset, in judicial practice, vindication and *condictio* are applied simultaneously, i.e. the title owner can retrieve his property from unreasonable ownership through both, vindication and *condictio*. In case of invalid bilateral agreements, this assumption is unacceptable for Georgian law. It is unacceptable, as in Georgian Civil Code there is no provision corresponding to Paragraph 273 of BGB. In Georgian law there is no regulation allowing A to delay fulfillment of B's vindication claim related to restitution of the thing, until B, on his side, did not

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<sup>136</sup> *Flume W.*, Der Wegfall der Bereicherung in der Entwicklung vom römischen zum geltenden Recht, Festschrift Niedermeyer, 1953, 164, 169.

<sup>137</sup> *Ib.*, 171.

<sup>138</sup> Compare with the relevant criticism: *v. Caemmerer E.*, Bereicherung und unerlaubte Handlung, Festschrift Rabel, 1954, 333 et seq., 368; *Larenz K.*, *Canaris C.W.*, Lehrbuch des Schuldrechts, II/2, 1994, § 72 III 1; *Reuter D.*, *Martinek M.*, Ungerechtfertigte Bereicherung, 1983, 518.

satisfy his *condictio*.<sup>139</sup> Absence of such provision in practice can lead to the outcome, where only a person, who submitted the claim first, would have opportunity to satisfy his claim. For example, any of the parties may get bankrupted and his property was sold through auction but the contractor will be still obliged to fulfill his liability, though he will have no opportunity to receive the opposing performance of the obligation.

And finally, we provide the arguments, due to which, for invalid bilateral agreements only performance *condictio* should be applied and not vindication.

1. Only law on unjust enrichment allows, through the "theory of balance", avoiding of absolutely unreasonable outcomes. Though by means of so called "theory of counter performance *condictio*" it is possible to spread such solution to the vindication claims, this solution, dictated by necessity, provides no any other results but additional complications.

2. "Theory of balance" and relevant principle was reflected by Georgian legislators in Section 4, Article 979 of GCC, thus taking into consideration the experience of German judicial practice and avoided the difficulties common in Austrian law, in attempts of integration of this theory into its legal system.<sup>140</sup> Due to this provision (similarly, due to Section 5, Article 979 of GCC), it is clear that principle "*casum sentit dominus*" does not operate, with the exception of cases where distribution of risk of accidental destruction results from the substance of the very legal regulation, on the basis of which the agreement was deemed invalid. Hence, with some exceptions, irrespective of the property destruction and irrespective of the fact that the received enrichment is no more in the property of unauthorized owner, he is still obligated to compensate its value. Decision of Georgian legislators is unambiguous – in case of invalidity of bilateral agreement, the regulations on unjust enrichment and not vindication claim comprise the special provisions, by means of which the outcomes of the agreement invalidity shall be eliminated. In such cases only law on unjust enrichment shall be applied, not to avoid Section 4, Article 979 of GCC. The form and conditions of transfer of these provisions to the vindication claim and generally, what are the benefits of its application in analogy with Article 172 of GCC, is absolutely unclear and it is not necessary at all.

3. According to the above arguments, at a time of competition between the additional claims of *condictio* and vindication the provisions of unjust enrichment shall prevail. Regarding that the regulations dealing with unjust enrichment in Georgian law regulate compensation of the benefits and costs made for the property in all aspects, there is no need of application of the relevant regulations of vindication. On the contrary, their application, in number of situations described above, create additional difficulties.

German law has to simultaneously apply the regulations of these two institutes as the institute of unjust enrichment, unlike the Georgian one, does not contain detailed provisions regulating some cases, e.g. compensation of the costs; while Section 1, Article 980 of Georgian Civil Code contains the

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<sup>139</sup> Section 3, Article 163 of GCC provides for delay of returning of a thing within vindication relations, i.e. the case, where the parties oppose with vindication claims. This function can not be vested in Article 369 of GCC, which corresponds to Article 320, BGB and I applicable to the opposing claims from the mutual agreements. Subject of described discussion is making of mutuality link between the claims from invalid agreement, where there is no a priori mutuality link. Solving of this problem so that it was applied by analogy with the regulation, precondition of which is the mutuality link, I beyond any dogmatic limits.

<sup>140</sup> As we have mentioned, Switzerland is an only country recognizing prevalence of vindication over *condictio*,

requirement of compensation of costs, in the provisions on unjust enrichment and Section 2 of the same article, links with the claims of the other party so that application of factual mutuality principle is not even necessary. The same could be said about compensation of losses. Hence, for the additional claims the law on unjust enrichment contains all-embracing provisions.

4. The last argument in favor of application of the provisions on unjust enrichment in Georgian law (where the performances within invalid bilateral agreement are to be reclaimed) is as follows: if we regard that in case of invalid purchase, while the seller can claim the property both, by vindication and *condictio* (or through vindication only), the buyer can claim his performance only through *condictio* (as in any case close to reality the seller will mix the received amount with his own money) and this leads to the result that linking of the seller's vindication and buyer's *condictio* is impossible.

On the basis of all above, what are the conclusions with respect of correlation between vindication and *condictio* claims? Vindication provides possibility to a party to claim his property back and return nothing in its stead (or compensate the improvements of this property only). So called "theory of balance" is intended against such outcomes and this theory could be taken into consideration in case of unjust enrichment only. To avoid discrepancy where from the invalid purchase agreement the seller is able to vindicate his property and the buyer is able to claim the price paid by him through *condictio* only and because additional claims originating from vindication are not suitable for reversion of the property movement induced by invalid agreement<sup>141</sup> Honsell is for introduction of the principle of abstraction in Swiss law. In such case, both, the seller and buyer would have opportunity to claim back his performance from invalid purchase, thus allowing consideration of all above aspects. Introduction of the principle of abstraction into Georgian law is impossible yet, as the causality principle, unlike Swiss *Obligationsrecht*, is provided for in Section 1 of Article 186, GCC.

Though Georgian legal doctrine can choose unjust enrichment as the special instrument for elimination of the results of invalid bilateral agreement and thus exclude vindication in competition. This would allow transfer of factual mutuality, as a main driver of performances by the parties in dogmatic form, as well as avoiding of the problems caused by mismatch of the legal outcomes of vindication and *condictio*.

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<sup>141</sup>*Honsell H.*, Tradition und Zession - kausal oder abstrakt?, Festschrift Wiegand, 2005, 356.

**Lika Sajaia\***

## **The Right for Authorship and for Name – Georgia Copyright Law and Modern Legal Trends**

### **1. Introduction**

The personal, non property rights of an author regarding the works of literature, art and science are recognized by Paragraph 6 of Bern, 1886.<sup>1</sup> The Bern Conference offers those minimum of personal non property rights protection of which are necessary for the member countries. Among these rights are the rights of authorship recognition and the right for the integrity of the work.

The right of personal non property authorship protection, just like that of basic human rights, is guaranteed on international level by the human rights declaration according to which, paragraph 27, 2, all the people have the right to see their moral and physical interests be protected as a result of that scientific, literary or artistic work that belongs to the author proper.<sup>2</sup>

Paragraph 15 of the International Covenant on Social, Economic and Cultural Rights of December 16, 1966 indicates the fact that a person enjoys the possibility by exercising the right for moral and physical protection of those works in case of recycled usage that were created under her personal authorship.<sup>3</sup>

The authorship right is also protected by the International Convention of Authorship in America (1946, June 22), according to which the person whose works have been protected by legal authority enjoys the right to be called the author of the works mentioned even after having granted or otherwise managed his/her authorship rights.<sup>4</sup>

The Bern Convention, just like other international acts, does not represent the right for title as a separate one and considers it as a legal component of the authorship rights. The same approach applies in Continental Europe and in the countries of general law.

The authorship and right for name, like those of the Bern Convention, are united under the same right of legal code of the unified continental Europe. In the French law the same right is formulated as follows: an author has right to respect<sup>5</sup> their title and authorship. In German is right is called *Anerkennung der Urheberschaft* - that means authorship recognition and comprises both authorship recognition and rights for title.

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<sup>1</sup> <[http://www.wipo.int/treaties/en/ip/berne/trtdocs\\_wo001.html](http://www.wipo.int/treaties/en/ip/berne/trtdocs_wo001.html)> [20.04.2013].

<sup>2</sup> < <http://www.un.org/en/documents/udhr/>> [20.04.2013].

<sup>3</sup> <<http://www.ohchr.org/EN/ProfessionalInterest/Pages/CESCR.aspx>>[20.04.2013].

<sup>4</sup> <[http://www.wipo.int/edocs/trtdocs/en/iac/trt\\_iac.pdf](http://www.wipo.int/edocs/trtdocs/en/iac/trt_iac.pdf)>[20.04.2013].

<sup>5</sup> Code de la Propriété Intellectuelle. Art. L 121-1, available at: <<http://www.wipo.int/wipolex/en/details.jsp?id=5563>>[20.04.2013].

The right for authorship and title is given under the same term by the legal ground of the countries of general law. This right in English speaking countries is called "Right of Paternity".

This term has its root from the Latin word *pater*, which is father. By generalizing this term lawyers indicate that just as natural father has the personal, non-profit right for his children, the same right the author enjoys towards their works.<sup>6</sup>

According to the Act for Authorship Protection of Canada, paragraphs 28, 2 and 14, 1 (1), along with the rights for integrity, the author has all the rights that are associated with the work proper – either by his/her name, pseudonym or anonymously.<sup>7</sup>

While interpreting the general law, namely the authorship, designs and patent law of England of 1988 and that of Australia 1968, the lawyers of general law explain the essence of Paternity Right by the following mode: the authorship right, including the author's right to indicate their true name on the work after the work has been prepared and is not at their hands<sup>8</sup> (to be recognized as valid).

Georgian Copyright Law does not share the legal approach of Bern and European Law and does not unify the right for authorship and title under the same right.

The law concerning the authorship and neighboring rights (paragraph 17) that concerns the private, nonprofit authorship rights regulated the ones for authorship and name in a separate mode.<sup>9</sup> According to paragraph 17, point 1 of the law ("a" sub point) an author has the right to be recognized as the one for the work created and file for the recognition of this right per each copy and or by any usage of one – in a proper way along with the right of the title to be given (authorship rights).

Regardless the fact that according to paragraph 17, point 1, sub point a, the right for name is represented as a composite of the authorship rights, the right for name is still given as a separate one under the b sub point of the same paragraph. The right for name comprises the right to ask for the pseudonym on every copy and or during the usage of the same work in any form, also the right to renounce the usage not only of the pseudonym but any name proper.

In the comment line for the authorship and neighboring rights it is clearly signified that the right for authorship and name should be given in a unified mode, as the very right of authorship creates the right for title, the fact clearly seen in point 1, paragraph 17 of the law.<sup>10</sup>

How reasonable is the legal approach of Georgian law for authorship and neighboring rights and how right is it to represent them in a separate way? What are general distinguishing marks between these rights and what are the mechanisms of protection? What are the differences between the authorship rights and paragraphs 17, 19 of civil code of Georgia protecting the rights for title? This article is dedicated to these issues. As Georgian authorship law is being developed to be well adjusted

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<sup>6</sup> Dzamukashvili D., *Intellectual Rights*, Tbilisi, 2006, 200 (in Georgian).

<sup>7</sup> Copyright Act of Canada, 1985, available at: <<http://laws-lois.justice.gc.ca/eng/acts/C-42/page-1.html>> [20.04.2013].

<sup>8</sup> Adeney E., *The Moral Rights of Authors and Performers, an International and Comparative Analysis*, New York, 2006, 328.

<sup>9</sup> The Law of Authorship and Neighboring Rights, 1999, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>10</sup> Dzamukashvili D., Shengelia R., Gabunia D., Khrustali V., Jorbenadze S., *Comment from the Georgian Law of Authorship and Neighboring Rights*, Tbilisi, 2003, 112 (in Georgian).

to that of European one, the right for title and authorship will be considered according to the European case study example.

## **2. The Authorship Right**

According to the Authorship and Neighboring Rights Law of Georgia, paragraph 17, point one, sub point a, the nonprofit, personal authorship right means the author be recognized as such towards their work and ask this recognition per each copy of the one or (and) use it in any fashion including the right to give the proper name (the authorship right).

The authorship right, as we see from the law of Georgia about On Author's Rights and Neighbouring Rights is split in two parts – to be recognized as the author of the work and ask for the recognition to be notified.

In legal science the authorship right is divided by three components: the rights to ask for authorship recognition, to restrict the third party use their names on other works and prohibit the usage of other's name on his/her work.<sup>11</sup>

How proper is the term formulating "the authorship right" of Georgian law for authorship and neighboring rights? In jurisdictional literature there is a version, according to which the term "right for authorship" lacks the legal precision, as the possibility to become an actor is not a right but a fact. Therefore in the legal science there is a thought that the Law of Authorship Rights be changed for "the right for the authorship protection".<sup>12</sup>

The right for authorship is known as the right for authorship recognition by the sixth paragraph of the Bern Convention for Protection of Literary and Artistic Works.

According to the international acts the authorship creates the right for the authorship recognition, protection or renouncement of such. But we consider, thought, the right for authorship respect as the more precise legal point (according to the code of the intellectual protection rights of France) as the authorship right protection is mostly carried out by and is possible through the very respect for the authorship right.

### **2.1. Authorship Right as a Personal, Nonprofit One**

Paragraph 17 of Georgian Law of Authors Rights and Neighboring Rights says that an author has the right to ask for recognition for the each copy of the work and (or) the usage of it in any form including the right to give each one the proper authorship name (title). Therefore the name is one of the legal components of the authorship protection right and the authorship one represents much broader idea. What does the authorship protection/ respect right also comprise apart from the one to protect the name? What recognition or notification possibility (rights) does an author have?

The authorship right is considered in legal literature as the following one: an author has the right to be respected according to his/her skills and qualifications. The authorship right comprises the possibilities

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<sup>11</sup> *Subbian A.*, Intellectual Property Rights: Heritage Science and Society under International Treaties, New Delhi, "Deep & Deep Publications", 2007, 164.

<sup>12</sup> *Dzamukashvili D.*, Intellectual Rights, Tbilisi, 2006, 201-202 (in Georgian).

except just for name, academic ranking and the right to be named as the author and not just another participant during the work creation process, also be named as the sole creator and not as a co-one.<sup>13</sup>

The authorship right also comprises the sub right so as the author protects his/her own name when it's omitted or someone's name or when someone's name or pseudonym is given instead of the authentic author's one; choose a specific way and possibility for highlighting his/her name – for example only initials or any other details; use a pseudonym or stay incognito and never display the name. On the other hand, all these rights are united under the basic one to protect the authorship when it is infringed.<sup>14</sup>

For publishers French Law issued a specific norm so as the moral rights, also the rights for authorship property<sup>15</sup> be solely respected.

The rights for name and authorship are the absolute ones and therefore any person shares responsibility to respect both the name of the author, and his authorship right. This right is intertwined into the right for name and other basic rights of a person.

The link between the authorship right and other individual rights was highlighted by the number of court rulings. For example during the clarification of the authorship rights the Quebec Appeal Court had ruled: the right the work to be carefully attributed to someone equals the right to respect a person's name and the very moral values such are respect for creativity and merit.<sup>16</sup>

The rights for name and authorship have both positive and negative meanings. The title infringement can happen either by infringing the name proper (by spelling correspondently) or by misappropriation. By the wrong attribution of the name along with the name infringement the right for authorship is also violated. The court has in practice the cases when, for example, world famous poet Byron and also an outstanding writer Mark Twain protested the fact of being attributed the very works they never created.<sup>17</sup>

Misappropriate usage of authors' names might be even more harmful for their reputation and merit than simply omitting their names. This fact is also regarded as the usurpation of the author's prestige – the case that often takes place when one author's name is given (inscribed) on the canvas.<sup>18</sup>

In cases of authorship misappropriation the countries of general law also resort to the norms of fair competition while these mostly happen for economic reasons – to spread the books copies and see gain and so the author has the right to be restituted by the vey amount gained that the violator received through unauthorized usage<sup>19</sup> of the title proper.

To be identified with one's own work is the author's authentic right, not his/ her liability. Therefore an author is free at choice to use their names, initials, pseudonyms or stay anonymous.

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<sup>13</sup> Adeney E., *The Moral Rights of Authors and Performers, an International and Comparative Analysis*, New York, "Oxford University Press", 2006, 180.

<sup>14</sup> Lipszyc D., *Copyright and Neighboring Rights*, Paris, UNESCO, 1999, 171.

<sup>15</sup> Code de la Propriété Intellectuelle, Art. 1 132-11, available at: <<http://www.wipo.int/wipolex/en/details.jsp?id=5563>> .

<sup>16</sup> Adeney E., *The Moral Rights of Authors and Performers, an International and Comparative Analysis*, New York, 2006, 232.

<sup>17</sup> *Lord Byron v. Johnson* [1816] 2 Mer.29; 35E.R.851, in: *International Encyclopedia of Comparative Law*, Vol. 11, Part 1, 1983, 59; *Samuel L. Clemens vs. Belford, Clarce & Company*, see: <<http://www.twainquotes.com/CourtDecision.html>> [20.04.2013].

<sup>18</sup> Lipszyc D., *Copyright and Neighboring Rights*, Paris, UNESCO, 1999, 172.

<sup>19</sup> *Jeremy Ph.*, *Introduction to Intellectual Property Law*, London, "Butterworth", 1986 and *Howell R.G.*, *The Common Law Appropriation of Personality Tort* , "I.P.J.", No. 2, 1986, 149, 151.

The author, even if he grants the editorial rights for his work to someone else, keeps the right not to see his identity displayed. In this case the editors protect their rights. But if the editor still goes against the author's will to stay incognito, by this very fact he/ she violate their authorship rights.

The authorship rights belong to the group of so called negative (defensive) rights. Just as the right for the work authenticity, the authorship right can be protected by other by other persons (legally authenticated, or by organization like the National Centre of Intellectual Rights of Georgia), the author has the right to leave his right under someone else's custody (Georgian Law about Authorship and Neighboring Rights, Paragraph 5, Point 6).

Can the authorship right be the part of agreement? The personal nonprofit rights of an author, just like the authorship right itself, represent non transitional rights and therefore cannot be represented as parts of any agreements. In continental European law the authorship recognition can be announced valid only through the law. The author enjoys the right to renounce the usage of his/her name. But in the countries of general law the authorship depends on the contract agreement and is often regulated by agreements designed at publishing house.<sup>20</sup>

## **2.2. The Authorship and Co-authorship Rights**

While discussing the authorship rights let's see who the author might be. Georgian authorship law follows that of the European one, its principles, according to which only physical entity has the right to be an author. (Georgian Law for Authorship and Neighboring Rights, point 4a). In the countries of general law an author can be a legal entity, the owner of "copyrights". This distinction is most vivid when we meet audio visualization works.

In Germany an author must be a physical entity who has performed an intellectual work. Therefore according to the German law a producer cannot be considered as an author while his work is not considered as an intellectual, creative one.<sup>21</sup>

According to the French authorship law an author can be only a physical entity who has invested their personality and originality into their work proper and as a must has spent time and effort. Therefore, a person who has announced only an idea cannot be considered as the one.<sup>22</sup> The same approach is shared by South American countries where the film author is automatically considered as a film director (not a producer), for example paragraph 26<sup>23</sup> of Brazilian act for authorship and neighboring law of February 19, 1998).

The authorship right is an interesting case in the framework of the South American Law for Authorship where it is connected not only to the Intellectual Creative work, but to the terms of agreement and the one who is responsible to manage the work creation process.<sup>24</sup>

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<sup>20</sup> *Dworkin G.*, The Moral Rights and English Copyright Law, in: IIC NO04/1981, 481.

<sup>21</sup> *Adeney E.*, The Moral Rights of Authors and Performers, an International and Comparative Analysis, New York, "Oxford University Press", 2006, 230.

<sup>22</sup> *Ib.*, 117.

<sup>23</sup> <<http://www.wipo.int/wipolex/en/details.jsp?id=514>> [20.04.2013].

<sup>24</sup> *Owen H.*, Moral Rights Reports presented at the Meeting of the International Association of Entertainment Lawyers MIDEM, 1995, Netherlands-Belgium, 1995, 133.



The works to be protected under the authorship law represent the intellectual products. This kind of a product can be created only by the person's mind. Appealing to this idea lawyers pose that if a legal entity can be seen as an author, then we could think about the legal authentication possibilities of those mechanism that creates it.<sup>25</sup> Therefore as computer cannot be the author of the work translated through its help, so the legal entity cannot be represented as the owner of the personal, nonprofit authorship rights. Behind the translation done by computer there is a person who created the program just like product created by the name of the legal entity is being produced through individuals' work.

The authorship law of continental Europe is established on the principle saying that the authorship be available according to the each person's contribution into the intellectual activity. The same principle is shared by Georgian Law about Authorship and Neighboring Rights, according to which (paragraph 15) media work authors (co-authors) are: a stage director, a scenarist, dialogue author, the author of music containing (or not) lyrics, which was produced specifically for this media work.

In the countries of general law, in England and the USA the author of media work is considered the person who took necessary measures to record the work. The same rule applies to movies. Hence, producer was considered as a movie author while he/ she took active measures to create<sup>26</sup> the movies.

This very important difference between the laws of Continental Europe and the countries of the general one translates into the author's approach towards the personal, nonprofit right: the countries of general law recognize the personal, nonprofit authorship rights only in limited framework. For example in English the protection of personal, nonprofit authorship rights is performed by general, not authorship law, while the law of the USA recognizes the very rights of authorship only if the works of fine art are concerned. For the countries of general law the authorship rights first of all represent the property ones and therefore a legal entity can have the same ownership. But in the countries of continental Europe the personal, nonprofit authorship rights are considered as individual and thus his/her inherent ones. Therefore even for the dutiful rights regardless the fact whether they are the physical or legal entities of merit, they still can't be the owner's of the personal, nonprofit authorship rights.<sup>27</sup>

The Authorship and Neighboring Rights Law of Georgia (paragraph 11) concerns co authorship issue. According to the law, the authorship right for the work mutually created by two or more people represents the property of co authorship. Before 1999 legal changes took place the authorship rights had also been regulated by the civil code of Georgia. In paragraph 1033 it was noted that the co authorships belonged to the people, two or more, who took part in creation of the work proper. This paragraph was transferred into the Law about Authorship and Neighboring Rights almost intact, only the work "creative" was exempt. Also Georgian lawyers gave this change negative qualification. In the legal comment it is noted that the change considerable aggravated the clarity of the norm. No country law of the same character contains "only the mutual work" as clarification of co authorship as the

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<sup>25</sup> *Subbian A.*, Intellectual Property Rights: Heritage Science and Society under International Treaties, New Delhi, "Deep & Deep Publications", 2007, 164.

<sup>26</sup> *Torremans P.*, Hopyoak and Torremans Intellectual Property Law, 6<sup>th</sup> Edition, Oxford, "Oxford University Press", 2010, 110.

<sup>27</sup> *Adeney E.*, The Moral Rights of Authors and Performers, an International and Comparative Analysis, New York, "Oxford University Press", 2006, 231.

mutual co authorship, if it's not creative, cannot be considered as such.<sup>28</sup> In 2005 another amendment was received and the word "work" was changed by intellectual activity.

Georgian Law recognizes shared and integral co authorship. The integral one means the work as indivisible one where one cannot single out particulars. What about the shared co authorship the work represents one unity but its division is possible according to the authors. In both cases co authors should participate in creative rather than mechanical type of work during the work creation process. It is not necessary the shares be divided in quantitative or qualitatively equal way. The minimal requirement is the person to participate in creation of work before it is completed. For example correction work, while the book is already finished, cannot be considered as the co authorship participation.<sup>29</sup>

### **3. The Right for Name**

The right for name, along with the authorship rights, is one of the most important personal, nonprofit rights. It's not liable to any limitations is left to the author even if the one has no other authorship rights.

According to the Georgian Law of Authorship and Neighbouring Rights (paragraph 8) contains the norms for those rights that are not represented as part of the authorship ones. However, according to the same paragraph, point 2 the official state symbols (regalia) such as flags, insignia, the anthem, awards, money denominations and other state (official) signs and symbols contain only rights for name, namely in case these signs are used having other people's names on, the right for authorship title is to be protected. It would be just to protect not only authorship title, but the authorship protection proper because the authors – creators of state regalia must enjoy the rights both for authorship right protection and securing their authorship respect correspondingly.

Along with the authorship right, title protection is guaranteed by the civil code – as the personal nonprofit individual one. It is protected by paragraphs 17, 18 of the civil code. These paragraphs can also be used to protect the authorship title, thus before we directly set to the title discussion, we will generally characterize the authorship right, as the virtue protected by the civil code.

#### **3.1. The Authorship Title Right and the One Protected by Civil Code**

In the modern civil code there is a wide spread thought considering the right for title as an absolute and personal one.<sup>30</sup>

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<sup>28</sup> *Dzamukashvili D., Shengelia R., Gabunia D., Khrustali V., Jorbenadze S.*, Comment from the Georgian Law of Authorship and Neighboring Rights, Tbilisi, 2003, 67-68 (in Georgian).

<sup>29</sup> *Fishman S.*, The Copyright Handbook, How to Protect and Use Written Works, 7<sup>th</sup> Edition, "Nolo", 2003, 8/27.

<sup>30</sup> *Jorbenadze S., Khvlediani Z., Zoidze B., Ninidze T., Chanturia L., Ninidze T.*, Comment from Georgian Civil Code, Book I, Tbilisi, 2002, 52 (in Georgian).

Georgian Civil Code (paragraph 17) confirms the title protection issue. It implies the full name of a person. Whether the name be considered as part of the nonprofit, personal virtues of a person and therefore protected by the civil code is the subject of the ongoing debates. The name is also means<sup>31</sup> against the social negligence.

The name, as the subject to protection, is also used in the public law, though the law protects the name as the inherent element of a person. Any person who is able to enjoy their legal rights wears their name proper to signify and confirm<sup>32</sup> their individual identity in legal and social relationships.

The civil name can also coincide to a legal entity. For example according to the Georgian Law for Industry (paragraph 6.2) when a person registers as an individual producer, he/ she is liable to give their personal name and surname.

In modern legal literature people have discussions about commercial values of the name, especially throughout commercial relationships. Therefore there is a try to differentiate the same names. For example, in one case the right for a name is strictly nonprofit, personal, but in other cases – when used in business relationship, it is represented as non physical property right.<sup>33</sup>

Often there are cases when people transfer their rights for name to other persons for product proliferation or branding, thus signifying the fact of commercialized name use. For example, the inventor of Kalashnikov, a well known automatic rifle, to receive extra honorary from the Barnaul alcohol producers, let his name be used on new vodka brands<sup>34</sup> produced.

Thought, apart from some other commercial values of the name use, the name use itself is considered as a personal, nonprofit right. In the civil code (paragraph 18) it is represented among other personal, nonprofit rights.

The right protected by paragraph 17 – as we already noted – relates only to the physical entity. Paragraph 18 does not specify whether the right to wear the name be applicable only to physical or legal entities. In the countries of continental Europe the idea of the name has much broader meaning. While discussing the German Civil Law lawyers underscore the following: any word or notification that differentiates one person from another, same for the surname, baptism name or pseudonym, is protected by the Civil Code. Besides, there is an idea according to which the same protection is applicable to the visualized notifications, for example on the military insignia.<sup>35</sup>

German lawyers also note that the right for name is the subject both for legal and physical entities, for example for a company, political party, professional association and cities.<sup>36</sup> Therefore paragraph 12 of German Civil Code protects not only personal names, but also differentiating signs that are used in business and be subject for products or services. In recent years the same paragraph 12

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<sup>31</sup> Jorbenadze S., Khvlediani Z., Zoidze B., Ninidze T., Chanturia L., Ninidze T., Comment from Georgian Civil Code, Book I, Tbilisi, 2002, 52 (in Georgian).

<sup>32</sup> Chanturia L., General Part of Georgian Civil Code, Tbilisi, 2011, 196 (in Georgian).

<sup>33</sup> Ib.

<sup>34</sup> Malenina M.L., Personal, Non-property Rights of Citizens, Moscow, 2001, 117 (in Russian).

<sup>35</sup> Beverley-Smith H., Ohly A., Lucas-Schloetter A., Privacy, Property and Personality, Civil Law Perspectives on Commercial Appropriation, New York, "Cambridge University Press", 2005, 109.

<sup>36</sup> Klipper, Schutz des Namens, 546 et seq (see: Beverley-Smith H., Ohly A., Lucas-Schloetter A., Privacy, Property and Personality, Civil Law Perspectives on Commercial Appropriation, New York, "Cambridge University Press", 2005, 109).

applied to the internet domain titles of firms and personalities.<sup>37</sup> Another case is also of some interest, according to which the same paragraph was enacted for the name of one city in Germany. German Railway named one of the railways stations after the city name – this fact considered as the violation of the aforementioned paragraph 12 guaranteeing the right<sup>38</sup> for the name.

The right for title protected by the Civil Code (according to paragraph 18, part 1) says that if a person considers his right to wear a name is being disputed or the interests being infringed, enjoys the right to ask the violator to stop the illegal usage or renounce it at all.

In the countries of general law where the personal, nonprofit authorship rights are not regulated by specific authorship protection norms, the norms of general law are used. According to the general law any person, among them authors of art, literature or scientific works, has the right to prohibit the usage of their names to other people. How reasonable is it the Authorship Law of Georgia to be qualified (regulated) by other civil codes and norms for authorship?

Some scientist believe that the approach formed inside Georgian legal system and continental law of Europe is reasonable; it gives possibilities for further enhancement of name protection procedures and is not subject to restrictions along with the other norms of authorships law just as the application of other parallel norms of civil law.<sup>39</sup>

However, between the rights protected by the authorship law and paragraphs 17, 18 of the civil code considerable differences are visible.

The main difference means the reason for purchase. The civil code gives thoroughly the legal terms for the civil name purchase: birth, marriage and voluntary name change. The most frequent case for the name purchase is the name appropriation at birth. According to the 1194 paragraph of the civil code of Georgia parents mutually agree on choosing the right name for their children. The surname is defined according to that of the parents'. If the parents have no mutual surname, the child is given either mother or father's name – according to the parents' agreement.

The second foundation for the name acquisition is marriage. Also voluntary choice is another option. The name change reasons can be of different character, less preferable sound character of the name, nationality change and etc.<sup>40</sup>

In these cases the civil code of Georgia works according to the set of rules that regulate the name change procedures (paragraph 17, point 2). If the reason for the name change is not directly connected to the law, then the Ministry of Justice is the legal, competent agency that confirms the compliance of the change.<sup>41</sup> The right for the name change is enjoyed both by legal age population and underage ones. The underage children may use this right only after their parents or custodian's permission.<sup>42</sup>

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<sup>37</sup> *Klipper*, Schutz des Namens, 546 et seq (see: *Beverley-Smith H., Ohly A., Lucas-Schloetter A.*, Privacy, Property and Personality, Civil Law Perspectives on Commercial Appropriation, New York, "Cambridge University Press", 2005, 109).

<sup>38</sup> *Ib.*

<sup>39</sup> *Dzamikashvili D.*, Intellectual Property Law, Tbilisi, 2003, 53 (in Georgian).

<sup>40</sup> *Chanturia L.*, General Part of Civil Law, Tbilisi, 2011, 204 (in Georgian).

<sup>41</sup> *Jorbenadze S., Khvlediani Z., Zoidze B., Ninidze T., Chanturia L; Ninidze T.*, Comment from Georgian Civil Code, Book I, Tbilisi, 2002, 55 (in Georgian).

<sup>42</sup> *Ib.*

The acquisition of the name by the authorship law is performed by the work composition process. Just as for appropriation of other authorship rights the registration of the work is not a must for acquisition of the name, neither are we liable to go through other formalities. Regardless her age and capabilities the author according to her own discretion decides the name, pseudonym or anonymity for her work proper. According to the Georgian Law of Authorship and Neighboring Rights, paragraph 9, the registration of the work, formatting and other formalities are not necessary for the issuance and performance of the authorship rights.

The second important difference between the rights guaranteed by the authorship law and the civil code of Georgia (paragraphs 17, 18) are the subjects holding these rights. If in the first case the subject is a physical entity who according to the registration rules by the civil code of Georgia purchases or changes her name, in the second one the very subject represents an author and without any formalities acquired the right for the name proper only through the work performed.

The contents of these rights are partly different. If paragraph 17 of Georgian Civil Code comprises the name and surname of the physical entity, the Law of Authorship and Title Rights (paragraph 17) comprises the right to use the name, pseudonym or use her work anonymously. It means that the right protected by the authorship right comprises the sub right the person renounce the use of her name.

Between the right guaranteed by the civil code and the authorship law there is a considerable difference with regard of protection too. Namely, according to paragraph 18, part 1 of the civil code of Georgia the very person who is being disputed to use her name has the right to protect it. But, according to paragraph 19 of the civil code of Georgia, the person may protect personal right, among those the name use, after the subject is deceased, who does not represent the name or personal merit holder of the title in view but owns the proper, honorable interest to protect it.

The authorship right guaranteed by the Georgian Law on Author's Rights and Neighbouring Rights can be secured by another person during the author's lifetime. According to paragraph 35, point 5, the author has the right to indicate the person whom he wishes to appoint as her defense regarding the authorship, name and the work integrity rights. But what about the Georgian Law of Authorship and Neighboring Rights, paragraph 10, the work issued under the person's pseudonym or anonymity is considered to be under the publisher's custody, so the publishing house has the authority to protect the authorship rights. In this case both property and personal, non property rights are meant, including the right for the name.

### **3.2. A Pseudonym and the Right for the Name**

According to paragraph 17 of the Authorship and Neighboring Rights of Georgia the new right comprises the right to use a pseudonym and the author's one not to give his name and stay anonymous.

The right for name is one of the most important ones and its protection was guaranteed by the European Authorship Law far earlier than protection of some other, nonprofit authorship rights. For example in the German Law of 1870 citing a literary or performing a musical work one was obliged to give the composer's name. Protection of this right aimed at two objectives: to avoid public confusion

and protect the author's rights.<sup>43</sup> Later in 1976 the same normative protection applied to the works of the fine art.<sup>44</sup>

In the countries of such a law the author's right is not protected by any specific acts of the law. Though, it doesn't mean that the authorship right is not properly protected. Protection this right first started in the XIX century England (at the beginning of the century). In 1816 Lord Byron versus Johnson the court ruled the Lord's name be prohibited for any use on those verses, which he had not composed.<sup>45</sup>

In England just as in other countries of general law protection of the name is carried out by means of those norms of defamation and delict law that in English speaking world are called as passing-off. The passing-off is the delict of the general law, which in English – Georgian dictionary has the following translation: quackery, naming and using the other person's name and authority so as to realize the product to be sold.<sup>46</sup>

Passing-off is mostly used on the product labels to protect the proper rights. It protects the goodwill of the product producer, their reputation and thus restricts the trade using the products that do not belong to the person involved. Passing off principles are used when someone's business, products or personal attributes are inappropriately used, that causes the mixes in society and the vivid involvement of the parties – the claimant and respondent – the final infringement of the individual's goodwill.<sup>47</sup>

At times protection of the title means protection of not that much of the author herself but the society proper, their interests. Regarding this issue, one case is specifically interesting as it dealt with the use of Stephan King's, the writer's name in the film's title. The movie company, which had no ties with the writer, made the movie having the following title: "Stephan King as a loan moaner". The court signified in its ruling that the company has the right only to indicate the following – the movie is based upon the Stephan King's work.<sup>48</sup>

One of the most important components of title protected by the authorship rights is a pseudonym. Georgian civil code does not regulate in the separate way relationships associated with the pseudonym. In jurisdictional literature it is noted that the pseudonym is regulated by the authorship right norms and therefore it does not stay off the framework of the legal regulation.<sup>49</sup>

It should be noted that regulation of this kind is not enough. Georgian Law of Authorship and Neighboring Rights makes clear only the author's and performers' rights for the pseudonym. It is used not only in art and literature. It can be used, for example, by a famous sportsperson or any person who

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<sup>43</sup> *Adeney E.*, The Moral Rights of Authors and Performers, an International and Comparative Analysis, New York, "Oxford University Press", 2006, 50.

<sup>44</sup> Gesetz betreffend das Urheberrecht an Werken der Bildenden Künste, 9.01.1876 § 6. Line 4, available at: <[http://de.wikisource.org/wiki/Gesetz,\\_betreffend\\_das\\_Urheberrecht\\_an\\_Werken\\_der\\_bildenden\\_K%C3%B4nste](http://de.wikisource.org/wiki/Gesetz,_betreffend_das_Urheberrecht_an_Werken_der_bildenden_K%C3%B4nste)> [20.04.2013].

<sup>45</sup> *Lord Byron v. Johnson* [1816] 2 Mer.29; 35E.R.851, in: International Encyclopedia of Comparative Law, Vol.11, Part 1, 1983, 59.

