

DISCUSSION

CHALLENGES AND DEVELOPMENT OF INVESTMENT PROTECTION MECHANISMS IN GEORGIAN CORPORATE LAW: IS THERE A MIDDLE GROUND?

Davit Maisuradze,* Irakli Shakiashvili,** Irina Iamanidze***¹

Abstract: Georgia is a Civil Law country and a developing economy. German and other European scholars were actively helping Georgian government in forming the new legislation including in Corporate Law. After 2003, the principles of the common law were actively implemented in Georgian legislation, which diverted the focus of academia, practitioners and businesses to different and unconventional ways of investment protection that became increasingly popular.

The aim of the article is to discuss the challenges of the investment protection mechanisms of the Corporate Law in Georgia within the frames of influence of Common Law and Civil Law. The influence of both legal systems created the unique platform of research and debate. Authors of this article reviewed the relevant academic literature on investment protection mechanisms, but they were unable to find the combination of analysis on minimum capital requirement, piercing the corporate veil, pre-emptive rights and fiduciary duties. Simultaneously, no scholar has emphasized the role of piercing the corporate veil to balance the interests of the creditors during the absence of minimum capital requirement; secondly, pre-emptive rights are not widely considered as the alternative to Poison Pills and with this, the effect of pre-emptive rights as the instrument for antitakeover regulations is diminished. At the same time, the link between the pre-emptive rights and fiduciary duties is also very weak which reduces its antitakeover features and affects the investment protection mechanisms. Article aims to fill this gap.

Keywords: investment protection, minimum capital requirement, preemptive rights, piercing the corporate veil

INTRODUCTION

Market Economy is based on several fundamental aspects and protecting the investments is crucial aspect for ensuring its transparency and trustworthiness. Investment Protection is also vital for the development of financial markets. In countries where investment protection is better ensured, investors have more motivation to acquire voting stock or debt securities.² Attracting the investments is important not only for companies but also for a State in general. When the investor is lending money to the company or is

* Associate Professor, Dr. Davit Maisuradze, Ph.D., is the Head of the Project. He is the Associate Professor and Director of the Centre for Corporate and Commercial Law at the School of Law of LEPL Ilia State University, Tbilisi, Georgia

** Mgr. Irakli Shakiashvili is a Researcher at the LEPL Ilia State University, Tbilisi, Georgia

*** Mgr. Irina Iamanidze is a Researcher at the LEPL Ilia State University, Tbilisi, Georgia

¹ This work was supported by Shota Rustaveli National Science Foundation (SRNSF) [Grant Number: YS-2016-50; Project Title: Investment Protection Mechanisms according to Market Regulated Corporate Law].

² LA PORTA, R., LOPEZ-DE-SILANES, F., SHLEIFER, A., VISHNY, R. Investor Protection and Corporate Valuation. *The Journal of Finance*. 2002, Vol. LVII, No. 3, p. 1147.

buying the shares, such investor gets the rights of a creditor or a shareholder depending on the legal and economic status of the investment. These rights might include voting rights, preemptive rights, nominating and electing the directors, demanding compensation in case of company bankruptcy, etc. On the other hand, Corporation has obligations to the investors such as protecting their rights, ensuring transparency and accountability of the corporation and implementing fiduciary duties of directors to protect the rights of investors. Thus, protection of the shareholders and creditors rights depends on Corporate Law, Bankruptcy Law, Securities Exchange Regulation and other fields of law.³

For Georgia, which has developing economy and tries hard to attract investors to support market economy, it is of utmost importance to guarantee the stable legal conditions for shareholders and creditors. In this regard, as it was mentioned above, Corporate Law is playing an important role.

For the last 25 years Georgian Corporate Law went through dozens of changes and fell under influence of Civil Law and Common Law. The aim of the article is to discuss the challenges of the Corporate Law in Georgia with the connection to Civil Law and Common Law countries and legal systems. As it is acknowledged, Common Law is more loyal to the investors and their rights than the Civil Law.⁴ The research question of the article is to compare the influence of Civil Law and Common Law on the example of investment protection mechanisms of the Georgian Corporate Law, and based on the empirical evidence and international comparative analysis emphasize the better regulations that are most fit to the interests of the investors.

In order to locate our paper in scientific debate and research, we have reviewed the relevant literature and there are two important missing points: firstly, no scholar has emphasized the role of piercing the corporate veil to balance the interests of the creditors during the absence of minimum capital requirement; secondly, pre-emptive rights are not considered as the alternative to Poison Pills and with this, the effect of pre-emptive rights as the instrument for antitakeover regulations is diminished. At the same time, the link between the pre-emptive rights and fiduciary duties is also very weak which reduces its antitakeover features and affects the investment protection mechanisms.

Georgia traditionally was the part of Continental Legal System.⁵ At first, Law of Georgia “On Entrepreneurs”,⁶ which was elaborated with the help of German scholars, had strict regulations on establishing the companies. For example, in order to establish the Company (Limited Liability Company, Joint Stock Company and Co-operative Society) it was necessary to have minimum capital requirement. Minimum Capital Requirement was considered as chief financial source for ensuring the future requirements of the creditors.