<sup>46</sup> *Qqolini P.*, English-Georgian Law Dictionary, Tbilisi, 2004, 410 (in Georgian).

<sup>47</sup> *Jeremy Ph.*, Introduction to Intellectual Property Law, London, "Butterworth", 1986; *Howell R.G.*, The Common Law Appropriation of Personality Tort, 1986, "I.P.J.", No. 2, 149. 151.

<sup>48</sup> *Nemschoff L.*, United States of America, A Rose by any other Name the US. And Moral Rights. Moral Rights Reports Presented at the Meeting of the International Association of Entertainment Lawyers MIDEM 1995, Cannes. Netherland-Belgium, 1995, 169.

<sup>49</sup> *Chanturia L.*, General Part of Georgian Civil Code, Tbilisi, 2011, 196 (in Georgian).

may use it in her activity. According to the Georgian civil code, paragraph 17 the right for the title comprises the name and the surname; that is in this case these norms are not to be applicable to the pseudonym either. What about paragraph 18 of Georgian Civil Code, which protects the right for the title among other nonprofit, personal ones, in this case it is not specified whether at using the name full name and also the pseudonym are to be implicated. It is possible once the pseudonym is contrived. In the comment line of the civil law of Georgia it's indicated that pseudonym means another contrived name and not the usage of the one of another person.<sup>50</sup> In the same code, paragraph 18 it is noted that the person has the right for defense if it is clear that her rights are infringed by someone else's use of her name. The appropriation of the pseudonym might damage the person's prestige even more than a simple, unauthorized acquisition of a name or a surname. Regarding the mentioned, a literary, artistic or scientific pseudonym is protected by the authorship and neighboring rights' law and in other specific cases paragraph 18 of the Georgian Civil Code is used.

Unlike the civil code protecting the right for name, to acquire a pseudonym registration procedures are not necessary just like fulfillment of other formalities. An author is authorized to carry out these requirements herself or even ask another person to use his (her) name as the pseudonym to be used for the authorship purposes.

In legal literature different ways of pseudonym acquisition are considered: one time use, long term use, registration. Soviet scientists believed that this kind of registration should have to be started.<sup>51</sup> But of course did idea did not get realized and for Georgian Law it would have stayed unacceptable as our country is a Bern Council member and therefore the work created is protected without any registrations involved.

True, a pseudonym use is not connected to formalities, though there are some difficulties regarding its choice procedure: for example according to the Swiss Federal Law of Authorship and Neighboring Rights of October 9 1992, paragraph 50, the work of literature and art could not be available for publication under signature or pseudonym if their authors could be easily messed up with the one associated with the previously issued works.<sup>52</sup>

The term of legal limitation of the pseudonym choice is explained by the fact that under each pseudonym already created reputation is given as a background which carries just as moral, so values of commercial use. Therefore the author surely has right to prohibit other people use their pseudonym in unauthorized way.

What about the pseudonym appropriation a well known American writer Mark Twain applied to court when he found out that another person had been using his pseudonym for their own works. At the process *Samuel Clemens versus Belford and Company* the claimant used to note that the pseudonym thanks to the twenty year literary work had become the brand mark of the author. Another person's right to issue books, sketches or other literary works would equal the unauthorized expropriation of property. The court did not satisfy the claim for the reason saying that the pseudonym did not enjoy more protection rights than the civil or baptismal names of a person and its use could not

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<sup>50</sup> Jorbenadze S., Khvlediani Z., Zoidze B., Ninidze T., Chanturia L., Ninidze T., Comment from Georgian Civil Code, Book I, Tbilisi, 2002, 53 (in Georgian).

<sup>51</sup> Romanovskaya Z.V., Personal, Non-property Rights of USSR Citizens, Author's Abstract from Dissertation, 14 (see: Malenina M.N., Personal Non-property Rights of Citizens, Moscow, 2001, 209 (in Russian)).

<sup>52</sup> <<http://www.wipo.int/wipolex/en/details.jsp?id=5223>> [20.04.2013].

be the prohibition subject to anyone, but the norm about commercial signs did not appeal to the property of literature.<sup>53</sup>

One century later this ruling had been decreed, the issue is being treated in a totally different way, including at those countries of the general law. For example, the Supreme Court of Wales satisfied the claim of one of the newspaper journalist so as another newspaper did not have the right to issue their periodicals under the first one's pseudonym. The court took in consideration that the journalist was in time to have been built the reputation using the pseudonym in view and if another entity would use it, it would in an unauthorized way use the reputation previously established.<sup>54</sup>

This approach is shared by Georgian law too. It does not matter whether the person has different motives to choose her pseudonym. Georgian Authorship Law has only one limitation regarding the pseudonym issue: according to the law on Author's Rights and Neighbouring Rights, paragraph 33, it is inappropriate and unacceptable to issue work or publicly announce it using the pseudonym that might use the publicity means to equal the work in view to the ones that had been previously issued by the authors known or available to society – to avoid a possible social confusion.

Other types of limitations exist in the legal system of other countries. For example according to the Russian Authorship Rights a pseudonym should not go against moral norms and be of insulting character and not have a potential to mislead the society. Otherwise an author might be refused any protection rights. According to paragraph 10 of Russian Civil Code, it is considered as the ill use of the civil rights.<sup>55</sup>

Under the same pseudonym several people might be leading literary or arts activity. For example brothers Zhemchuzhnikovs and the poet A. K. Tolstoy used to issue their works under the same pseudonym – Kozma Prutkova. Besides it would be interesting once we consider the case being not under the pseudonym of one particular entity, but the one the whole literary group uses. Here are people of art and literature united – for example a well known unity of Georgian poets "Tsisperkantselebi". From the viewpoint of the authorship law, the pseudonym cannot be regarded as such as it doesn't belong to any specific person. Though, it still needs protection. One of the main goals of the pseudonym protection is avoidance of the authorship mess. The same reason might serve the purpose of literary and artistic unity protection. The unity name contains the legal similarities with those of industry names of collective industry feature protection under which the industry representatives seek unifications and proceed in their practice. However, protection of unity titles will not keep under the application of these very norms, as in these cases no industrial activities are given. To protect the unity titles paragraph 18 of the civil code can be used. But it would be better the Law of Authorship and Neighboring Rights foresee the correspondent norm.

What are the cases the rights for name can be violated? In this case it would be better we are more precise about the terminology and say that not the rights for name but the right for name protection can be violated at times. The rights for name – as we mentioned earlier – have positive and negative

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<sup>53</sup> *Samuel L. Clemens vs. Belford, Clarce & Company*, available at: <<http://www.twainquotes.com/CourtDecision.html>> [20.04.2013].

<sup>54</sup> *Dzamukashvili D.*, Intellectual Property Law, Tbilisi, 2003, 53 (in Georgian).

<sup>55</sup> *Solovyov R.V.*, Authorship Right, Moscow, 2001, 23 (in Russian).



interpretations, that is the rights for name can be violated by both not indicating the author's name or by misappropriation of the authorship and name rights.

Plagiarism is the most wide spread name right violation. In case of work appropriation and unauthorized edition both authorship rights and the ones for name are being violated.

The rights for name comprise the author's right not to resort to her name use, therefore the author's name expose to public represents another identity right violation carried out without direct authorship authorization. There is a notion that the name used by the author who works under the pseudonym can be revealed in case of a slanderous or provocative article issuance – only under the court authorization term. Otherwise the publisher's are not liable to reveal the author's pseudonym.<sup>56</sup> However, it might be noted that Georgian Law does not take cases of these character in consideration. Also according to the Law of Speech and Free Expression, paragraph 7, it is unacceptable to legally force a person display the anonymity source. What for the legal obligation to make someone reveal such a pseudonym, special decree for this regard does not exist. Here it should be also noted that in case of slander the necessity of the authorship revelation will not be actual as according to paragraph 6 of the same law in case of slanderous case consideration responsibility comes upon the appropriate media holder.

Protection mechanisms of the name are the same as for the violation of the both civil, and authorship, personal, nonprofit right violations. According to paragraph 18, part 1 a person has the right to ask the violator suspend such illegal activity or totally renounce it. The claim raised on the same violation basis might be of the property character: according to paragraphs 18, part 6 – "if the violation was caused by illegal activities, the claimant is authorized to ask for restitution for the violation of the authorship rights proper". These very mechanisms can be used in case of the name right violation, namely: the right recognition, the restoration of legal status quo and prevention of those actions that the claimant was affected due to the authorship right infringement; compensation for the property and income damage the amount of which to be determined by court; taking other measures, defined by the Georgian Law and aimed at protection of the authorship and name rights.

#### **4. General and Differentiating Signs between the Authorship Rights and the Rights for Name**

The right for authorship and name, as we have already mentioned, in the legal framework of continental Europe are given under the same unified right. In the countries of general law the personal, nonprofit rights of an author are recognized only related to the works of art and combine these two rights under the same term – Right of Attribution. According to interpretations of the common law specialists, the idea of this right means protection of the authorship interests regarding the very existence of the just and accurate information of the work proper. It comprises the following rights: the work authorship; the author's right to prohibit his name's use on any kinds of fine arts works that he has not created; prohibit his name use on the works that initially were created by him but later went

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<sup>56</sup> *Solovyov R.V.*, Authorship Right, Moscow, 2001, 22 (in Russian).

through modification, change, afflicted or made subject to the circumstance by which the author's reputation may somehow be under offence.<sup>57</sup>

According to paragraph 17, part 1, point a of the Georgian Law on Author's Rights and Neighbouring Rights the authorship right means recognition for being such and the same recognition of authorship per every copy of the work or any mode of its further use including the claim for name (title) inclusion. What about the right for title it comprises the rights for the pseudonym or its refusal. Regarding the contents of paragraph 17 (part 1, point b) we can conclude that the right for the title is the part of the authorship right. In Georgian legal literature the following opinion is given: the distancing of the authorship and rights for names from each other carries both theoretic and artificial features. If the right for name should have been singled out, then the civil indication of the authorship title should have been inserted in the framework of this right.<sup>58</sup>

Although according to paragraph 17 the right for title is considered as part of the authorship right, the right for name might be violated in those cases when the authorship does not come under dispute and quite opposite – the authorship right be violated, while the name itself is correctly given. To illustrate this fact we could give several cases: the authorship might not be disputed but the parties cannot come to agreement concerning some rules for the name use – namely the property owner of the work and its sole author. Regarding this issue the following case is interesting that the Munich court took in consideration in 1969. The claimant was an architect who built a building for the municipal library. His claim was the building had a 35/70 mm stand that would advertise his name. The municipality of that city did not satisfy this claim for the following reason, namely: the building did not satisfy the criteria of the arts work on the very level so that the architect's name is directly inscribed on the one and the second reason was – in industrial practice this method was not exercised. The first argument was ruled for the citizen's favor while the court declared it couldn't decide whether the building truly represented the sample of architectural value while it did satisfy criteria defined by the authorship law. What about the second argument, the court ruled that the authorship right could not be restricted by industrial practice whether the author's name be actually attributed to the work proper. This right can be only restricted and ceded only according to the contract agreement. However, the court also highlighted that the author's right to define the way how their name be advertised was not off any limits. Therefore the court took into consideration the municipality interest the author's name to be posted by more modern and less ostentatious way.<sup>59</sup>

That is the right for name can be brought to the point at which the matter how the author will represent the attribution will be defined. The author may give their full name in extended way, only name or just initials. However, if only initials are given, in this case this work is considered to be those of anonymous ones.<sup>60</sup>

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<sup>57</sup> *Leaffer M.A.*, Understanding Copyright Law, 4<sup>th</sup> Edition, "LexisNexis Group", 2005, 382.

<sup>58</sup> *Dzamukashvili D.*, Intellectual Rights, Tbilisi, 2006, 201 (in Georgian).

<sup>59</sup> Namensnennungsrecht des Architekten (OLG Munich, 1969) GRUR 146 – Signum auf Werkexemplaren (see: *Adeney E.*, The Moral Rights of Authors and Performers, an International and Comparative Analysis, New York, "Oxford University Press", 2006, 50).

<sup>60</sup> *Solovyov R.V.*, Authorship Right, Moscow, 2001, 21 (in Russian).

What might the authorship right contain apart from the right for the name and what are those cases at which this right is still violated while the title is correctly indicated?

One of these examples is the Canada court decision that dealt with the authorship respect issue. In 2003 the court considered the case against DImag Erskin where a university professor was represented as a claimant party who had prepared guidance work for his students and issued it as a book. The editors put on the book that it had been created by the author. The court ruled that the words –"was created" and "by the author" were not of the equal importance. The phrase saying the work having being created by such and such person does not contain the authorship proper and possibly is aimed at diminishing the author's role. A person has the right to be recognized (and indicated) as an author. The claimant won this case and was given 3000 dollars as a direct compensation as his contribution into the work was considered as diminished.<sup>61</sup>

In this case the right for title was not violated and neither plagiarism took any place. The person's name that created it was correctly indicated while his role as that of an author was diminished.

The German scientist Adolf Ditz represents the differences between the authorship and title right in the following way: the authorship right, the respect for authorship qualification takes place in the very case when the author prefers to stay incognito or uses a pseudonym and still retains the right for authorship respect.<sup>62</sup>

However, in this case it should be also noted that although the author stays incognito, he still uses the right for title as the right to stay anonymous is part of the right for title. The authorship right means a broader concept in scale and comprises the minute identification of author's contribution, qualification, titles and his preferences to be identified.

The authorship right first comprises the authorship right for respect. This right could not be a subject of any restriction. What about the right for the name use, it can be the subject of some limitations such like the Munich decision, when the court did not satisfy the claim of the claimant and noted that the name (title) had to be noted by modern and less ostentatious way. The legislature of the general law foresees some limitations of the name. According to the US act for the fine arts authors, (part 106 (c) (3)) this right does not extend over those works of art that are represented in commercial media – for example in movies or magazines.<sup>63</sup> Regarding commercial media and advertisement, these limitations is caused by the following reason: after each ad release so as the ad author be signified, this fact will count for both the ad producer and advertisement company representative. In this case the right to indicate the name contradicts to the other person's commercial rights (in this case the media holding interests). Although this issue is regulated by law, the form the way the right is indicated, period and means might be the subjects of agreement if and only if the use of product implies any commercial purposes. Georgian lawyers think that it is right thing to do if the right for the name use is used as part of agreement designed. If these terms are fulfilled, then parties won't have any rights to claim for signifying the author's title (name) in any other way.<sup>64</sup>

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<sup>61</sup> *Adeney E.*, *The Moral Rights of Authors and Performers, an International and Comparative Analysis*, New York, "Oxford University Press", 2006, 323.

<sup>62</sup> *Diets A.*, *Das Droit Moral des Arhebert im Neuen Französichen und Deutsch Urheberrecht*, Munich, 1968, 117.

<sup>63</sup> *Leaffer M.A.*, *Understanding Copyright Law*, 4<sup>th</sup> Edition, "LexisNexis Group", 2005, 382.

<sup>64</sup> *Dzamikashvili D., Shengelia R., Gabunia D., Khrustali V., Jorbenadze S.*, *Comment from the Georgian Law of Authorship and Neighboring Rights*, Tbilisi, 2003, 113 (in Georgian).

## **5. Conclusion**

The authorship right contains right for name and their taking apart under the Georgian legal basis would carry artificial character. It would be right Georgian Authorship law take in consideration the approach of Bern Agreement and those of the continental Europe and guarantee protection for the name along with the general authorship one as in these legal, authorship relations the subject, an author, protects not a civil name, but the one of creator, as an integral element of her authorship. It would be reasonable, similar to French code for intellectual rights these two rights be united under the same term "the Right for Authorship Respect", while the authorship right protection is carried out by the very respect shown.

Georgian Law on Author's Rights and Neighbouring Rights, paragraph 8 contains a bylaw concerning those rights, on which the authorship rights do not apply. But according to the second part of the same law, only the right for title can be subject to the national regalia (a flag, a coat of arms, an anthem, awards, currency banknotes, other official, state marks and symbols), namely in case these items are used by another entity the right for authorship title protection is possible. It would be better in this case not only the right for title, but the authorship rights be protected because the authors of these items have not only right for name use, but the right for authorship respect.

Georgian Law of Authorship and Neighboring Rights protects the author's right to indicated a pseudonym instead of her actual name per each copy of the work (paragraph 17, 1, a), though the mentioned right concerns only physical entities but not the names of any literary unions, for example like "Tsisperkantslebi". One of the most important goals for the pseudonym protection may be the avoidance for the authorship title mess. The same purpose might be served for any literary and arts unity name protection. For this reason, protection of literary union (or unity) name, one can appeal to paragraph 18 of Georgian Civil Code but the sole protection of the literary and arts authorship rights is prerogative of the Law of Authorship and Neighboring Rights of Georgia and therefore to be reflected in this legal framework.

The Georgian Law for Authorship and Legal Rights corresponds to the internationally recognized trends of the authorship right, though for further harmonization with the European law the issue needs additional study and legislature refinement.

**Lasha Tsertsvadze\***

## **Duties of Board of Directors (Director) in Company Management (Comparative Analysis According The US (State of Delaware) Corporate Law and Corporate Law of Georgia)**

### **1. Introduction**

Duties of the Directorate in management of the Company is the topic, consideration of which is impossible to avoid upon discussing the judicial practice and experience of the countries of general law inasmuch as the primary duties of the Directors, such are Duty of Care and Duty of Loyalty originate therefrom.<sup>1</sup>

It would not be exaggeration if I say that the corporate law, developed in the State of Delaware (USA) had the highest impact on this sector of the general law, spreading beyond USA. Moreover, the excellent practice has been established in the State of Delaware regarding the duties of the Directorate, which has further been reflected world-wide.

It is noteworthy that several years ago (2008), the Law on Entrepreneurs of Georgia became the subject to significant amendments. For instance, the two-stage mandatory system, prescribed under the preceding corporate law on corporate governance became the thing of the past. Existence of the supervisory council, rather than exceptional events, which we will discuss further, is no longer obligatory.<sup>2</sup> The above-mentioned example reveals that the implemented amendment will definitely entail development of the duties of the Directors in a new manner and will establish the new standards and requirements towards them.

The hereby work reveals that the important amendment to the law on Entrepreneurs (developed based on the German analogue thereof) has been implemented as a result of impact of American and English law. However, it must be mentioned that the current Law of Georgia on Entrepreneurs is not the copy of the relevant laws of USA, England and Germany, on the contrary, it significantly differs from the current norms in these countries and this difference gives originality to it, making it interesting. Inasmuch as the Law of Georgia on Entrepreneurs is the mixture of German, American and English legislation, thus the hereby thesis will reflect consideration of current legislation and practice in the said countries and the current judicial practice and the Law on Entrepreneurs of Georgia. Using the contrastive-legal method, the hereby work, as the integral part of the thesis, concerns the current corporate legislation in Georgia and USA, namely in the State of Delaware and holds the contrastive analysis thereof.

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<sup>1</sup> *Hamilton R.W.*, The Law of Corporations, 5<sup>th</sup> Edition, St. Paul, "West Group", 2000, 446.

<sup>2</sup> Article 55, Para. 1, The Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: [https://matsne.gov.ge/index.php?option=com\\_ldmssearch&view=docView&id=28408](https://matsne.gov.ge/index.php?option=com_ldmssearch&view=docView&id=28408).

As the professor, Mr. Besarion Zoidze noted, copying the legal norm from one legal system to another may entail negative impact on development of transplant recipient law.<sup>3</sup> It is a very interesting opinion, as irrespective of the legal norm, copied from the legislation of foreign country, cannot exist without connection of other norms of legal system. Taking the above-mentioned into account, the hereby work aims at clarifying how efficiently and naturally the new legal norms were copied and harmonized into the current legislation of Georgia. The methodological principle of comparativeness is revealed in its functionality, which in itself implies that the norms shall be compared to each other, which implements similar functions, otherwise the contrastive analysis cannot entail the desired outcome.<sup>4</sup> Taking the above-mentioned into account, the hereby work aims at introduction of the view of the author, using the contrastive-legal method concerning the said issue, to indicate to the positive and negative sides, which may exist in terms of Georgian regulatory legislation and to hold the comparison thereof with more or less relevant norms of USA, the State of Delaware.

The hereby work aims at answering the important questions regarding the duties of the Directorate, based on the contrastive-legal research, making crystal clear for the reader what basic duties (obligations) are imposed on the Director in managing the company and what is the US practice in this term. The objective of the work is to become the primary compendium for the Directors of the companies, functioning in Georgia, for lawyers, jurists or judges, inasmuch as the practical purpose exactly provides its vital capacity.

As it was noted, the work will provide the judicial practice as far as possible, inasmuch as it has utmost importance for development of legal culture in general. The judicial practice has a high impact on legislation, forasmuch as the judge himself/herself encounters all these problems, which might not be taken into account upon adoption of the norms by the legislators due to the simple reason that it appears impossible to foresee all possible remedies and regulation thereof by means of relevant norms.

Deriving from the above-mentioned, it can be stated that the purpose of the court is not usage of the current norm solely. The court enlivens each norm. The judge has to adjust these norms to the existing remedies and correspondingly, it is highly dependent thereon the elucidation of the norm and the manner of enlivening thereof.

The defect of any object, item, right, duty etc. is revealed upon active usage thereof. For instance, if we do not use the newly purchased TV, we can never find the shortcomings thereof, if we do not enjoy own rights (of any type, e.g. property right), we can never detect whether this right has any gaps or whether it is restricted with other rights.

Similar is with the court towards the legal norms. If they are not used, it will be impossible to detect any gaps, to find out whether the legislators regulated either one or other relations accurately, whether the legal norms respond to or fit for solution of events, confronted by the real court.

Taking all above-mentioned into account, it is crystal clear that the judicial practice is of utmost importance; hence it would be expedient to consider sundry decisions of the Supreme Court of Georgia and courts of the State of Delaware, concerning the said issues, provided in the hereby work.

When speaking of the duties of the Directors, one cannot evade discussion of the principles of corporate governance. Corporate governance and the separate issues, included thereto, are one of the

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<sup>3</sup> Zoidze B., Reception of European Private Law in Georgia, Tbilisi, 2005, 5 (in Georgian).

<sup>4</sup> Zweiger K., Kötz H., Introduction to Comparative Law, Oxford, "Clarendon Press", 1998, 34.

most urgent spheres of the private law. The corporate governance-related problems are as acutely felt in Georgia as in the rest of the world. Development of bank and insurance infrastructure and large capital investments from abroad raises the necessity of control of activity of the corporate governance in Georgian business. It is of utmost importance how effectively the corporate governance is implemented, what type of management is applied by the companies and how efficient and attractive it is for the investors.

Regardless the fact that the level of corporate governance is higher comparatively with the preceding years, we cannot state that the corporate governance in Georgia corresponds to the international standards and international practice. It is as well noteworthy that there is no best model of the corporate governance. The corporate governance system depends on market structure, regulatory norms, traditions, cultural and social values, inculcated in specific society.<sup>5</sup> Therefore, upon reforming the Law on Entrepreneurs in Georgia, we shall not rely on successful functioning of this or that model even under the conditions of the most developed law and order. As it was noted, the norm, acceptable for one society and adjusted to the specific realities, may be totally useless in another legal system in the event of copying thereof.

Regardless dissension on definition of corporate governance, it's evident that recently it became the subject of intensive discussion as amongst the practicing lawyers, so amongst the academic circles and it is considered that existence of perfect mechanisms of corporate governance in the country significantly increases attraction thereof for the potential investors.<sup>6</sup>

The country, having the best corporate governance system with its financial, economic and socio-political outcomes, *ceteris paribus* achieves success in the regional European or global competition.<sup>7</sup>

The hereby work provides consideration of the main duties and functions, imposed on the Directors and correspondingly, on the basis of consideration thereof, it is possible to make the conclusion to define the place, occupied by the Director/Directorate in the process of corporate governance and what the obligations are, imposed thereon in this course.

The primary duty of the Director is to *bona fide* manage the company. Managing the company implies reasonable creation of competent management to develop the company policy and it is the highest link of the leadership.<sup>8</sup>

Correspondingly, the profitability of the specific company depends on the talent and capacities of the leader.<sup>9</sup>

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<sup>5</sup> *Kuchava K.*, Corporate Governance Related Problems in Georgia, IFC/Intenacionale Finance Corporation, Corporate Governance, "Quarterly Bulletin", IFC, No. 12, January-March, 2008, 4-5 (in Georgian).

<sup>6</sup> *Lazarev N.*, On Certain Issues of the Modern Corporate Governance Reform in Russia, "I.C.C.L.R" (see: *Janjalia B.*, IFC/International Finance Corporation, Corporate Governance, "Weekly Bulletin", No.11, October-December, 2007, 16-17 (in Georgian)).

<sup>7</sup> *Hopt K.J.*, Corporate Governance in Europe: neue regelungsaufgaben und Soft Law, in: Corporate Governance, Der Gesellschafter (GesRZ) Sonderheft, *Doralt P., Kalss S.* (Hrsg.), Wien (Linde), 2002, 4-13.

<sup>8</sup> *Qoqrashvili Q.*, Commercial Law, Tbilisi, 2005. 103 (in Georgian).

<sup>9</sup> *Ib.*

The structure of the bodies of the corporate governance, the composition thereof and the rule of formation have high impact on their activity, thus the management bodies (considered the Directorate first of all) must provide maximal democracy, protection of interests of the partners and realization of steady implementation of managerial decisions.<sup>10</sup>

In this specific event we will consider the functions of the Directors/Directorate and correspondingly, deriving from the functions, fulfilled by the body of this company and the obligations thereof, prescribed under the legislation, it will become clear what the place is, occupied by the Directorate/Director in the company system and what the obligations are, imposed thereon towards the company.

The duties of the Director in corporate governance will be considered in the work on the model of Joint-Stock Companies and Limited Liability Companies, inasmuch as they represent the capital enterprises of the classic type, where the duties and functions of the Directorate are most clearly revealed.

According to IFC, the corporate governance is the unified system of management and control, defining distribution of rights and responsibilities between the administrative bodies, executive bodies, stockholders and other concerned in the company parties. The corporate governance as well comprises the rules and procedures, related to monitoring of the efficiency of implementation of the decisions and the company activity.<sup>11</sup>

According to the Code of Corporate Governance of the Great Britain, the corporate governance is the unified system of corporate management and control. The Directorate is responsible for corporate governance. The role of stockholders in the corporate governance is appointment of the Directors and Audit members. The Directorate shall provide the effective management of the company, shall supervise implementation of the outlined business plans and on the basis of the thorough knowledge of the state of affairs, shall submit the complete information to the meeting of the stockholders.<sup>12</sup>

The above-mentioned elucidations clarify that the immense importance is attached to observance/exercise of the duty/obligation of generosity and good faith by the Directors and proper responsibility of offenders in the course of corporate governance.<sup>13</sup>

The corporation, as the subject of the private law is the practical realization of one of the fundamental Constitutional rights – the right of union of the persons for the purpose of tangible benefits.<sup>14</sup> The interests of the members (shareholders, partners) and the heads of the corporation in this union do not always coincide.

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<sup>10</sup> *Qoqrashvili Q.*, Commercial Law, Tbilisi, 2005. 101-102 (in Georgian).

<sup>11</sup> Code of Corporate Management for the Commercial Banks, IFC, Tbilisi, 2009 (in Georgian).

<sup>12</sup> The UK Corporate Governance Code, 2012, available at: <[www.frc.org.uk](http://www.frc.org.uk)>.

<sup>13</sup> *Jugheli G.*, Protection of the Capital in the Joint Stock Company, Tbilisi, 2010, 164 (in Georgian).

<sup>14</sup> *Schram H.I.*, Control over the Public Bodies by the State, the Duty of Honest Administration and Responsibility in the Joint-stock Company according to Georgian and German Law, the Material of the II German-Georgian Symposium on Corporate Law, Tbilisi, 2003, 167.



Correspondingly, the Director is assigned to achieve the golden mean and manage the company to avoid damage to the own and the interests of the shareholders and employees, which seems to be quite a complicated task

## **2. Current System of Corporate Governance in Georgia**

As a result of the changes adopted to the Law on Entrepreneurs it appears hard to say what type of corporate governance and system has been chosen by the legislators. In accordance with the changes, existence of the Supervisory Board is no longer obligatory except the events, prescribed under the legislation. That's why it is important to note that the type of the corporate governance system is active in general in Georgia under the conditions when it deviated from the German regulations and is tend to American model.

The significant changes in this regards have been adopted to the Law on Entrepreneurs in 2008.

Even upon the changes, implemented before 2008, the legislators strived at the maximal extent to consider the contemporary trends of development of corporate law. We can name the vicious practice as a model, when the issues regarding dismissal of the Director are solved by the Georgian courts in accordance with the Labor Code. The changes of 2008 imperatively excluded application of the labor legislation upon definition of the responsibilities of the heads of the corporation and thus uniquely underlined the specific legal nature of these relations.

The changes of March 14, 2008 to the Law on Entrepreneurs are of particular interest, which cardinally changed the legal regime of regulation of Georgian corporations. The preceding edition of the law envisaged existence of the Supervisory Board in Joint-Stock Company as mandatory, these bodies were optional for the Limited Liability Companies. The capacity of the regulatory norms of the Limited Liability Company has been drastically reduced after the changes. The legislator granted the entrepreneur subjects the wide authority to regulate the relevant issues under the Articles, as a result of which the reference to the Supervisory Board in regards with the Limited Liability Company has been totally disappeared. Existence of the Supervisory Board is optional for the Joint-Stock Company as well except the events, prescribed under the legislation. Namely, existence of the Supervisory Board is mandatory for the Joint-Stock Companies, which under the law on "Securities Market" is an accountable company, the securities of which are issued to the securities market for commerce, or the Joint-Stock Company is licensed by the National Bank of Georgia, or the number of the shareholders of the Joint-Stock Company exceeds one hundred.<sup>15</sup> In any other event creation of Supervisory Board is not obligatory.

As to the Commercial Banks, which as known are created in the form of the Joint-Stock Companies, the rules of creation of the Supervisory Board shall be defined under the law on "Activity of Commercial Banks."<sup>16</sup>

It can be generally stated that as a result of the changes, the imperative norms to the Law on Entrepreneurs are significantly reduced. The person, willing to found the Joint-Stock Company, is free by means of adoption to the Articles, to regulate and consider the important issues. For instance: "the amount

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<sup>15</sup> Part I, Article 55 of the Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>16</sup> *Ib.*, Article 14.

of the dividends and the rule of obtainment thereof shall be defined under the Articles of the company",<sup>17</sup> "the Articles may establish the diverse rule, providing alias definition of the rights of the regular and privileged shares".<sup>18</sup>

The old edition of the law did not consider the possibility to define the rights of the regular and the privileged shares by means of adoption of the diverse rule to the Articles.

Thus, it can be stated that the Georgian model of corporate governance has further deviated from the German version. For instance, if the Member of the Supervisory Board was prohibited from being the Director of the Company at the same time, nowadays it is permitted.

"The Articles may define the fact that the member(s) of the Supervisory Board to be the Director(s) of this Joint-Stock Company".<sup>19</sup> One more imperative norm has been abolished in accordance with this provision, prescribed under the Law on Entrepreneurs: "the member of the Supervisory Board shall not be simultaneously the Director or other executive officer of this Company".<sup>20</sup> In accordance with the abolished edition of the law, the functions of the Director shall not be delegated to the Supervisory Board, and the current edition provides contrary and unambiguously elucidates that the functions of the Director can be delegated to the Supervisory Board if prescribed under the Articles.

The primary functions of the Supervisory Board are reflected in oversight of the activity of the Director exactly. The Supervisory Board, at any time, is entitled to inquire the report of the activity by the Directors, is entitled to appoint and dismiss the Directors at any time and to conclude and terminate the contracts therewith.

As the professor Lado Chanturia notes, oversight on the activity of the Directors by the Supervisory Board does not imply the oversight and control on legitimacy of the activity solely but control of expediency and thrift (saving) of the activity.<sup>21</sup> Thus, the Supervisory Board is not responsible for solely expedient implementation by the Directorate but for efficiency thereof with the perspective for the company to obtain the profit at the maximal extent.<sup>22</sup> Thus the question is: if the Director of the Company may at the same time be the member of the Supervisory Board, will it entail reduction of control by the Supervisory Board on activity of the Directorate?

Absence of the above-mentioned control may have fatal impact on the future of the company. The question requires to be answered. The Director of course, who is the member of the Supervisory Board at the same time, cannot hold control over self in an effective and qualitative way, and the norm of the law, according to which the Directors cannot be in majority in the Supervisory Board, cannot give the proper guarantees simply speaking.

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<sup>17</sup> Sentence 3, Article 52 of the Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>18</sup> *Ib.*, Sentence 4, Article 52.

<sup>19</sup> Sentence 2, Para. 2, Article 55 of the Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>20</sup> *Ib.*, Article 55.3 (Abolished Edition).

<sup>21</sup> *Grunewald B.*, *Gesellschaftsrecht*, 2.Aufl, 1996, S. 254-255 (see: *Chanturia L., Ninidze T.*, *The Comment to the Law on Entrepreneurs*, 2002, Tbilisi, 411 (in Georgian)).

<sup>22</sup> *Chanturia L., Ninidze T.*, *The Comment to the Law on Entrepreneurs*, Tbilisi, 2002, 411 (in Georgian).

The Supervisory Board with participation of the Directors is more and more alike the American Board (the Board of Directors) and unlike the German Supervisory Board (Aufsichtsrat). According to the universally recognized opinion, the American Board is the only obligatory body of the corporate governance.<sup>23</sup> Besides, the Board has authority as of the Supervisory Board so of the Management (Directorate), which makes it the most powerful and influential body of the corporation.<sup>24</sup> Georgian Supervisory Board can be such body exactly, composed of the Director.

## **2.1. Board of Directors and Supervisory Board**

The Director is the necessary body of the corporate governance, granted with the crucial importance in accurate implementation of corporate governance.<sup>25</sup> Correspondingly, it has to be stated that after the changes, existence of the independence Directors has not been taken into account – so called "Non-management Directors." Under the conditions, when it does not represent the obligatory body of the Supervisory Board, it is important to have control on activity of the Directorate "Board".

The general meeting of the shareholders cannot hold the effective control over the routine business production. For the investor, intending to invest his/her money, it is of utmost importance how the decisions are made and if the control is held over the decisions of the Directors. The control on implementation of the made decisions is implemented by the Director himself/herself of course. Here we speak about the decision-making by the Directorate itself, how this body makes decisions and if there is the control how accurately has been the decision made.

Existence of the independent Directors in the Board is an important signal for the investors, inasmuch as it reveals that the Directorate is always ready to be subject of "inspection" by the independent personnel. The second positive feature that the existence of the independent Directorate can have is that the Directors are more protected from the suits by the shareholders.<sup>26</sup>

Taking the above-mentioned into account, we can reach the conclusion that after the changes, the system of the corporate governance, prescribed under the Law on Entrepreneurs appears not quite attractive for the investors. The rights and functions of the Directorate are increased and control is decreased. For instance, in accordance with the paragraph 117 of the German Law on "Shares", the right to demand the design is granted to the company by means of Directorate instead of the single shareholders. The shareholder independently shall not file the demand of reimbursement of the damage to the inflictor of the

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<sup>23</sup> *Chanturia L.*, Corporate Management and Responsibility of the Heads in the Corporate Law, Tbilisi, 2006, 112 (in Georgian).

<sup>24</sup> *Ib.*, 112.

<sup>25</sup> *Lazarashvili L.*, Official Contract with the Director of the Company, the Partner and the Director in Intra-Company Relations, in: The Theoretical and Practical Issues of Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 309 (in Georgian).

<sup>26</sup> *Clarke D.C.*, Three Concepts of the Independent Directors (PP 73-111), "Delaware Corporate Law Journal", Vol. 32, 2007, 106 (retrieved from HeinOnline Database).

damage, he/she shall initially address to the Directorate of the company as to the administrative and representative body.<sup>27</sup>

The paragraph 8 of the article 3 of the Law on Entrepreneurs emphasizes the fact that if the dominant partner or the group of partners, jointly acting, abuse the dominant condition against the interests of the company, then they shall reimburse to the rest of the partners the damage.<sup>28</sup> Taking the mentioned into account, it is evident how immense the role of the Directorate is even for the shareholder to have the right to protect and realize own rights. As it was mentioned, the victim shareholder addresses the Directorate to demand reimbursement of damage, and the Directorate as the representative of the company and the administrative body, is the plaintiff against the shareholder, inflicting the damage.

In accordance with the paragraph 10 of the article 3 of the Law on Entrepreneurs,<sup>29</sup> the partner of the company is empowered to obtain information about the activity of the company, for instance the copy of the annual report etc. and the person, in charge to issue the said information, is the company, i.e. directorate, as the representative and administrative body of the company. The directorate is responsible body for issuing the information instead of the Supervisory Board.<sup>30</sup>

Presumably, the said norms have been adopted to the Law on Entrepreneurs under the influence of the German analogue, though further followed the changes to the Georgian corporate legislation and unlike the German analogue, here existence of the Supervisory Board is no longer obligatory.