³ LA PORTA, R., LOPEZ-DE-SILANES, E., SHLEIFER, A., VISHNY, R. Investor Protection and Corporate Governance. *Journal of Financial Economics*. 2000, Vol. 58, No. 1–2, pp. 4–7.

⁴ LA PORTA, R., LOPEZ-DE-SILANES, E., SHLEIFER, A., VISHNY, R. *Investor Protection and Corporate Governance*. pp. 8–9.

⁵ CHANTURIA, L., NINIDZE, T. *The Comments on the Law of Georgia “On Entrepreneurs”*. 3rd revised edition. Tbilisi: Samartali Publishers, 2002, pp. VI–XII.

⁶ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087.

In 2008, the Law of Georgia “On Entrepreneurs” was fundamentally amended, particularly, various formal requirements were abolished, including the minimum capital requirement; thus, establishment of the companies became simpler and more affordable. The aim of the amendments was to promote local and foreign investments in Georgia. After these amendments, Georgia took superior positions in the ranking of DoingBusiness as one of the leaders in the easiness of starting the business.⁷ Theoretically, it is acknowledged that companies need statutory capital in order to ensure their responsibilities before the creditors, however, the amendments enacted in Georgian legislation enabled creation of commercial entities without minimum capital requirement.⁸ With this reform, Georgia separated itself from the traditional approaches of the Civil Law⁹ and became closer to Anglo-American Legal System where minimum statutory capital is randomly required.¹⁰

On July 1, 2016, EU/Georgia Association Agreement entered into force which includes the approximation process of Georgian legislation to European. For instance, the new draft law “On Entrepreneurs” is already elaborated which considers EU requirements as well, including the minimum capital requirement.¹¹ Particularly, for establishing the Joint Stock Company minimum capital requirement will be 25000 EUR equivalent to GEL.¹²

Apart from the minimum capital requirement that can be the source to satisfy financial requirements of the creditors, piercing the corporate veil is another important legislative mechanism in Georgian Corporate Law for protecting the rights of creditors with satisfying their requirements based on the personal property of the shareholders.¹³ Piercing the Corporate Veil is important both from the perspectives of the partner of the company and the creditor. On the one hand, partners/investors want to use the legal form of company as a way to protect their individual property from the demands of the creditors/investors, on the other hand, based on the certain grounds, creditors/investors want to satisfy their financial requirements with the use of the individual property of the partners/investors.

Finally, Article will analyze the influence of European and Anglo-American Legal Systems on two more mechanisms of investment protection: pre-emptive rights and fiduciary duties. Pre-emptive rights will be discussed as a right of the shareholder to secure the ownership of certain percentage of shares in the company. Regarding the fiduciary duties, they are important bases for protecting interests of the investors.¹⁴

⁷ THE WORLD BANK. Doing Business. In: *The World Bank* [online]. [2019-10-15]. Available at: <<http://www.doingbusiness.org/data/exploreeconomies/georgia>>.

⁸ BURDULI, I., *Foundations of the Corporate Law I*. Tbilisi: Meridiani Publishers, 2010, pp. 142–144.

⁹ Department of Trade and Industry by the Centre for Law and Business, Faculty of Law, University of Manchester. *Company Law in Europe: Recent Developments*, 1999, p. 5.

¹⁰ BURDULI, I. *Foundations of the Corporate Law I*. pp. 142–144.

¹¹ Directive 2017/1132/EU of the European Parliament and of the Council of 14 June 2017 on relating to certain aspects of company law (codification); Official Journal of the European Union L 169, 30.06.2017, pp. 46–127 (hereafter – Company Law Directive).

¹² Draft Law of Georgia On Entrepreneurs of the Parliament of Georgia, Article 161. In: *Google* [online]. 2018 [2018-07-30]. Available at: <https://drive.google.com/drive/folders/17JUL5iYPaA0AKMQJKd_Bl0VP94JAEIEY>. This draft law was elaborated as the part of the EU-Georgia Association Agreement and is not initiated in the Parliament of Georgia yet (hereafter – Draft Law).

¹³ O’KELLEY, R. T. C., THOMPSON, B. R., *Corporations and other Business Associations*. 5th rev. ed. New York: Aspen Publishers, 2006, pp. 541–542.

¹⁴ OESTERLE, D. A., CHAIR, R. G. J., MORTIZ, E. M., *The Law of Mergers and Acquisitions*. 3rd rev. ed. St. Paul: Thomson/West, 2005, pp. 558–561.

Another significant point of the article is presenting the development of investment protection mechanisms whilst being under joint influence of Civil Law and Common Law. This approach will be interesting to faculty and practitioners alike.

Authors actively used the method of comparative and descriptive analysis; formed a hypothesis and put a research question. First section of the article is the introduction which is followed by the analysis of Statutory Capital and Piercing the Corporate Veil. During the analysis of Statutory Capital empirical evidence is used from Georgia. Fourth section describes the Preemptive rights, grounds for its implementation and its connection with Poison Pills. Fiduciary Duties are analyzed in relation to Preemptive Rights. Last part of the article assesses the results of the research and discussion and concludes the findings.

IS MINIMUM CAPITAL REQUIREMENT REALLY NECESSARY?