Due to lack of experience and culture of corporate governance in Georgia, the directors, the Supervisory Board (if such exists) and the shareholders are on one side of the "bridge" and the employees are on another. In accordance with the established practice, the director shall implement the instructions by the shareholders and the members of the Supervisory Board, otherwise he/she may be dismissed.<sup>31</sup> The mentioned practice does not of course correspond to the norm of the Law on Entrepreneurs, according to which the duty of the heads of the company shall not be terminated due to the fact that they act to implement the decisions of the partners.<sup>32</sup>

The director (manager) shall be a good mediator and act for the benefits of the shareholders and the employees of the company. The director, standing on one side of the "bridge", will fail to faithfully implement the duties, imposed under the legislation, despite on which side of the bridge he/she stands.

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<sup>27</sup> *Burduli I.*, Abuse of Rights of Petty Shareholders/Theoretical and Practical Issues of the Modern Corporate Law, Tinatin Tsereteli Institute of State and Law, Tbilisi, 2009, 270-271 (in Georgian).

<sup>28</sup> Para.8, Article 3 of the Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>29</sup> *Ib.*, Para. 10, Article 3.

<sup>30</sup> Abuse of Rights of Petty Shareholders/Theoretical and Practical Issues of the Modern Corporate Law, Tinatin Tsereteli Institute of State and Law, Tbilisi, 2009, 276 (in Georgian).

<sup>31</sup> Case N AS 68-767-03, Supreme Court of Georgia, 2003 (in Georgian). The Supreme Court of Georgia returned the case for reconsideration. The case concerned dismissal of the Director and the ground for dismissal was stated as discord between the director and the shareholders.

<sup>32</sup> Article 9(6), Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

### 3. Directors' Rights

#### 3.1. Directors' Right of Access to Board Information and to Participate in Board Action

The role of the Directorate in the corporate governance process is immense. The directors do not act similar to the scientists, lawyers, architects etc. Their obligation mainly implies business oversight, definition of corporate policy and decision-making on issues which business transaction is profitable for the company.<sup>33</sup>

Correspondingly, the right of the director to possess complete information upon decision-making is very important.

The Law of Georgia on Entrepreneurs does not comprise any of the special norms regarding the above-mentioned right. It must be stated that without realization of this right, the director (directorate) will fail to completely implement the obligations thereof towards the company.

Without possession the relevant information, decision-making goes beyond any reasonable boundaries, when the Law on Entrepreneurs obliges the directors to be provident and act as persons with the common sense in the similar situation upon decision-making.<sup>34</sup>

According to the legislation of the State of Delaware, the director is empowered to possess the complete information concerning the transactions to be implemented, though there are the events, when the shareholder is capable not to admit the director to any type of information. Except this fact, the director is in any case entitled to possess the complete information concerning the activity of the company.<sup>35</sup>

The member of the collective body of the management shall provide other members with the information, which is important for their decision-making or supervising.<sup>36</sup>

It is natural that the director does not possess comprehensive information and knowledge on all issues. He/she may rely on the reports and information, provided by the employees, the conclusions by the Board committee, the recommendations by the lawyers, tax counselor or other experts. Except the decision-making, he/she is as well entitled to consider the results of implementation of the delegated authorities by the committee or any other high officials.<sup>37</sup>

#### 3.2. Access to Legal Advice

The directorate is the most important link of public management. The professionalism and ability of the director significantly defines the success of the company, correspondingly the right of the

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<sup>33</sup> *Hanks J.Jr.*, Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, Journal "The Business Lawyer", Vol. 43, No.4, 1988, 1232.

<sup>34</sup> Article 9(6), Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>35</sup> *Welch E.P., Turezyn A.J.*, Folk on the Delaware General Corporation Law, Fundamentals, New York, "Aspen Publisher", 2005, 94.

<sup>36</sup> *Jugheli G.*, Protection of Capital in the Joint-stock Company, Tbilisi, 2010, 165 (in Georgian).

<sup>37</sup> *Ib.*, 166.

director to enjoy the legal aid, have consultation with the relevant employee or with the committee is of utmost importance.

The legislation of the State of Delaware calls this right as crucial. The Law of Georgia on Entrepreneurs does not comprise any similar norms, though on the basis of elucidations of the relevant articles of the Law of Georgia on Entrepreneurs<sup>38</sup> it is possible to reach the conclusion that the director of Georgian company has the right to demand the legal aid concerning the decisions to be made. Moreover, if the director makes the decision without the relevant information, he/she may be in charge for the damage if such is entailed as a result of the decision.

## 4. Directors' Duties

### 4.1. Conceptual Similarities and Differences

"The duty of the director" is a wide concept. It is noteworthy that the directors are the important (obligatory) persons for the corporate governance and in the course of representation thereof with the third parties.<sup>39</sup> According to the part one of the Article 56 of the Law of Georgia on Entrepreneurs, the duties of administration and representation of the company are imposed on the directors. Moreover, as the professor Lado Chanturia notes, the duties and the functions of the directorate are so specific that they shall not be delegated to any other body of the company.<sup>40</sup> The above-mentioned opinion completely shares the American direction of the company development, according to which the directors are the persons, who are imposed with the duty to manage the company and the fact they and not the shareholders possess the authority of corporate governance entails the fiduciary duty of the directors as towards the shareholders so towards the company itself.<sup>41</sup>

The duty of the directors can be divided into two wide categories, namely the duty of care and the duty of loyalty and they can in general be called a duty of care of directors. That's why directors are frequently called as the feduciaries.<sup>42</sup>

The duty of the directors, moreover, they shall be encouraged to make risky decisions in order to increase profit and income for the company and the shareholders correspondingly.<sup>43</sup>

Despite the similarity of the norms of the law, Georgian corporate law is not dignified with accurate formulations and definitions of duties of the directors. For instance, the Supreme Court of Delaware elucidated on one of the famous case - *Smith vs. Van Gorkom*<sup>44</sup> that the fiduciary duty of

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<sup>38</sup> Article 9, Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>39</sup> Chanturia L., Ninidze T., The Comment to the Law of Georgia on Entrepreneurs, Tbilisi, 2002, 119 (in Georgian).

<sup>40</sup> Ib.

<sup>41</sup> Smith J.A., Morreale M., Global Climate Change and U.S. Law, Chicago, American Bar Association (Illinois), 2007, 498.

<sup>42</sup> Hamilton R.W., The Law of Corporations, 5<sup>th</sup> Edition, St. Paul, "West Group", 2000, 444 -445.

<sup>43</sup> Ib.

<sup>44</sup> *Smith v Van Gorkom*, Supreme Court of Delaware, 1985, available at: <[http://international.westlaw.com/find/default.wl?sp=intbucrs000&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=intbucrs000&rp=%2ffind%2fdefault.wl&sv=Split&rs=WLIN11.04&cite=488A.2d+858+&fn=_top&mt=314&vr=2.0&findjuris=00001)>.

the directors towards the company comprises duty of care and duty of loyalty,<sup>45</sup> when similar unequivocal direction does not exist in Georgian legislation.

The duties of care and loyalty in the State of Delaware are imposed on the directors towards the company itself instead of the creditors thereof. They are obliged to act in good faith in corporate governance and with the sincere belief that the decisions made thereby primarily serve for the interests of the company and are directed to increase the income of the shareholders.<sup>46</sup>

According to the model business corporation act (MBCA) of the State of Delaware, the duties of the directors towards the company are considered individually to each director and not to the directorate as a body. In different situations, the director may have various duties. The duty of the director towards the company permanently exists unaltered, but what type of obligation is imposed on the director deriving from the specific case shall be defined as a result of consideration of this specific case. For instance, if the obligation of the director towards the company, encountering the financial problems and the obligation of the director towards the company, defined as for sale, are different and shall be defined as a result of independent consideration of each circumstances.

When speaking about the duties of the director, the law on corporation of Georgia provides that the Director shall act in good faith and on the basis of the comprehensive information with the belief that his/her act is the most beneficial for the company. In the event of violation of the above-mentioned obligations, the director shall reimburse the damage to the company (if such exists). In the event of damage the director shall be imposed with the joint responsibility with all the available property thereof.<sup>47</sup> If damage is inflicted, the director shall confirm that he/she has been acting in accordance with the requirements of the Law on Entrepreneurs. From its part, the company is entitled to decline reception of reimbursement of the damage by the director. The right to decline reimbursement of the damage is granted to the creditors of the company if the company fails to satisfy the legal demands thereof.<sup>48</sup>

The norm of the Law of Georgia on Entrepreneurs is quite interesting, envisaging that the directors shall be imposed with responsibility for the damage inflicted to the company jointly with all the available property thereof directly and peculiarly.<sup>49</sup> It is noteworthy and requires to be elucidated the issue of joint responsibility of the directors, namely whether the similar formulation of the norm of the law excludes individual responsibility of each director. This norm has to be given the wide explanation and thus shall be interpreted as it is interpreted in America and England and as above-mentioned. Georgian legislation on Entrepreneurs enables the individual responsibility of each director as it is provided under the wide explanation of the said norm. Otherwise, this norm of the Law on Entrepreneurs would lose the meaning.

According to the universally recognized opinion, the director shall act for the benefit of the company instead of for the benefit of any of the shareholders. Moreover, upon intersection of the

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<sup>45</sup> *Welch E.P., Turezyn A.J.*, *Folk on the Delaware General Corporation Law, Fundamentals*, New York, "Aspen Publisher", 2005, 82.

<sup>46</sup> *Hamilton R.W.*, *The Law of Corporations*, 5<sup>th</sup> Edition, St. Paul, "West Group", 2000, 497.

<sup>47</sup> Para. 6, Article 9, Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>48</sup> *Ib.*, Para. 4, Article 56.

<sup>49</sup> *Ib.*, Para. 6, Article 9; Paragraph 4, Article 56.

interests between the company and the group of shareholders, the director shall have the position which in his belief, is beneficial for the company and in this event failure to act by the director shall be considered as violation of loyalty and duty of care towards the company.<sup>50</sup>

In this term, Georgia has different condition. According to the current practice, the persons shall be appointed as the directors in Georgian company, who have close relations with the shareholders and are their friends instead of taking their professionalism into account. (This does not apply to 100% of the acting companies in Georgia, though unfortunately this is the main trend). With such decision, the shareholders strive to have direct influence on the director and correspondingly on the decisions made thereby. It is evident that similar practice cannot have the positive impact on development of corporate governance system, moreover, it can be considered as impediment inasmuch as in such events, the main principles are not protected upon decision-making, which serve as the basis for American, English and German corporate governance systems.

Taking the specific circumstances into account, the conditions under which the director has been elected, some may consider that he/she is so-called "honorary director" without any real obligations towards the company. Some of them, based on wrong supposition, believe that being in the minority in the Board, he/she has no obligations towards the company and does not assume responsibility for happening. It must be stated that any kind of violation in the course of the corporate governance is violation of the duty of care. Due to the above-mentioned circumstances, the responsibility of the director for this violation shall not be excluded.<sup>51</sup>

It is evident that violation of the duty by the director may occur as in Georgia so in America, England and Germany. The main difference between the countries occurs when the legislation fails to create the system, avoiding imperfect implementation of obligations or at least reducing such facts. Naturally, Georgia in this term encounters higher risk than England, USA and Germany. Occurrence of the similar problem is particularly less expected in USA (State of Delaware) where influence of judicial power on the corporation law is immense.<sup>52</sup>

## **4.2. Duty of Care**

The Law on Entrepreneurs prescribes the duties of the directors and the members of the Supervisory Board to manage the company in good faith and take care of it as does an ordinary person with common sense on the similar position and under the similar conditions and to act with belief that their acts are most beneficial for the company.<sup>53</sup> The said norm is quite general and leaves the question who shall be considered as "an ordinary person with common sense on the similar position and under the similar conditions" and where requirements he/she shall meet. Georgian judicial practice

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<sup>50</sup> *Welch E.P., Turezyn A.J.*, Folk on the Delaware General Corporation Law, Fundaments, New York, "Aspen Publisher", 2005, 88.

<sup>51</sup> *Hamilton R.W.*, The Law of Corporations, 5<sup>th</sup> Edition, St. Paul, "West Group", 2000, 450-451.

<sup>52</sup> *Cox J.D.*, How Delaware Law Can Support Better Corporate Governance, 335-350, in: Perspectives on Corporate Governance, *Kieff S.F., Paredes T.A.* (Eds.), New York, "Cambridge University Press", 2010, 339.

<sup>53</sup> Para. 6, Article 9, Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.



has not clearly defined and prescribed the said norm. According to the law on corporations of the State of Delaware, the director shall, upon decision-making, possess comprehensive information and consider all possible outcomes regarding the issue, subject to be decided.

This norm of the law on "Corporations" of the State of Delaware may serve as a good model for Georgian legislation and judicial practice when speaking of the duty of care of the directors. True, the latter even does not give the possibility of evaluation of the acts by the directors by absolute accurate manner but it contains more clarity, it is more concretized about the obligations of the director upon corporate governance and decision-making in general.

According to the law on "Corporations" of the State of Delaware, the director is obliged towards the company to manage in good faith and take care of it. The majority of US States share the norms Model Business corporate act, according to which the director shall: 1) in good faith, 2) take care of the company as the person with common sense on the similar position would in the similar situation, 3) sincerely, with reasonable belief that acts with consideration of the best interests of the company.<sup>54</sup>

Responsibility of the director may rise in the event if it is revealed that he/she made precipitate and poorly thought-out decision or if it is revealed that he/she did nothing to avoid the possible loss.<sup>55</sup> Moreover, even the subjective circumstances such are disease, age etc. of the director shall not serve as the ground for exemption thereof from responsibility. Inasmuch as membership of the corporate governance imposes at least one obligation to the director – to resign from the position if he/she feels that fails to meet the requirements and fulfill the obligations, which are prescribed under the legislation on corporations and the Articles of the Company. The director shall not be exempted from responsibility only because these obligations are too hard for him/her to implement.<sup>56</sup>

The said principles may not exclude responsibility of the director at all for breach of the duties but significantly reduce the risk.<sup>57</sup> Inasmuch as the minimal standard shall exist, it will only assist the directors and the lawyers thereof to be aware of the minimal obligation of the director towards the company. For instance, according to the Court of Chancery<sup>58</sup> of the State of Delaware, if the director is aware of the issue, decided by the directorate but failed to express his/her position upon discussion thereof, it shall be considered that the director is against the decision made by the directorate. The similar approach aids the court and the companies themselves to define whether the director breached the duty of care towards the company when his/her position on any concrete transaction is vague.<sup>59</sup>

Despite the above-mentioned, the scopes of duties of the directors and the nature are one of the most discussable issues in the Court of Case Law and Doctrine of the State of Delaware. The opinions are different about the requirement subject to be filed to the director and whether the negligent and

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<sup>54</sup> *Hamilton R.W.*, *The Law of Corporations*, 5<sup>th</sup> Edition, St. Paul, "West Group", 2000, 448.

<sup>55</sup> *Smith J.A., Morreale M.*, *Global Climate Change and U.S. Law*, Chicago, American Bar Association (Illinois), 2007, 498.

<sup>56</sup> *Hamilton R.W.*, *The Law of Corporations*, 5<sup>th</sup> Edition, St. Paul, "West Group", 2000, 451-452.

<sup>57</sup> *Ib.*, 453.

<sup>58</sup> <<http://courts.delaware.gov/chancery/>>.

<sup>59</sup> *Welch E.P., Turezyn A.J.*, *Folk on the Delaware General Corporation Law, Fundamentals*, New York, "Aspen Publisher", 2005, 119.

imprudent act of the director shall be considered as breach of duty and whether the responsibility thereof shall raise upon gross negligence.<sup>60</sup>

Gross negligence shall be considered as the imprudent attitude of the director or deliberate groundless ignorance of the interests of the shareholders and the company and towards the important transactions for implementation.<sup>61</sup> The practicing lawyer may deviate from speaking of the standard of duty of care upon issuing the relevant recommendations to the director, that's why the Court of Appeal of the State of Delaware tries to define the main directives regarding the duty of care of the director.<sup>62</sup>

Breach of the duty of care by the director shall be considered as the breach of obligation. He/she shall manage and control the company and the activity thereof.<sup>63</sup> According to the US-based practice, the director shall make decision and trust the comprehensive and verified information. Though, the responsibility of the director does not apply the quality of information, obtained by the subordinate responsible person.

The duty of care defines that the director shall act in good faith on the basis of the information available and shall not consider the origin and the source of the information.

Correspondingly, the duty of care by the director shall not be considered breached when they make decision on the basis of the information obtained from the above-mentioned persons.<sup>64</sup>

The Court of Appeal of the State of Delaware defines that the director should be fully protected if upon decision-making he/she acted in good faith on the basis of the information obtained from the subordinate managers or hired experts.<sup>65</sup>

Despite the above-mentioned, it is necessary to define the minimal standard in regards with the information, obtained by the director.

The director shall analyze all possible alternative decisions regarding the concrete corporate transaction where he/she shall consider importance of the transaction for the company, the value thereof etc. For instance, when the decision concerns alienation or re-capitalization of the company, which may entail change of control over the company, deriving from importance of such transactions, the director shall be imposed with particular responsibility and burden of claim in order to confirm that such decision has been made on the basis of the relevant comprehensive information.<sup>66</sup>

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<sup>60</sup> *Drexler D.A., Black L.S., Gilchrist Sparks A.*, Delaware Corporation Law and Practice, New York, "Bender", 2010, 15-40.

<sup>61</sup> *Smith J.A., Morreale M.*, Global Climate Change and U.S. Law, Chicago, American Bar Association (Illinois), 2007, 500.

<sup>62</sup> *Drexler D.A., Black L.S., Gilchrist Sparks A.*, Delaware Corporation Law and Practice, New York, "Bender", 2010, 15-41.

<sup>63</sup> *Welch E.P., Turezyn A.J.*, Folk on the Delaware General Corporation Law, Fundaments, New York, "Aspen Publisher", 2005, 79.

<sup>64</sup> *Ib.*, 104.

<sup>65</sup> Delaware General Corporate Law, Section 141(e)od 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 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 D.A., Black L.S., Gilchrist Sparks A.*, Delaware Corporation Law and Practice, New York, "Bender", 2010, 15-45.

<sup>66</sup> *Welch E.P., Turezyn A.J.*, Folk on the Delaware General Corporation Law, Fundaments, New York, "Aspen Publisher", 2005, 82.

It must be stated that conscientiousness of the director upon obtaining and evaluating the information, is the impediment in regards with the qualification of responsibility of the director.<sup>67</sup>

As upon consideration of one of the famous cases *Smith vs. Van Gorkom* has been revealed, even the director without the financial interest may be personally responsible for business decisions if he/she has breached the necessary standard of duty of care.<sup>68</sup> Correspondingly, the fact solely that the director had no financial interest to the transaction, does not mean that he/she made the decisions in good faith.

Duty of care and the above-mentioned aspects concerning thereto, is in the course of development in Georgia. The main principles and standards regarding the said issue are not yet defined by the judicial practice as it is in the State of Delaware. Relevantly, the experience of the Delaware corporate law and rich judicial practice concerning the duty of care by the director towards the company may become the model and optional mean for Georgian corporate law in regards with definition of the duty of care.

### 4.3. Duty of Loyalty

The directors, who are the significant figures in the company, may have personal business interests as well. Correspondingly, the risk of deviation from the duties for the purpose to obtain personal benefit of course exists and will always exist. The duty of the director to avoid threat is often called the duty of loyalty.<sup>69</sup> Duty of loyalty obliges the director to exclude competition with the company for personal interest. The director shall act in good faith in order to contribute own mite in success of the company. In view of personal profit, he/she shall not use the resources and capacities, appurtenant to the company.<sup>70</sup>

According to the American law on "Corporation", the director shall not disclose the classified information, obtained upon implementation of own activity. He/she is as well prohibited from using this information for own purposes.<sup>71</sup> The same norm is provided in the paragraph 9.6 of the Law of Georgia on Entrepreneurs,<sup>72</sup> which is one more clear evidence similarities of Georgian Law on Corporation and its American model. Any corporate governance system is created to reduce the costs of corporate governance and increase the profitability of the company on the base of the good governance. The reduced costs versus increased efficiency – this construction shows the level of complication of the problem.

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<sup>67</sup> *Welch E.P., Turezyn A.J.*, *Folk on the Delaware General Corporation Law, Fundamentals*, New York, "Aspen Publisher", 2005, 82.

<sup>68</sup> *Allen W., Kraakman R., Subramanian G.*, *Commentary and Cases on the Law of Business Organization*, 2<sup>nd</sup> Edition, New-York, "Aspen Publishers", 2007, 257.

<sup>69</sup> *Smith J.A., Morreale M.*, *Global Climate Change and U.S. Law*, Chicago, American Bar Association (Illinois), 2007, 504.

<sup>70</sup> *Allen W., Kraakman R., Subramanian G.*, *Commentary and Cases on the Law of Business Organization*, 2<sup>nd</sup> Edition, New-York, "Aspen Publishers", 2007, 241.

<sup>71</sup> *Kleinberger D.S.*, *Agency, Partnerships and LLCs*, 2<sup>nd</sup> Edition, New York, "Aspen Publishers", 119.

<sup>72</sup> Article 9(6), Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

The authors in the corporate governance system name legal regulation of the activity of the director as the only way of solution of the problem. Though, we need to be very careful as decision-making by the director is a vivid process where it appears impossible to plan every nuance and regulate them with legal manner. Correspondingly, restriction of the director in decision-making and necessity to obtain permission by other superior bodies in any other routine activity may appear detrimental for the company. Speed of decision-making is one of the main factors for success. "Time is money" – relevantly if the decision is not made promptly, the company will lose income which will be directly reflected on the condition of the shareholders and the owners. Granting absolute independence to the directors on its hand contains risk.

That's why, according to the established practice, in the country with such tradition of corporate governance as USA, the director is never in charge only because his/her decision failed to gain profit for the company. He/she is in charge first of all because he/she made the decision on inaccurate information.

Also important place is dedicated to the deals made on behalf of the director of the company. The directors are not prohibited from making such deals though he/she shall in any case prove that this deal is of absolute profit for the company<sup>73</sup> that in similar condition the same deal would be made with another person with the same conditions.

The Law of Georgia on Entrepreneurs contains the similar norm as well, so the members of the Directorate and the Supervisory Board, if such exists, shall not without the preliminary permission by the meeting of partners, use for the personal purpose the information concerning the activity of the company, of which have become aware upon exercising the duties or due to their official position.<sup>74</sup>

The director, having the personal financial interest to the deal, may be biased. Correspondingly, the conflict of interests of the heads may entail damage to the corporation. On the other hand, such deals often are beneficial for the companies than legal relations with the third party, deriving from the relations of the parties.<sup>75</sup>

According to the law on "Enterprises" of the State of Delaware, the head of the company shall notify the corporation initially about the company chances of which he/she is aware. In the event of refusal by the company, the director of company to enjoy the enterprise opportunities himself/herself.<sup>76</sup>

In regards with usage of the company opportunities, the director is empowered to preliminarily demand approval on usage thereof, thus avoiding responsibility. The responsibility of the director shall not occur if in regards with the implemented transaction he/she arguments that acted in accordance with the interests of the company first of all.

The Law of Georgia on Entrepreneurs does not provide the similar norm, though it is possible to achieve the same conclusion on the basis of the wide elucidation of the paragraph 9.5 of the same law. However, a problem is to be taken into account in terms of control of conscientiousness of the director as there is no such controlling norm in Georgian legislation.

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<sup>73</sup> *Kraakman R., Davies P., Hansmann H., Hertig G., Hopt K., Kanda H., Rock E.*, The Anatomy of Corporate Law, New York, "Oxford University Press", 2003, 24.

<sup>74</sup> Article 9(6), Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>75</sup> *Enriques L., Hertig G., Kanda H.*, Related-Party Transactions, The Anatomy of Corporate Law, *Kraakman R., Hopt K.* et al. (Eds.), 2<sup>nd</sup> Ed., 2009, 154-155 (see: *Jugheli G.*, Protection of Capital in the Joint-Stock Company, 2010, Tbilisi, 169 (in Georgian)).

<sup>76</sup> *Jugheli G.*, Protection of Capital in the Joint-Stock Company, 2010, Tbilisi, 171 (in Georgian).

Hence, it is more justified to find the balance between the expected risks and benefit than declaration of the same deals as void.<sup>77</sup> In USA the decision on the acceptability of the deal adopts the directorate composed of three independent directors.<sup>78</sup>

In accordance with the current legislation of Georgia, the similar decisions are to be made by the Supervisory Board (if such exists). Though, as it was noted, existence of the Supervisory Board is not mandatory. Correspondingly, the decisions of the director in the company where such body is absent, is remained uncontrolled inasmuch as it is impossible for the general meeting of shareholders to hold the control over routine activity.

Any type of action, which may gain profit to the director thus inflicting loss to the company, shall be considered as breach of duty of loyalty by the director.<sup>79</sup>

In order to protect the duty of loyalty of the directorate, the directorate shall do the best to prevent loss or shall abstain from such deals, which may entail negative impact to the company. The director shall put the interests of the company above personal interests and thus make the decision. As a rule, in such events, the director shall on the basis of particular providence and care, make the final decision.<sup>80</sup>

The above-mentioned shall not be interpreted that director is under constant supervision and each of his/her decision fall under control according to the above-mentioned criteria. On the contrary, the Court of Appeal of the State of Delaware upon litigation of one of the most world famous Paramount case has elucidated that "in ordinary circumstances neither the Court nor the shareholders themselves are authorized to interfere in the decision-making process by the directorate."<sup>81</sup> According to the above-mentioned criteria, estimation of the decision by the director shall only occur if the plaintiff confirms that the directorate has made the decision dishonestly. The decision by the Court of Appeal of the State of Delaware may be a good model as for Georgian Court so for the active businessmen, directors, shareholders and practicing lawyers inasmuch as due to the unfortunate practice established in Georgia, decision-making by the director is often interfered mainly by the shareholders.

## 5. Business Judgment Rule

Judgment rule, one of the remarkable institutes of American law was created by courts trying to defend directors' rights when facing an unwanted takeover.<sup>82</sup>

Deriving from the content thereof, it can be called the "Presumption of innocence" towards the actions made by the director,

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<sup>77</sup> *Jugheli G.*, Protection of Capital in the Joint-Stock Company, 2010, Tbilisi, 169 (in Georgian).

<sup>78</sup> *Ib.*

<sup>79</sup> *Welch E.P., Turezyn A.J.*, Folk on the Delaware General Corporation Law, Fundaments, New York, "Aspen Publisher", 2005, 83.

<sup>80</sup> *Ib.*

<sup>81</sup> *Paramount Communications, Inc. v. QVC Network*, Supreme Court of Delaware, 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](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)>.

<sup>82</sup> *Hamilton R.W.*, The Law of Corporations, 5<sup>th</sup> Edition, St. Paul, "West Group", 2000, 460.

It protects the director from responsibility if validity thereof meets the reasonable requirements.<sup>83</sup>

Business Judgment Rule has the character of presumption of protection of the heads of the company in judicial practice of America, to "overcome" which is obligation of the plaintiff which implies that the plaintiff shall argue the fact of breach of the fiduciary duty (duty of care) that he/she acted dishonestly. The Court starts essential consideration of the case in the event solely if the plaintiff manages to argue all the above-mentioned. In this event, the burden to prove shall be loaded on the director and he/she shall argue that acted deriving from the interests of the company.

Only due to the fact that the decision made by the director appeared harmful to the company, his/her responsibility shall not occur. If the fact was confirmed that the director acted in good faith within the authority thereof upon decision-making, the responsibility thereof shall not occur, which is one of the positive characteristics of Business Judgment Rule. "Proving the fact that the damage was inflicted to the company as a result of the deal, concluded by the manager within authority thereof, made in good faith, on legal basis and taking the objectives of the company into account, cannot be the basis for responsibility regardless the quality of argumentation of the implemented investment post factum".<sup>84</sup>

The judicial practice of America has considered the demand of absolute accuracy by the director as inadmissible severity. According to the Law of Georgia on Entrepreneurs, the directors and the members of the Supervisory Board shall administer the activity of the company in good faith, namely shall care as takes care the ordinary person with a common sense on the similar position and under the similar circumstances and shall act with the belief that their action is most beneficial for the company.<sup>85</sup>

If they fail to fulfill this duty, they shall be imposed with the joint responsibility for the damage to the company with all the available property directly or indirectly. If reimbursement appears necessary, the duty of the leadership of the company shall not be ceased due to the fact that they acted in order to implement the decisions of the partners.<sup>86</sup>

Georgian legislation and judicial practice do not provide the norm, similar to the Business Judgment Rule, though analysis of the said norms reveals that the Law of Georgia on Entrepreneurs establishes a specific standard upon decision-making and does not oblige the director to make an absolutely accurate decision. Important is that the latter shall make decisions in good faith and within common sense. Criticism of the instance is entailed with the fact that the edge of common sense is not defined, there are no concrete principles to be observed by the director upon decision-making to appear under observation of this rule. The Court shall consider and estimate each concrete case

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<sup>83</sup> *Jugheli G.*, Protection of Capital in the Joint-Stock Company, Tbilisi, 2010, 185 (in Georgian).

<sup>84</sup> *Gagliardi v. TriFoods Intern., Inc.*, 683 A.2d 1049, 1051. (Del. Ch., 1996): "to allege that a corporation has suffered a loss as a result of a lawful transaction, within the corporation's powers, authorized by a corporate fiduciary acting in a good faith pursuit of corporate purposes, does not state a claim for relief against that fiduciary no matter how foolish the investment may appear in retrospect"; see also *Cinerama, Inc. v. Technicolor, Inc.*, 1991 WL 111134, at \*15 (Del. Ch., 1991) (see: *Jugeli G.*, Protection of the Capital in the Joint-stock Company, 2010, Tbilisi, 187 (in Georgian)).

<sup>85</sup> Article 9(6), Law of Georgia on Entrepreneurs, 1994, available (in Georgian) at: <[www.matsne.gov.ge](http://www.matsne.gov.ge)>.

<sup>86</sup> *Ib.*

independently. The judicial practice of the State of Delaware is very rich and flexible in this term. It is considered that at the maximal extent it guarantees protection of the rights of the directors.<sup>87</sup>

Taking the fact into account that as a result of the changes, implemented in Georgia, the role of the director has been increased in the corporate governance, necessity appears for him/her to feel protected and have the feeling that he/she will not be punished for non-profitable decision if this decision is made in good faith on the basis of fact evaluation and with the belief of the best decision for the company. In this event, if the dispute appears, Georgian Court shall consider the experience and practice of the State of Delaware and impose the burden on the plaintiff to overcome the Business Judgment Rule. Inasmuch as the director administers the affairs on the basis of own responsibility and the principle of freedom of decision-making for the company,<sup>88</sup> and violation of this rule will decrease the will of the director to assume some risk to gain success for the company.

## **6. Conclusion**

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

Georgian law on corporation has those effective mechanisms, which facilitate to swift and effective application of norms of law in business routine, when the Courts in the State of Delaware are important institutions, facilitating implementation of the norms of the law on "Corporations" and establishment and development of new, modern regulations of the corporate governance.

The number of progressive norms have been created in American law on "Corporations" considering the case law, correspondingly, it can be stated that the case law is able to elucidate this norm the way, preventing further disputes and the more improved is the law, the less is the risk of disputes.

As a result of the changes in spring 2008, the role of the directorate in corporate governance has been significantly increased. The norms, regulating the corporate governance before changes were under strong influence of German law. After the changes, the influence has been weakened. Georgian legislation has been filled with the innovations, characteristic for Anglo-American legislation, which is utterly interesting. Nowadays, the current Georgian model is the quite original synthesis, characterized with separate features as of German so of Anglo-American law.

Professor Lado Chanturia notes that the fate of the company is mainly dependent on the skills and the knowledge, experience and capability of the director – is it cost-effective or not. At the same time, the director shall be accountable towards the company.<sup>89</sup>

Taking the above-mentioned into account, it clearly can be stated that the role of the directorate in corporate governance system in accordance with Georgian and American law, is decisive.

The director has the duty to act within own authority, otherwise responsibility thereof might occur.<sup>90</sup>

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<sup>87</sup> *Hamilton R.W.*, The Law of Corporations, 5<sup>th</sup> Edition, St. Paul, "West Group", 2000, 461.

<sup>88</sup> *Lazarashvili L.*, Official Contract with the Director of the Company, the Partner and the Director in Intra-Company Relations, in: The Theoretical and Practical Issues of Modern Corporate Law, *Elizbarashvili N.* (Ed.), Tbilisi, 2009, 339 (in Georgian).

<sup>89</sup> *Chanturia L., Ninidze T.*, Comments on the Law of Georgia on Entrepreneurs, Tbilisi, 2002, 115 (in Georgian).

I would emphasize two duties of the directors in the law on "Corporations", imposed thereon towards the company - duty of loyalty and duty of care. Each of the duties establishes the general standard of activity by the director.<sup>91</sup>

The Law of Georgia on Entrepreneurs also provides the similar duties of the directors, though as it was mentioned, Georgian legislation needs to be improved and précised in this direction.

The role of the directorate and relevantly, responsibility thereof are immense, thus it is necessary to elect qualified and experienced manager of the company with capacity to fulfill the tasks imposed instead of according to personal acquaintances. A bad manager, under the regulations of Georgian legislation, can lead the company to absolute fiasco and not only welfare of the direct owner of the company but the welfare of the employees thereof, implementing their duties in good faith, depend on the company fate. With the increased authorities and the decreased control, the directorate is a threat for the companies functioning in Georgia at least because of absence of experience and traditions of corporate governance, correspondingly it can be concluded that implementation of legal norms from one legal system to another without consideration of the traditions and the experience of the latter may appear detrimental, thus high caution is necessary upon implementation of legal norms. Due to the regrettable practice, established in Georgia, the legal norms are frequently copied without any system and understanding, hastily and simply, only translating the relevant norm into Georgian. As the professor Lado Chanturia notes: "so many desultory and hard to explain changes have been made to the Law on Entrepreneurs during the years that it is high time to develop a new law".<sup>92</sup>

Deriving from the above-mentioned, it can be stated that 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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<sup>90</sup> Kleinberger D.S., Agency, Partnerships and LLCs, 2<sup>nd</sup> Edition, New York, "Aspen Publishers", 123.

<sup>91</sup> Palmiter A.R., Corporations, 5<sup>th</sup> Edition, New York, "Aspen Publishers", 193.

<sup>92</sup> Chanturia L., European Private Company-innovation in European Corporate Law, "Law Journal", No.1, 2009, 41 (in Georgian).



**Nino Khunashvili\***

## **Controlling the Content and Restriction of a Contract's Standard Conditions on the Basis of the Good Faith Principle**

### **1. Introduction**

Private legal relations are based on independence, private initiative, and the freedom of an individual. In civil law Freedom is demonstrated in the first place by the freedom of parties of civil legal relations in concluding a contract, determining the content and the future of a contract. Although the freedom of a contract does not automatically ensure the protection of contractual justness between partners having equal rights. It is easy for a powerful party to impose its position on another party. Therefore contracts cannot always be the result of two equal compatible wills.<sup>1</sup> The Civil Code envisages the possibility of breach of parity and sets forth the principles and evaluative categories a judge should be guided by when adjudicating a specific dispute.

The application of such principles becomes increasingly necessary. The thing is that given scientific-technical development, global internationalization, mass production and mass consumption of standard goods and services the nature of contractual relations has changed substantially, and it impacts the content of contracts. Namely, contract terms and conditions became complex, detailed and standard and they are often determined beforehand and unilaterally.

Article 346 of the Civil Code of Georgia (hereinafter the CC) envisages following parity when forming standard provisions; this Article stipulates the mechanism of safeguarding a weak party from the application of provisions that substantially infringe a contractor's rights on the basis of the good faith principle. This standard applies to commercial transactions as well as in customer relations. Pursuant to Article 346 of the CC standard provision of contracts is null and void irrespective of its inclusion in the contract if it is harmful to another party of a contract contrary to the principles of trust and good faith. "Standard provisions that are harmful to another party" imply such conditions that disproportionately infringe the rights and interests of a party accepting contract terms and conditions. The present paper reviews the peculiarities of control over standard provisions in contractual relations exactly on the basis of good faith principle. It should be mentioned in general that a contract is an effective, free economic setup "engine " and also "a tool for free self-determination of an individual".<sup>2</sup> In modern period not only the functions and field of using contracts change but also the nature of regulation of relations through a contract. Due to mass production and consumption of standard goods and services those contractual

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<sup>1</sup> *Eckl Ch.*, *Treu und Glauben in spanischen Vertragsrechts*, "Studien zum ausländischen und internationalen Privatrecht", Band 183, Tübingen, "Mohr Siebeck", 285.