After 2003, Georgian law “On Entrepreneurs” went through the changes that shifted it from the influence of Civil Law to Common Law. Major amendments to the Law of Georgia “On Entrepreneurs” that ensured even more deregulation were implemented on March 14, 2008. It should be highlighted that these amendments annulled requirements for minimum capital requirement which served as a registration requirement for a company and a guarantee for satisfying the creditors’ financial requirements.¹⁵ Therefore, it became possible to establish a company without minimum capital requirement that was a novation at that time.

At first minimum capital requirement in Law of Georgia “On Entrepreneurs” for Limited Liability Company was 1000 USD equivalent to GEL,¹⁶ then the law was amended, and the minimum capital requirement was stipulated as 2000 GEL,¹⁷ after that it was reduced to 200 GEL¹⁸ and then abolished. In case of Joint Stock Company, the minimum capital requirement was 10000 USD in GEL,¹⁹ then the amount was changed, and the minimum capital requirement was 15000 GEL.²⁰ Later, in 2008, the minimum capital requirement was abolished.

Abolishment of the minimum capital requirement together with other steps of liberalization made Georgia’s progress in Doing Business highly remarkable which in the end supported further growth of investments. In 2004 9 procedures were necessary to start a business in Georgia.²¹ In 2006–2007 Georgia was among 10 most reformer countries and

¹⁵ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087. 14/03/2008 edition.

¹⁶ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 45, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087. 28/10/1994 edition.

¹⁷ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 45, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087. 13/12/1996 edition.

¹⁸ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 45, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087. 24/06/2005 edition.

¹⁹ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 51, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087. 28/10/1994 edition.

²⁰ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 51, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087. 13/12/1996 edition.

²¹ WORLD BANK, THE INTERNATIONAL FINANCE CORPORATION and OXFORD UNIVERSITY PRESS. Doing Business in 2004 – Understanding Regulation. In: *The World Bank* [online]. 2004 [2018-07-20]. Available at: <<http://www.doingbusiness.org/~media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB04-FullReport.pdf>>.

in 2008 was on the 18th place in DoingBusiness.²² In 2010 Georgia was on 11th place and there were only 3 procedures necessary for starting the business.²³ According to the last ranking of the DoingBusiness Georgia is on the 9th place, and just 2 procedures are required to start a business.²⁴

The information was retrieved by the authors from the LEPL National Public Registry of the Ministry of Justice of Georgia regarding the number of registered companies. According to the September 14, 2017 #380073 letter from the LEPL National Public Registry – 70104 legal entities (not including the sole proprietorships) were registered from October 28, 1994 (the date of adoption of the Law of Georgia “On Entrepreneurs”) to May 10, 2008 (the date when the “March 14, 2008 reform” entered into force). From this amount, number of Limited Liability Companies equaled 63590 entities. Number of Joint Stock Companies equaled 2283. From May 10, 2008 till July 31, 2017 – 146430 commercial entities were registered (not including the sole proprietorships). From this number, 143395 were Limited Liability Companies. Number of Joint Stock Companies equaled 565. Until the year of 2008, approximately 4542 Limited Liability Companies were being registered annually, after 2008 (when the requirement for minimum capital requirement was abolished and the registration of the companies became simpler) approximately 14339 Limited Liability Companies were being registered annually. Undoubtedly, it is impossible to say that this increase in number of registrations was caused particularly by the abolishment of the minimum capital requirement, however, amendments to the Law of Georgia “On Entrepreneurs” also supported this increase. Regarding JSCs it should be highlighted that most of the corporations (1948 JSCs) were established from 1995 to 2000. This was caused by privatization of the former state companies that were inherited from Soviet Union.

Therefore, from the abovementioned evidence, authors claim that minimum capital requirement is not a necessity for supporting the establishment of companies. Companies can generate property and capital in free competition, and the creditor may choose the company which has more property, better reputation and/or more business contacts to start a business relationship with. In this case, minimum capital requirement will not ensure the success of the agreement or trustworthiness of the creditor. If the amount of minimum capital requirement will be high, it would probably adversely affect the number of newly registered companies, and if such amount is very small, then cannot be the way to insure the interests of the creditors.

²² WORLD BANK AND THE INTERNATIONAL FINANCE CORPORATION. Doing Business 2008. In: *The World Bank* [online]. 2007 [2018-07-20]. Available at: <<http://www.doingbusiness.org/-/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB08-FullReport.pdf>>.

²³ WORLD BANK, THE INTERNATIONAL FINANCE CORPORATION AND PALGRAVE MACMILLAN. Doing Business 2010. In: *The World Bank* [online]. 2009 [2018-07-21]. Available at: <<http://www.doingbusiness.org/-/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB10-FullReport.pdf>>.

²⁴ INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT AND THE WORLD BANK. Doing Business 2018. In: *The World Bank* [online]. 2018 [2018-08-15]. Available at: <<http://www.doingbusiness.org/-/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB2018-Full-Report.pdf>>.