<sup>2</sup> *Langenfeld G.*, *Vertragsgestaltung: Methode-Verfahren-Vertragstypen*, 2. Aufl., München, "Beck" 1997, Rdnr. 417.

conditions based on which such goods or services are offered into commercial circulation become more complex, they are set forth in more detail and in a standard manner.<sup>3</sup> Standard provisions emerged in 1970's as a result of industrial revolution.<sup>4</sup> Western lawyers from the end of 1950's considered standard provisions to be in the ranks of the most important theoretical and practical problems of the contract law.<sup>5</sup> Industrial revolution in Great Britain and the resultant development of railway and other monopolistic enterprises has conditioned the development of standard contractual provisions. Often enterprises were ready to strike deals on the basis of very standard provisions.<sup>6</sup> These also included such provisions that limited or even excluded the liability of an enterprise. In early 1900's in Germany control was limited to only such cases as the abuse of monopolistic position.<sup>7</sup>

In Georgian reality too, the role and importance of standard provisions increases gradually and relevant practice is being established. Judicial practice evidences that standard provisions are controlled through the good faith principle.<sup>8</sup>

Standard provisions are used in relations with those entities of law that conclude contracts where relations are organized in detail. The need for such organization is explained by high number of customers and complex nature of relations. Effectively all enterprises in Western European countries and in North America use standard provisions (standard form of contracts, *Allgemeine Geschäftsbedingungen*) when concluding contracts. In practice various templates with standard provisions are used. This may be one document that has blanks in addition to standard provisions; and the blanks are filled in later by the parties (details of parties and specifically agreed contract terms are indicated). On one side of the document subject of specific agreement between the parties may be written by hand or printed, while on the reverse side of the document standard provisions that one of the parties uses when concluding contracts are typed, titled according to one of the following: "general (or standard) provisions of a contract", "general provisions of purchase and sale", "general provisions for supply and payment", etc. The use of texts stored in computer is very common. This enables in some cases to enter standard provisions directly in the contract's wording. Sometimes in the individual part of a contract where substantial provisions are provided a reference about standard provisions offered by one of the parties is made, and these standard provisions may be appended to the contract on a separate sheet of paper. Standard provisions are often used by banks, insurance organizations, transportation companies, forwarders, utilities, hospitals, airline companies. Standard provisions are used in retail trade as well. The cases when banks or other entities with monopolistic position on the market use standard provisions is frequent in Georgia.<sup>9</sup> In Germany almost 100% of commercial contracts in the fields of banking and

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<sup>3</sup> *Heinrichs H.*, in: *Palandt: Kommentar zum BGB*, 59. Auflage, München, "Verlag C.H. Beck", 2000, 2176.

<sup>4</sup> *Rombach J.*, *Allgemeine Geschäftsbedingungen bei freien Dienstverträgen*, Köln/Berlin/Bonn/ München, "Heymanns", 1997, 5.

<sup>5</sup> *Atiyah P.S.*, *An Introduction to the Law of Contract*, 5<sup>th</sup> Edition, Oxford, "Clarendon Press", 1995, 16.

<sup>6</sup> *Taylor R.*, *Law of Contract*, 6<sup>th</sup> Edition, Oxford, "Blackstone Press Limited", 1998, 100.

<sup>7</sup> *Kaiser-Wilhelm-Kanal-Entscheidung des Rg.*, Germany Supreme Court, 1906 RGZ.Bd.62, 264(265).

<sup>8</sup> Case N as-722-1045-05, Civil, Business and Bankruptcy Board of the Supreme Court of Georgia, 2005; case N as-992-1245-05, Civil, Business and Bankruptcy Board of the Supreme Court of Georgia, 2006 (in Georgian).

<sup>9</sup> *Todua M., Wilems H.*, *Law of Obligations*, Georgian Young Lawyers' Association, 2006, 43-44 9 (in Georgian).

credit, touristic services, trade in vehicles, purchase and sale are concluded using standard provisions. The number of standard contracts in the fields of construction, brokerage services and trade in furniture is 90%, while in the fields of motor vehicle services, dry cleaning and repair services – it is 50%.<sup>10</sup> The reason for such widespread use of standard contract provisions is the need for streamlining of conclusion and performance of contracts. Trade, especially trade with the goods of mass consumption would be difficult without having standard provisions. If every customer and enterprise held special negotiations about every article of a contract, agree upon each other's conditions, this would give rise to significant extra costs related to the formulation of provisions and holding negotiations. This includes, for example, legal expenses, for it will be hard for a non-specialist to understand complex and long standard provisions without special legal education, etc. The application of standard provisions streamlines formalizing, recording and performance of contracts for offerors.<sup>11</sup> The fact that large part of a contract is prepared in advance allows to save time on the preparation of a contract. This enables to free up employee time. It is no longer necessary for them to participate<sup>12</sup> in formulating contract terms and provisions for often contracts are actually concluded by people who do not have legal training and are not prepared for negotiations related to contract provisions. The use of standard provisions reduces costs significantly.<sup>13</sup>

All of the above mentioned makes the study relevant. Given the currency of the problem of control of standard provisions and since there are not many papers on this problem in Georgian literature, and judicial practice is being currently formed along with Georgian materials foreign doctrine and the examples of judicial practice are also provided in the paper.

## 2. The Abuse by the Offeror of the Right to Unilaterally Set the Standard Provisions

When determining contract standard provisions offeror tries not only to make it easier to conclude and perform a contract but effectively always tries to improve its own condition in detriment of another party's interests, and to make such condition much more favorable than determined under the dispositional norm. Although Article 325 of the Civil Code has an imperative provision according to which in case the terms and conditions of fulfilling an obligation are to be determined by one of the parties of a contract or a third party then in case of doubt it is assumed that such determination has to be made on the basis of justness. The given norm is about the necessity to maintain justness. The category of justness differs from the category of good faith, but this norm in a way fills the norms that regulate standard provisions and effectively ban the offering of unjust, as well as unfair conditions to another

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<sup>10</sup> Müller H., *Allgemeine Geschäftsbedingungen im internationalen Wirtschaftsverkehr* Neuwied, Kriftel/Berlin, "Luchterhand", 1994, 1.

<sup>11</sup> This is an entity that, when concluding a contract with a party uses standard provisions. This term is used in the Netherlands Civil Code ("*gebruiker*") where its definition is provided in Article 6:331(b). This term, "*Verwänder*" is used in the 1976 Law of Germany on Organizing the Law of General Provisions of contracts, and in other laws, <<http://dejure.org/gesetze/AGBG/24a.html>>.

<sup>12</sup> Yates D., *Standard Business Contracts: Exclusions and Related Devices*, London, "Sweet & Maxwell", 1986, 3.

<sup>13</sup> *Ib.*, 3.

party, because it sets forth a general rule for just contractual relation. Despite law-prescribed prohibitions there are often the cases when an offeror enters into a contract provisions that limit its liability or the provisions that entirely exclude its liability. According to such provisions all risks rest with another party. For example, in Great Britain in the "travel tickets case"<sup>14</sup> the companies performing passenger and cargo railway and marine transportation and shipment used standard provisions for the first time, with the purpose of limiting liability or exemption from liability (excluding liability). Initially companies tried to use standard provisions to limit strict (objective, without fault) liability of a carrier company. Next, they started to formulate standard provisions in a way that enabled them to have as favorable situation as possible in relation to a client. Ultimately, any type of liability of a carrier was excluded while the customers effectively ended up to be without rights.

Formally, standard provisions become part of a contract that restricts only those parties who have concluded standard provisions based on mutual agreement although in practice determining standard provisions and offering by one of the parties at the time of concluding a contract is done in a way that another party is unable to enter any change in the content of these provisions. This means that only one of the party enjoys the freedom granted equally to both parties; that of determining the content of a contract; while another party is unable to participate in determining contract provisions. This is because for a client the price and quality of an offer is of primary importance, not the "quality" of standard provisions.<sup>15</sup> Therefore, contracts that employ standard provisions are concluded using the principle of "take-it-or-leave-it".

If another party wants to modify provisions then an offeror will refuse to conclude a contract: "if you want these goods or services then we have only those provisions that can be used for buying those. Accept those or decline a contract".<sup>16</sup>

A client is unable to freely conclude a contract in case it needs goods or services while an offeror has monopolistic condition on the market. French lawyers were the first ones to use such concept as "contract d'adhesion"<sup>17</sup> (a contract concluded by means of acceptance)<sup>18</sup> for the contracts which provisions are determined by one of the parties in advance and may not become the subject of a contracts and that can be accepted only in whole. As has been mentioned in literature in many fields where contracts are concluded there are no preconditions of achieving contractual agreement freely and independently.<sup>19</sup> Often there is inequality between the parties when a participant of civil transaction is in an unfavorable situation and is unable to exercise their interests when leading negotiations. Economic, informational superiority, and in some cases psychological superiority of one of the parties of a contract

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<sup>14</sup> *Richardson, Spence & Co. v. Rowntree*, Court of Appeal of England and Wales, 1984; *South Eastern Railway Co.*, Court of Appeal of England and Wales, 1877, 416; *Thompson v. London, Midland & Scottish Railway Co.*, Court of Appeal of England and Wales, 1930 (retrieved from LexisNexis).

<sup>15</sup> *Heinrichs H.*, in: *Palandt: Kommentar zum BGB*, 59. Auflage, München, "Verlag C.H. Beck", 2000, Rdnr. 3.

<sup>16</sup> This is Lord Diplock's formulation on the case: *Schroder Music Publishing Co Ltd v. Macaulay*, Court of Appeal of England and Wales, 1974 (retrieved from LexisNexis).

<sup>17</sup> Was first used by *Saleilles R.* in work *De la declaration de volonte. Contribution a l'étude de l'acte juridique dans le code civil allemand*, 1901, N 89, 229.

<sup>18</sup> *Mai S.K.*, *The Overview of the General Part of Burgeous Obligations Law*, Moscow, 1953, 40-44.

<sup>19</sup> *Hemme K. E., Wußt A.*, *Basics Zivilrecht: Juristisches Repititorium Hemmer*, Würzburg, 1997, 29, Rdnr. 66.

is considered to be the reason for disturbing the equality between parties and therefore the reason for inability to take decision freely and independently.<sup>20</sup>

In such case a powerful party is able to unilaterally dictate contractual provisions to another party. This infringes the right of a weak party to take decision independently that is contrary to the principles of autonomy of will and the freedom of contract. The principle of freedom of a contract in a relation between parties with unequal power on the market does not ensure that the provisions of a contract concluded between such parties are formulated pursuant to good faith principle. Therefore, contract freedom has to be limited by the mentioned principle. The limitation of contractual freedom by good faith principle (including when determining contract standard provisions) is reflected in Georgian doctrine as well.<sup>21</sup>

In modern period standard provisions are considered to be part of services, i.e., special product that is offered by the offeror under a "package" together with main services (goods).

With its designation contract is a means for regulating relations in accordance with individual interests and needs of civil legal transaction. And in case of inequality between parties it is impossible to speak about free expression of will. Dictating contract provisions to another party unilaterally is incompatible with the principle of freedom of contract. It would be unfair to have contractual restraint towards the party that although has formally concluded an agreement (contract) but when concluding such contract it effectively was unable to exercise the right to freely set forth contract terms and conditions.

In such case legislator balances relations between parties by means of imposing certain liabilities on a more powerful party and grants special rights and priority to a weak party. Just interest of a weaker party lies in that that a contract or a specific provision of a contract that is counter to good faith principle should not be mandatory to such party. Respectively, such party has to be granted the right to demand relieving thereof from an obligation imposed on the basis of such contract or any contractual provision.

That is exactly why it is necessary to limit an offeror's right to set forth the content of standard provisions on the basis of good faith principle. Standard provisions of a contract or a deal can be considered as some kind of a legal product that is offered by one party to another along with principal goods or principal services. Like any other product, standard provisions have to be of relevant quality and be free of "concealed" fault, deficiency. The content of standard provisions must be in conformity with the good faith principle. This means that the interests of another party have to be considered in accordance with the good faith principle. In Germany this situation is most often in relations in construction business.<sup>22</sup> Good faith principle mandates the offeror of standard provisions to consider the interests of a contractor, imposes the duty of care. A contractor expects that standard provisions regulate relations between parties in a reasonable manner and in good faith. That is exactly why a contractor has to be safeguarded against such explicitly unconscientious standard provisions.

The abuse of freedom of contract differs from the abuse of right emanating from a contract.<sup>23</sup> In case of abuse of freedom of contract formally there is an agreement reached on the basis of a contract

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<sup>20</sup> Wolf M., *Rechtsgeschäftliche Entscheidungsfreiheit und Vertraglicher Interessenausgleich*, Tübingen, 1970, 18.

<sup>21</sup> Shengelia I., *Contractual Freedom*, Dissertation for a Doctor of Law Degree, Tbilisi, 2010, 106-126 (in Georgian).

<sup>22</sup> Bunte H.J., *Zehn Jahre Gesetz zur Regelung des rechts der Allgemeine Geschäftsbedingungen- Rückblick und Ausblick*, "NJW", 1987, 921ff.

<sup>23</sup> Eckl Ch., *Treu und Glauben in spanischen Vertragsrechts*, "Studien zum ausländischen und internationalen Privatrecht", Band 183, Tübingen, "Mohr Siebeck", 284.

that based on the *Pacta sunt servanda* principle is mandatory but in such case it cannot be considered that a contract between parties is the result of self-determination based on private autonomy for one of the parties "abuses" its monopolistic position on the market, its power when forming a contract.<sup>24</sup> According to the good faith principle such articles of a contract are the subject of control of content of contract standard provisions that were not the subject of separate negotiations. Although standard provisions have been entered in the contract but actually one party (as a rule this is a customer) agreed to standard provisions set forth by another party (offeror) without having the possibility to influence content of contract standard provisions.<sup>25</sup>

Considering such contracts entirely null and void in which case essentially one party dictates contractual terms to another would be directed against reality and modern commercial practice requirements. Therefore it is not arguable that such contracts concluded in such manner are compulsory. As for safeguarding rights and interests of a weak party of a contract this is done in order to prevent the abuse of contract standard provisions by an offeror. Namely, standard provisions directed against contractual justness or provisions that disturb the balance between performance and reciprocal performance are considered null and void.<sup>26</sup> When contract terms and conditions become especially burdensome for a weak party of a contract. Contract standard provisions will be considered unjust and hence null and void in case they violate the good faith principle by causing significant inequality between contractual rights and duties.<sup>27</sup>

Provisions of a contract concluded with customers should correspond to the model of behavior implied under good faith. If contractual provisions are not in conformity with the good faith principle then it will be regarded that they had been abused, are unjust that will result in their voidness. This means that the law provision which normative content is emanating from a model behavior expressed in the good faith principle turns into a compulsory ,i.e., imperative norm (i.e., becomes a legal standard) which may not be modified on the basis of a will expressed in a contract, especially to the detriment of a customer.<sup>28</sup>

### **3. Definition of Standard Provisions as the Mechanism of Controlling the Content of Standard Provisions**

Article 345 provides a rule about ambiguous provisions. Since an offeror unilaterally formulates standard provisions in advance ambiguous wording of contract standard provisions is interpreted in favor of a client. Further, standard provisions have to be interpreted in an objective manner, irrespective of parties' willingness and objectives. In disputed cases (even among businesses) the matter is decided in

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<sup>24</sup> *Lasarte C.*, Clausulas abusivas y nulidad parcial del contrato en el ordenamiento juridico espanöl contemporaneo. *Revista de Derecho Comparado*, Mexico, 2001, 139 ff., 159, available at: <www.biblio.juridicas.unam.mx>.

<sup>25</sup> *Ib.*, 144.

<sup>26</sup> *Ib.*, 145.

<sup>27</sup> *Eckl Ch.*, *Treu und Glauben in spanischen Vertragsrechts*, "Studien zum ausländischen und internationalen Privatrecht", Band 183, Tübingen, "Mohr Siebeck", 287.

<sup>28</sup> *García A.M.*, *Consideraciones a la Buena fe contractual*, *Actualidad Civil* 2000, 3 (see: *Eckl Ch.*, *Treu und Glauben in spanischen Vertragsrechts*, "Studien zum ausländischen und internationalen Privatrecht", Band 183, Tübingen, "Mohr Siebeck", 288).

favor of a client.<sup>29</sup> This rule is explained by the fact that determined obligation corresponds to the ability to unilaterally set forth contract content. An offeror has to take measures to make contract provisions clear and comprehensible.<sup>30</sup> A party developing standard document has all capacity to regulate legal relations in an unambiguous and clear manner. If it does not use such ability then simple justness demands that negative results of vagueness in wording to affect the offeror in the first place. This effectively means that during litigation vague provision (condition) has to always be interpreted in favor of an offeror's contractor. But just Article 345 is not enough to set forth the will of parties and safeguard the interests of a contractor.

The Civil Code of Georgia does not comprise a special norm analogous to the German Civil Code Article 157 which would set forth a rule of interpreting the contract on the basis of good faith principle. Further, the need for having such a rule in Georgian law would not be argued. Possibly, in the future such rule would not be included in the Civil Code as a special norm. Therefore, it is advisable and necessary to broadly interpret Article 52 of the Civil Code of Georgia in judicial practice and along with other factors, in general, when interpreting any contract on the basis of good faith principle to establish actual will of parties. Further, a judge making a decision should not be obliged to establish will of parties based on the literal meaning and point of the contract. Such a rule would enable a judge in cases where parties have not distinctively regulated established terms and conditions (for they simply have not thought about it) to make a conclusion by means of interpretation of a contract about the presence of actual will of parties based on the fact that the parties have agreed on other analogous conditions. Thereby, court decision will in a way complete a contract concluded between parties. Respectively, it is advisable to use general norms of Civil Law in relation to the interpretation of standard provision of a contract.

## **4. Voidness of Standard Provisions that Are Contrary to Good Faith**

### **4.1. General Provisions**

"Since standard provisions are determined by only one party it is necessary to protect the interests of another party who does not participate in setting forth the provisions."<sup>31</sup> That is why according to the imperative provision standard provisions that are contrary to the good faith principle are null and void. Although, care has to be applied when using the measure of recognizing a contract null and void in order not to jeopardize the stability of civil transaction. Respectively, voidness of a contract on these grounds has to be restricted to such cases when it is absolutely necessary. In case a contract is declared null and void in entirety or partially it is necessary to take into account legitimate interests of a powerful party of a contract. To ensure stability of civil legal transactions it is necessary to precisely determine the criteria for evaluating those circumstances in the presence of which the imbalance of powers reaches such degree when it is no longer possible to speak about informed and voluntary consent to contract

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<sup>29</sup> *García A.M.*, Consideraciones a la Buena fe contractual, *Actualidad Civil* 2000, 3 (see: *Eckl Ch.*, *Treu und Glauben in spanischen Vertragsrechts*, "Studien zum ausländischen und internationalen Privatrecht", Band 183, Tübingen, "Mohr Siebeck", 393).

<sup>30</sup> *Lindacher W.F.*, Gesetz zur Regelung des rechts der Allgemeinen Geschäftsbedingungen, *Kommentar v. Wolf M., Horn N., Lindacher W.F.* (Hrsg.), 3. Aufl., München, "Beck", 1994, §5 Rdnr 24.

<sup>31</sup> *Akvlediani Z.*, *Law of Obligations*, Second Edition, Tbilisi, 1999, 24-28 (in Georgian).

provisions by a weak party (a freely made decision) when key principles of civil law are breached. In such case a contractor (weak party) may be relieved from negative consequences of expressed will thereof. Interests of contract parties may be balanced as follows: a party who agrees to standard provisions is granted certain privilege (for example, entitlement to price reduction or other benefit) in exchange to unfavorable contract conditions (including standard provisions). Further, the balancing of specific terms and conditions of a contract can be influenced by such factors as is the degree of interest of parties in concluding a contract, current state on the market, etc., although this does not resolve the problem of unconscientious terms and conditions of a contract for ultimately such terms and conditions of a contract may have a negative effect on the interests of parties.

In judicial practice in Georgia when determining the issue of voidness of standard provisions such factors are considered as whether a contract has a price or is gratis. For example, when an item is stored for a price a party storing the item will be required to exert increased attentiveness and responsibility than in case of storage for gratis irrespective of whether parties have agreed or not on the scope of obligation. In practice standard provisions that are detrimental to a creditor are considered null and void on the basis of Article 346 of the CC. The factor whether an entity is an entrepreneur is of high importance. For example, a bank is a business entity that has gained the right to carry out banking activity on the basis of a special permit issued by the government. In his/her relations thereof an individual is able to assume that a bank's activity will be performed in compliance with relevant rules. I.e., the trust towards a bank is presumed by the assumption of another party's reliability and the assumption of special protection of an individual's assets.<sup>32</sup> While for one of the cases it is noted that the Civil Code that is based on the principle of equality in some cases increased civil legal responsibility of certain category of entities – entrepreneurs is stipulated, which is especially demonstrated in contractual relations concluded under standard provisions. In this regard the Civil Code sets forth prohibiting norms that limit the attempt of businesses to shift the risk of a civil transaction to those entities that are not leading business activity. In the given case an entity with a dominant condition on the market was a party of a contractual relation and it was obliged to offer to a customer just contractual provisions and not to abuse its power in the business field which is the only means for meeting essential needs for another party. In a number of issues a business entity is restricted by and acting pursuant to the rules determined by a government body (in the given case under the GNERC decrees) it is obliged to take into account and base its activity on government attitude towards customers. This attitude was clearly defined by mandatory participation of a customer when drawing up a violation protocol. Respectively, an entrepreneur was obliged to act within the scope of this very protocol and carry out its activity respectively.<sup>33</sup> Civil Code requiring the parties to demonstrate mutual respect and sympathy in relation to another party in this respect imposes to both parties higher obligation than that agreed upon. This very obligation is prescribed by Article 316(2) of the CC that stipulates that an obligation, considering its content and nature, may involve imposing on each party special sympathy towards the rights and assets of another party. That is why on another case in addition to that an entity setting forth standard

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<sup>32</sup> Case № as-722-1045-05, Civil, Business and Bankruptcy Board of the Supreme Court of Georgia, 2005; case № as-992-1245-05, Civil, Business and Bankruptcy Board of the Supreme Court of Georgia, 2006 (in Georgian).

<sup>33</sup> Case № as-611-837-08, Civil, Business and Bankruptcy Board of the Supreme Court of Georgia, 2008 (in Georgian).



provisions was an enterprise attention was placed on that it had dominant standing on the market therefore pursuant to Article 319 of the Civil Code it did not have the right to offer unequal terms and provisions of a contract to another party without having such grounds.<sup>34</sup>

A judge is obliged to indicate the interests and principles that he/she considered when taking a decision.

The criterion for assessing the behavior of a party offering standard provisions, pursuant to Article 346 of the Civil Code<sup>35</sup> is the principle of good faith. According to the mentioned principle responsibility is imposed on the powerful party (in this case the party offering standard provisions) provided rights and interests of another party are infringed (are breached or they are not considered by a powerful party) due to the misbalance between the powers and abilities of parties and such infringement of rights is due to the influence of the sphere of authority of a more powerful party. In other words, responsibility is imposed on a more powerful party provided it takes advantage of unequal situation and thereby infringes the interests of a weak party. On the basis of good faith principle true substance, point and meaning of a contract, and not its literal meaning is decisive and key.

When assessing court has to determine whether the weak party of the contract (to whom standard provisions were offered) had the possibility to get involved in formulating standard provisions, and if it did not, why this happened, have standard provisions been formulated in accordance with the requirements of the good faith principle, have rights and interests of another party been considered in them? The lack of will should not be the case and further, the agreeing to standard provisions should be the result of free demonstration of will. As a rule, the entity who due to economic reasons is unable to decline a contract, even if a contract comprises unfavorable provisions agrees to the unconscientious and unjust standard provisions. If one party develops, formulates contract terms in advance and later uses those terms repeatedly multiple times without modifying it can be said that formulating contract content is not dependent on the negotiations between parties and such party has certain (economic or tactical) superiority over another party in contractual relations. Further, the size of contract terms and conditions has absolutely no importance. Therefore, the norms of the Civil Code of Georgia about standard provisions of a contract are also used when just one contract provision designed for multiple use has been formulated in advance. Article 346 of the Civil Code of Georgia that prohibits the use of standard contract provisions that contradict with the good faith principle should not be regarded as a norm that limits the right of a party offering standard provisions to formulate contract conditions; rather, this norm

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<sup>34</sup> Case № as-992-1245-05, Civil, Business, and Bankruptcy Board of the Supreme Court of Georgia, 2006 (in Georgian).

<sup>35</sup> The standard is about declaring standard provisions that are contrary to trust and good faith principles null and void. It makes the impression as if it is about two different principles --- trust and good faith principles. While actually the good faith principle comprises the element of trust as well, therefore we have to conclude that this is not about two different principles, but about the good faith principle that comprises the element of trust as well. When addressing the good faith principle the literature notes rightly that the use of these principles is mainly conditioned by such cases where demand or the behavior of another party corresponds to the official material law but its implementation in a specific case is unjust or is contrary to the justified trust of another party. Compare: *Kereselidze D.*, Private Law Most General Systemic Concepts, Tbilisi, 2009, 84 (in Georgian).

is used to safeguard the principle of autonomy of will and ensure just and clear organizing of legal relations by considering the interests of another party.

German courts regarded standard provisions to be null and void in case they unjustifiably infringed the interests of another party.<sup>36</sup> For this the courts used the principle of good faith although in reality this was the "law invented by judges".<sup>37</sup>

The control of the content of standard provisions on the basis of good faith principle is stipulated under the Greek legislation as well. Control is performed on the basis of general norms of civil law about good faith.<sup>38</sup> Further, general norms of the Greek Civil Code about the abuse of right and the voidness of a contract are used according to which the provision of a contract is null and void in case it 1) contradicts with good ethics, namely, disproportionately limits the freedom of another party or gives rise to its exploitation (Articles 178 and 179 of the Greek Civil Code) that can be used only in extreme cases); 2) Sets forth such rule of performing an offeror's obligation without regard to the interests of another party that this contradicts with the good faith principle (Articles 288 and 371 of the Greek Civil Code); 3) when using in a specific case explicitly violates the boundaries set forth under the good faith principle, or good ethics principle, or those established under the law for economic purpose (Article 281 of the Greek Civil Code, titled "The abuse of power"); 4) is used by a foreigner and its application is contrary to the public order of Greece (Article 33 of the Greek Civil Code).

In Paragraph 2-302 of the Unified Trade Code of the US the concept of "unjustifiability" (*unconscionable*) of a contract, its part or a specific provision is used. A judge is authorized to dismiss the demand of forcible performance of an unjustifiable contract. The judge can recognize the portion of a contract excluding the unjustifiable provision to be valid or limit the application of any unjustifiable provision in a way that unjustifiable results are avoided.<sup>39</sup> General approach lies in that contract provisions should be considered to be unjustifiable if they are so much one-sided that this, considering the circumstances present as of the concluding of a contract are "unjustifiable".<sup>40</sup> A contract may not comprise such terms and conditions that are unreasonably favorable only for one party. The use of such a term as "unjustifiability" enables a court to assess how much the balance is maintained between the contractual rights and obligations of the parties. In addition to contract terms and conditions judge has to study specific circumstances of concluding a contract in order to establish the fact of imposing unjustifiable terms and conditions to another party.

In France, pursuant to Article L.132-1 of the Customer Code (1993) the unconscientious provisions (*abusives*) are considered null and void. Any provision can be considered unconscientious (standard as well as individual) if it is established that an enterprise imposes them on a customer by means of the abuse of economic power (*abuse de puissance economique*) and thereby gains excessive advantage (*avantage excessif*). The provisions of the law do not apply to the relations among enterprises.

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<sup>36</sup> *Medicus D.*, Bürgerliches Recht, 18 Aufl., Köln/Berlin/Bonn/München, 1999, 42-44.

<sup>37</sup> *Kötz H.*, Europäisches Vertragsrecht, Tübingen, 1996, 217.

<sup>38</sup> Handbuch des Kaufvertragsrechts in den EG-staaten einschl. Österreich, Schweiz und Un-Kaufrecht v. *Dr. Westphalen F.G.* (Hrsg.), Köln, "Otto Schmidt", 1992, Rdnr. 36, 495-496.

<sup>39</sup> Uniform Commerce Law of the USA, 1952, Transl. from English by the International Center for Financial and Economic Development, 1996, 65.

<sup>40</sup> *Komarov A.S.*, Liability in Commercial Transactions, Moscow, "Legal Literature", 1991, 155 (in Russian).

Pursuant to Paragraph 24a of the 1976 Law of Germany on Organizing the Law of General Provisions of Contracts the only criterion determining control of good faith in contracts concluded with the involvement of a customer is the preliminary formulation of contract terms and conditions (that content cannot be influenced by a customer) – even if the contract terms and conditions are designed for one-off use. As for commercial transactions (relations among enterprises) two preconditions have to be met in commercial transactions for the application of the above-listed Law of Germany, namely: courts are able to verify "good faith" or "proportionality" (adequacy) only of those general provisions of contracts that had been formulated beforehand by one of the parties for multiple use.

Unlike the relations where costumers are involved the application of the criteria of preliminary formulation without such a criterion as multiple use may not be a sufficient proof for the inequality of the powers of parties when concluding a contract in commerce.<sup>41</sup> The thing is that contract terms and conditions have to be formulated in advance and in full in all offers, because it is only an acceptance (without alterations) that gives rise to concluding a contract. Therefore, it is necessary to use additional criteria in order to prove that the powers of parties are unequal and this very inequality has become the cause for the entry of unconscientious provisions in a contract and enabled one of the parties to the abuse of power of determining contract provisions. Such criterion is multiple use of contract provisions.

If the standardizing of contract terms and conditions is a precondition for entitling an entity to safeguarding against unconscientious provisions of contract the offeror can prove that the condition had been agreed upon individually, respectively, the norms about the recognizing the provision null and void cannot be applied.

As for the assessment of the validity of contract provisions by court is should be mentioned that such factors are considered important as the circumstances under which a contract where various provisions were used was concluded. Court has to ascertain whether a contract provision inadequately infringes the interests of another party; or limits the essential rights and duties emanating from the contract nature against another party's interests in a way that it jeopardizes the attainment of contract purpose; or, considering all circumstances of the case grossly violates their interests of another party.

Pursuant to Paragraph 9 of the 1976 Law of Germany on Organizing General Provisions of Contracts (this provision is used in commerce as well as in relations with customers) the provisions in general (i.e., standard) terms and conditions are null and void provided they disproportionately (unangemessen) infringe the rights and interests of another party of a contract, contrary to the good faith principle (trust and loyalty principle). Disproportionate infringement of interests "is assumed in case of suspicion" provided a standard provision of a contract is incompatible with key ideas in legislation that were rejected by an offeror, or if it limits essential rights and duties emanating from the nature of a contract to such extent that jeopardizes the attainment of a contract purpose.

When court decides on the issue of recognizing a standard provision null and void on the grounds of breaching the requirement of good faith principle it has to verify how much the freedom of will of another party was limited when concluding the contract. Further, the disproportion of another party in

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<sup>41</sup> *Larenz K., Wolf M., Allgemeiner Teil des Bürgerlichen Rechts, 8. Aufl., München, "C.H. Beck", 1997, §42, Rdnr. 31.*

legal condition has also to be taken into account. Contract provision has to be considered null and void in case it grossly breaches another party's interests contrary to the good faith principle. The offeror of standard provisions has to adhere to the good faith principle when setting forth the rights and duties of parties. Pursuant to Article 40 of the March 15, 1999 Law of the People's Republic of China on Contract Law the standard provision is null and void in case such provision excludes the responsibility of an offeror, increases the responsibility of another party, or deprives another party of material rights.

The 1977 Law of Great Britain – Unfair Contract Terms Act uses the reasonableness and justness principle as a criterion for controlling the content of provisions that limit or exclude responsibility. The requirement of justness and reasonableness implies that a provision is a just and reasonable provision to be included in a contract considering those circumstances that had to be known or had to be taken into account by parties when concluding the contract (Article 11(1)). Thus, unfairness of a contract provision lies in that such a provision deprives or can deprive an entity against whom it is used special granted right this party is trusted with under the social policy or such rights that the recipient of goods (services) may reasonably had at the time of concluding a contract.<sup>42</sup> The burden of proof that some provisions do not meet the principle of reasonableness rests with the party who asserts that the provision does not meet the reasonableness criterion.<sup>43</sup>

As for Georgian law considering foreign experience several important provisions can be distinguished. Namely, standard provision of a contract has to meet the good faith principle, means:

1) Unusual provisions may not be used. The mentioned rule safeguards a party from surprise. A party should be able to trust that standard provisions of a contract will be provided in such a format a party usually has to expect in case of such a contract.<sup>44</sup> Such provisions are sometimes referred to as "surprise" provisions. The legislator safeguards client as much as possible from the so-called surprise provisions, i.e., unexpected, unusual provisions.<sup>45</sup> In practice, in real life a client rarely examines all provisions of a contract individually. A client expects that an unusual provision would not be stipulated in standard provisions of a contract. The provisions a client does not expect according to circumstances and especially according to general nature of a contract do not become part of a contract.

A judge determines whether or not provisions are unusual based on a case by case basis.

2) Another party's interests may not be infringed in a disproportionate manner. A provision through which an offeror tries to unilaterally reflect its interests in a contract in a way that not to offer anything in exchange (in compensation) to another party. Further, disproportion depends on the conformity of a contract condition with another party's interests based on main ideas of a law and the nature of contract. Further, the method of comparing the interests of parties can be used to evaluate the proportion of contract provisions. Although, the proportionality of contract price may not be controlled. Since the content of standard provisions is determined by one of the parties the temptation is high for

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<sup>42</sup> *Zimenkova O.N.*, Unconscientious Terms and Conditions in Contracts with Customers: Legislation and Practice of Foreign States, Key Institutions of Civil Law in Foreign States, Comparative-legal Study, Moscow, "Norma", 1999, 407-408 (in Russian).

<sup>43</sup> *Komarov A.S.*, Liability in Commercial Transactions, Moscow, "Legal Literature", 1991, 154 (in Russian).

<sup>44</sup> *Brox H., Walker W.D.*, Allgemeines Schuldrecht, 32 Auflage, München, "Verlag C.H. Beck", 2007, 44 (in: *Chechelashvili Z.*, Law of Contract (Comparative-legal Study on the Basis of Georgian Reality), Tbilisi, 2008, 106 (in Georgian)).

<sup>45</sup> *Zhalynskiy A., Reuricht A.*, Introduction to German Law, Moscow, "Spark", 2001, 392 (in Russian).

such a party to enter in a contract as many provisions as possible favorable thereof, further, another party's interests are not considered at all. Based on the analysis of Article 346 of the Civil Code of Georgia on the basis of foreign doctrine we can conclude that it considers two types of cases when disproportionate infringement of interests of one of the parties is usually assumed. Namely, the first group implies such cases when contract provision is incompatible with essential principles of law. For example, about the application of the good faith principle against such provision that deprives a foreign trade representative a right to demand compensation at the time of termination of a contract<sup>46</sup> is referenced in literature

The principles of law imply dispositional rules (i.e., norms of normative acts and first of all the Civil Code, customs, principles of law established by the doctrine and judicial practice) that are used only where the parties did not consider anything else. Effectively, pursuant to Article 346 courts have to verify the conformity of the relation of the parties' interests with dispositional norms of law. Although parties are entitled to deviate from a dispositional norm in a contract and although standard provisions of a contract in official and legal terms are contractual provisions dispositional norm the function of some kind of a "sample".<sup>47</sup>

German judicial practice (that is advisable to be considered in Georgian reality as well) designed an approach according to which they distinguish between the rules based on reasonableness considerations and the principles based on the ideas about fairness (based on the fairness considerations). In the first case, as a rule, when the content of contract is determined in a different manner than that dispositional norm there is no disproportionate infringement of interests. In case a rule stipulated under a law provision is based on the principle of fairness then evaluation is made based on the opinions of a lawmaker about justness. Further, in case an offeror is interested in regulating the relations between parties in a different manner than as stipulated in the law then court has to establish in the given case to grant priority to an offeror's interests or whether it is necessary to safeguard the interests of another party on the basis of the fairness principle. Depending on the outcome of such evaluation court makes a decision about admissibility of a provision. Another group of cases implies that a contract may not lose its essence and importance. Namely, there is disproportionate infringement of interests when based on the nature of a contract essential rights and obligations are limited to the extent that the attainment of contract objective is jeopardized.<sup>48</sup> In such case there is the deviation from main objective of a contract, the rejection of main objective of a contract. Offeror does not formulate its obligations and a client's right that is necessary and natural for a given contract, which conflicts with the nature of a contract and jeopardizes the meaning of a contract.