Even among German Scholars, minimum capital requirement is increasingly regarded as a financial mechanism which is not consistent with the real protection of creditors. “First, if the required amount is too high, even economically beneficial projects will be deterred, whereas if the amount is too low, the requirement does not perform any screening function since practically anybody will have access to the funds necessary. Second, a uniform minimum capital requirement lacks any economic rationale since, for a given amount of working capital companies operating in different lines of businesses will not exhibit a uniform probability of insolvency. Third, regardless of the amount chosen, a minimum capital requirement will not prevent a company from becoming insolvent as a result of ongoing poor management or ongoing poor business conditions”.²⁵

Future development for the minimum capital requirement can be seen via the Draft Law of Georgia “On Entrepreneurs” which envisages the minimum capital requirement of 25000 EUR equivalent to GEL for JSCs.²⁶ According to the draft law there is no minimum capital requirement for Limited Liability Companies. Therefore, if JSC cannot satisfy the requirement of minimum capital requirement, it can reorganize as Limited Liability Company. This on the one hand will satisfy the requirements of EU and will also preserve the business relations on market because number of Limited Liability Companies are almost 50 times more than of JSCs. It should also be highlighted that according to the EU Directives,²⁷ the Draft Law of Georgia “On Entrepreneurs” enables partners to provide their investments in capital within 5 years of company registration.²⁸

2. CAN PIERCING THE CORPORATE VEIL BALANCE THE INTERESTS OF THE INVESTORS?

Personal liability of partners of companies is limited before third parties. When the investor becomes partner of the company, he/she obtains the immunity against creditors because investor’s personal property is safe from the creditor’s reach.²⁹ Though there is a limited liability, Corporate Law still knows cases of personal liability with overcoming the limited liability form. Therefore, it is possible that the creditors satisfy their requirements with the partners’ personal property which is called as Piercing the Corporate Veil.³⁰

Piercing the Corporate Veil was used by *Maurice Vormser* in his article “Piercing the Veil of Corporate Entity”, 1912. According to *Vormser* the legal form of corporate entity is meant to reveal those who violate corporate legislation and abuse company’s business conduct with achieving monopoly or hiding the crime. In this case, court will determine such company as the association of shareholders (men and women) and will find justice among them.³¹

²⁵ MULLBERT, O. P. A Synthetic View of Different Concepts of Creditor Protection – or: A High Level Framework for Corporate Creditor Protection. *ECGI Working Paper Series in Law*. 2006, Working Paper No. 60/2006, p. 29, [2018-10-08]. Available at: <<https://ssrn.com/abstract=883625>>.

²⁶ Draft Law, Article 161.

²⁷ Company Law Directive, Article 48, p. 71.

²⁸ Draft Law, Article 158.

²⁹ COX D. J., HAZEN L. T., *Business Organizations Law*. 4th rev. ed.: West Academic Publishing, 2016, p. 33.

³⁰ COX D. J., HAZEN L. T., *Business Organizations Law*. pp. 135–137.

³¹ VORMSER I. M., Piercing the Corporate Veil of Corporate Entity. *Columbia Law Review*. 1912, Vol. 12, No. 6, pp. 496–518.

In earlier cases, it was necessary to establish fraud for piercing the corporate veil.³² Although, later, theories of Instrumentality and Alter Ego were developed which shifted the involvement of Piercing the Corporate Veil on triangular relationship involving corporation, shareholder and creditor. It should be noted that both these theories are based on three main factors: 1) Corporation does not possess any features of independence and is the instrument of shareholders; 2) Corporation should be used for fraud or for unjust purposes by the shareholders; 3) The damage to the creditor should be caused by the conduct of shareholder.³³ Thus, though both of these theories exist separately they are replaceable and can be often used by courts as alternatives to each other.³⁴

Another ground for using the Piercing of the Corporate Veil is undercapitalization. When the company is involved in business dealings, but the amount of its capital is not enough to ensure the risks of the agreement, the creditors for the company can sue the partners and demand personal liability for compensating the damages.

The absence of minimum capital requirement though good for company registrations can be considered as undercapitalization, therefore, creditors can sue damages and personal liability of the company partners if there is an inadequate level of assets.³⁵ Thus, this investment protection mechanism can balance the absence of minimum capital requirement.

In Georgian Corporate Law, before amendments, the partners were individually liable before creditors if they were not properly keeping the books of the organization and, therefore, it was difficult to differ the personal property and/or liabilities from the property and/or liabilities of the organization.³⁶ According to the current regulation, the grounds for Piercing the Corporate Veil are not specific and partners are personally liable if they abuse the limited liability form.³⁷

In 2015 First two decisions (LEPL Revenue Service against LLC “L. 2009”³⁸ and LEPL Revenue Service against M. and G. Ks³⁹) on the Piercing the Corporate Veil were adopted by the Supreme Court of Georgia in 2015. In both cases, the Supreme Court of Georgia was discussing the grounds for personal liability for the company director and partners if the company was not able to pay the taxes. In both circumstances’ defendants lost the cases. In these cases, defendant companies didn’t have enough capital, therefore, Supreme Court discussed undercapitalization as one of the forms of seeking the personal liability and satisfying the requirements of the creditors.

³² *Booth v. Bunce* [NY], no. 33/139, §160, 1 June 1865.

³³ BAINBRIDGE M. S., *Corporate Law*. 2nd rev. ed. Thomson Reuters/Foundation Press, 2009, pp. 53–54.

³⁴ COX D. J., HAZEN L. T., *Business Organizations Law*. pp. 135–140.

³⁵ GELB, H. Piercing the Corporate Veil – The Undercapitalization Factor. *Chicago-Kent Law Review*. 1982, Vol. 59, No. 1, pp. 1–22.

³⁶ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 3, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087. 11/07/2007 edition.

³⁷ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 3, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087.

³⁸ *LEPL Revenue Service v. LLC “L. 2009”* no. 1307/1245/2014, Supreme Court of Georgia, 2015.

³⁹ *LEPL Revenue Service v. M. and G. Ks* no. 1158/1104/2014, Supreme Court of Georgia, 2015.

After these decisions many Georgian scholars and practitioners argued that it would adversely affect the new investments in Georgia because investors would be more cautious in establishing new businesses as their personal property would not be safe from the creditors' requirements. Though, others justified these decisions because it can be only used on extraordinary basis and with meeting certain conditions.⁴⁰

Draft Law of Georgia "On Entrepreneurs", Article 27.2 envisages that "partners of insolvent Comandit Companies, Limited Liability Companies, Joint Stock Companies and Cooperatives are personally liable if they abuse limited liability form and their liability is necessary for satisfying the requirements of the creditors".⁴¹

Therefore, the responsibility for Piercing the Corporate Veil will be still broad in the future but the insolvency will be its new component. Thus, undercapitalization can be also illustrated as part of insolvency.

PRE-EMPTIVE RIGHTS AS THE WAY FOR PROTECTING INVESTMENTS⁴²

Pre-emptive rights are one of the crucial legal institutes for investors. Different jurisdictions and legislations regulate Preemption Rights differently. In the USA, particularly, in Delaware General Corporation Law and in MBCA pre-emptive rights are not absolute and they can be regulated by Bylaws and/or Articles of Incorporation and managed by the Management Bodies of the company. European countries have more strict regulations towards preemption rights but this right can be withdrawn by the General Meeting of Shareholders.⁴³

The regulations of Preemption Rights should balance the optimal financial structure and the rights of the shareholders in the corporation.⁴⁴ To achieve this balance, three principles should be considered: rules which share the issuing function of new shares between the directors and the shareholders should exist; preemption rights should be envisaged when the new shares are sold; and directors should have fiduciary duties when the new shares are sold.⁴⁵

Subscription rights are one of the major property rights of the partners and shareholders together with participation in the liquidation of the company, receiving the dividend, and the compensation during the squeeze out.⁴⁶ Therefore, it is important to discuss pre-emptive rights as the way for protection of the investors.

⁴⁰ NARMANIA, G. Georgian Supreme Court Redefines Personal Liability of Shareholders and Directors. *European Company and Financial Law Review*. 2016, Vol. 13, No. 2, pp. 453–466.

⁴¹ Draft Law, Article 27.

⁴² Also referred as preemption rights or subscription rights.

⁴³ AWWAD, A. A. Shareholders Preemptive Rights in Listed and Closely-Held Corporations and Shareholders' Protection Methods. In: *SSRN* [online]. 21. 3. 2017 [2018-05-10]. Available at: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2739375>.

⁴⁴ VENTORUZZO, M. Issuing New Shares and Preemptive Rights: A Comparative Analysis. *Richmond Journal of Global Law and Business*. 2013, Vol. 12, No. 4, pp. 517–518.

⁴⁵ *Ibid.*

⁴⁶ BURDULI, I., *Foundations of the Corporate Law II*. pp. 247–258.

In the USA management bodies have broad discretion during the issuance of new shares and the shareholders are protected with the fiduciary duties of the Board. According to the Delaware General Corporation Law shareholders do not have pre-emptive rights unless it is directly stipulated by the articles of incorporation.⁴⁷ This rule was added to the DGCL in 1967.⁴⁸ DGCL unlike MBCA does not consider pre-emptive rights under the authority of Board. However, DGCL stipulates broad rights of the Board to protect the best interests of shareholders. In other States the basic principles of pre-emptive rights follow the DGCL and MBCA. Several States have different approach where pre-emptive rights are guaranteed unless they are restricted by the bylaws.⁴⁹ For protecting the best interests of shareholders Directors can execute various defensive mechanisms which in this sense are close to preemptive rights. For example, in Georgian corporate law the typical parallel for Flip-in Poison Pills would be pre-emptive rights which is discussed in more details below.⁵⁰

In Europe, shareholders are protected with the legislative regulations which mandate the pre-emptive rights. Shareholders can withdraw the pre-emptive rights but only in limited circumstances.⁵¹ In different jurisdictions shareholders are protected differently. This, of course, is envisaged by the economic and legal features of the specific country.

According to the Law of Georgia “On Entrepreneurs” if Joint Stock Company issues new stock, shareholders have the right to acquire such stock in proportion to the percentage of their current shares. Partial or full withdrawal of pre-emptive rights is possible by the decision supported by more than 75% of the voting shares of the shareholders that are present at the General Meeting.