On the basis of the purpose and content of a contract first it has to be determined as to what is "the nature of a given contract". Essential and conventional rights and duties of parties are based on contract nature. If these rights and obligations are limited to the extent that the attainment of a contract is jeopardized then a relevant provision is an inadmissible provision. To put it in other words it is

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<sup>46</sup> *Hepting R., Detzer K.*, Die Abdingbarkeit des Ausgleichsanspruchs ausländischer Handelsvertreter und Vertragshändler insbesondere durch Allgemeine Geschäftsbedingungen, "RIW", 1989, 337-347.

<sup>47</sup> *Heinrichs H.*, in *Palandt: Kommentar zum BGB*, 59. Auflage, München, "Verlag C.H. Beck", 2000 (2176), §9 Rdnr. 18.

<sup>48</sup> *Klunziger E.*, Einführung in das bürgerliche Recht, 5. Aufl., München, "Verlag Vahlen", 1993, 86, 11.

inadmissible that standard provisions of a contract may not be used to render the contract without essence and to deprive it of its purpose. When using this criterion the scope of an assessment is not a sample set forth under the law but the overall contract.

Disposition norm, as a sample function has determined importance not only within the scope of the matter of substantial principles but also in the matter of interpretation of Article 346. On the basis of good faith principle the High Federal Court of Germany developed the Principle of Openness (*Transparenzgebot*)<sup>49</sup> that completes the provision about good faith. According to the mentioned principle the offeror of standard provisions is obliged to formulate rights and duties of another party in a clear and distinct manner and in a way as to make the implementation of such rights and obligations possible. Standard provisions have to be clear, understandable and easy to perceive. It is inadmissible to make the content of the provisions vague, by using the formulations that are unclear, vague and formulated in a complex manner.<sup>50</sup> Moreover, a contract has to be clear, distinct, i.e., contractual provisions have to be set forth in a clear manner. Businesses as well as customers have to be safeguarded from standard contract provisions that are contrary to good faith. When determining standard provisions unilaterally an offeror may not use the method of "secretly dictating" contractual provisions. In such case the principle of good faith limits the principle of freedom of a contract and thereby safeguards the interests of a weak party of a contract. Sentence 2 of Article 346 of the Civil Code of Georgia is worthy of mentioning; according to which those circumstances have to be taken into account during the presence of which these conditions were entered in the contract, bilateral interests of parties, etc. For example, standard provision of a contract will be null and void if such provision, considering all circumstances of the case grossly violate the interests of another party. Further, since standard provisions set forth the rules different from dispositional norms, on the one hand, the advisability of determining the standard contract provisions that are different from the rules set forth under dispositional norms (deviation from dispositional norms) have to be assessed while the dispositional norms equally consider the interests of both parties. Secondly, it has to be checked how much the freedom of the will of another party has been limited. Further, the disproportion of the parties' legal situation has to be considered as well. The infringement of another party's interests as of the instance of concluding a contract is decisive. If one of the provisions of a contract grossly breaches the interests of another party then it has to be evaluated in complex and by taking into account other provisions of a contract.

As has been mentioned standard provisions of a contract are formulated in advance for many contracts and they are offered by an offeror (set forth) to a client unilaterally. This means that the offeror enjoys the right of unilaterally determining the content of a contract<sup>51</sup> and tries to restrict a client with such contract provisions. If contractual provisions have not been offered by one of the parties (for example, a notary has offered contractual provisions to parties) then it is considered that they have not been determined unilaterally and such provisions do not fall within the scope of the norms regulating

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<sup>49</sup> BGH Urt.v. 29.9.1983- VII ZR 225/82 (Koblenz), "NJW", 37, 1984, 171-172; BGH, Urt.v. 10.7.1990 XI YR 275-89 (Düsseldorf), "NJW", 43, 1990, 2383.

<sup>50</sup> *Thamm M.*, Taschenkommentar zum AGB-Gesetz, Heidelberg, "Verl. Recht und Wirtschaft", 1998, §9 Rdnr. 13.

<sup>51</sup> *Brox H.*, Allgemeines Schuldrecht, 24. Aufl., München, "Beck", 1997, 29 Rdnr. 46.

standard provisions. But in this case the conformity of contract provisions content with the good faith principle can be checked.<sup>52</sup>

Contract provision may not be regarded as a standard provision in case the parties have determined it jointly. Contract provision is regarded as agreed upon between parties when an offeror has given another party effective opportunity to participate in determining contract provisions and in its turn, another party has exercised its right. Another party has to have the possibility of checking the content of a contractual provision or the entire standard portion of a contract and entry of modification thereof. Offeror has to offer to another party with a serious intention the provisions reflected in contract standard provisions and give another party the freedom to formulate contract provisions in order to safeguard another party's interests.<sup>53</sup> First of all, another party has to be able to influence the content of those provisions of a contract that are used for modifying or completing the rule stipulated under the dispositional norm. In case the subject of negotiations was just a specific provision of a contract and not all provisions of a contract formulated beforehand then the remaining provisions are treated as contract standard provisions.<sup>54</sup> Just consideration of a contract's provisions formulated in advance between parties or just defining their content and meaning may not be considered as "the agreement around the condition". Just interpretation does not imply that parties have agreed if at the same time another party did not have an actual chance to modify something in contract provisions,<sup>55</sup> but in this case Article 344 of the Civil Code can no longer be used (the prohibition of unusual, surprise provisions) for a provision which meaning was explained to another party in a specific manner cannot be extraordinary (unexpected).

There is no agreement also when in a standard contract text a client is given possibility to choose among different alternatives, namely, to mark the conditions desirable thereof or cross off undesirable conditions.<sup>56</sup> It is not sufficient if a buyer had just the opportunity to reduce contract text, or when there are blanks left in standard text that are filled according to the negotiation results (i.e., when possible, just entry of additions).

The issue of distribution of the burden of proof is important. Namely, a party that indicates (relies on) standard provisions in case of suspicion has to prove that standard provisions became part of a contract. The party who indicates about the necessity of using the safeguarding norm (in the given case, Article 346 of the CC) carries the burden of proof that disputable provisions are standard provisions of a contract. In case an offeror states that in a specific case conditions not only had been entered in the contract but are also the subject of an individual negotiation/agreement then it carries the burden of proof of this circumstance.

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<sup>52</sup> BGH, Urt. v. 21.4.1988 - ZR 146/87 (Stuttgart) "NJW", 41, 1988, 1972.

<sup>53</sup> BGH, Urt.v. 30.9.1987- IVaZR 6/86 (Köln), "NJW", 41, 1988, 410; BGH, Urt.v. 11.7.1995-X ZR 99/92 (Düsseldorf), "NJW", 41, 1996, 783.

<sup>54</sup> BGH, Urt.v. 11.7.1995-X ZR 99/92 (Düsseldorf), "NJW", 41, 1996, 783.

<sup>55</sup> BGH, Urt.v. 29.9.1983 - VII ZR 225/82 (Koblenz), "NJW", 1984, 171.

<sup>56</sup> BGH, Urt.v. 9.4.1987-III ZR 84/86 (KG), "NJW", 1987, 2011.

## **4.2. Conditionally Null and Void Standard Provisions**

When considering Article 346 of the Civil Code of Georgia we should not miss Articles 347-348. Although Articles 347-348 are not used in business i.e. commercial relations (an explicit indication on this is contained in the mentioned articles) they play major role when interpreting Article 346 of the Civil Code. Therefore, the analysis of provisions of these norms is also interesting. In its essence, the prohibitions reflected in Articles 347-348 specify general norm reflected in Article 346 in non-business, non-commercial relations. Articles 347-348 refer to such standard provisions that inadmissibly infringe the interests of one of the parties or where there is no balancing of interests. Respectively, a question comes up, both Article 347 and Article 348 are about the voidness of such standard provisions of a contract that are used by an offeror towards non-entrepreneur individuals then what has conditioned the presence of these norms in the Civil Code as separate Articles? It should be stated that this is not accidental or due to legislative deficiency. The thing is that Article 347 of the CC sets forth the provisions that are prohibited conditionally, and in Article 348 – the provisions that are prohibited absolutely.

In the listing of Article 347 of the CC we constantly see such concepts that require judicial assessment. It is about such concepts as "inadequately long", or "clearly short timeframes", "timeframes not prescribe to a sufficient degree", etc. The provisions set forth in Article 347 of the CC can be regarded void when studying specific circumstances of the case. To establish voidness court has to interpret the given concepts.

Conditionally prohibited provisions that are listed in Article 347 of the CC are valid in the presence of the determined preconditions. Namely, when analyzing a contract's standard provisions a judge based on the content of Article 347 has to use the following criteria:

- a) Proportionality (means the proportionality of timeframe when executing, accepting, when postponing, extending, the performance period of a contract; proportionality of the pay for the performance; proportionality of the reimbursement for incurred costs);
- b) Definitiveness (implies the definitiveness of performance, acceptance, postponement, extension);
- c) Justifiability/feasibility and the presence of a special reference (the declining of a contract has to be justifiable and should not be made without the grounds indicated in the contract; the grounds for declining a contract has to be specifically referenced in a contract);
- d) The presence of a noteworthy interest;
- e) Acceptability to another party (means the acceptability of alteration of promised performance, acceptability of modification of a contract).

## **4.3 Absolutely Null and Void Standard Provisions**

Unlike Article 347 of the CC Article 348 does not contain indefinite concepts (Sub-paragraph (a) of the same Article being the exception). The conditions that contradict with Article 348 of the CC are void and no additional court interpretation is necessary for recognizing them void. The provisions listed



in Article 348 of the CC will be treated as void in any case and they do not provide a judge the possibility of free assessment. Hence, in Article 348 absolutely void conditions are listed. If any specific provision used in non-business relations is not indicated in Articles 347-348 it has to be verified whether such a provision is an unusual (unexpected) in the sense of Article 344 of the CC or a disproportionate provision in the sense of Article 346. In this regard on the basis of the good faith principle, as on the basis of a general norm a judge is also able to control such provisions about the existence of which the legislator still did not know at the time of adopting the civil code and thus was unable to directly make reference in Articles 347-348.

In practice we have to start verifying the acceptability of standard provisions of a contract with Article 348 of the CC and we have to use Article 347 only afterwards, if necessary. German lawyers have such approach to analogous matters.<sup>57</sup> If a provision does not fit to any of the indicated group of cases then the general norm set forth under Article 346 of the CC has to be used. The prohibition set forth in Article 346 of the CC of disproportionate infringement of another party's interests plays significant role also when interpreting Article 347 of the CC. In turn, Articles 347-348 of the CC make essential influence on the interpretation of Article 346 of the CC where Articles 347-348 of the CC are not used, namely, in business relations.

In conclusion we have to say that the fact that the principle of good faith carries the function of control and correction of contracts<sup>58</sup> is clearly demonstrated in the norms regulating standard provisions of contracts. Material-legal control over the content of standard provisions is determined under Articles 343-348 of the Civil Code of Georgia. The essence and meaning of these norms lies in that it is necessary to limit the freedom of determining the content of standard provisions more strictly than it is established under general rules of limiting the freedom of a contract for otherwise the principle of freely determining the content of standard provisions of a contract would be used by just the offeror, and a client would be forced to determine freely only whether or not to conclude a contract. Naturally, a client's rights should not and may not be infringed. This is an unconditional objective of a social state's order.<sup>59</sup> To achieve this objective Articles 347-348 of the CC provide a quite long listing of prohibited standard provisions that are harmful to a client. But despite such casuistry and detailed determination of banned provisions there can be another inadmissible provision as well that is not considered in this listing that gives rise to a gap in law. And the general provision stipulated under CC Article 346 enables them to overcome a gap; this is the provision of respecting the good faith principle in standard contract provisions. The mentioned principle is a measure of control over the content of standard provisions. The content of Article 346 is also noteworthy. Namely, this norm is comprised of two sentences. Based on the first sentence the good faith principle is a final and imperative measure (sphere) of control over the content of standard provisions. And another sentence enables court when recognizing a provision void to take into account the circumstances in the presence of which these provisions were entered in the

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<sup>57</sup> *Medicus D.*, Bürgerliches recht: Eine nach Anspruchgrundlagen geordnete Darstellung zur Examensvorbereitung, 18 Aufl., Köln/Berlin/Bonn/München, "Heymanns", 1999, 28, Rdnr. 9, 10.

<sup>58</sup> *Vashakidze G.*, The System of Complicated Obligations of the Civil Code, 2010, 67 (in Georgian).

<sup>59</sup> *Heinrichs H.*, *Palandt* 2388 (see: *Zhalynskiy A.*, Introduction to German Law, Moscow, "Spark", 2001, 394 (in Russian)).

contract, bilateral interests of parties, etc. It is about circumstances that conditioned (caused) the striking of a void provision, entry into the contract, concluding a contract. Respectively, the content of another sentence reduces the role of a general provision about good faith and renders control more concrete.

As for the scope of the control of content of standard provisions with their content standard provisions are subordinated to the control under the law only in case when they stipulate the rules different from the norms of law or complete the norms of law (Article 342(1) of the CC).

## **5. Results of Voidness of a Contract Standard Provisions**

If one or several standard provisions of a contract are null and void, namely, because they contradict with Articles 344, 346, 347-348 of the CC then in such case the principle is applied according which if one of the provisions of a contract is void the contract remains valid in remaining portions according to the provisions about partial voidness of a contract. In such case it would be advisable to use those dispositional norms or trade customs in lieu of void provisions that the parties have considered in a contract different from requirements thereof contrary to the good faith principle. "One of the features of a standard provision is that it is used to set forth the rules that differ from law-prescribed norms and that complete those".<sup>60</sup> An entire contract may be regarded void due to the voidness of one of its provisions in case when the parties would not conclude a contract without such condition, or when the performance of a contract would be an excessively heavy burden for one of the parties even considering that instead of void provisions dispositional norms are used. But this rule is rarely used in practice.<sup>61</sup> This is explained by the fact that the rules about voidness of unconscientious provisions, first of all, are safeguarding another party. The purpose of safeguarding another party would not be achieved provided an offeror who entered an unconscientious provision in a contract would be entitled to rely on the voidness of the entire contract (indicate to the voidness of the entire contract) and force another party to return thereof the performance (provided) and thereby pass on the risk emerged due to its fault to another party.

Sometimes we see contract provisions that only partially contradict with what could have been considered in a contract. A question comes up: can a contract provision in such case be considered as a partially valid provision? This is possible if contract provision can be broken down into two parts, that, despite the link at the level of idea they differ by text and content.

If a valid part of a contract provision cannot be separated from the void part then contract provision cannot be considered as partially valid provision. In such case contract provision is regarded to be fully void: a judge is not authorized to reduce the point, meaning of a void provision to the extent when such provision could have been regarded as a valid provision. Otherwise an offeror would be given the incentive to enter in a contract an explicitly inadmissible provision. Further, this would support misleading the majority of clients, while those who would apply to court would attain only partial voidness of contract provisions. When commenting on Article 347 of the CC Professor L. Chanturia notes: "the entry of provision stipulated in Article 347 in contract standard provisions, although causes

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<sup>60</sup> *Akhvlediani Z.*, Law of Obligations, 2<sup>nd</sup> Edition, Tbilisi, 1999, 24-28 (in Georgian).

<sup>61</sup> *Baumbach A., Duden K., Hopt K.J.*, *Handelsgesetzbuch: mit GmbH & Co., Recht der Allgemeinen Geschäftsbedingungen und Handelsklauseln*, 28. Aufl., München, "Beck", 1989, 1714.

voidness of such provisions as of the instance of concluding a contract but not the voidness of a contract. Contract is fully "in force, but without these void parts thereof."<sup>62</sup> In such case the norms of law are applicable instead of void provisions of a contract.

When a contract provision is void the content of a provision is not reduced to the meaning allowable by the law. Otherwise an offeror would not have anything to risk when entering such a provision in the contract which voidness it knows beforehand. In such case it would hope that even the void provision will be valid in the portion allowable by the law. For example, the following formulation will be void: "the responsibility of an offeror for inflicting damage in any form will be excluded", for such formulation conflicts with legal provision stipulated under Article 348(f) of the CC. Such condition would be regarded as acceptable: "an offeror is not liable for simple negligence of its representative". This second provision although is narrower as compared to the first one, is reduced, but still, the former provision cannot be narrowed down to the content of the latter. The validity of the void provision ceases in a manner that it is not substituted by another provision. As a result, offeror is liable even for simple negligence of its representative.

It should be mentioned also about incomplete formulation of a norm stipulated under Article 348(f) of the CC. Namely, pursuant to this norm, a provision is void that excludes or limits liability for the damage that is caused by the breach of obligation due to gross negligence of an offeror or its representative (liability for negligence). In the norm emphasis is made on the gross negligence as one of the forms of fault. If it is inadmissible to exclude or limit liability due to the breach of obligation through gross negligence then even the more this should be inadmissible due to intentional breach of an obligation. Although this is not clear from the norm. While the entity using the norm irrespective of Article 395 in the Civil Code may assume that it is possible to exclude or limit liability due to intentional breach of obligation for Article 348 specifically relates to a contract standard provision. Especially in brackets legislator indicates to responsibility for negligence, while Article 395 is a general norm. Thus, the mentioned provision of Article 348 may in practice become a factor conditioning the drawing of wrong conclusions. Therefore, it is advisable to modify its formulation and this part of the norm should be formulated as follows: "a provision that excludes or limits liability for the damage caused due to the breach of obligation by intent or gross negligence on the part of an offeror or its representative."

If it is possible to divide contractual provision into parts and one of the parts conflicts with the Civil Code then voidness will apply to only this portion. The admissible part of the contract provision remains valid.

Thus, if based on contract standard provisions the result of analysis, evaluation of all rights and duties shows that there is misbalance, inequality, that contradicts with the good faith principle then it should be taken into account that only that part of a contract is void that causes worsening of the situation of one of the parties. As for remaining part of the contract it has to be retained.

The good faith principle plays certain role not only when determining contractual misbalance but it is also a measure of deciding on the matter of identified misbalance. Afterwards, the principle of good faith starts operation, as the criterion of evaluating a provision of a contract. It is necessary to determine results objectively independently of parties for the will expressed in the contract, in case when contract

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<sup>62</sup> *Chanturia L.*, Commentary to the Civil Code of Georgia, Tbilisi, 2001, 201 (in Georgian).

provisions have been dictated by one of the parties as a rule is not a good tool for restituting objective contractual fairness. Since the chapter of the Civil Code that relates to standard provisions directly does not contain special norm regulating the results of voidness of standard provisions a general norm set forth under Article 62<sup>63</sup> Of the CC has to be applied based on which the voidness of a specific standard provision or part of the provision does not cause voidness of the entire contract (transaction) and remaining (other) standard provisions of a contract. This rule has to be used only in case when a contract is separable, i.e., the voidness of one of the provisions (or part of provision) logically does not cause the voidness of the whole contract. But the voidness of one of the provisions (or part of provision) automatically causes the voidness of provisions related to a provision (part of provision) null and void according to contract purpose and meaning, essence even if such contractual provisions are not structurally interrelated.<sup>64</sup> The provisions that are not related to the condition recognized null and void according to the purpose of a contract remain valid irrespective of whether such contractual provisions are combined in a systemic manner.<sup>65</sup>

## **6. Conclusion**

On the basis of the analysis of Georgian and foreign legislation, doctrine and judicial practice the paper reviewed the problems of control of content of contract standard provisions and the problems of applying standard provisions in practice, the recommendations for resolving those and the improvement of deficient norms were suggested. We can focus on essential aspects related to the problem of application of standard provisions and formulate key results of a study, specifically:

a) Mechanism of control over standard provisions has to be refined. Standard provisions are actively used in Georgian reality by banks, insurance organizations, and entities with dominant position on the market that indicates the increase of the importance of standard provisions, although a weak party is not adequately safeguarded from unfair standard provisions. Respectively, the need for controlling the content of standard provisions is explained by the factor that when applying provisions it is expected that an offeror will use the right to unilaterally set forth standard provisions in an unfair manner. And this gives rise to misbalance in contractual relations between parties. A contractor (a weak party of a contract) should have adequate means for safeguarding its interests. The principle of good faith has to be given special importance in the control of content of standard provisions.

b) Georgia civil code does not consider the peculiarities of interpretation of standard provisions in a complete manner while the interpretation of such provisions is one of the means for their control. While having just Article 345 does not address the problem. And neither is Article 52 of the Civil Code

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<sup>63</sup> Clearly, this norm is not complete and does not regulate the legal outcomes of voidness of a contract in a detailed manner. Special norm determining the legal results of voidness of standard provisions has to be introduced, or Article 62 should be refined, for example, it would be advisable if on exceptional cases the entire contract is regarded null and void, in case performance of a contract would be excessively burdensome for one of the parties even after the norms of law are used in lieu of contract standard provisions.

<sup>64</sup> *Zhalynskiy A., Reuricht A.*, Introduction to German Law, Moscow, "Spark", 2001, 393 (in Russian).

<sup>65</sup> *Ib.*

enough for interpretation of standard provisions in accordance with the good faith principle. It is advisable to indicate in this norm, or in Article 345 that the interpretation of contracts is done in accordance with the good faith principle.

c) It is advisable to organize in detail the matters related to legal outcomes of voidness of standard provisions of a contract, namely, the cases and rules of full or partial voidness of standard provisions of a contract. For example, it will be reasonable if on exceptional basis the whole contract is considered null and void provided the performance of a contract will be extremely burdensome for one of the parties even after the norms of law are used instead of void standard provisions of a contract.

d) It is advisable for a legislator to create such mechanism that will ensure the application of the good faith principle in a complete manner in contractual relations. In this regard, it is advisable to remove the second sentence from Article 346 of the Civil Code of Georgia that makes the control of content of standard provisions more specific and with its substance, reduces the importance and application of the good faith principle by rendering the application of this principle dependent on specific circumstances of the case.

e) The approach formed in Georgia judicial practice is appropriate; this practice envisages putting forward increased requirements to businesses when determining standard provisions and entities having dominant position on the market in relations with customers. Respectively, when the safeguarding of the interests of entities becomes on the agenda it is advisable to develop a differentiated approach when exercising control over the content of standard provisions according to whether another party is an individual or a business entity.

f) Article 346 of the CC is not about two different principles, the principles of trust and good faith separately, as can be observed in the formulation of this norm, but the principle of good faith that implies trust based relations as well.

**Maia Kopaleishvili \***

## **Does the Action Provided by Para. 5<sup>1</sup> of the Article 42 of the Criminal Code of Georgia Involve Criminal Responsibility of a Parent**

### **1. Introduction**

In scientific circles, among practicing lawyers, law students, who are interested in practical aspects of application of the norm of criminal law, consideration of criminal law, as a branch, from scientific viewpoint, the regulation specified in para. 5<sup>1</sup> of the Article 42 of the Criminal Code of Georgia, which provides for imposition of responsibility of payment of penalty, imposed on insolvent under-age convict, onto the parent, is actual and causes discussions. As we know, the norm obliges the parent to pay the penalty, imposed on insolvent under-age convict. In the opinion of stakeholders, the mentioned norm involved criminal responsibility of the parent, which contradicts the principles of Criminal Law of Georgia. It shall also be mentioned that although this ruling of Criminal Law might cause the opinion of the stakeholders that is violates the right supported by the Constitution of Georgia, but it shall also be taken into account that imposition of this or that obligation by the legislator may have the effect of criminal punishment but not be criminal punishment. Following the above mentioned, clarification of the goals of this obligation, understanding of its essence and determination of whether factual punishment is present, is always important. In the course of discussion attention shall also be paid to the circumstance that the issue concerns under-age person, who is the subject of care of the state and public. Discussion shall be held on the issue, application of which punishment/ measures (either preventive or pedagogical) will be more effective towards the adolescents, who committed criminal offence. As we know, the persons interested in criminal cases of adolescents agree that application of the so-called stationary sanction (confinement) towards under-age persons is harmful and is causes negative result in regard to development of adolescents.

Our goal is not consideration and analysis of actual topics related to the adolescent justice or pros and cons of the institution of criminal responsibility of a parent in different countries; our goal is to organize large-scale discussion in front of the interested society and bring the practice of legal proceedings of the Constitutional Court of Georgia, related to the Constitutionality of para. 5<sup>1</sup> of the Article 42 of the Criminal Code of Georgia near to them.

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## **2. Circumstances of the Case**

### **2.1. Factual Circumstances of the Case**

Constitutional Court of Georgia considered the case "Public Defender of Georgia vs. The Parliament of Georgia." The Public Defender of Georgia, by constitutional suit (registration No 416) demanded determination of constitutionality of para. 5<sup>1</sup> of the Article 42 of the Criminal Code of Georgia – "if the convict is an adolescent and insolvent, the court shall oblige his/ her parent, guardian or care-giver to pay the penalty imposed upon him/ her" - in regard to the Article 39, para. 1 of the Article 40 and first sentence of para. 5 of the Article 42 of the Constitution of Georgia.

The case was considered by the Plenum of the Constitutional Court of Georgia, as, in compliance with the Article 21<sup>1</sup> of the Organic Law of Georgia on the "Constitutional Court of Georgia," the Judicial Panel considered that the case under consideration would give rise to rare and particularly important legal problem of definition of the Constitution and handed over the case to the Plenum. In regard to the above mentioned case, the Constitutional Court of Georgia made Decision No 3/2/416 dated July 11, 2011 and didn't satisfy the Constitutional suit.

#### **a. Legal Bases of the Case**

**2.2.1.** The Public Defender of Georgia was requesting to determine the compliance of para. 5<sup>1</sup> Of the Article 42 of the Criminal Code of Georgia with the principle of "individualization of punishment." The plaintiff pointed out that the principle of individualization of punishment, as well as the principle of inadmissibility of responsibility without blame, is not directly declared in the Constitution of Georgia, but in accordance with the Article 39 of the Constitution of Georgia, it follows from the principles of the Constitution. In the opinion of the plaintiff, as the Constitution of Georgian forms high standard of the basic human rights of freedoms, the principle of individualization of punishment follows from the principles of the Constitution of Georgia.

The Public Defender considers that in Criminal Code, a person can be acknowledged as criminal only based on the verdict of guilty, legally validated by the court. According to the statement of the Public Defender, the punishment shall be assigned only to the person who committed low offence. And in accordance with the norm, punishment is imposed on the person, who wasn't acknowledged guilty, but on his/ her legal representative. Just the above mentioned violates the principle of individualization of punishment.

The plaintiff considers that the penalty, which represents penalty – type of criminal responsibility -for the purpose of criminal justice, is imposed on the parent (guardian, care-giver), whereas their criminal action is not obvious. And the above mentioned violated the requirement mentioned in the first sentence of para. 5 of the Article 42 of the Constitution of Georgia. The plaintiff considers that criminal responsibility (penalty) is imposed on the parent without committing a crime and a verdict of guilty only because his/her underage child doesn't have independent income; which, in the opinion of the plaintiff, implies imposition of criminal responsibility for the crime, committed

by other person. And thus the disputable norm contradicts para.1 of the Article 40 of the Constitution of Georgia. The representative of the Public Defender explained that from para.1 of the Article 40 and the first sentence of para. 5 of the Article 42 of the Constitution of Georgia follows the principle, according to which, nobody can be sentenced to punishment if his/ her blame is not determined in specific action. And according to the disputable norm the parent (guardian, care-giver), who is imposed a punishment, has neither committed offence nor is announced as a convicted.

The representative of the plaintiff stated in the course of hearing of the case that he can't see principal difference between the imposition of penalty and enforcement of the imposed penalty, as the penalty, as property- related sanction, burdens not the adolescent who committed the crime, but the parent, who is responsible for payment. He stated that it is not specified in the legislation what kind of obligation the imposition of payment of penalty may represent. In his opinion, payment of penalty, which is imposed on the parent, is a legal obligation, failure to comply with which leads to responsibility and according to the disputable norm, pure criminal obligation occurs, which, following the principle of individualization of punishment, has no legal basis.

**2.2.2.** The representatives of the Parliament of Georgia didn't agree to the demand of the plaintiff in regard to in-constitutionality of the disputable norm. According to his explanation, in accordance with the disputable norm, the subject of criminal prosecution is an under-age convict, in regard to whom the verdict of guilty is made. Correspondingly, imposition of criminal punishment, penalty, is performed only in regard to him/her. The legislator isn't bringing a parent into criminal relations. The parent isn't the subject of criminal prosecution at any stage of proceedings, and the verdict of guilty isn't brought against him/ her either. Legal nature of parent's obligation is related not to specific spheres of law, but to his/ her status, legal obligation existing between him/her and his/ her child. The respondent, in support to its arguments, makes parallel with the existing regulations in the legal acts of other spheres. In particular, it indicates to the Article 994 of the Civil Code of Georgia, in accordance with which parent is responsible for the financial liabilities of the child, which he/ she can't fulfill himself/ herself. Also, the respondent refers to the ruling of para. 2 of the Article 290 of the Code of Administrative Offenses, in accordance with which if the persons under the age of 18, who have committed small hooliganism, don't have independent income, the penalty shall be paid by their parents or people replacing them.

In the defendant's opinion, one key-note follows through the rule established in the mentioned articles and disputable norm – parent fulfills unfulfilled financial liabilities of the child. Fulfillment of the liabilities of under-age children by their parents can't be equaled to criminal punishment, as it doesn't have personal nature. The disputable norm doesn't establish new obligation, but the parents', guardians', care-givers' traditional obligations are incorporated into the Criminal Code. Obligation and responsibility are different legal categories not only from terminological, but from content-related views. Consequently, the defendant considers that the disputable norm doesn't contradict to the requirements established by para. 5 of the Article 42 of the Constitution of Georgia.

In the defendant's opinion, the disputable norm is in full compliance with the norms and principles established by the Constitution of Georgia. In particular, they explain, that the disputable norm doesn't consider the parent as the subject of crime provided by Criminal Code and doesn't put forward the issue his/ her conviction. Consequently, they consider the connection or contradiction of the disputable norms with the Article 39 and para. 1 of the Article 40 of the Constitution of Georgia.



**2.2.3.** The expert, invited to the case, explained that the disputable norm is in compliance with the requirements established by the Constitution of Georgia. He stressed special relations of a parent and a child. In his opinion, relations between a parent and a child do beyond blood, biological connection. Till full age, the child is in intense legal relation with the parent and the legislation doesn't strictly delimit these two subjects from each other. This is a unique social- legal relation with special chain of rights and obligations. Parent isn't just "other person," but he/ she is the defender of child's interests, career, responsible for bringing child up and for various obligations. The specialist mentions that financial liabilities, arising due to illegal actions of an adolescent shall be fulfilled by the parent, which is universal principle and it is reflected in Georgian legislation as well. The specialist relates the introduction of the mechanism of imposition of penalty upon a parent by the disputable norm to the unique social-legal relation existing between a parent and a child as well as special responsibility of a parent in formation of personality of the adolescent.

### **3. Motivation of the Court**

In the framework of dispute on Constitutional suit, Constitutional Court of Georgia decided constitutionality of para. 5<sup>11</sup> of the Article 42 of the Criminal Code of Georgia in regard to the first sentence of para. 5 of the Article 42, para. 1 of the Article 40 and Article 39 of the Constitution of Georgia. Consequently, found out the content of the disputable norm, its legitimate purpose and the issue of its inter-relation with the above mentioned constitutional norms, which enabled the Court to determine whether the disputable norm is constitutional or not.

Constitutional Court of Georgia touched many factors in the motivation part of the mentioned decision and finally, as a result of well-grounded arguments, definitions, judgment, comparing of norms, fundamental legal and factual analysis and assessment, arrived to the conclusion that the disputable norm doesn't contradict the Constitution.

The motivation of the Court is represented in regard to the relevant articles of the Constitution of Georgia.

#### **3.1. Relation of the Disputable Norm to the First Sentence of Para. 5 of the Article 42 of the Constitution of Georgia**

**3.1.1.** The Court, having summarized the argumentation of the plaintiff, stated that in the plaintiff's opinion the disputable norm violated fundamental principles of criminal law "there is no crime without law" (*nullum crimen sine lege*), "there is no punishment without law" (*nulla poena sine lege*) and "there is no punishment without guilt" (*nulla poena sine culpa*).

In the framework of the given dispute, the Constitutional Court of Georgia primarily clarified: 1. whether the disputable norm establishes criminal responsibility of the parent (guardian, care-giver) of an insolvent under-age convict and/ or 2. Whether criminal responsibility is factually imposed on the parent (guardian, care-giver) under the disputable norm i.e. whether the imposition of the obligation of payment of penalty onto the parent, mentioned in the disputable norm, equals to imposition of criminal

responsibility upon him/ her and, consequently, whether the disputable norm contradicts the first sentence of the para. 5 of the Article 42 of the Constitution of Georgia.

In accordance with the first sentence of the para. 5 of the Article 42 of the Constitution of Georgia "nobody shall be responsible for the action which, at the time of its committing, wasn't considered an offence." The Court explained that the mentioned Constitutional ruling 1) establishes the basis of bringing a person to responsibility, 2) supports the guarantee that any crime and punishment shall be clearly defined in the criminal law, 3) it is based on the universally known principle: "there is no crime without law" and "there is no punishment without law" (*nullum crimen sine lege, nulla poena sine lege*), 4) the first sentence of the para. 5 of the Article 42 of the constitution of Georgia established guarantee of prevention of wide definition of criminal law to the damage of person (by analogy), 5) it also obliges the hearing court to define the norm so that a person can clearly understand which of his actions of absence of action leads to criminal responsibility, 6) the guarantee, supported by the mentioned Constitutional ruling, is an integral part of the principle of legality. The principle of legality protects a person against arbitrary application and spreading of criminal enforcement by the state, and, at the same time, provides a person with the opportunity to foresee the existence of the signs, prohibited by criminal procedures, in his/ her own actions.

**3.1.2.** The Court presented the content of the first sentence of the para. 5 of the Article 42 of the Constitution of Georgia and noted that it 1) prohibits criminal responsibility for the action, which, at the time of its committing, wasn't considered a criminal offence, 2) unambiguously establishes that criminal responsibility shall be based on action (offence), 3) establishes that only per person, who committed criminal action, shall be responsible for such action. Respectively, the Court defined that the mentioned norm of the Constitution includes the principle of individualization of criminal responsibility (the principle of personal responsibility), to which, actually, the plaintiff pointed by his argumentation.

Taking into account that the plaintiff considered that the disputable norm contradicted the principle of individualization of criminal responsibility (the principle of personal responsibility), the Court defined this principle. In particular, it was mentioned that the principle of personal responsibility rules, that only the person, who committed criminal action shall be responsible for this action and not other, third person, who is not the subject of specific criminal legal relations. A person can't be responsible for the action, in committing of which his/ her guilt can't be established. The principle of personal responsibility in criminal law means that the issue of responsibility of the person may arise only when he/ she personally, individually is guilty for action or absence of action. This principle has special significance in criminal law as criminal responsibility is strictly personal. The principle of personal responsibility protects a person against responsibility for the action which he/ she hasn't committed. The principle of personal responsibility covers not only formal legal guarantees but spreads to various spheres of material law.

**3.1.3.** Taking into account, that the Constitutional Court had to clarify in the given case – how much the ruling established by the disputable norm represented criminal responsibility for non-guilty person – parent/ guardian/ care-giver, for the purpose of resolution of the five dispute, the Court considered it necessary to clarify, on the basis of the provision of the Criminal Code, how well-grounded the plaintiff's opinion was. It also explained when the retaliation can be regarded as punishment.

The Court determined when the state measure is a criminal one: 1) responsibility, envisaged by law, is a criminal one, when criminal legislation defines it as such. At the same time, responsibility might not be defined in criminal legislation, but following its 2) gravity, 3) resulting affect and 4) level of limitation of rights, it can be equaled to punishment, especially in the cases, when classic forms of punishment aren't provided by the law. When defining the essence and legal nature of the responsibility envisaged by the law, 5) the purpose, for achievement of which it is used shall also be taken into account. Consequently, the court decided that the nature of responsibility, function, purposes and other elements differentiates legal responsibility from other types of retaliation.

In accordance with para.1 of the Article 1 of the Criminal Code of Georgia, "Criminal Code of Georgia establishes the basis of criminal responsibility, determines which action is criminal and establishes the relevant punishment or other criminal-law measures". Under para. 1 of the Article 2 of the same Code, "criminality and punishability of action shall be determined by criminal law, which was valid at the time of its committing". Under para.1 of the Article 7, "the basis of criminal responsibility is a crime, i.e. illegal and guilty action provided by this Code...".