Management (Directors or the Supervisory Board) of the Corporation should present their written statement on withdrawal of the preemption rights before the General Meeting where the necessity of the abolishment should be stated.⁵² In the last paragraph of the Article 54.6. of the Law of Georgia “On Entrepreneurs”, it is indicated that the rights of the General Meeting can be shifted to other management bodies (Directors or the Supervisory Body) of the corporation.⁵³ From this context it can be concluded that the partial or full withdrawal of preemptive rights can be also transferred to the Directors or to the Supervisory Board, thus, from this point of view, Law of Georgia “On Entrepreneurs” shares the views of the American Corporate Law and the protection of the rights of shareholders (investors) is mostly based on fiduciary duties of Directors.⁵⁴

⁴⁷ State of Delaware Statutory Code of the Legislative Council and General Assembly of the State of Delaware on Corporations; Article 102(b)(3), 28/01/2019, p. 5. In: *Delaware Code Online* [online]. 28. 1. 2019 [2019-10-15]. Available at: <<http://delcode.delaware.gov/title8/title8.pdf>>.

⁴⁸ CAHN, A., DONALD C. D. *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA*. Cambridge University Press, 2010, p. 206.

⁴⁹ VENTORUZZO, M. *Issuing New Shares and Preemptive Rights: A Comparative Analysis*. p. 521.

⁵⁰ MAISURADZE, D. *The Implementation of Defensive Measures During the Reorganization of Capital Entity*. Tbilisi: Meridiani, 2015.

⁵¹ VENTORUZZO, M. *Issuing New Shares and Preemptive Rights: A Comparative Analysis*. p. 518.

⁵² Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 53, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087.

⁵³ *Ibid.*, Article 54.

⁵⁴ MORAWETZ, V. The Preemptive Rights of Shareholders. *Harvard Law Review*. 1928, Vol. 42, No. 2, pp. 186–197.

According to the German Stock Corporation Act (Aktengesetz) shareholders have two weeks for implementing pre-emptive rights when the corporation is issuing new shares for monetary or non-monetary capital investments.⁵⁵ Preemption rights can be partially or fully withdrawn during the issuance of the new shares. This decision on abolishment of preemptive rights should be preceded by the recommendation of the management body where the reasons and necessity for such withdrawal should be indicated.⁵⁶ German court practice obligates management to prove the priority of interests of the corporation to the interests of shareholders.⁵⁷

In France, pre-emptive rights are obligatory but it may be abolished by the General Meeting of shareholders. In the decision of the General Meeting, the specific individuals who will receive the new shares, should be indicated. These indications regarding beneficiaries do not refer to corporations which are trading their stock at Stock Exchange Markets. At the same time, in Public Corporations, General Meeting of shareholders could decide the duration when the shareholders have the right to use pre-emptive rights.⁵⁸

UK, though is not the part of Continental Legal System, still regulates preemptive rights more alike the EU countries. In UK, shareholders have the preemptive rights when the new shares are issued instead of monetary capital investments. According to the UK model, preemptive rights cover both closely and publicly held corporations.⁵⁹

In Spain, when the corporation issues new shares, the shareholders have pre-emptive rights. These rights were covering the owners of bonds as well, however, the CJEU case of 2008 (Commission v Kingdom of Spain⁶⁰) abolished this right of bondholders. The preemptive rights of shareholders can be abolished by the General Meeting, and the directors should present the purposes for such abolishment and the list of investors which they are backing with the pre-emptive rights.⁶¹ In these regards, the common features of the French and Spanish corporate laws are worth highlighting because in both jurisdictions, management has the obligation to present the list of beneficiaries who receive the shares.

The article 29 of EU Directive 77/91/EEC⁶² (thereafter – second directive) regulates the pre-emptive rights. According to the Article 29.1 of the second directive, when the capital

⁵⁵ Stock Corporation Act of 6 September 1965; Federal Law Gazette I, 17/07/2017 edition. In: *Bundesministerium der Justiz und für Verbraucherschutz* [online]. [2018-09-10], Available at: <https://www.gesetze-im-internet.de/englisch_aktg/englisch_aktg.html#p0981>. Article 186.1, p. 2446.

⁵⁶ Ibid. Article 186.3, Article 186.4.

⁵⁷ CAHN, A., DONALD C. D. *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA*. pp. 201–202. See also VENTORUZZO, M. *Issuing New Shares and Preemptive Rights: A Comparative Analysis*. pp. 536–537.

⁵⁸ VENTORUZZO, M. *Issuing New Shares and Preemptive Rights: A Comparative Analysis*. p. 538.

⁵⁹ CAHN, A., DONALD C. D. *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA*. p. 203.

⁶⁰ CJEU, Commission v. Kingdom of Spain [2008] Case C-338/06, ECLI:EU:C:2008:740.

⁶¹ VENTORUZZO, Marco. *Issuing New Shares and Preemptive Rights: A Comparative Analysis*. p. 539.

⁶² Directive 77/91/EEC of the Council of the European Communities of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent; Official Journal of the European Communities L26, 10/11/2017, pp. 1–13, (hereafter - Second Council Directive).

of the company is rising with the use of monetary investments, shares should be proposed to the shareholders in proportion to the percentage they are holding.⁶³ Article 29.4 sets forth that pre-emptive rights should not be restricted with the legal acts or incorporation documents; pre-emptive rights can only be withdrawn on General Meeting where the management should demonstrate the reasons for abolishment of pre-emptive rights.⁶⁴

Directive 2017/1132 is also important because it consolidated other directives including the abovementioned second directive. Article 72.1 of the 2017/1132 Directive⁶⁵ is regulating pre-emptive rights during the increase of capital by consideration in cash. According to the article 72, when the capital is increased by consideration in cash, the shares should be offered by pre-emptive basis to shareholders in proportion to the capital represented by their shares.⁶⁶

According to the Article 72.4 of the Directive, pre-emptive rights should not be restricted with the bylaws and the articles of incorporation. Pre-emptive rights can be withdrawn only by the decision of the General Meeting where the Management Bodies are obliged to present the written statement where the withdrawal of the pre-emptive rights will be explained in details and the proposed price will be justified.⁶⁷

THE FUTURE OF PRE-EMPTIVE RIGHTS AS ANTITAKEOVER MECHANISM

Pre-emptive rights are often seen as a method for protecting the interests of the corporation as the form of antitakeover mechanism. As Poison Pills is the USA creation, scholars were trying to identify the method which might have the same usage as Poison Pills. Pre-emptive rights was considered as such method.

It should be mentioned that Georgian legal doctrine analyzes pre-emptive rights of shareholders as a way for using the Flip-in Poison Pills⁶⁸ in Georgian practice.⁶⁹ According to the current legislation it is possible to transfer the withdrawal of pre-emptive rights to the management, therefore, it is also possible that after such transfer management will withdraw the pre-emptive rights partially or fully. Thus, in practice this tactic can have the same purpose as the Poison Pills. For example, during the hostile takeover Board of Directors can issue new shares and partially withdraw the pre-emptive rights for the raiders who at that time might be owners of shares of target company, thus, effectively diminishing the percentage of ownership of the hostile company in the target.

In one of the cases, Supreme Court of Georgia stated that Preemptive Rights are mechanism for defending the interests of the company to avoid selling shares to the

⁶³ Second Council Directive, Article 29, pp. 9–10.

⁶⁴ *Ibid.*

⁶⁵ Company Law Directive, Article 72, pp. 81–82.

⁶⁶ *Ibid.*

⁶⁷ *Ibid.*

⁶⁸ O'KELLEY, R.T. C., THOMPSON, B. R., *Corporations and other Business Associations*. 5th rev. ed. New York: Aspen Publishers, 2006, p. 779.

⁶⁹ MAISURADZE, D. *The Implementation of Defensive Measures During the Reorganization of Capital Entity*. pp. 215–245.

undesirable party.⁷⁰ According to the Law of Georgia “On Entrepreneurs” pre-emptive rights are guaranteed by the law, but they can be withdrawn. Withdrawal of pre-emptive rights is granted to the General Meeting of Shareholders while at the same time it is possible to transfer these rights to Directors and Supervisory Board.⁷¹

Article 174.2 of Draft Law “On Entrepreneurs” stipulates the pre-emptive rights regarding the JSCs where the pre-emptive rights can be withdrawn by the consent of majority of voting stock participating in the General Meeting of Shareholders. In this case, the quorum should consist with no less than 2/3 of shareholders owning the voting stock. This decision should be adopted only by written report of the Board of Directors where the grounds for withdrawal should be clarified and the value of shares demonstrated.⁷²

As it was mentioned above, draft law, unlike the current law “On Entrepreneurs”, does not stipulate the right to transfer the withdrawal of pre-emptive rights to the management bodies. Further, there is no relevant court practice on withdrawal of pre-emptive rights in JSCs, therefore, the Georgian legal doctrine can be used for providing the evidence for withdrawing the pre-emptive rights.⁷³ Georgian legal doctrine establishes almost the same two standard rule for justification of withdrawal of pre-emptive rights as it is set by *Unocal*.⁷⁴

After enacting the draft law “On Entrepreneurs” it will be impossible to implement withdrawal of pre-emptive rights for the purposes of Flip-in Poison Pills. For the Georgian purposes withdrawal of pre-emptive rights will not be the effective anti-takeover mechanism because its adoption will be dependent on the General Meeting of Shareholders without the possibility to delegate this function solely on the Board of Directors.⁷⁵

Pre-emptive rights will have crucial importance during the hostile takeover when the Board has to act without violation of fiduciary duties and protect the best interests of the Corporation which might mean defending the corporation or selling it at the best price. On these occasions opinions of the management and shareholders often differ.⁷⁶ Who should be responsible for executing Pre-emptive rights as corporate defensive measures and make decision whether the corporation should defend itself and make withdrawal of pre-emptive rights for certain shareholders?

⁷⁰ *T. K. v. LLC “B.” LLC “S.” LLC “M. 5” & Others* No. 1344/1362/2011, Supreme Court of Georgia, 2011.

⁷¹ Law of Georgia On Entrepreneurs of the Parliament of Georgia; Article 54, Legislative Herald of Georgia 577, 28/10/1994, Registration Code 240.000.000.05.001.000.087.

⁷² Draft Law, Article 174.

⁷³ CHANTURIA, L., NINIDZE, T. *The Comments on the Law of Georgia “On Entrepreneurs”*. p. 376. BURDULI, I., *Foundations of the Corporate Law II*. pp. 254–255.