Following the content of the mentioned norms, the Court stated that, taking into account the principle of legality, the action, envisaged by criminal law is considered a crime by the Criminal Code. The Court clearly explained that criminal law is the law of action the object of criminalization isn't a person but action of capable person. It, in its turn, indicates that the composition of criminal action shall substantially be described in the Criminal Code. Without substantial description of action it's impossible to determine illegality and guilt, without which, in its turn, it's impossible to qualify an action as a crime and impose criminal responsibility on a person.

The Court explained that the existing Criminal Code doesn't provide for description of illegal and guilty actions of the parent (guardian, care-giver) of insolvent under-age convict. The action is qualified as crime and, consequently, criminal responsibility is imposed on person only establishment, as a result of the relevant procedural actions, of the set of actions in the actions (behavior) of a person, which is provided by the criminal law. Criminal law norms are directed towards person's actions. Legislator threatens the performer of the criminal set of actions with punishment. A pre-condition for the application of punishment is the existence of guilt, and only illegal action can be guilty.

The Court also focused on the subject of criminal-law relations. It explained that according to the disputable norm, not a parent (guardian, care-giver) is the committer of illegal and guilty act, but an adolescent, fair punishment on criminal case is determined not in regard to a parent (guardian, care-giver), but in regard to an adolescent. Parent (guardian, care-giver) is not the subject of criminal prosecution at any stage of criminal proceedings. On the basis of the disputable norm, a parent (guardian, care-giver) doesn't turn into the party to criminal relations. The regulation of the disputable norm doesn't show that a parent (guardian, care-giver) is blamed in committing of any criminally prohibited action.

The Court also indicated that, from juridical viewpoint, a crime is committed only if it is confirmed by the verdict of guilty brought by the court (presumption of innocence (absence of guilt)). And the Court's verdict of guilty is brought in regard to an adolescent.

As a result of analysis of the relevant norms of the Criminal Code and comparison/ difference of the established regulations in various spheres of law, the Court stated that the results which follow the

verdict of guilty (conviction, repetition of crime, etc.) don't apply to the parent (guardian, care-giver) either, and if the parent (guardian, care-giver) fails to pay the amount of the penalty (disregarding the application of the measures of forced enforcement measures to property, provided by the Law of Georgia "On Enforcement Measures" in regard to him/her), the punishment, imposed on the adolescent – penalty, on the basis of the rule provided by para. 6 of the Article 42 of the Criminal Code of Georgia, will be changed into other punishment in regard to the adolescent – community works, correction works, limitation of freedom or confinement.

Punishment, as special enforcement measure of the state, is re reaction of the state to the crime. As it was already stated, if punishment is not provided for the committed crime, it means that the action is not a crime. As punishment is strictly personal, punishment is applied only to the criminal and not the other person. The disputable norm clearly indicates that punishment (penalty) is imposed on the insolvent under-age convict. Consequently, the purpose of criminal law is not imposition of criminal responsibility on the parent (guardian, care-giver) of the insolvent adolescent.

Considering the above mentioned, the Court explained that the statement that just the existence of the disputable norm in the Criminal Code and imposition of payment of the penalty, imposed on insolvent adolescent onto the parent (guardian, care-giver) in the framework of the disputable norm, at the same time, represent imposition of criminal responsibility on the parent (guardian, care-giver) is groundless.

**3.1.4.** For the purpose of clarification of the content and purposes of the disputable norm the Court also discussed the nature of penalty, as criminal punishment. The disputable norm is given in the Article 42 of the Criminal Code, which defines the legal nature of criminal punishment – penalty – and the rule of its application. In accordance with the mentioned Article: a) penalty is a monetary payment; b) it can be imposed only onto the convict, with consideration of financial situation of the latter, his/her property, income, and other circumstances; c) penalty may be imposed as additional punishment even in the case where it is not provided as such by the relevant article of the Criminal Code; d) in the case of insolvent under-age convict, the court will impose payment of penalty onto the parent (guardian, care-giver); e) is the convict avoids payment of penalty or forced payment is impossible, other punishment will be applied instead.

On the basis of historical – legal analysis the Court stated that the mentioned punishment was established in criminal law as the alternative to classical punishments (confinement, death penalty). Application of penalty, as sanction, is associated with certain property-related (financial) losses for a person, which is regarded as sufficient and adequate response from the side of the state to the action committed by a person. Penalty is defined as ideal criminal sanction from liberal viewpoint. It is preferred among other form of sanction, as it can be enforced, saving state resources and causing less pain to the offender. But it doesn't make it a non-full value criminal sanction. Penalty, applied for criminal purposes, maintains punishing nature and is individualized, oriented towards individual guilt. Penalty is applied individually against the offender through limitation of the right of ownership, seizure of property (money).

Here the Court deemed it necessary to explain the nature of money: money, following its historically formed nature, is characterized by special peculiarities. It, unlike freedom, is not such an irreplaceable good, which loses its importance when transferring from one person to another. The

nature of the penalty, differing from other criminal sanctions, is demonstrated in the circumstance that it can be paid by other person instead of the criminal so that the purposes of imposition of criminal responsibility could be deemed achieved and, besides, the latter will not be regarded as a person, bearing responsibility. Penalty has unique nature, making it the type of criminal sanction, legal fulfillment of which is possible by other person instead of the criminal.

Consequently, the Court states that imposition of the obligation of payment of penalty imposed on insolvent under-age convict onto the parent (guardian, care-giver) shall not be understood as imposition of penalty (punishment); for this purpose, the action of the state shall contain the elements and purposes of imposition of criminal responsibility onto the person. It shall be mentioned that when imposing the payment of penalty imposed on insolvent under-age convict onto the parent (guardian, care-giver), the purposes of imposition of criminal responsibility – punishment onto the parent (guardian, care-giver) – restoration of justice, prevention of new crime, elements of resocialization of a criminal -are not present in the actions of the state; the above stated additional legal elements are not related to it.

Following the above stated, the Constitutional Court of Georgia indicated that imposition of the payment of penalty, imposed on insolvent under-age convict, onto the parent, guardian or care-giver on the basis of para. 5<sup>1</sup> of the Article 42 of the Criminal Code of Georgia cannot be regarded as imposition of criminal responsibility on them and, consequently, the disputable norm doesn't violate the principle of personal responsibility.

**3.1.5.** At the same time, Constitutional Court discussed the purpose of a legislator when establishing the obligation of payment by parent (guardian, care-giver) of penalty, imposed on under-age insolvent convict. The Court paid attention to the circumstance that the parent's (guardian's care-giver's) obligation, established by the disputable norm, to pay the amount of punishment- penalty, imposed on under-age insolvent convict, follows from special legal relations existing between the mentioned persons and related to the number of peculiarities of criminal responsibility of adolescents. The legislation, primarily, proceeds from constitutional and international legal principles of personal freedom and inviolability. The task of the legislator is to facilitate protection of adolescent's best interests, social rehabilitation of under-age criminal, not to use strict punishment where it is not necessary. The goal of the disputable norm is to use towards under-age criminal a light punishment measure – penalty, as an alternative to confinement or other, stricter punishment.

The Court judged in regard to the issue under consideration from comparative viewpoint about possibility of using of compulsory measure of pedagogical influence. It is stated in the Court decision that legislation may provide for binding under-age criminal's parent (or substituting persons) with obligation of performance of certain action, which will contribute to the interests of rehabilitation of an adolescent. E.g. compulsory measure of pedagogical influence may be used, like obliging of parent or the substituting person or specialized state authority to make a pedagogical impact on an adolescent (Article 93 of the Criminal Code of Georgia). Parent, as well as his/ her under-age child is obliged to participate in the mentioned compulsory measure. Such obligation doesn't belong to the category of criminal punishments, although it establishes certain limitations towards parent (substituting person or state authority). Occurrence of such obligation isn't accidental. Origination of some rights is firmly connected with origination of the respective related obligations. The right of parent (guardian, care-

giver) implies origination of the relevant legal obligations. In this case we deal with binding of the parent's (guardian's, care-giver's) right with the obligation of care-taking.

**3.1.6.** The Court discussed the relations existing between a parent and a child, the right of free development of under-age person, the level of influence of punishment on the adolescent convict in the case of payment of penalty by parent instead of adolescent convict. In particular, the Court explained: Georgian legislation recognizes special relation between parents and children, unique status of parent and the obligations following from it. The parents are authorized and obliged to bring up their children as worthy members of society, care about their physical, mental, spiritual and social development. An under-age person, as well as a full-age one, enjoys the right of free personal development, so the state protects him/ her from Constitutional viewpoint. Mental and physical capabilities of an adolescent are in the process of development and they need special care. Just for this reason, the legislator identifies a parent, guardian and care-giver as the persons obliged to take care of an adolescent. The opinion that in the case of payment of penalty by a parent (guardian, care-giver) instead of an under-age convict the level of influence of punishment on the adolescent is low, is deprived of grounds due to the argument that enforcement of penalty is related to money as transferable object. This peculiarity of money deprives payment of penalty (money) of personal nature, which is characteristic, for example, for serving of sentence in the form of limitation of freedom or confinement. Thus, if the enforcement of limitation of freedom/ confinement has personal nature, the process of enforcement of payment of penalty is expressed in transfer of transferable object – money – to the state. Consequently, the effect of personal impact of the punishment on the criminal (and the level of this effect) occurs independently from enforcement action (charging with penalty, or, e.g. confinement of person for serving the sentence) and it is directed only towards the criminal's person.

### **3.2. Relation of the Disputable Norm to para. 1 of the Article 40 of the Constitution of Georgia**

The plaintiff considers that the disputable norm also contradicts para. 1 of the Article 40 of the Constitution of Georgia, in accordance with which: "a person is presumed innocent unless his/her guilt is established in accordance with the procedure under law and legally validated verdict of guilty brought by the court". The Court explained that mentioned norm of the Constitution, in general, administers the guarantee of presumption of innocence (not guilty). Although the Court, within the limits of the given dispute, wasn't facing full-value definition of the presumption of innocence (not guilty), the Court specified that the presumption of innocence (not guilty) represents guiding principle of criminal law, which, inter alia, implies that everybody shall be treated with presumption that he/she is innocent, until, through the relevant procedure, his/ her guilt is established by the verdict of guilty of the Court. Consequently, it's impossible to recognize a person guilty without the relevant procedure.

The Court indicated that in this specific dispute, in order to establish whether para.1 of the Article 40 of the Constitution of Georgia is violated, primarily, it's necessary to clarify whether recognition of a parent (guardian, care-giver) as a guilty person, occurs. Only after that it will be possible to clarify whether the state was obliged to observe the guarantees of presumption of

innocence (not guilty). Consequently, as, in regard to the disputable norm, the Court ruled that by its action the parent (guardian, care-giver) of an adolescent isn't pled guilty, and criminal responsibility isn't imposed on him/her, i.e. as it was already stated, as the disputable norm doesn't rule criminal responsibility of a parent (guardian, care-giver) of insolvent under-age convict for any action, it is in full compliance with para.1 of the Article 40 of the Constitution.

### **3.3. Relation of the Disputable Norm to the Article 39 of the Constitution of Georgia**

According to the Article 39 of the Constitution, "the Constitution of Georgia doesn't deny universally recognized human and citizen rights and guarantees, which are not mentioned here, but follow from the principles of the Constitution." In regard to the above mentioned article the Constitutional Court of Georgia stated that "the purpose of the mentioned Constitutional norm is to ensure protection of rights and freedoms in the case if it is not directly specified in the Constitution, but follows from Constitutional principles and international obligations taken by the state in the sphere of human rights... a plaintiff can appeal to the Article 39 when the right is not provided in the Constitution of Georgia or the framework of the Constitutional right is narrower than provided by international obligations" (ruling 1/2/458 dated June 10, 2009 of the Constitutional Court of Georgia, "David Sartania and Alexander Macharashvili vs. the Parliament of Georgia and the Ministry of Justice").

With the consideration of the above mentioned, the Court indicated that the principles, towards violation of which the plaintiff actually indicated in his argumentation, are protected by the Articles 40 and 42 of the Constitution. Consequently, there is no need of checking of compliance of the disputable norm with the Article 39.

## **4. Conclusion**

In the Decision № 3/2/416 dated July 11, 2011, in the course of clarification of the ruling established by para. 5<sup>1</sup> of the Article 42 of the Criminal Code of Georgia, the Constitutional Court of Georgia studied, analyzed many legal issues and made conclusions, demonstrated the essence of regulation provided by the disputable norm. It determined that the disputable norm doesn't contradict the Constitution of Georgia. Disregarding the possible existence of opposite opinion in the society, the Constitutional Court clearly indicated when this or that measure shall be regarded as punishment and criminal responsibility and, respectively, formed its view why the disputable norm is not non-constitutional. It shall be mentioned that the Court serves to development of public opinion only when it makes resolute, efficient steps forward based on the Constitution. By such steps, the Court contributes to progressiveness of the society and public opinion.

We hope that the mentioned Decision of the Court will form basis for sound and objective discussion on the actual issues provided in the Decision.

**Irakli Kobakhidze\***

## **The Principle of the Legal State (as of the Valid Law)**

### **1. The Concept of the Valid Law**

The concept of the valid law concerning the human rights of a person is defined by Georgian constitution law, paragraph 7. The concerning the attachment of "valid legal power authority" to a person was taken<sup>1</sup> from the valid legal norm of German constitution that was, on its own, based on negative experience of Weimar republic<sup>2</sup> whose constitution that attributed the human rights issue only the role of defined in their program and therefore couldn't guarantee<sup>3</sup> the efficient right protection of those from public authority. The concept of valid law, first of all, means the full fledged legal possibilities of a physical entity to protect their rights<sup>4</sup> defined by constitution in court – the constitutional norms enhancing the legal rights of individual to which the constitution attributes the valid legal status; so they don't require further legal definition and directly represent individual right of legal requirement.

In broader legal aspect, we should consider the valid law not only the basic rights of human, of course, but all norms of Georgian constitution. The decision is cemented by 5 and 6<sup>th</sup> s paragraphs of Georgian constitution, according to which the "state authority is exercised in the framework of constitutional norms"; "Georgian constitution represent the supreme law of Georgia and all other legal acts should come upon its regulation". These statements make it clear, that each constitutional norm enjoys the right of direct influence and leave their impact on the legal regulations of different legal issues. The qualitative difference between the norm of basic human rights and other constitutional norms lies in the following fact: these don't create the legal requirement right, for the pursuit of which an individual would use constitutional or general legal mechanisms.

It must be noted, that German constitution does not certify so called second generation basic rights, which according to their abstract character, are not considered as subjects of valid law. In opposite to this, Georgian constitution recognizes social rights too as the subject of the valid law, the fact that we can receive as an essential constitutional fault.

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<sup>1</sup> The lines corresponded to the seventh paragraph of Georgian constitution literally repeats the words of the constitution of German Federal State ("unmittelbar geltendes Recht").

<sup>2</sup> The Weimar Republic was the name of German state that existed in 1919 – 1933 and whose stately weakness, instability and irrelevant democratic system caused the national socialistic upheaval and Third Reich come to power. See *Schlink B.*, Grundrechte: Staatsrecht II, 18., neubearb. Aufl., Heidelberg 2002, Rn. 36 ff.

<sup>3</sup> *Höfling F.*, Art. 1, in: *Sachs M.* (Hrsg.), Grundgesetz: Kommentar, München, 2003, Rn. 72 ff.; *Dreier H.*, Art. 1, in: *Dreier H.*, Grundgesetz-Kommentar, Tübingen, 2004, Rn. 18; *Hesse K.*, Bedeutung der Grundrechte, in: *Benda E., Maihofer W., Vogel H.-J.*, Handbuch des Verfassungsrechts, Berlin/New York, 1995, 2. Aufl., Rn. 70 ff.

<sup>4</sup> *Höfling F.*, Art. 1, in: *Sachs M.* (Hrsg.), Grundgesetz: Kommentar, München, 2003, Rn. 75; *Dreier H.*, Art. 1, in: *Dreier H.*, Grundgesetz-Kommentar, Tübingen, 2004, Rn. 18.



The valid legal authority of secondary constitutional norms is problematic considering the circumstances according to which the larger share of these norms are directly connected to the basic but subjective interests and rights of individual, including the basic human rights. Especially this concerns the legal principle of the state the realization of which serves not only objective reasons, but is vital<sup>5</sup> to guarantee the subjective interests of each individual.

Georgian constitution recognizes the principle of the legal state by several statements. This statement is mentioned in the preamble of Georgian constitution, which ascertains the establishment of legal state as the strong will of Georgian citizens and presents it as one of the main task and objective of constitution. Some elements of legal states – the supremacy of constitution, ramification of authority branches and imminence of basic human rights – are given in 5, 6 and 7<sup>th</sup> paragraphs of constitution, also guaranteed by separate legal statements enhancing the idea of the basic human rights.

In traditional democratic countries abroad the protection and provision of principle of legal state is mostly provided by the high legal culture and legal awareness of state officials, executives and ruling elite. In Georgian legal practice, regardless the formal adhesion to the constitutional principle of legal state, this dogma of constitutionalism, since its validity from the day of adoption, had never been fully observed, the fact that in most cases translated in to violation of subjective and basic rights of individuals. Therefore, regarding the deficiency of legal culture, Georgian agenda means acquisition of the very legal mechanism that would add to the legal enhancement of valid law and thus provide the fundamental rights interests of the citizens. Thus the necessity of implementation of such mechanisms in Georgian reality is confirmed by the argument, according to which in 1949 German legislature shoes the legal status to be directly attributed to the basic human rights protection – if the legal culture in the country is unable to provide properly the fundamental principles of law, for the provision of legal supremacy the law itself should define the self protective mechanisms. The defining of these mechanisms<sup>6</sup> is furthermore important considering those circumstances according to which some elements of legal state principle like the principle of adequacy, legal protection etc. are not directly reestablished by Georgian constitution, another fact that poses more complicated case of the proper performance.

The objectives of the given article is assessment of protective measures of some legal elements of the principle of legal state in Georgia, that will give us possibility to work out recommendations for the right attribution of legal authority to these very elements from the valid law. Besides, the principle of legal state, its condition, will be assessed (and recommendations issued) in accordance with the basic human rights considering the specification of aforementioned legal elements.

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<sup>5</sup> About the direct link between the principle of the legal state and the basic human rights, see *Sommermann K.-P.*, Art. 20, in: *Mangoldt H.V., Klein F., Starck Ch.*, *Kommentar zum Grundgesetz*, München, 2010, Rn. 231 ff.; *Sachs M.*, Art. 20, in: *Sachs M.* (Hrsg.), *Grundgesetz: Kommentar*, München, 2003, Rn. 74.

<sup>6</sup> With this regard we could make some analogies with András Sajó discussion, the one who sees constitutional law through fear, see *Sajó A.*, *The Introduction of Legal Self-limitation of the State – Constitutional Analyzes*, Tbilisi, 1999, pp. 1-59 (in Georgian).

## 2. The Essence of Principle of Legal State

According to materialistic definition of legal state criteria, its main function represents provision of social and human freedoms.<sup>7</sup> The limiting of authority (as self limiting) that is part of the legal state concept,<sup>8</sup> first of all translates itself into the right distancing of state from the society in large and by reduction of the free use of state authority envisages the maintenance of legal parity of all individuals facing the law. Each element of legal state should be considered through the prisms of this general goal.

The formal idea of legal state was first defined in the nineteenth century and included three general aspects: legal reasonability of executive branch activity, independence of court and division<sup>9</sup> of state powers. By using these three instruments the bourgeois liberal state was trying to limit the absolute powers of their monarch. At the same time this "formal" legal state was serving a material objective – establishment of civil freedom by formal instruments and guarantees.<sup>10</sup>

The idea of nineteenth century legal state reflected the concept of liberal state well established in the political sphere of the west that absolutely denied the material aspect of equality and guarantees<sup>11</sup> of freedom for general material rights. Just because of such a rigid nature, the ideologists of socialism used to harshly criticize the concept of the legal state and saw it as a screen of bourgeois ideology. Namely, the socialists believed, that in capitalistic based economic model by formal usage of bourgeois freedom and equality postulates the bourgeois class tried to screen materialistic deficit and social, material inequality. But, although the first radical resistance, on the basis of leftist and rightist ideological confrontation, it became possible to mix the elements of liberal state and social concepts,<sup>12</sup> that provided the establishment of modern type legal, socially fair European state that is equally recognized and respected in democratic world by the parties who represent both left and right ideological political powers.

The concept of legal state grew quickly and refined with the time, especially after the Second World War period. Qualitatively, the set of legal elements of this principle also increased. The modern legal doctrine and practice attributes a number of aspects to the principle of legal state, out of which the main ones can be named the following: supremacy of law, supremacy of constitution, priority of law and its arrangement, adequacy and fair protection principles. Besides, the most important institutional mechanism for executing the principle of legal state is the ramification of power branches,

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<sup>7</sup> See *Sommermann K.-P.*, Art. 20, in: *Von Mangoldt H., Klein F., Starck Ch.*, Kommentar zum Grundgesetz, München, 2010, Rn. 232.

<sup>8</sup> *Sajó A.*, The Introduction of Legal Self-limitation of the State – Constitutional Analyzes, Tbilisi, 1999, pp. 1-59, (in Georgian); *Maurer H.*, Staatsrecht I: Grundlagen, Verfassungsorgane, Staatsfunktionen, 2. Aufl., München, 2001, S. 216 ff.; *Sachs M.*, Art. 20, in: *Sachs M.* (Hrsg.), Grundgesetz: Kommentar, München 2003, Rn. 103 ff.

<sup>9</sup> Besides these instruments, the formal concept of the legal state meant the protection of the law superiority throughout the legal limitations of subjective rights and property along with the authority for budget and tax code agreements. See *Degenhart Ch.*, Staatsrecht I: Staatsorganisationsrecht, 18., neu bearb. Aufl., Heidelberg, 2002, Rn. 235.

<sup>10</sup> *Ib.*

<sup>11</sup> *Böckenförde E.-W.*, Entstehung und Wandel des Rechtsstaatsbegriffs, in: Festschrift für Adolf Arndt, Frankfurt am Main 1969, S. 66 f.

<sup>12</sup> See *Benda E.*, Der soziale Rechtsstaat, in: *Benda E., Maihofer W., Vogel H.-J.*, Handbuch des Verfassungsrechts, 2. Aufl., Berlin/New York, 1995, Rn. 91 f.

protection of basic human rights at court and constitutional justice. Not quite often some other important issues and institutions are associated with the legal state concept such are the neutrality of public office, transparency of public institutions, fairness of administrative procedures, state responsibility for private case violations, the right for protest and rebellion against non democratic state and others.<sup>13</sup> The protection of this very element of legal state is crucial in realization of human rights that on their own are the cornerstone of the democratic state.

Recent years in Georgia were characterized by number of complications on the way of the right realization of the elements of the principle of the legal state, the main accent of whose comes on law supremacy, supremacy of constitutional law, law priority and legal agreement, state power division, legal adequacy and security, neutrality of public governance and the legislative and administrative process.

## 2.1. The Principle of Power Division and the Possibility of its Realization in Georgia

Power division is the general principle for establishing legal state. The concept of power division, which historically developed along with the concept of legal state, means division of the state authority according to different functions and aims at limiting political power among the state authorities (branches) through mutual control and checks and balance system establishment.<sup>14</sup> This kind of a system should guarantee efficient delineation and control of authority, raise the state accountability and level of responsibility and contribute to the proper realization of public tasks and objectives.

In the last years of Georgian reality the practical level of power division in Georgia was considerably low. Although the 5<sup>th</sup> paragraph (point 4) of Georgian constitution clearly ascertains the principle, other norms of constitution go against the idea, which provides the concentration of power in the hand of one of the main governmental branches. At the same time the main task of power division is establishment of such a government run system that would eliminate the misbalance among the power branches and asymmetric accumulation of authority in one of those. By imitating the Russian model, in our country non classical, semi presidential model of governance has established (in 2004 due to constitutional amendment the government model was established acceptance of which translated into excessive authority for President), by which state leader was equipped with the power of executive leader function and too much of "repressive" rights both towards government and the parliament. The introduction of the legal possibility for the president to oust the government predisposed the transmission of dualistic state into the presidential republic. In these circumstances by

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<sup>13</sup> *Sobota K.*, Das Prinzip Rechtsstaat, Tübingen, 1997; *Kunig Ph.*, Das Rechtsstaatsprinzip, Tübingen, 1986; *Degenhart Ch.*, Staatsrecht I: Staatsorganisationsrecht, 18. neu bearb. Aufl., Heidelberg, 2002, Rn. 233 ff.; *Sachs M.*, Art. 20, in: *Sachs M.* (Hrsg.), Grundgesetz: Kommentar, München, 2003, Rn. 77 f.

<sup>14</sup> See *Sajó A.*, The Introduction of Legal Self-limitation of the State – Constitutional Analyzes, Tbilisi, 1999, pp. 87-129 (in Georgian); *Sommermann K.-P.*, Art. 20, in: v. *Mangoldt H.*, *Klein F.*, *Starck Ch.*, Kommentar zum Grundgesetz, München, 2010, Rn. 197 ff.; *Sachs M.*, Art. 20, in: *Sachs M.* (Hrsg.), Grundgesetz: Kommentar, München, 2003, Rn. 79 ff.; *Benda E.*, Der soziale Rechtsstaat, in: *Benda E.*, *Maihofer W.*, *Vogel H.-J.*, Handbuch des Verfassungsrechts, 2. Aufl., Berlin/New York, 1995, Rn. 38 ff.

giving the president the possibility to dissolve the parliament the balance between legislative and executive branches was automatically distorted. Besides, the problem of balance distortion was further intensified by the very fact that after declaring several times the distrust by the parliament towards the government, President was given the right to form the government without mutual consent from the legislative body, but the parliament was then limited the right of declaring distrust to the government.<sup>15</sup> Among the high state authoritative bodies the perfunctory study of such issues proves that the state governing model established in 2004 rudely contradicts with the principal, constitutional principle of state power division.

In 2010, according to the constitutional amendments, in Georgia at the end of 2013 quasi parliamentary, "super prime ministerial" model has been established that also does not quite fit in the model of classic power division idea.<sup>16</sup> The main fault of the new model is fact that constitution extremely limits the possibility of the parliament to declare distrust towards the government, the fact that is quite incongruent with the parliamentary run, also mixed government logic. The arrangement of these relationships, as was noted in the final conclusion by Venetian commission, "diminishes the parliament authority and decreases the responsibility level of prime minister",<sup>17</sup> that should have been the cornerstone of the new system. The system won't work without this cornerstone – deemed to imbalance for benefit of the interests of those subjects that are equipped by the low constitutional responsibility "privilege".

It must be noted that by 2010 constitutional amendments some constitutional norms disagree not only with requirements of legal state, but the requirements of democratic principles. For example, the norm according to which the parliament has the right to overrun the vote of presidential veto only by 3/5 does not correspond to the principle of majority that in the framework of constitutional law is represented as the democratic cornerstone of legal state doctrine.<sup>18</sup> In democratic rule public decisions, as a rule, should be accepted by absolute majority vote. Exceptions are possible and decision making procedure by qualified majority (or minority) should be established only aiming at the right protection of minority rights in the cases when the specification of the issue indicates its necessity or reasonability on the bases of special agreement. In the aforementioned case the rule of decision making by qualified majority guarantees protection not of the rights or interests of political minority but serves the protection of initial decision concerning the formation of the government selected by political majority, the fact that can't be regarded as the legal foundation of the deviation from the majority right principle. This conclusion is justified by experience of democratic states, namely the circumstance that no constitution of any democratic country foresees the declaration of distrust

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<sup>15</sup> See Georgian Constitution, Articles 80, 81.

<sup>16</sup> For the detailed analyses of constitutional changes, see *Kobakhidze I.*, The Critical Analytic Review of the Constitutional Bill, available at: <[http://www.osgf.ge/index.php?lang\\_id=GEO&sec\\_id=122&info\\_id=2130](http://www.osgf.ge/index.php?lang_id=GEO&sec_id=122&info_id=2130)>.

<sup>17</sup> European Commission for Democracy Through Law (Venice Commission), Final Opinion on the Draft Constitutional Law on Amendments and Changes to the Constitution of Georgia (15 October 2010), available at: <[http://www.venice.coe.int/docs/2010/CDL-AD\(2010\)028-e.pdf](http://www.venice.coe.int/docs/2010/CDL-AD(2010)028-e.pdf)>.

<sup>18</sup> *Maihofer W.*, Prinzipien freiheitlicher Demokratie, in: *Benda E., Maihofer W., Vogel H.-J.*, Handbuch des Verfassungsrechts, Berlin/New York, 1995, 2. Aufl., Rn. 62 ff.; *Maurer H.*, Staatsrecht I: Grundlagen, Verfassungsgorgane, Staatsfunktionen, 2. Aufl., München, 2001, S. 205 ff.

towards the government by the absolute vote of majority.<sup>19</sup> Such violation of majority principle negatively reflects itself on the balance between the executive and legislative bodies of the state and thus contradicts the concept of the power division concept.

In the doctrine of constitutional law the vertical measurement of power division principle is considered as the decentralization of governmental rule, which predisposes<sup>20</sup> the establishment strong, independent local governmental bodies in the country. Along with the horizontal division of the state power, decentralization guarantees successful check and balance system of the government and is meant to be as the main element for the balanced authority system. Decentralization of the ruling system is tightly connected with the realization of individual subjective rights, as it provides the realization of the basic human interest – to manage their own space and participate in decision making on the local governmental level. On the contemporary state of historical development in all democratic countries the ruling system is strongly decentralized and local governments are fully equipped with the proper legal rights and resources to manage the issues of the local level. In opposition to this phenomenon, the level of decentralization in Georgia is too low because of which the local governments in Georgia have no possibility to balance efficiently the state authority and manage the issues of local importance.<sup>21</sup> In addition, regardless the fact that in 2010 the guarantees of decentralization had been accepted by the new, urgent constitutional paragraph and the local entities then had the right to litigate having constitutional legal ground this constitutional novice has not caused any difference in the current reality. Therefore the valid legal authority has not been acquired by constitutional norms ensuring decentralization guarantees so far, the fact that surely should be considered as the problematic scenario.

The survey of problematic issues regarding the power division principle indicated the fact that efficient legal mechanisms should be worked out that will enable individuals to realize the interests and rights connected to the principle mentioned above.

## 2.2. Rational Public Office and Neutrality of Public Office Workers

The inherent element of the legal state is rational public office. In the state, where the principles of objectivity, impartiality, transparency, accountability and staff stability, the risk for establishing of autocratic, oligarchic management is very high. The non stable condition of public office naturally predetermines patrimonial, politicized system of governing, where relationships are maintained by personal bias for political nomenclature or unofficial relations from the public office employees. Due to the lack in legislature<sup>22</sup> these actual office relationships do not fully correspond to the Weberian rational

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<sup>19</sup> See, for example, Constitutions of Germany, France, Spain, Italy, Greece, Austria, Sweden, Denmark, Finland, Belgium, Estonia, Lithuania, Hungary, Romania, Bulgaria, Slovakia, Slovenia, Japan.

<sup>20</sup> *Vogelgesang K., Lübking U., Ulbrich I.-M.*, *Kommunale Selbstverwaltung: Rechtsgrundlagen, Organisation, Aufgaben, neue Steuerungsmodelle*, 3., neubearb. Aufl., Berlin, 2005, Rn. 22.

<sup>21</sup> See the Annual Account of Local Democracy Development in Georgia: 2009-2010, Open Society Foundation Georgia, available at: <[http://www.osgf.ge/files/publications/2011/Report\\_web.pdf](http://www.osgf.ge/files/publications/2011/Report_web.pdf)>.

<sup>22</sup> The law about "public office" does not contribute to the establishment of the modern system of human resource management in public office institution, does not set the rules for the professional planning, promotion and dismissal of a public worker and etc.

model that, in practice, creates the very problems, which are attributed to the patrimonial public management. For the further refreshment of the public office system functioning, it is necessary Georgian constitution and legislatures provide the staff stability in the mentioned office. In relation to the mentioned above, one should note that constitutions of number of different countries attach the same importance to the guarantees<sup>23</sup> of public rights as to the basic human ones, the fact that authenticates the valid legal state authority for the principles of the rational public office. Determining the public office rights of an individual on the same level as of their general human rights in Georgia would have positive effect in our country too in relation to the very realization of the principle of the valid legal state.

While having discussions about public office, special attention should be paid to the principle of neutrality of the public office that is the most prerequisite of the legal state. This principle requires performing impartial work by the public office workers from both political and other viewpoints. Besides, the principle of public office neutrality is gains its special importance in relation to the law enforcement bodies, political bias of whose excludes the state justice from the very start. In recent years the principle of legal state neutrality has been several times violated in Georgia by the law enforcement officials and as an example the dissolution of the 2009 of May 6 peaceful opposition rally by the police forces appealing to President can be represented. Of the very special concern one could count the statements made by lawyers and parliament members, who tried to legally explain and acquit the very acts of police. This phenomenon speaks about the low level development of the legal culture and indicates towards creation of legal guarantees providing political neutrality for the public office personnel.

### **2.3. The Supremacy of Constitution**

Since 1995 Georgian constitution has been subject to thirty amendments, including the cardinal change in state governing system. The practice of constitutional change had been experiencing faults from the very start – the first amendment, which was received on July 20<sup>th</sup>, 1999, roughly went against the principle of the democratic state and foresaw the introduction of the nondemocratic, seven percent election barrier – the fact that had subjective political interests in its background. In Georgian constitution the amendments received until present time aimed at specific political interests, even at specific personalities. Besides, the fact of changing constitution of 2012 under the interests of specific people on the day of the amendment was even openly declared by politicians.<sup>24</sup> Naturally these kinds of events cast shade to the special status of constitution and its importance in the framework of the overall legal system, which directly contradicts with the fundamental principle of constitutional supremacy.

To secure the principle of constitutional supremacy, it is reasonable to limit the possibilities for the constitutional change procedures in our country. The reasonability of this thesis is proved by the following circumstance: as mentioned above, the major part of constitutional amendments so far

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<sup>23</sup> See, for example, the Para. 33 of the German Constitution that enjoys the same privilege regarding protection of the human rights.

<sup>24</sup> At constitutional change the law makers openly declared that constitutional changes were aimed at personal needs of a politician to participate at elections.

received in its idea contradicted with the fundamental principle of fundamentalism and therefore, by its essence, represented anti constitutional character. It must be noted that constitutions of modern democratic states offer different examples of complicated constitutional change procedures, among which the most interesting are the procedures by two call parliament approval, the fact that on its own excludes any possibilities of change aimed at amending constitution by any legislative body on straightforward and hasty basis.<sup>25</sup>

While discussing ant constitutional changes in Georgian constitution, the very circumstance should be highlighted according to which in Georgia no public instances are functioning that would have the proper authority to analyze the reasonability for any constitutional change.<sup>26</sup> In order to protect the idea of constitutionalism and constitutional supremacy, it is preferable Georgian constitutional court be equipped with preventive mechanism for constitutional amendments. This mechanism would guarantee the avoidance of collision among constitutional norms, the presence of which is clearly obvious in the texts of Georgian constitution, both current and to be enabled since 2013.

#### 2.4. The Principles of Law Priority and Legal Arrangements

The principles of the legal state oblige a legislator personally make decision regarding fundamental and public issues. Accordingly, it's highly unacceptable to delegate for the authoritative government such issues, which in their essence are to be regulated by law. This requirement that is called the essential principle<sup>27</sup> in legal doctrine is regarded as one of the most important element of the legal state.

Besides, the foundation of legal, democratic state is the legal adequacy of executive authoritative branch that is regulated by the principle of legal agreement and priority. The principle of legal priority means limiting executive authority by the valid law, but the principle of legal agreement requires the legal foundation for the functioning of executive authority. These principles are paid crucial importance to protect individuals from the free will of public office executives and therefore to help them realize their main rights.

By the principle of legal priority the executive authority is limited by intervening, and also at making privileged decisions. No matter the mode of the executive authority performance. It is equally limited by law at the issuing of the normative laws and individual legal acts, just as during the real act performances and making administrative agreements. Besides, it must be noted that the principle of legal supremacy requires limiting the executive authority not only by existing laws, but by the law related normative norms – as much as these represent the mechanisms of legal instruments.<sup>28</sup>

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<sup>25</sup> See examples, namely the constitutions of Spain, Greece, the Netherlands, Belgium, Luxemburg, Sweden, Denmark, Iceland, Finland and Estonia. Regarding the constitutional change procedures see also European Commission for Democracy Through Law (Venice Commission), Report on Constitutional Amendment, CDL-AD(2010)001.

<sup>26</sup> The constitutional court of Georgia two times declined to consider the legal claims of this character – the ones that aimed at assessing the constitutional reasonability of the constitutional amendments in view, see the Court Rulings of Georgian Constitution №549, February 5, 2013; №523 October 24, 2012.

<sup>27</sup> See *Degenhart Ch.*, Staatsrecht I: Staatsorganisationsrecht, 18. neu bearb. Aufl., Heidelberg, 2002, Rn. 65 f.