⁷⁴ *Unocal Corp. v. Mesa Petroleum Co.* Delaware Supreme Court, 1985, 493 A.2d 946.

⁷⁵ GORDON, J. N. An American Perspective on the New German Anti-takeover Law. Columbia Law and Economics Working Paper No. 209. In: SSRN [online]. 7. 10. 2002 [2018-05-18]. Available at: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=336420>.

⁷⁶ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* Delaware Supreme Court, 1986, 506 A.2d 173. *Unocal Corp. v. Mesa Petroleum Co.* Delaware Supreme Court, 1985, 493 A.2d 946. BEBCHUK, A. L., *The Case Against Board Veto in Corporate Takeover*. In: Thomas W. Joo (ed.). *Corporate Governance, Law, Theory and Policy*. 2nd rev. ed. Carolina Academic Press, 2010, pp. 554–573.

As it is widely known, DGCL gives vast authority to Directors.⁷⁷ This includes implementation of corporate defensive measures despite the will of shareholders.⁷⁸

It is acknowledged that without referring to the particular exceptions, shareholders are vulnerable group who do not know the situation at financial markets, are not aware which decision they should support at General Meetings, etc.⁷⁹ Accordingly, management should recommend them the advantages and disadvantages of each decision. Shareholders have the right to follow or to reject the advice of the Directors. During the hostile bids, management of the target company should provide evidence-based statement on the upcoming decision to shareholders. Same statement should be provided by management when they are addressing shareholders on withdrawal of pre-emptive rights.

On the other hand, shareholders can impeach directors, withdraw corporate defensive measures and sell the corporation anyways.⁸⁰

The most interesting case is when shareholders want to sell the corporation but Directors plan to implement defensive measures. What should Directors do? Continue protection of corporation or follow the will of shareholders and sell it?

Practitioners and scholars have various opinions on this issue. Some think that with implementing defensive measures corporation makes its acquisition more difficult, and, therefore, obliges buyer to pay more.⁸¹ Others consider that assuming various financial factors, the money offered at the preliminary stage of acquisition is usually more than the amount reached after the negotiations.⁸²

Although, when it is obvious for a management that the Corporation will be sold then management should try to sell the corporation at the highest possible price. This principle, established as *Revlon Rule* probably is the best way to protect investments based on the fiduciary duties.⁸³

CONCLUSION

For developing countries legal environment is crucial for further improvement of economic conditions. Legal acts are often amended the way to attract more investments, and investors need certain assurances to protect their businesses. Corporate Law plays a crucial role in this regard.

⁷⁷ State of Delaware Statutory Code of the Legislative Council and General Assembly of the State of Delaware on Corporations; Article 144, 28/01/2019, p. 21.

⁷⁸ BAINBRIDGE, M. S. Unocal at 20: Director Primacy in Corporate Takeovers. *Delaware Journal of Corporate Law*. 2012, Vol. 31, No. 3, pp. 769–862. *Air Products and Chemicals, Inc. v. Airgas, Inc.* 2011 WL 806417 (Del. Ch. 2011).

⁷⁹ OESTERLE, A. D. The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court. *Cornell Law Review*. 1986, Vol. 72, No. 1, pp. 117–157.

⁸⁰ GILSON, R. J., Unocal Fifteen Years Later (And What Can We Do About It). In: Thomas W. Joo (ed.). *Corporate Governance, Law, Theory and Policy*. 2nd rev. ed.: Carolina Academic Press, [2010], pp. 544–554.

⁸¹ LIPTON, M. Pills, Polls, and Professors Redux. In: Thomas W. Joo (ed.). *Corporate Governance, Law, Theory and Policy*. 2nd revised edition: Carolina Academic Press, [2010], p. 580.

⁸² BEBCHUK, A. L. *The Case Against Board Veto in Corporate Takeover*. p. 572.

⁸³ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* Delaware Supreme Court, 1986, 506 A.2d 173.

Corporate Law of Georgia is under dual influence of Anglo-American and Continental Legal Systems. Therefore, despite the historical preferences, it is important to select the best approaches to achieve better results.

From what we have discussed above, the following can be concluded:

Minimum capital requirement should not be obligatory for all companies, and the decision implemented in draft law of Georgia “On Entrepreneurs” to establish it only for JSCs is the best solution both for the approximation purposes to EU Directives and for reduction of requirement for starting the new businesses. Investors will themselves choose which are more reliable companies.

Absence of minimum capital requirement will be also compensated by Piercing the Corporate Veil. Though, it makes partners individually liable, if executed only on certain grounds - it will affect the investors less and will support them in protecting their interests more.

Pre-emptive rights are probably the most important mechanism for securing the ownership and investments in the company. That is why we analyzed it in more details. The main question here would be the purposes of pre-emptive rights and its withdrawal. If we want to use anti-takeover mechanisms effectively in Corporate Law, with prevailing interests of the corporation, then it is better to give Boards of Directors rights to issue new shares and partially or fully withdraw pre-emptive rights on limited grounds. This will enhance protection of corporation’s interests and serve as a flip-in version of poison pills.

In conclusion, authors of this article state that Georgian example of analysis on investment protection mechanisms and the influence of Common Law and Civil Law on its progress can have an extensive significance for other countries as well which share the same path of development.