<sup>28</sup> *Degenhart Ch.*, Staatsrecht I: Staatsorganisationsrecht, 18. neu bearb. Aufl., Heidelberg, 2002, Rn. 316 ff.

According to the legal agreement principle, any actions performed by the executive authority require clear legal foundation. Besides, legal foundation is that much required for the very administrative law related acts, which are used to regulate private freedoms and rights. These acts represent administrative ones, which require individuals perform or not to perform some actions or limits their rights and freedoms in some other ways (also the acts, which contain some negative warnings). The foundation for administrative intervention can be defined by the law related normative acts, though, in this case, this law related act should maintain the legal bases where one could clearly read the reason and objective of such an intervention. By issuing so called privileged administrative acts, the executive authority requires the relevant legal ground in the very case if such acts somehow limit the rights and equalities of individuals and therefore equals to the intervening acts. In other cases the executive authority does not go under the strict authority limitations by the principle of legal agreement so that its maneuverability and efficiency be properly secured. For the legitimate issuance of the neutral privileged administrative acts it's quite necessary the administrative body or a high rank official have the right legal authority.<sup>29</sup> The legal agreement principles also includes the requirement according to which if the governmental body rights or the right procedures to execute them are regulated in the highest legal order, any discrepancy in the authority system or from the legal authority performance is automatically considered as an illegal act.

To illustrate the violation of the supremacy of law and legal agreement principle, we could take as example several cases from Georgian legal practice: by the decree of Georgian president the upper income level of the local government officials, while the law gives president such authority to performed only according to the ranks.<sup>30</sup> In recent years during the peaceful rally dissolution the police used non lethal fire arms more than one time, while the law "about the police" contained the minute list of the weapons at the rally dissolution procedure and in this very list the non lethal fire arms were not present at all<sup>31</sup> (and also other such cases). Such rude violations of law supremacy and legal agreement principle are surely inadequate to the concept of the legal state.

Also, the second point of the 11<sup>th</sup> paragraph of the law "about the normative acts" contradicts with the principle of legal agreement, by which Georgian president is equipped with authority regulated by the normative act that is not regulated by the legal acts of Georgia. The right for free space use and enjoyment guaranteed by law is absolutely irrelevant not only with the principle of the law supremacy and legal agreement, but also with the principle of state power division and parliamentary sovereignty. It must be noted that in 90s just on the bases of such a norm the institute of the state representative – the governor – was established in Georgia, which used to function throughout years without any constitutional or legal foundation. The faulty practice of legal norm usage once again proves that attributing such was legal authority to the non legislative branch is absolutely unacceptable.

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<sup>29</sup> *Degenhart Ch.*, Staatsrecht I: Staatsorganisationsrecht, 18. neu bearb. Aufl., Heidelberg, 2002, Rn. 319 ff.; *Maurer H.*, Staatsrecht I: Grundlagen, Verfassungsorgane, Staatsfunktionen, 2. Aufl., München, 2001, S. 219 ff.

<sup>30</sup> See the Para. 9, Point 2 of the Public Office of Georgia and the Presidential Decree N726, 2005 on the Salaries for Officials of Autonomous Republics Authorities, Local Government and Ruling Bodies.

<sup>31</sup> See the Law on the Police before July 17, 2009.



Similar to the principles of law supremacy and legal agreement, the principle of constitutional supremacy and constitutional agreements should be unambiguously guaranteed. However, it must be noted that in Georgia there are difficulties at performing these duties. For example, in the organic law "about political unions of Georgian citizens" according to the amendment made on October 28<sup>th</sup>, 2011, Georgian chamber of control was given authority to perform financial monitoring of political parties, while according to the 97<sup>th</sup> paragraph of Georgian constitution, the chamber has the authority to control and monitor only the state run expenditures and recourses. Another example of the legal agreement principle violation is the Law on Georgian Capital Tbilisi – although the constitution clearly required the definition of local governments by the organic law, the local governments of Tbilisi are regulated by the common law – that fact that directly contradict with the case related constitutional principle. Such a rude violation of constitution can be perceived as low legal culture among political circles or perfunctory attitude of legislators towards the constitutional concept, thus creating the barriers for realization of the principle of the legal state in Georgia.

## 2.5. Law Making and Administrative Process

In legal state any kind of public decision should be born thought the process of rational legal and complex judgment. The rationality and complex character of decision making should be guaranteed by the legislature of the law making and administrative process, by which the procedures of legal acts and administrative ones are being carried out. Regardless the fact that in theory Georgian legislation is generally based on the western model, in practice its execution is characterized with number of difficulties. Quite often administrative bodies issue legal acts without administrative process, the rules for administrative processing are not always correctly observed, no rehearsals being held for interested parties concerned, during the legal hearing of administrative acts the courts leave or in most cases pay least attention to the formal- procedural aspects of acceptance or issuance of these acts and etc. Even in Georgian parliament laws are sometimes accepted by the violation of the regulatory procedures. And one of the clearest cases of this trend is the process of constitutional amendment (taken on October 15<sup>th</sup>, 2010) – although after the second hearing (according to the regulations) it is possible to make only the editorial change in the bill, Georgian parliament qualitatively changed several very important norms of the constitutional law project before the third hearing.<sup>32</sup> This kind of practice poses serious threat for realization of the legal state idea in our country and requires urgent refreshment, the performance of which is the duty of constitutional and general courts.

## 2.6. The Adequacy Principle

The greatest achievement of the legal state idea is the adequacy principle, according to which any acts issued by administrative government, which is directly or indirectly connected with the limitation of individual rights, should serve legitimate goals, must be usable for achieving necessary legitimate objectives and should also correspond to importance of the very interests, the protection of

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<sup>32</sup> For the detailed analyses of constitutional changes, see *Kobakhidze I.*, The Critical Analytic Review of the Constitutional Bill, available: <[http://www.osgf.ge/index.php?lang\\_id=GEO&sec\\_id=122&info\\_id=2130](http://www.osgf.ge/index.php?lang_id=GEO&sec_id=122&info_id=2130)>.

which it is aimed at.<sup>33</sup> The adequacy principle was developed in XIX century by the German theorists of administrative law, but in XX century it was already acclaimed world-wide.<sup>34</sup> Currently the adequacy principle is considered as the most guidelines principle for the European Court<sup>35</sup> and other International Justice institutions.

In Georgian law the adequacy principle established ten years ago. In most cases based on the German doctrine of the human rights protection, the principle is well reflected in the Georgian legal textbooks, also in other doctrinal sources, which describe the basic constitutional rights of people.<sup>36</sup> In recent years the adequacy principle was firmly established in the practice<sup>37</sup> of Georgian constitutional court. Though in the legislature and executive branches the maintenance of this principle met serious problems.

The most vivid case of the negligence showed towards the adequacy principle was reflected in the 2011 December amendments in the organic "law about political unions of citizens", according to which financial limitations set of political parties was fully applied to the physical entities related to the parties and having different political goals and objectives. Besides, non adequacy of norms in organic law sometimes reached the absurd limit, when on their bases the party officials and supporters were legally refused to participate in production field, to have paid duties, receive resources from abroad, get financial loans and etc.<sup>38</sup> In the Georgian reality of recent years the adequacy principle was extremely violated by administrative bodies especially at performing real act duties, the vivid example of which we could take the inadequate force used by Georgian police to dissolve the peaceful rally, also without having the right bases<sup>39</sup> in 2007 (November) declaring the emergency state and etc.<sup>40</sup> The subject of the biggest concern is the circumstance according to which the adequacy principle violations that took place in Georgia were connected to the most resonant periods of political activity. In these circumstances the negligence towards the adequacy principle has far going negative, contaminating effects and it predefines the spread of the negligent practice in the overall system of

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<sup>33</sup> Sommermann, Art. 20, in: *v. Mangoldt H., Klein F., Starck Ch.*, Kommentar zum Grundgesetz, München, 2010, Rn. 308 ff.; *Pieroth B., Schlink B.*, Grundrechte: Staatsrecht II, 18. neubearb. Aufl., Heidelberg, 2002, Rn. 361; For the legal adequacy principle analyzed in detail, see the Aaron Barak's monograph: *Barak A.*, Proportionality: Constitutional Rights and their Limitations, New York, "Cambridge University Press", 2012.

<sup>34</sup> *Barak A.*, Proportionality: Constitutional Rights and their Limitations, New York, "Cambridge University Press", 2012, pp. 175-210.

<sup>35</sup> See the Precedential Law of European Courts for Human Rights, Tbilisi, 2004 (in Georgian).

<sup>36</sup> See *Izoria L., Korkelia K., Kublashvili K., Khubua G.*, Comments of Georgian Constitution, Basic Human Rights and Freedoms, Tbilisi, 2005 (in Georgian); *Kublashvili K.*, Human Rights, Tbilisi, 2003; *Demetrashvili A., Kobakhidze I.*, Constitutional Law, Tbilisi, 2003 (in Georgian); *Demetrashvili A., Kobakhidze I.*, Constitutional Law, Tbilisi, 2010 (in Georgian).

<sup>37</sup> Four of the six rulings issued by the constitutional court of Georgia (2011- 2012) were based on the legal adequacy principle.

<sup>38</sup> For the detailed analyses of legal change see *Izoria L., Kobakhidze I., Turava P.*, The Analyses of Amendments Adopted for the Organic Law of Political Unions (29.12.2011), Tbilisi, 2012 (in Georgian).

<sup>39</sup> See also Human Rights in Georgia, The Report of Georgian Ombudsman of 2007 (second half), pp. 21 – 58 (in Georgian); the Account of Georgian Ombudsman Regarding the Level of Protection of Basic Human Rights and Freedoms, pp. 72-80 (in Georgian).

<sup>40</sup> See UN rights boss rebukes Georgia for use of force, reuters.com, Stephanie Nebehay, 8 Nov 2007; Closure of Media Outlets Not in Line with NATO Values – Scheffer The Georgian Times, Civil Georgia 8 Nov. 2007.

governmental authority. In future to limit such a trend, it is necessary the quality of actuality towards the adequacy principle be increased both in scientific and social debates and its legal realization be guaranteed both on constitutional and legislative levels.

## 2.7. The Principles of Legal Security

The principle of the legal state requires the execution of public authority in the legal framework and protection of private subject from illegal state intervention. The satisfaction of these requirements, apart from the legal related executive branch duties and the constitutional character of laws, is guaranteed by the mechanisms of legal security. In the legal state the legal order provides for its norm addressee the firm, clear and reliable ground. The physical entity should have the possibility to understand clearly the rule of act and set to the contents of their acts according to the foundation offered. From general viewpoint, the principle of legal security also requires the sequence provision throughout the law making process and stable, steady legislature – the legal security should protect people's trust both towards the legal norms and, in general, to legal order in large.<sup>41</sup>

The principle of legal security mainly requires the clearance of legal norms.<sup>42</sup> The text should be clearly defined and the will of law making process awareness should be available for an individual. The legal norm should be unambiguous and its jurisdictional results – clearly foreseeable.<sup>43</sup> Besides, it must be noted that the principle of legal security does not exclude the possibility for norm interpretation and presence of general norms received by the administrative bodies. Thus, the principle of legal security determines only minimal requirements towards the norms' texts and does not exclude the attribution of the special discretion role for the administrative officials throughout the execution of these legal norms.<sup>44</sup> Regardless such a loyal nature of awareness principle, in recent past a number of violations showed in this field.<sup>45</sup>

It must be noted that according to the version spread in legal doctrine, the awareness principle enjoys actuality only towards the legal norms and requires the understanding of only written norms by an individual.<sup>46</sup> Though Georgian reality proves that it would be far better once the awareness principle starts leaving its impact on the non normative intervention from the Government, namely

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<sup>41</sup> See *Degenhart Ch.*, Staatsrecht I: Staatsorganisationsrecht, 18. neu bearb. Aufl., Heidelberg, 2002, Rn. 347 ff.; *Sachs M.*, Art. 20, in: *Sachs M.* (Hrsg.), Grundgesetz: Kommentar, München, 2003, Rn. 122 ff.; *Sommerrmann K.-P.*, Art. 20, in: v. *Mangoldt H.*, *Klein F.*, *Starck Ch.*, Kommentar zum Grundgesetz, München, 2010, Rn. 288 ff.; *Maurer H.*, Staatsrecht I: Grundlagen, Verfassungsorgane, Staatsfunktionen, 2. Aufl., München, 2001, S. 231 ff.

<sup>42</sup> This principle in Georgian legal annals is often called as "the determination principle", thought the "clarity principle" will better highlight the idea.

<sup>43</sup> See *Degenhart Ch.*, Staatsrecht I: Staatsorganisationsrecht, 18., neu bearb. Aufl., Heidelberg, 2002, Rn. 348 ff.

<sup>44</sup> *Ib.*, Rn. 349.

<sup>45</sup> The most vivid violation of the clarity principle might be considered the change received in the organic law of "rights for political unions", according to which the vague idea of politically related person, with correspondent political tasks and objectives had been determined, and the party related financial limitations directly attached to him, see *Izoria L.*, *Kobakhidze I.*, *Turava P.*, The Change Analyses of the Law Regarding Political Unions in Georgia (29.12.2011), Tbilisi, 2012 (in Georgian).

<sup>46</sup> See *Degenhart Ch.*, Staatsrecht I: Staatsorganisationsrecht, 18. neu bearb. Aufl., Heidelberg 2002, Rn. 349 ff.

during the realization process of any real act performance by any administrative body, the individual must have the right to understand the mentioned intervention, so that determine right the contents of their behavior, also counter behavior possible. For example, according to the awareness principle, the representatives of law enforcement should be strictly held accountable for wearing their work uniforms during the dissolutions of peaceful rallies. Otherwise an individual is taken the opportunity to understand the contents of the intervention, the fact that gives them hand for legal right not to obey the authority representative and resist by the same counter actions – what they would do towards the physical entity for the self protection need.

The most important aspects of legal security principle are the principles of prohibiting of the backlash of norms and legitimate trust.<sup>47</sup> The principle of norm backlash prohibition has rather long history of practice in Georgia, the fact that positively showed itself in realization of its protective measures. For example, it is the rude violation of the legal state principle to attribute the backlash of the norm to such administrative public acts, which do not regulate the relationships between the state and individuals. The clear case of such a violation represents the norm valid before January 1<sup>st</sup>, 2013 of the organic Law on the Local Government according to which the specific authority of local governance was established by the backlash.<sup>48</sup> The definition of the public bodies' authorities according to the past (back) time frame violates not only the backlash principle, but can be assessed as the legal non sense as well.

The separate cases of violation of the legal security principle prove that to protect it firm constitutional and legal foundation should be established.

## **2.8. The Law Supremacy**

The arguments over the supra positive nature of law dates back centuries.<sup>49</sup> Regardless the absence of the clear demarcation line among diverse opinions of the jurisprudents regarding such fundamental issues, different positions gradually tend to approach. As a result modern jurisprudence prefers the intermediary perception of the legal phenomenon and equally acknowledges both the positive and super positive sources of the law.<sup>50</sup> Besides, the argument about the super positive nature of the law partly lost its actuality regarding those very circumstances, according to which in modern constitutions the principles of super positive law in face of legal state, democracy and social state principles and human rights protection translated into straightforward normative acts and got established for all. The institute of constitutional law contributed to the acknowledgement of the super

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<sup>47</sup> *Ib.*; *Sommermann K.-P.*, Art. 20, in: *v. Mangoldt H., Klein F., Starck Ch.*, *Kommentar zum Grundgesetz*, München, 2010, Rn. 292 ff.

<sup>48</sup> The Organic Law on Local Governance, 2005, Article 56<sup>2</sup>, Article 4 established: "Until January 2013 the local entity enjoyed the right, in special cases, the option to meet the issue of raising voluntarily material – technical support for the local state agencies. This norm is to be applied to be valid for legal relationship since January 1 2006".

<sup>49</sup> See *Zippelius R.*, *Rechtsphilosophie*, 4. Auflage, München 2003, S. 76 ff.; *Rüthers B.*, *Rechtstheorie*, 2. Auflage, S. 238 ff.

<sup>50</sup> *Ib.*

positive nature of law. The constitutional court, which is responsible to expand the compact constitutional norms, "is forced" to be guided by the forces of super positive legal principles and use the legal essence as the general measure for the measurement of the just state (government) function evaluation.

This positive trend in modern jurisprudence, in formal viewpoint, left its impact on Georgian reality. However in Georgian legal practice the recognition of super positive source of law and respect for law supremacy was laden by serious setbacks and we can easily illustrate them on specific cases. For example in 2010, during the local election the law representatives of the government admitted the possibility for the party agitators to stay around the voting urns, also provided by party recourses for the transportation of electorate to the urns with the further indication that these kind of actions had not been subject to any restrictions by any law. In 2009 the same politicians declared that the police had the right, delegated by president, to dissolve the peaceful rally, as they were not subjects for any restriction for such an action. These kinds of statements by politicians are of big concern as for the lawyer aware of elementary constitutional elements it should be clear that aforementioned acts rudely contradict with the constitutional principle of free elections and neutrality of public office. This kind of attitude by policy lawyers - the fact that can be qualified as kind of normative bias and from a strict position as the fruit of legal primitivism - speaks about low legal development level. The negative character of Georgian reality can be counted the very phenomenon according to which in oral speech instead of "legal supremacy" "supremacy of law" is used <sup>51</sup> that speaks about inadequate meaning to the just requirement of law.

In Georgian legal practice it is quite often a case when the logic of general law is frequently violated, that according to the principle of legal supremacy, should also be counted as quite a problematic issue. For example according to the independent principle of law the counter regulation of determined legal relations should correspond to its initial regulation. The violation of this principle can be counted the norms established by the 2010 constitutional amendment, according to which president actively intervenes into the procedures of distrust declared by the parliament to the government, while at declaring trust act<sup>52</sup> for the government President's participation in this procedure carries only of symbolic character. According to the law (paragraph 26) about "the structure, authority and functioning regulations of Georgian government", some state officials are appointed by the prime minister in agreement with President but their dismissal is performed by President by his own initiative (or Prime minister by introducing his own candidature). The dismissal by President of a state official appointed by the prime minister also contradicts with the legal logic. These violations towards the essence of law translate into perfunctory attitude or inadequate level of legal technique.

In theory the violations of legal supremacy principle and the legal logic in Georgia once again confirms that realization of the principle of the legal state is essentially related to the constitutional traditions and development of legal culture in the country.

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<sup>51</sup> This trend is easily testified by Google search engine, which at the indication of "law supremacy" issue offers 89 thousand results, and rather one thousand results regarding the "legal supremacy" idea.

<sup>52</sup> See *Kobakhidze I.*, *The Critical Analytic Review of the Constitutional Bill*, available at: <[http://www.osgf.ge/index.php?lang\\_id=GEO&sec\\_id=122&info\\_id=2130](http://www.osgf.ge/index.php?lang_id=GEO&sec_id=122&info_id=2130)>.

## **1. The Mechanism of Attributing of Valid Legal Authority to the Principle of the Legal State**

According to the general definition the legal state is the state where policy is determined by law unlike the police state policy dominate the law. Under the dictatorship of policy over the legislature and the practice of its application people experience the constant risk for the basic human rights violation. This is also proved by the aforementioned examples of the principle of the legal state: the violation of the state power division principle and concentration of power in the hand of only one power branch may determine the "unbridled" approach of authority towards the rights and freedoms of an individual that, first of all, reflects into the basic human rights violation; the patrimonial system of public office determines the political bias of public workers (also some law enforcement executives), the fact that translates itself into the rude violation of human rights; the inadequate realization of the principle of constitutional supremacy poses direct threat to the basic human rights that hind their normative recognition in constitution; the law priority and the law agreement principle violation with the given appropriate examples makes clear that these kind of precedents predispose the straightforward violation of basic human rights; the same can be said about the shortages in the law making and administrative legal procedures, the fact that leaves especially negative impact on realization of the essential human rights; the principles of legal adequacy and legal security were established specifically to protect these rights and therefore, naturally, the discrepancy in there execution cause the violation of the same rights; the violation of the principle of legal supremacy and the essence of law has directly negative influence on conditions of human right realization.

To consider the link between the inadequate insurance of the elements of the legal state and direct violation of human rights, it is vital in some form the principle of the legal sate be attributed the authority of the valid law that will guarantee the actual and universal protection of the rights of an individual. This goal is achieved by application of different legal mechanisms: the actual legislature and established legal practice does not leave the possibility with the help of constitutional ground to overcome the contradictions between the fundamental principle of the legal state and other institutional regulations. To eradicate this collision Georgian constitutional court may be equipped with the competence relevant to the constitutional norms of the fundamental principle of constitutionalism. Besides it must be noted that to guarantee the constitutional stability this right, as a rule, should also carry preventive character and foresee the preliminary control by the constitutional enforcement body.

The preventive guarantee aimed against establishment of patrimonial public office is possible by promoting the rational office related human rights to the rank of the basic status, the fact guaranteed by constitutions of many democratic states. For this reason the minimal guarantees of public official status should be established by the second paragraph of Georgian constitution.

Regardless the fact that political bias of public workers, in general, straightly contradicts with the basic human rights, the very examples analyzed above clearly show that in most cases it is not easy to attribute these contradictions to separate individuals, which further will complicate the legal protection of violated subjective rights in court. For example, during the protest rally dissolution the

police regularly appealed to President's name or displayed political bias by other means and thus automatically violated rights of the protesters, though this kind of violation would hardly create the necessity for each protester to protect their legitimate interests in court. In this case the most efficient mechanism for protection of the principle of the public office neutrality reestablishment of this very principle by constitution and detailed legal regulation must be considered as the case.<sup>53</sup>

As mentioned above to guarantee the constitutional supremacy principle it is necessary the procedures to introduce any amendments to existing constitution be complicated. It mostly concerns the norms regarding the basic human rights, which according to the constitution of number of democratic states should be set as an example and protected as a norm. Through these mechanisms<sup>54</sup> the hasty and straightforward changes in constitution will be avoided, the practice broadly appealed in Georgia – the fact extremely important to guarantee the fundamental constitutional and basic human rights principles.

Above mentioned examples proved that negligence towards the legal priority and legal agreement principles may cause both direct and indirect violation of human rights. In case of direct violation the individual enjoys the right to appeal in court, which offers the proper legal protection and legal authority equipment, but in case of indirect violation the individual lacks these possibilities, therefore it is highly necessary to legally and constitutionally regulate the principles of legal agreement and law priority. Constitutional hierarchy of norms and their attribution to the other sources of legal acts should be clearly defined, which guarantees the right execution of the legal agreement and law supremacy principles.

The same might be said about the faults displayed during the law making and administrative procedures. In case the discrepancies have direct to do with the violation of human rights, according to Georgian constitution the individual has the right based on the formal intervention criteria agreement protect their own subjective rights. Though, in case of non existence of such a direct connection, Georgian legal system does not take in consideration the efficient mechanism of law making power abuse protection. This mostly concerns the faults primarily displayed at the time of constitutional change the preventive mechanisms of which Georgian legal system does not recognize at all. Regarding the fact that special attention is paid to the right adherence of procedures during the law making process from the viewpoint of legal and human right protection it is reasonable the legal rights of constitutional court be expanded to cancel the laws received on the too contradictory legal ground, including the constitutional ones. Besides, it would be preferable the circle of the authoritative constitutional claimants be wider determined.

The principles of legal adequacy and security are directly connected with the basic human rights; therefore the violation of these principles, as a rule, automatically means the rude violation of the basic rights proper. Thus, the principles of legal adequacy and security along with the human rights enjoy the same valid legal status. Hence, for the practical realization of these principles the crucial

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<sup>53</sup> See *Huber M.*, Präambel, in: *Sachs M.* (Hrsg.), *Grundgesetz: Kommentar*, München, 2003, Rn. 8 ff.

<sup>54</sup> *Sobota K.*, *Das Prinzip Rechtsstaat*, Tübingen, 1997, S. 44 ff.; *Degenhart Ch.*, *Staatsrecht I: Staatsorganisationsrecht*, 18., neu bearb. Aufl., Heidelberg 2002, Rn. 236; *Sachs M.*, Art. 20, in: *Sachs M.* (Hrsg.), *Grundgesetz: Kommentar*, München 2003, Rn. 78.

importance lies on the right application and improvement of this practice by administrative bodies and the parliament.

Besides, conditioned by legal culture deficiency it is preferable the legal adequacy and security principles (its separate elements) be constitutionally improved in Georgia.

In the end we should accentuate on those legal and legislature faults in Georgia, which contradict with the principle of legal supremacy and the faulty practice of legal logic violation. The supremacy of law is the main idea of the legal state concept and therefore the appeal for its violation should be based on the principles of the legal state. Hence, Georgian constitutional court has possibility through abstract norm control or other procedural forms accept for further consideration the very constitutional claim based on such legal aspects of constitution that contradict with the general idea of the law (and the legal logic as well). At the same time regardless the fact that the normative nature of preamble is the subject of scientific dispute, it must be noted that it represents one of the inherent elements of constitutional contents (*sui generis*) and therefore can be used as the legal outcome for constitutional measurement.

As noted above, one of the most important institutional mechanisms for realization of the principle of the legal state is the constitutional justice. Constitutional court is the very body, which should guarantee the supremacy of constitution, protect individual freedoms and play the role of supreme arbitrage between the highest power state bodies. Although Georgian constitution by court legislature, formally is equipped by all these legal possibilities, in practice regardless the frequent violations of the elements of the legal state, in reality it does not have power to be represented as the true constitutional guarantor. The following circumstance speaking about the fact that constitutional court was able to rule only six decisions in 2011-2012 confirms it as well. This practice makes clear, that constitutional law requires functional enhancement that, first of all, should be represented as the widening of the circle of the competent constitution claimants and increasing its actual rights.

In the end attention should be paid on the basic human rights, which from the viewpoint of protection the legal state principle may play special role. In the legal doctrine it is recognized that violation of the fundamental principles of constitutionalism, along with the principle of the legal state automatically means the violation of the basic human rights.<sup>55</sup> This conclusion leaves the constitutional court the legitimate right based on the 17<sup>th</sup> paragraph of Georgian constitution on the basis of individual claim cancel any normative act that rudely violates any fundamental principle of the legal state. Thus, the main right for human merit, just as the valid law, can be used as the actual mechanism as the valid law by which the valid legal authority is indirectly attributed to the principle of the legal state.

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<sup>55</sup> *Pieroth B., Schlink B., Grundrechte: Staatsrecht II, 18. neubearb. Aufl., Heidelberg, 2002, Rn. 361.*



**Dimitry Gegenava\***

## **Georgian Model of Constructive Vote of No-Confidence: Gordian Knot in the Constitution of Georgia**

*"Constitutional biography of the power is a biography writing of which starts immediately on the birth of the constitution."*<sup>1</sup>

### **I. Introduction**

A basic essence of the state as a political-legal integrity is considerably defined by the level of legal and political consciousness of people. The knowledge accumulated during the history of mankind must inevitably be reflected positively on the development of law. Constitutionalism, in the end, "is a trunk full of experience, though it is not a collection of ready receipts",<sup>2</sup> every nation chooses on its own a governance form and mechanism considering its ethno-mentality and history.

"Both constitutionalism and liberalism in essence personify restriction of the power, the theory and practice of the restricted governance, but democracy is striving to accumulate the power as much as possible in the hand of the leaders chosen by the majority of people and use it."<sup>3</sup> Whether a certain model of governance corresponds to the basics of constitutionalism is defined by the mechanisms of cooperation of the systems of the power apportion, retention and balancing, the power branches and the mechanisms of protection of human rights included in the constitution.<sup>4</sup> In the system of checks and balances (especially in parliamentary or inclined to parliamentary countries) a significant role plays mechanism of no-confidence of the government, one of which - constructive vote of no-confidence – is a recognized and effective instrument of repression and prevention of political and legal crises.<sup>5</sup>

As a result of the constitutional reform of 2010 in Georgia's constitution was considered a mechanism of constructive vote of no-confidence,<sup>6</sup> a final regulation of which even before passing the constitutional draft law caused discontent of a big majority of the juridical society.<sup>7</sup>

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<sup>1</sup> *Sajo A.*, *Limiting Government, An Introduction to Constitutionalism* (translated into Georgian by *Maisuradze M.*, under the editorship of *Ninidze T.*), Tbilisi, 2003, 2 (in Georgian).

<sup>2</sup> *Ib.*, 15.

<sup>3</sup> *Muskhelishvili M.*, *Change of the Constitution in Georgia, Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People*, Tbilisi, 2005, 105 (in Georgian).

<sup>4</sup> *Khmaladze V.*, *Demetrashvili A.*, *Nalbandov Al.*, *Ramishvili L.*, *Usuphashvili D.*, *Djibghashvili Z.*, *State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People*, Tbilisi, 2005, 11 (in Georgian).

<sup>5</sup> *Ib.*, 29.

<sup>6</sup> Article 81 of the Constitution of Georgia (Shall Be Enforced from the Next Presidential Election of October 2013 within the Newly Elected President Takes Oath, 15.10.2010, №3710).

Choosing of an incorrect form of giving the government a vote of confidence – no-confidence might annihilate the assignment of the parliamentary control and cause a significant political crisis.<sup>8</sup> Therefore it is inevitable to study in details the Georgian model of a constructive vote of no-confidence in order to give a scientific strength to the facts and increase the convincingness of the substantiation.

The aim of the work is to overview a mechanism of giving the government a vote of no confidence stated by Article 81 of the constitution of Georgia,<sup>9</sup> to analyze possible problems connected with its practical realization and as a result of logical understanding to work out ways of overcoming and eradicating the difficulties: offers, recommendations and prepare a desirable, optimal project of the above mentioned Article.

By using comparative research the Georgian regulation of the mentioned institute will be discussed in relation to the states which are equipped with a similar parliamentary control mechanism in order to get a suitable and, what is very important, acceptable model for Georgia.

## **II. Georgian Model of Constructive Vote of No-Confidence**

### **1. Constructive Vote of No-Confidence as a Mechanism of Checks and Balances between the Parliament and the Government**

Constitution must ensure the balance of the authorities' power and must not allow even the "worst" authority to do harm to the state.<sup>10</sup> It must be such a political and legal document, which "will give an opportunity to the society to solve hard and conflict problems peacefully".<sup>11</sup> Just considering these principles after the World War II Germany included into its basic law quite strong mechanisms of separation of powers and checks and balances,<sup>12</sup> from which we should note German novelty – a new constructive mechanism a vote of no-confidence in the government (*Konstruktives Misstrauensvotum*<sup>13</sup>).

Consideration of a constructive vote of no-confidence in Germany's basic law was due to the motive of the government stability provision.<sup>14</sup> The main idea of the German constructive vote is that

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<sup>7</sup> *Khmaladze V., Djibgashvili Z.*, Comment of the Constitutional Draft Law on Changes and Amendments to the Constitution of Georgia (2010), Tbilisi, 2010, 21 (in Georgian).

<sup>8</sup> *Kandelaki K., Losaberidze D., Rukhadze Z., Tabutsadze I., Khmaladze V., Djibgashvili Z.*, Constitutional Systems and Constitutional Process in Georgia (1995-2009), Perspectives of its Development, Tbilisi, 2009, 15 (in Georgian).

<sup>9</sup> For the aim of the work a talk in the text is about Article 81, which will be enforced from the next presidential election of October 2013 within the newly elected president takes oath.

<sup>10</sup> *Khmaladze V., Demetrashvili A., Nalbandov Al., Ramishvili L., Usuphashvili D., Djibgashvili Z.*, State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 12 (in Georgian).

<sup>11</sup> *Schwartz H.*, Building Blocks for a Constitution, "Constitutional Law Review", No.1, 2009, 7.

<sup>12</sup> *Steinack K.*, The Impact of Multi-Party Government on Parliament-Executive Relations - Examples from Abroad, Paper presented at the Australasian Study of Parliament Group, Annual Conference 2011, The Executive versus the Parliament - Who Wins?, Melbourne, Parliament House, 6-8 October, 2011, 3.

<sup>13</sup> Introduction to German Law, *Ebke W. F., Finkin M.W.* (Eds.), "Kluwer Law International", 1996, 61.

<sup>14</sup> *Melkadze O., Ramishvil N.*, Constitutional Law of Germany, Tbilisi, 1999, 116 (in Georgian).

a Federal Chancellor will not be counted as dissolved until his substitute is not chosen by vote and proved by Bundestag.<sup>15</sup> Unlike the destructive vote of no-confidence, a constructive vote serves for the aim of the government stability,<sup>16</sup> because of which very many European states adopted the innovation of Germany.<sup>17</sup>

Parliament, as a supreme representative organ, is a display of a will of people, carried out by the representatives elected by voters considering basics of democracy.<sup>18</sup> A legislative organ is a basics of the representative democracy, by means of which people control executors' work and protect own rights.<sup>19</sup> Though at the same time the principle of the parliamentary supremacy often causes considerable problems associated with quite hard consequences.<sup>20</sup> Often establishing own superiority by the parliament is beyond the classical functions of the legislative government,<sup>21</sup> because together with the legislative organ is a political organ as well and like the government the parliamentary majority conducts a policy too.<sup>22</sup>

A constructive vote of no-confidence serves for avoiding a constitutional crisis. Besides until discharging the situation the government is doing its duties,<sup>23</sup> or the mentioned model "is opposing confidence and no confidence to each other in such a way in the end in favor of the confidence, that a vacuum is not created in the executive authority".<sup>24</sup>

Before using a constructive vote of no-confidence the parliament has to think over and weigh the pros and cons so that will not expose itself to danger in the future<sup>25</sup> and will not provoke its own dissolution. "In the conditions of nonsolid party system a constructive vote of no-confidence is a mechanism, neutralizing emotions caused by certain unpopular actions of the government in the parliament and by this means protects the state mechanism from frequent changes of the governments".<sup>26</sup>

<sup>15</sup> Introduction to German Law, *Ebke W. F., Finkin M.W.* (Eds.), "Kluwer Law International", 1996, 61.

<sup>16</sup> *Tordia G.*, Half-presidential Model from the Angle of the Current Constitutional Changes in Georgia, *Journal "Justice"*, No. 3, 2011, 51 (in Georgian).

<sup>17</sup> *Tanchev E.*, Parliamentarism Rationalized, "East European Constitutional Review", Vol. 2, No. 1, 1993, 33.

<sup>18</sup> *Khmaladze V., Demetrashvili A., Nalbandov Al., Ramishvili L., Usuphashvili D., Djibgashvili Z.*, State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 9 (in Georgian).

<sup>19</sup> *Sajo A.*, Limiting Government, An Introduction to Constitutionalism (translated into Georgian by *Maisuradze M.*, under the editorship of *Ninidze T.*), Tbilisi, 2003, 136 (in Georgian).

<sup>20</sup> *Ib.*, 4

<sup>21</sup> *Sir Parlmer G.*, What is Parliament for?, "New Zealand Law Journal", December 2011, 379.

<sup>22</sup> *Sajo A.*, Limiting Government, An Introduction to Constitutionalism (translated into Georgian by *Maisuradze M.*, under the editorship of *Ninidze T.*), Tbilisi, 2003, 240 (in Georgian).

<sup>23</sup> *Khmaladze V., Demetrashvili A., Nalbandov Al., Ramishvili L., Usuphashvili D., Djibgashvili Z.*, State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 28-29 (in Georgian).

<sup>24</sup> *Melkadze O., Ramishvil N.*, Constitutional Law of Germany, Tbilisi, 1999, 117 (in Georgian).

<sup>25</sup> *Tordia G.*, Half-presidential Model in the Light of the Current Constitutional Changes in Georgia, *Journal "Justice"*, No. 3, 2011, 51 (in Georgian).

<sup>26</sup> *Khmaladze V., Demetrashvili A., Nalbandov Al., Ramishvili L., Usuphashvili D., Djibgashvili Z.*, State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 28 (in Georgian).

## **2. Georgian Model of a Constructive Vote of No-confidence**

### **2.1. The Necessity of a Constructive Vote of No-confidence in Georgian Reality**

In reality reasoning from the level of the civil society constitutional-legal processes in Georgia are quite unstable and are hindering the realization of constitutional institutes.<sup>27</sup> Moreover a constitution must be democratic in itself. It must provide democracy and effectiveness of the realization of the power,<sup>28</sup> if it can't be implemented in life, it will be necessary to make systematic changes.

"The main thing in the current constitutional reforms in Georgia is to define a constitutional status of the government and its place in the system of the state power organs".<sup>29</sup> As a result of the constitutional reform we received a mixed model of the governance, which is mostly characterized with the elements of the parliamentary republic.<sup>30</sup>

"Executive-legislative relations" are different for different states which are basically due to the governance form of these states.<sup>31</sup> According to the norms that are to be enacted from the end of 2013 the parliament will become a main controlling organ of the government.<sup>32</sup> Accordingly it will need really effective means for carrying out supervision over the government.

Even in 2004 on discussing constitutional changes many constitutionalists thought that it was necessary to implement a constructive vote of no-confidence in Georgia.<sup>33</sup> A constitutional reform of 2010 provided for the notes and included the above mentioned mechanism into the draft law. More actual than its usage is its existence in itself, this is some kind of preventive instrument among the levers of parliamentary control.<sup>34</sup>

Such type of no-confidence against frequent changes of governments was worked out after the second World War and was foreseen by many states of central and Eastern Europe,<sup>35</sup> though it must be

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<sup>27</sup> *Khmaladze V., Demetrashvili A., Nalbandov Al., Ramishvili L., Usuphashvili D., Djibgashvili Z.*, State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 13 (in Georgian).

<sup>28</sup> *Muskhelishvili M.*, Change of the Constitution in Georgia, Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 107 (in Georgian).

<sup>29</sup> *Kverenchkhiladze G.*, Countersign Institute: European Experience and Georgian Perspectives, Law Journal "Sarchevi", No. 1-2(3-4), 2012, 199 (in Georgian).

<sup>30</sup> *Kakhiani G.*, Consideration of Some Issues connected with Constitutional Draft Law, Law Journal "Sarchevi", No. 1-2(3-4), 2012, 191 (in Georgian).

<sup>31</sup> *King A.*, Modes of Executive-Legislative Relations: Great Britain, France, and West Germany, "Legislative Studies Quarterly", No.1, 1976, 11.

<sup>32</sup> *Kakhiani G.*, Consideration of Some Issues Connected with Constitutional Draft Law, Law Journal "Sarchevi", No. 1-2(3-4), 2012, 191 (in Georgian).

<sup>33</sup> *Khmaladze V., Demetrashvili A., Nalbandov Al., Ramishvili L., Usuphashvili D., Djibgashvili Z.*, State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 28 (in Georgian).

<sup>34</sup> *Melkadze O., Ramishvili N.*, Constitutional Law of Germany, Tbilisi, 1999, 117 (in Georgian).

<sup>35</sup> *Tanchev E.*, Parliamentarism Rationalized, "East European Constitutional Review", Vol. 2, No. 1, 1993, 33.

noted that "very important is a level of efficiency of the procedure of declaring no-confidence".<sup>36</sup> It's true that in the Constitution of Georgia was included a new mechanism of no-confidence, though with considerable differences from the German one, we can boldly say that there is a unique Georgian model, which has no analogy in the world constitutionalism.

## 2.2. Constitutional Regulation

### 2.2.1. Initiation

A new reduction of Article 81 of the Constitution of Georgia<sup>37</sup> offers a new Georgian version of a constructive vote of no-confidence to the world constitutionalism. For rising a question of declaring no-confidence to the government it is inevitable the initiation of the question by an authorized person. As a no-confidence institute is generally a prerogative of the parliament, as a legislative power and a mechanism of controlling the government,<sup>38</sup> its initiators' circle is from the parliament. 2/5 of the full list of the parliament is authorized to apply to the parliament with the request of arousing a question of no-confidence,<sup>39</sup> though it does not mean automatic starting of the procedure. 2/5 of the full list is only initiators and bringing up the question needs additional voting. Discussion of declaring no-confidence to the government will only be started, if half of the full list of the parliament supports this initiative.<sup>40</sup> Moreover the constitution fixes a certain time between applying to the parliament with a proper initiative and voting on starting the procedure of declaring no-confidence.<sup>41</sup>

The constitution envisaged risk factors accompanying this no-confidence mechanism, because of which in case of failure of bringing up a question (if a half of the full list does not support the starting the procedure of declaring no-confidence), during six months the same members of the parliament will not be authorized any longer to initiate the procedure of no-confidence.<sup>42</sup> Analogous restrictions are in force in the world practice,<sup>43</sup> though it is obscure what is meant under the words – "the same members",<sup>44</sup> which must be ascertained.

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<sup>36</sup> *Khmaladze V., Djibgashvili Z.*, Comment of the Constitutional Draft Law (2010) on Changes and Amendments to the Constitution of Georgia, Tbilisi, 2010, 20 (in Georgian).

<sup>37</sup> It will go into effect from the moment of making vow by the president elected in the regular presidential elections in October, 2013.

<sup>38</sup> *Melkadze O.*, State Control: Theory, Practice, Perspectives, Tbilisi, 1996, 43 (in Georgian).

<sup>39</sup> Para. 1, Sentence 1, Constitution of Georgia, 1995.

<sup>40</sup> *Ib.*, sentence three.

<sup>41</sup> No less than 20 and no more than 25 days, *ib.*, sentence two.

<sup>42</sup> *Ib.*, sentence four.

<sup>43</sup> *Tanchev E.*, Parliamentarism Rationalized, "East European Constitutional Review", Vol. 2, No. 1, 1993.

<sup>44</sup> What happens if only one member from the obligatory minimum is changed, in fact initiators are the same members, though formally the construction is already breached "by the same members".

## **2.2.2. Procedure**

A constructive vote of no-confidence generally consists of three stages: bringing up a question, discussing a question and making a decision. A procedure of bringing up a question is regulated by the first paragraph of Article 81 of the constitution of Georgia, according to which 2/5 of the full list of the parliament must support the initiative about starting the procedure of no-confidence.

In no less than 20 and no more than 25 days from making a decision the parliament is voting for the candidate named by no less than 2/5 of the full list.<sup>45</sup> Theoretically it is possible to name two candidates, as a circle of persons (2/5 of the full list) authorized to name a candidate gives this opportunity. In case of two candidates both of them are voted and in any case a candidate approved by the majority of the full list will be submitted to the president,<sup>46</sup> though if the legislative organ does not give its consent, the procedure of voting of no-confidence is ceased.<sup>47</sup>

The president agrees on the candidate elected by the parliament and proposes to appoint him/her to the position of prime minister or refuses to propose him/her. In the first case voting of confidence to the prime minister and the government is done according to the rule stated by the constitution, but in the second case the parliament can overcome the president's objection by the 3/5 majority of the full list and introduce the candidate proposed to him by the parliament.<sup>48</sup>

## **2.2.3. Participation of the President**

In the Georgian model of no-confidence the president takes an active part in the procedure. Formerly he must propose the candidacy for a prime minister, offered by the parliament, though he has considerable discretion. He is authorized to refuse the offer of the candidate nominated by the parliament,<sup>49</sup> which is actually the blockade of the parliament decision or a suspensive veto.

For overcoming the president's veto, the parliament needs the support of 3/5 part of the full list, which considerably raises the involvement of the state leader in the process of voting of no-confidence by the parliament. By overcoming the president's decision the parliament makes him propose the candidacy approved by the legislative organ.<sup>50</sup> After voting of no-confidence in the government recruitment of the government is carried out by an ordinary (voting of confidence) way.<sup>51</sup>

Voting of a no-confidence should be noted separately, when the president is authorized to dissolve the parliament in three days and to schedule pre-term elections.<sup>52</sup> It can be said that the leader of the state

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<sup>45</sup> Para. II, Article 81 of the Constitution of Georgia, 1995.

<sup>46</sup> *Ib.*

<sup>47</sup> *Ib.*

<sup>48</sup> *Ib.*, Paras. 2, 3 and 4.

<sup>49</sup> Para. 3, Article 81 of the Constitution of Georgia, 1995.

<sup>50</sup> *Ib.*, Para. 4.

<sup>51</sup> *Ib.*

<sup>52</sup> *Ib.*, Para.6.

has big authorities in the process of voting of no-confidence that even more aggravates a question of compliance of the Georgian model of voting of no-confidence with the constitutionalism standards.

## 2.2.4. Legal Results

According to the constitution of Georgia the procedure of voting of no-confidence in the government is connected with responsibilities of the parliament and the government. In the case of carrying out the procedure by the parliament successfully, voting confidence in a new prime minister and the government will be counted as voting of no-confidence in the current government and it gets its authorities ended.<sup>53</sup>

It's true that the idea of supremacy of the parliament is the main purpose of voting of no-confidence and in the process of carrying out the parliamentary control over the government it plays an important role together with the principle of apportioning the authorities,<sup>54</sup> though it must not cause irresponsibility, impunity feeling in the legislative organ. In this mechanism the institute of dissolution of the parliament is acting as compatibility of the powers. In case of voting of no-confidence in the new government the constitution of Georgia confers the president the authority to dissolve the parliament in three days and to schedule pre-term elections.<sup>55</sup>

## III. Problems of the Georgian Model

Georgian regulation of the constructive vote of no-confidence since the very beginning of its existence in draft law has been criticized by many critics,<sup>56</sup> due to objective or subjective reasons.<sup>57</sup> At Berlin conference three main problems were emphasized: 1. number of procedural stages; 2. timing; 3. quorum.<sup>58</sup> To these three problems can be added unprecedented active participation of the president in using a mechanism of the parliamentary control that is not merely an additional mechanism, but is substantively a distinguishable sign of the Georgian model from a traditional system of a constructive vote of no-confidence.

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<sup>53</sup> Para. 5, Article 81 of the Constitution of Georgia, 1995.

<sup>54</sup> *Verni D.V.*, Parliamentary Governance and Presidential Governance, Republic: Parliamentary or Presidential, *Melkadze O.* (Ed.), Tbilisi, 1996, 122 (in Georgian).

<sup>55</sup> Para. 6, Article 81 of the Constitution of Georgia, 1995.

<sup>56</sup> *Khmaladze V., Djibgashvili Z.*, Comment of the Constitutional Draft Law (2010) on Changes and Amendments to the Constitution of Georgia, Tbilisi, 2010, 21 (in Georgian).

<sup>57</sup> *Davituri G.*, Models of State Governance and Constitutional Reform of 2010 in Georgia and *Asatiani T.*, A Constructive Vote of No-confidence from the Angle of Constitutional Reform of 2010, in: Modern Constitutional Law, Book I, *Kverenchkhiladze G., Gegenava D.* (Eds.), Tbilisi, 2012 (in Georgian).

<sup>58</sup> Final Report of Berlin Conference on the Constitutional Reform of Georgia, prepared by *Babek V.*, Berlin, 14-16 July, 2010, 10.

## 1. Bringing up a Question and a Complicated Procedure

The main assignment of the power in the state is avoiding anarchy that is done directly by people or their representatives.<sup>59</sup> The existence of a legally and ideologically straightened constitution is not the only feature of constitutionality of the governance. In this concept a layman might have considered Soviet constitutions as oriented on human rights.<sup>60</sup>

According to Blankenagel a constructive vote of no-confidence "must represent the existed political context" and its constitutional regulation must not be complicated.<sup>61</sup> Parliament is thought to be an understanding and cooperating organ of political parties,<sup>62</sup> accordingly it must not become an institution causing crises in the state, the concrete steps of which will directly influence on the development of the state.

For passing a vote of no-confidence in the government in Georgian reality it is needed the initiation of no less than 2/5 of the full list of the parliament, after which the question goes for voting.<sup>63</sup> First of all it should be noted that there is no need of an individual procedure for bringing up a question about a vote of no-confidence.<sup>64</sup> In the states where this model is functioning a similar additional voting is not stated.<sup>65</sup> In this case the procedure is complicated and one voting is added. The above mentioned was severely criticized by Venice Commission, by the recommendation of which it is reasonable the existence of only one voting procedure.<sup>66</sup>

A complex mechanism in itself is complicated by the possibility of introducing two candidates. The constitution affords the possibility of nominating a candidature of prime minister not to the initiators, but to 2/5 of the full list of the parliament,<sup>67</sup> that is not adequate at all, as those initiators or parliamentary members must be able to nominate a candidate, which give the probability of a reasonable alternative. The main aim of a vote of no-confidence is to substitute the government by a fast and effective way, which will almost be excluded by the version of Article 81. By adding to the system of no-confidence a constructional mechanism, no-confidence was considerably weakened in itself, as the procedure became complicated,<sup>68</sup> but it was caused by the aim of strengthening of

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<sup>59</sup> *Szilagyi I. M.*, Presidential versus Parliamentary Systems, Journal "AARMS: Academic and Applied Research in Military Science", Vol. 8, No. 2, 2009, 307.

<sup>60</sup> *Muskhlishvili M.*, Change of the Constitution in Georgia, Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 106 (in Georgian).

<sup>61</sup> A Final Report of the Berlin Conference on the Constitutional Reform of Georgia, prepared by *Babeck W.*, Berlin, 14-16 July, 2010, 9-10.

<sup>62</sup> *Sir Parlmet G.*, What is Parliament for? "New Zealand Law Journal", December 2011, 379.

<sup>63</sup> Para. 2, Article 81 of the Constitution of Georgia, 1995.

<sup>64</sup> *Kobakhidze I.*, Critical Analysis of Notes to the Constitutional Changes, Tbilisi, 2010, 7 (in Georgian).

<sup>65</sup> Article 67 of the Basic Law of the Federal Republic of Germany.

<sup>66</sup> Final Opinion CDL-AD(2010)028 on the Draft Constitutional Law on Amendments and Changes to the Constitution of Georgia, Adopted by the Venice Commission at its 84th Plenary Session, Venice, 15-16 October, 2010, 12.

<sup>67</sup> Para. 2, Article 81 of the Constitution of Georgia, 1995.

<sup>68</sup> *Sajo A.*, Limiting Government, An Introduction to Constitutionalism (translated into Georgian by *Maisuradze M.*, under the editorship of *Ninidze T.*), Tbilisi, 2003, 236 (in Georgian).



interrelations between the parliament and the government. Constructive vote is successful, if a prime minister is losing the support of the majority of the parliament and the parliament is already agreed on the substitution,<sup>69</sup> if not, no-confidence might be caused by other reason.<sup>70</sup>

It's true that vote of no-confidence in the government must not be a simple procedure so that it will not cause instability in the state and frequent changes of the governments. This is of course justified,<sup>71</sup> though it must not be too difficult so that it will be possible to realize it in practice.

## 2. Timing

One of the weakest features of the Georgian model of the constructive vote of no-confidence is timing.<sup>72</sup> Article 81 of the constitution of Georgia states so long periods of time, that a mechanism, being considered to be the most effective and fastest way of solving crises, actually causes a political crisis with inadequately longer periods and lingering procedures.

According to the Georgian model in an ideal case voting of no-confidence lasts 40-55 days,<sup>73</sup> in case of disagreement between the problems, president and the government the procedure might last more than three months (with a perspective of further prolongation), which is unjustified at all. Radically are different examples of Germany, Spain, Greece and others, where the maximal duration of the procedure is expressed in much less.<sup>74</sup> In the native country of this mechanism, in Germany the procedure lasts 48 hours.<sup>75</sup>

"Time limit gives the prime minister the opportunity of maintaining the own post by means of mercantile dealings. The constitution must provide for avoiding such opportunity and not encouraging it."<sup>76</sup> It can be said that "longer periods are not stated by the constitution of any traditional democratic state either".<sup>77</sup>

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<sup>69</sup> Müller G., Evolution of the Government System after the Political Change in Hungary (1990-2009), "Curentul Juridic", 40, 2010, 33.

<sup>70</sup> For example, in Hungary this institute is thought to be rather a difficult mechanism and sometimes a governing political force is provoking it itself in order to change prime minister. See: Müller G., Evolution of the Government System after the Political Change in Hungary (1990-2009), "Curentul Juridic", 40, 2010, 33.

<sup>71</sup> For example, in Germany a procedure of no-confidence was used twice: in 1972 the attempt of Bundestag against Willi Brandt failed, though in 1982 federal chancellor Schmidt was substituted by Kohl, see: Melkadze O., Ramishvil N., Constitutional Law of Germany, Tbilisi, 1999, 117 (in Georgian); Introduction to German Law, Ebke W.F., Finkin M.W. (Eds.), "Kluwer Law International", 1996, 61.

<sup>72</sup> Kakhiani G., Consideration of Some Issues Connected with Constitutional Draft Law, Law Journal "Sarchevi", No. 1-2(3-4), 2012, 193 (in Georgian).

<sup>73</sup> Paras. 1 and 2, Article 81 of the Constitution of Georgia, 1995.

<sup>74</sup> Davituri G., Models of State Governance and the Constitutional Reform of 2010 in Georgia, in: Modern Constitutional Law, Book I, Kverenchkhiladze G., Gegenava D. (Eds.), Tbilisi, 2012, 179 (in Georgian).

<sup>75</sup> Basic Law of the Federal Republic of Germany, 1949, Article 67(2).

<sup>76</sup> Kobakhidze I., Critical Analysis of Notes to the Constitutional Changes, Tbilisi, 2010, 7 (in Georgian).

<sup>77</sup> Ib.

### 3. Voting Quorum

Generally for the initiation procedure of a constructive vote of no-confidence the necessary quorum ranges between 1/5-1/4 of the parliament composition.<sup>78</sup> In case of Georgia for bringing up a question 2/5 of the full list of the parliament is needed, but for the initiation - the absolute majority.<sup>79</sup> Such a high quorum is not in any other state. It can be said that for bringing up a question of a constructive vote of no-confidence needs unprecedentedly a high number of votes which is not known for the world constitutionalism,<sup>80</sup> for example, in the parliament of Hungary for bringing up no-confidence it is mandatory the support of 1/5 of the parliament members.<sup>81</sup>

Like the west European models the majority of the constitutions of east and central Europe for voting of no-confidence need consent of the absolute majority of the parliament,<sup>82</sup> as well as for voting of confidence in the government (only in exceptional cases there is stated the different majority).<sup>83</sup> In case of Georgia this principle is only observed at the basic stage, though the situation is radically changing in the case of using veto by president, when the parliament for overcoming the president's decision needs 3/5 of the full list of the parliament.<sup>84</sup> It takes place, when the obligatory quorum for confidence-no confidence in the government makes up the majority of the list. In this case a dogmatic discrepancy is evident: if voting of confidence in the government is done by the mere majority of votes, for voting of no-confidence and overcoming the president's veto must not be needed the support of 3/5 of the full list of the parliament.<sup>85</sup>

### 4. President's Veto

In constitutionalism the following principle is in force: "A person who appoints somebody to a position, the same person relieves him/her of his/her position".<sup>86</sup> The above mentioned fact is forming the most general and fundamental principle of responsibility and accountability which is used in any situation with a few exceptions. Rational parliamentarianism means provision of the government

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<sup>78</sup> *Tanchev E.*, Parliamentarism Rationalized, "East European Constitutional Review", Vol. 2, No. 1, 1993, 33-34.

<sup>79</sup> Para. 1 of Article 81 of the Constitution of Georgia, 1995.

<sup>80</sup> *Kobakhidze I.*, Critical Analysis of Notes to the Constitutional Changes, Tbilisi, 2010, 7 (in Georgian).

<sup>81</sup> *Sajo A.*, Limiting Government, An Introduction to Constitutionalism (translated into Georgian by *Maisuradze M.*, under the editorship of *Ninidze T.*), Tbilisi, 2003, 226 (in Georgian).

<sup>82</sup> *Tanchev E.*, Parliamentarism Rationalized, "East European Constitutional Review", Vol. 2, No. 1, 1993, 34.

<sup>83</sup> *Khmaladze V., Djibgashvili Z.*, Comment of the Constitutional Draft Law (2010) on Changes and Amendments to the Constitution of Georgia, Tbilisi, 2010, 20 (in Georgian).

<sup>84</sup> Para. 4 of Article 81, the Constitution of Georgia, 1995.

<sup>85</sup> *Kobakhidze I.*, Critical Analysis of Notes to the Constitutional Changes, Tbilisi, 2010, 8 (see: Final Opinion CDL-AD(2010)028 on the Draft Constitutional Law on Amendments and Changes to the Constitution of Georgia, Adopted by the Venice Commission at its 84th Plenary Session, Venice, 15-16 October, 2010).

<sup>86</sup> *Sajo A.*, Limiting Government, An Introduction to Constitutionalism (translated into Georgian by *Maisuradze M.*, under the editorship of *Ninidze T.*), Tbilisi, 2003, 238 (in Georgian).

stability in such a way that the features of the parliamentary model themselves including a principle of political responsibility of the government will not be neglected.<sup>87</sup>

A control over the activities of the executive authority organs is a mechanism of an outside parliamentary control;<sup>88</sup> accordingly the establishment of political responsibility of the government is exclusively the responsibility of the parliament being used by the parliament considering subjective factors.<sup>89</sup>

The constitution of Georgia gives rather a lot of authorities to president in the process of voting of no-confidence in the government. The thought that the political situation in Georgia is instable and the society has a scarce culture of political parties' activities, causing considerable risk-factors<sup>90</sup> of influence on small political parties, is rather unserious, because voting of no-confidence in the end needs majority of votes. The main regulation of democracy is an idea of governing the majority with the corresponding protecting mechanisms, in which the opportunity of using president's veto on the decision of no-confidence is not really meant.

No-confidence in the government is one of the ways of the parliamentary control and it is not clear what has common president with it, when he must be functioning as an arbiter in using a parliamentary mechanism of retaining and balancing?<sup>91</sup> Really debatable is a thought that in Georgian reality when using a constructive vote of no-confidence president plays only a formal role in forming the government, he appoints a person introduced by the parliament to the position of prime minister.<sup>92</sup> The president's veto on the procedure of a constructive vote of no-confidence "has no analogy in the constitutional practice of western countries".<sup>93</sup> President must be constrained by the parliament's decision; he must not have any possibility of discretion.<sup>94</sup>

Insurability of president's veto might become a ground of dissolving the parliament by president<sup>95</sup> - this was sharply criticized by the Venetian Commission.<sup>96</sup> The president's authority to dissolve the parliament in the process of using a constructive vote of no-confidence does not correspond to legal standards of this institute.<sup>97</sup> "The mentioned rule not only gives too much authorities to the president and

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<sup>87</sup> *Tanchev E.*, *Parliamentarism Rationalized*, "East European Constitutional Review", Vol. 2, No. 1, 1993, 33.

<sup>88</sup> *Melkadze O.*, *State Control: Theory, Practice, Perspectives*, Tbilisi, 1996, 43 (in Georgian).

<sup>89</sup> *Ib.*, 44.

<sup>90</sup> *Asatiani T.*, *A Constructive Vote of No-confidence from the Angle of the Constitutional Reform of 2010*, Book I, *Kverenchkhiladze G., Gegenava D.* (Eds.), Tbilisi, 2012, 218-219 (in Georgian).

<sup>91</sup> *Kobakhidze I.*, *Critical Analysis of Notes to the Constitutional Changes*, Tbilisi, 2010, 8 (in Georgian).

<sup>92</sup> *Demetrashvili A.*, *Paradigms of Constitutionalism in Georgia*, "Constitutional Law Review", No. 3, 2011, 124 (in Georgian).

<sup>93</sup> *Kobakhidze I.*, *Critical Analysis of Notes to the Constitutional Changes*, Tbilisi, 2010, 8 (see: *Babeck W.*, *Third Part of Comments, on Review of the Constitution of Georgia and Activities of the Constitutional Commission of Georgia*, June 23, 2010).

<sup>94</sup> When using a constructive vote if Bundestag makes a proper decision, the president is obliged to dissolve the government; it is similar in case of substitution of the government (see: *Melkadze O., Ramishvili N.*, *Constitutional Law of Germany*, Tbilisi, 1999, 116 (in Georgian)).

<sup>95</sup> Final Opinion CDL-AD(2010)028 on the Draft Constitutional Law on Amendments and Changes to the Constitution of Georgia, Adopted by the Venice Commission at its 84th Plenary Session, Venice, 15-16 October, 2010, 12.

<sup>96</sup> *Ib.*

<sup>97</sup> Notes and proposals of the Georgian Young Lawyers' Association on the draft laws of the constitution "about changes and amendments to the Constitution of Georgia", Tbilisi, 2010, 17.

weakens the power of the parliament, but lessens a level of political responsibility of the prime minister which must be a basic of the new system".<sup>98</sup>

#### **IV. "Europeanizing" of a Constructive Vote of No-Confidence**

##### **1. Ways of Solving Problems**

The Georgian model of a constructive vote of no-confidence, stated by Article 81 of the Constitution of Georgia, is very far from the standards to which a modern democratic and civilized state must be striving. It is necessary to solve those systematical problems perverting the institute which has not been put in force yet.

1. It is necessary to reduce an obligatory number of initiators of the no-confidence procedure and to state no more than  $\frac{1}{4}$  of the full list instead of  $\frac{2}{5}$  of the parliamentarians in order to start the procedure really.

2. Intermediate voting for bringing up a question must be cancelled; the initiation of the question by an authorized person must mean automatically bringing up (starting) the procedure of no-confidence.

3. Nominating candidacy of a new prime minister can be done either by the initiators themselves or by a reasonable number of parliamentarians instead of  $\frac{2}{5}$  of the full list; a candidate for a prime minister must be thought to be already existed that must become additionally a positive or negative motivator of voting of no-confidence in the current government.<sup>99</sup> The parliament must vote for a new candidate for the prime minister, the appointment of which it must oblige the president.

4. The president must be excluded from the procedure of no-confidence and his authority must be only defined by an obligatory putting forward a candidate elected by the parliament. The president's hesitative veto must be abolished, accordingly there will not be needed a mechanism for overcoming it. In the procedure of no-confidence which is a parliamentary control mechanism it is not still clear the existence of the president in any form.

5. It is necessary to reduce the period of the procedure. The duration of the whole procedure must not exceed two weeks (this is also provided for by the system of political culture of Georgia and the experience of political parties).

6. One of retaining factors of the procedure risk is an obligatory period of time needed for the repeated initiation of the question;<sup>100</sup> though it is necessary to define precisely what period of time must be passed before arising no-confidence in the future and a circle of persons which will be restricted in using this right (raising a question).

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<sup>98</sup> *Kobakhidze I.*, Critical Analysis of Notes to the Constitutional Changes, Tbilisi, 2010, 9 (see: Final Opinion CDL-AD(2010)028 on the Draft Constitutional Law on Amendments and Changes to the Constitution of Georgia, Adopted by the Venice Commission at its 84th Plenary Session, Venice, 15-16 October, 2010, 12).

<sup>99</sup> Regulations of the German Bundestag points out that if  $\frac{1}{4}$  parliament members initiating no-confidence has not chosen a new candidate for the position of prime minister, the question will not be entered into agenda (will not be discussed). See: Art. 97(1) of the Rules of Procedure of the German Bundestag, 1980.

<sup>100</sup> *Tanchev E.*, Parliamentarism Rationalized, "East European Constitutional Review", Vol. 2, No. 1, 1993, 34.

## 2. Draft Article 81 of the Constitution of Georgia

Provided for by recommendations and proposals it is necessary to form Article 81 of the Constitution of Georgia in a flexible form, which will establish a right, acknowledged and experienced legal mechanism.

### "Article 81

1. *The parliament is authorized to vote of no-confidence in the government.*

2. *No less than ¼ of the list of the parliament members can raise a question of voting of no-confidence in the government.*

3. *No less than ¼ of the list of the parliament members are authorized to introduce a candidate for prime minister to the parliament within three days from starting the procedure. The candidacy will be considered to be elected, if he/she is still supported by the majority of the list of the parliamentarians. Voting takes place in no later than 6 days from starting the procedure.*

4. *The candidate elected by the parliament is appointed as a prime minister by the president of Georgia within 24 hours. As soon as a new prime minister is appointed, the authorization of the government is ceased. A new government will be staffed according to rules stated by paragraphs 3 and 4 of Article 80 of the Constitution of Georgia.*

5. *If the parliament could not manage to elect a candidate for prime minister, a question of no-confidence is banned to be raised within six months from the starting of the procedure."*

## V. Conclusion

In the states inclined to the parliamentary governance a basic political climate is created by their political parties; just the interrelations of their parliamentary forces determine the basic directions of the government's activities.<sup>101</sup> In the states of the parliamentary system (Georgia just aimed at approaching to them) there are established different mechanisms of parliamentary control over the responsibility of the government, the final purpose of which is to dissolve the government.<sup>102</sup>

One of the purposes of constitutionalism is to respond to the results accompanying the effects of democracy, hazards caused from them and to prevent the risks.<sup>103</sup> The constitution must envisage the possible future problems, political or legal crises, which must be solved fast, if it is impossible to avoid them.<sup>104</sup> The constitution must be efficient and legal mechanisms on its basis must be effective

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<sup>101</sup> *Kakhiani G.*, Consideration of Some Issues Connected with Constitutional Draft Law, Law Journal "Sarchevi" No. 1-2(3-4), 2012, 193 (in Georgian).

<sup>102</sup> *Verni D.V.*, Parliamentary Governance and Presidential Governance, Republic: Parliamentary or Presidential, *Melkadze O.* (Ed.), Tbilisi, 1996, 121 (in Georgian).

<sup>103</sup> *Khmaladze V., Demetrashvili A., Nalbandov Al., Ramishvili L., Usuphashvili D., Djibgashvili Z.*, State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 9 (in Georgian).

<sup>104</sup> *Schwartz H.*, Building Blocks for a Constitution, "Constitutional Law Review", No. 1, 2009, 7.

and useful, otherwise it will have a formal character, which will reduce an ideological, political-legal function of the basic law.

Several waves of constitutional reforms<sup>105</sup> introduced lots of novelties into the Georgian legal reality, though novelty does not always mean progress and evolution. A mechanism of a constructive vote of no-confidence, which is an effective way of overcoming and preventing of generally acknowledged political crises,<sup>106</sup> was also included into the constitution of Georgia. It was really a reasonable and justified step.<sup>107</sup> It's another matter that the above mentioned institute was worked out and introduced in quite a new manner, in Georgian interpretation.

Generally the right functioning of the government is connected with giving the government a vote of confidence-no-confidence by the parliament.<sup>108</sup> No-confidence is a strong instrument, carrying out a retaining-balancing principle in life. As a result of the constitutional reform of 2010, a state governance form of Georgia more or less changed and moved to the parliamentary inclined system.<sup>109</sup> In analogous systems a legislative power is emphasized, a parliament becomes a main state institute, equipped with strong means of supervision in the state; unfortunately the Georgian regulation of no-confidence, offered by Article 81 of the Constitution, does not only have any legal status of a strong parliament, but is sharply moving away from almost all the acknowledged principles of constitutionalism.

The Georgian model of a constructive vote of no-confidence differs from any other kinds of this mechanism.<sup>110</sup> The main essence of this type of no-confidence is departed: instead of a strong mechanism of the parliamentary control it is represented as a weak instrument of the parliamentary supervision, which might become a political way of influence on the parliament in itself because of the possibility of dissolving the parliament by the president. The procedure is complicated with additional voting, very high quorum and President's veto, unknown for the world practice so far, that cannot be justified. Nor a low culture of political parties, external ways of influence, or political climate will justify the usage of a hesitant veto by the president in a classical mechanism of the parliamentary

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<sup>105</sup> Constitutional Reforms of 1993-1995, 2004 and 2010.

<sup>106</sup> *Khmaladze V., Demetrashvili A., Nalbandov Al., Ramishvili L., Usuphashvili D., Djibgashvili Z.*, State Power of Georgia at the Central Level: Balance between its Branches Process of Constitutional-Political Reform in Georgia: Political Elite and Votes of People, Tbilisi, 2005, 29 (in Georgian).

<sup>107</sup> The Constitution of Georgia and Constitutional Reform of 2010, Tbilisi, 2010, 60 (in Georgian).

<sup>108</sup> *Lowson K.*, State Structure of Human Society, Republic: Parliamentary or Presidential, *Melkadze O.* (Ed.), Tbilisi, 1996, 150 (in Georgian).

<sup>109</sup> Though it is impossible to say definitely that there has been established half-parliamentary or half-presidential governance, it will be reasonable if without concretization we call the system which is to be put into force from the end of 2013, mixed. See: *Kakhiani G.*, Consideration of Some Issues Connected with Constitutional Draft Law, Law Journal "Sarchevi", No. 1-2(3-4), 2012, 193 (in Georgian); *Davituri G.*, Models of State Governance and Constitutional Reform of 2010 in Georgia, in: Modern Constitutional Law, Book I, *Kverenchkhiladze G., Gegenava D.* (Eds.), Tbilisi, 2012, 170-188 (in Georgian); Final Opinion CDL-AD(2010)028 on the Draft Constitutional Law on Amendments and Changes to the Constitution of Georgia, Adopted by the Venice Commission at its 84th Plenary Session, Venice, 15-16 October, 2010, 59.

<sup>110</sup> Article 67 of Basic Law of the Federal Republic of Germany, 1949; Article 94 of Constitution of the Italian Republic, 1947; Article 84 of Constitution of Greece, 1975; Article 21 of Fundamental Law of Hungary, 2011; Article 88 of Constitution of the Slovak Republic, 1992 and etc.

supervision. The president must be thought to be an arbitrator which will directly interfere in exclusive authorities of the legislative power that considerably violates constitutional principles of dissociation, retention and balance of powers.

The analysis of Article 81 of the Constitution of Georgia gives the ground to say that the mechanism included in the Constitution does not serve for increasing the parliament's authorities and the real dissociation of the power. There is arising an impression that the constitution is directed to the maximal solidity and "permanency" of the prime minister's position, which can't be placed in any legal frame. It is impossible not to agree with Babeck, who mentions that "the main object of the regulations of the constitution must not be the protection of a prime minister – their object must be the protection of G".<sup>111</sup>

A constructive vote of no-confidence provides stability of the government and defines stability of political-legal interrelations between the government and the parliament.<sup>112</sup> A strong parliamentary instrument, introduced for the aim of avoiding crises<sup>113</sup> (and this aim has not lost actuality and that's why it was provided for by the majority of the states of east and central Europe<sup>114</sup>), might become itself a main source of causing conflicts and political crisis with groundlessly long and complicated procedure, extremely active participation of the president and the possibility of dissolving the parliament, which completely lowers the real essence and object of this institute.

The Georgian model does not satisfy any of the principles of a constructive vote of no-confidence, conditioning the existence of this institute: there is no mechanism of the classical parliamentary control; fast substitution of the government cannot be managed, on the contrary, the procedure is very prolonged; it envisages the interference of a non-parliamentary institution, the president's discretion connected with the appointment of a prime minister; for starting the procedure a number of the obligatory initiators considerably exceeds the generally accepted standard (instead of 1/5 of the parliament members it is foreseen 2/5 of the full list of the parliament); the procedure provides for the additional voting for bringing up a question of no-confidence. As for the possibility of the substitution of the current government by a new one, it is only a formal sign and not a substantial argument, as its purpose in a classical constructive vote is filling up a vacuum between governments which can't be reached by the Georgian model. Hence it can be said that in the Constitution of Georgia there was not envisaged a constructive vote of no-confidence, the institute given in Article 81 represents a mechanism of no-confidence, but not a constructive vote of no-confidence. It is legal pathology unknown so far for the world constitutionalism, needing fast reaction. It is inadmissible to

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<sup>111</sup> Kobakhidze I., *Critical Analysis of Notes to the Constitutional Changes*, Tbilisi, 2010, 8 (see: Babeck W., *Third Part of Comments, on Review of the Constitution of Georgia and Activities of the Constitutional Commission of Georgia*, June 23, 2010).

<sup>112</sup> Sajo A., *Limiting Government, An Introduction to Constitutionalism* (translated into Georgian by Maisuradze M., under the editorship of Ninidze T.), Tbilisi, 2003, 225 (in Georgian).

<sup>113</sup> Steinack K., *The Impact of Multi-Party Government on Parliament-Executive Relations - Examples from Abroad*, Paper presented at the Australasian Study of Parliament Group, Annual Conference 2011, *The Executive versus the Parliament - Who Wins?*, Melbourne, Parliament House, 6-8 October, 2011, 3.

<sup>114</sup> Tanchev E., *Parliamentarism Rationalized*, "East European Constitutional Review", Vol. 2, No. 1, 1993, 33.

put this version of the Article into effect, as it contradicts the objects of the constitutional reform of 2010,<sup>115</sup> the main regulations of which was working out effective mechanisms of retention-balance.<sup>116</sup>

An obscure mechanism of no-confidence in government represented in Article 81 of the Constitution of Georgia is Gordian knot, opening of which is vitally important for stability and development of the state. Its existence in the basic law of the state in such form (there is no sense in talking about putting it into effect and considering the hardness of procedures its realization in practice is almost unimaginable) points to a very low level of legal and political culture.

In the work all the problematic questions have been emphasized and offered appropriate recommendations and concrete ways of solving the difficulties, draft Article 81. The problem must be solved in the very beginning before putting constitutional changes into force, otherwise as a tumor mass deposits damages the whole organism, so does at first sight the harmless and "theoretic" recording, damaging the constitution, as a high political-legal integrity, which being a basic ground of the political system of the state is a main guarantee of its justice and democracy.

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<sup>115</sup> Constitution of Georgia and the Constitutional Reform of 2010, Tbilisi, 2010.

<sup>116</sup> Order No. 348 of the President of Georgia "About Approving the Statute of the Constitutional Commission".



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