

Vakhtang Nogaideli\*

Nana Turmanidze\*\*

## **Prohibition of Competition in Accordance with the New Version of the Law of Georgia on Entrepreneurs**

*Obligations under the Association Agreement between Georgia and the EU include the harmonization of national law with EU legislation. In 2021, in accordance with the Association Agreement, Georgia conducted a significant reform in Entrepreneurial Law, the obvious consequence of which is the adoption of a new version of the Law of Georgia on Entrepreneurs.*

*The new version of the law regulates certain matters in a new approach, inter alia: Article 53, which determines the prohibition of competition as a separate provision as one of the aspects of the governing body's duty of loyalty. Moreover thereof laid down the basis for liability for breach of this obligation.*

*The role of the manager in the successful functioning of the business entity is of utmost importance, which requires acting in the best interests of the entity. This article analyzes the core and objective of the prohibition of competition in Entrepreneurial Law. In this regard, it overviews the peculiarities of the regulation of the new version of the law and outlines the prospects for its practical application.*

**Keywords:** *Corporate governance, the duty of loyalty, conflict of interest, prohibition of competition, director(s), types of liability.*

### **1. Introduction**

On July 1, 2016, the Association Agreement between Georgia and the European Union entered into force,<sup>1</sup> under which Georgia undertakes to approximate national law to the principles of EU supranational law.

---

\* Ivane Javakhishvili Tbilisi State University, Faculty of Law, LL.M. Student. Chief Specialist of the State Procurement Agency.

\*\* Ivane Javakhishvili Tbilisi State University, Faculty of Law, LL.M. Student. Associate of the Law Firm “J&T Consulting”.

<sup>1</sup> Association Agreement Between the European Union and the European Atomic Energy Community and Their Member States, of the One Part, and Georgia, of the other Part, Signed June 27, 2014, for the full version of the document: <<https://matsne.gov.ge/ka/document/view/2496959>> [28.03.2022].

In accordance with these obligations, the Parliament of Georgia adopted a new version of the Law of Georgia on Entrepreneurs, which went into force on January 1, 2022. The law regulates entrepreneurial-legal relations from new perspectives.<sup>2</sup>

As a consequence of the reform, Georgia has shifted its focus from a deregulated model to a regulated model, which implies the establishment of statutory Corporate Law, in particular, a number of fundamental matters are regulated by means of legislation. Among them, Article 53 of the Law laid down the provision of prohibition of competition, which includes certain parallels with the previous version of the law, but also stipulates a new solution.

The article determines the prohibition of competition concerning managerial personnel, which in the case of unscrupulous governance in practice, frequently substantially damages the interests of the company. Consequently, under the new version of the law, the obligations of the managerial personnel as a subject with the duty of loyalty, which prohibits the performance of competitive activities, are extremely relevant. It is noteworthy that the successful functioning of the company itself relies significantly on the performance of the manager.

The objective of this article is to analyze the core and purpose of the prohibition of competition in Corporate Law, in accordance with the new version of the Law of Georgia on Entrepreneurs, including but not limited to: what kind of preconditions are provided under the effective Georgian law? Who is the subject of the article related to the prohibition of competition and who is entitled to impose such a restriction? Moreover, what forms and scope of liability does the law provide for breaching the provision of competition?

By applying comparative, systematic, and logical analysis methods, the paper considers and evaluates both legislative regulations and practical aspects of the application of the provision from the prism of entrepreneurial law.

## **2. The Substance and Objective of Competition Prohibition in Corporate Law**

### **2.1. The Role of Corporate Governance in Corporate Law**

The objective of Corporate Law is to improve the well-being of all the business entities that are affected by the Company's functioning, including the Company's partners/shareholders, employees, and third parties. This is what economists

---

<sup>2</sup> See. *Burduli I., Makharoblishvili G., Tokhadze A., Zubitashvili N., Aladashvili G., Maghradze G., Egnatashvili D.*, Corporate Law, Tbilisi, 2021, 57 (in Georgian).

characterize as the pursuit of overall social efficiency.<sup>3</sup> However, while discussing the objective of corporate law more closely, the role of corporate law is emphasized - to ensure the protection of the best interests of its partners/shareholders,<sup>4</sup> a fundamental part of achieving this is the effective corporate governance that governs and controls companies.

Effective corporate governance ensures companies successful work, improves access to the capital market, reduces risks, and protects the company from mismanagement. Besides, it makes companies much more accountable and transparent before investors, encourages new investment, boosts economic growth, and provides employment opportunities.<sup>5</sup>

It is noteworthy that the development of corporate governance was based on the concept of separation from ownership control, which implies that property belongs to the entity, although the manager is responsible for its management (director, board of directors, or supervisory board).<sup>6</sup> The involvement of third parties authorized to manage the functioning of the Company is associated with certain risks, including the misuse of its positions in the business entity for unfair competition.<sup>7</sup> Therefore, it is significant for partners to pre-insure the risks related to management, taking into consideration its legal framework and the interests of the business entity.

## **2.2. The Duty of Loyalty of the Manager as a Doctrinal Ground for the Prohibition of Competition**

The governing body plays an essential role in the corporate governance system. Its attributes vary from state to state (according to its mandate structure, level of independence, stakeholder representation, and other composition),<sup>8</sup> albeit each share two fundamental liabilities: advising management and controlling its

---

<sup>3</sup> *Armour J., Hansmann H., Kraakman R.*, The Essential Elements of Corporate Law, Oxford Legal Studies Research Paper, Oxford, №20, 2009, 26.

<sup>4</sup> If the company is admitted to the securities market.

<sup>5</sup> *Lawrence D., Brown J., Robinson M., Caylor M.*, Corporate Governance and Firm Performance, State of Georgia Georgia State University, 2004, 3.

<sup>6</sup> *Spencer W. W.*, Corporate Governance and Competition Policy, Chicago, Loyola University Chicago, School of Law, 2011, 4.

<sup>7</sup> *Jugeli G., Giguashvili G.*, Interpretation on The Draft Law of Georgia on Entrepreneurs, 2021, 76 (in Georgian).

<sup>8</sup> The new version of the Law of Georgia on Entrepreneurs provides as one-level as two-level of independence that the company shall choose.

activities.<sup>9</sup> In accordance with the Organization for Economic Co-operation and Development (OECD) corporate governance principles, the corporate governance framework shall provide the company with strategic leadership, effective management monitoring by the board of directors, and accountability of the board of directors to the company and its shareholders.<sup>10</sup>

The core liabilities of the manager fall within the broad principle of fiduciary duties.<sup>11</sup> The manager has a legal obligation to act „in the interests of the corporation“, which is referred to in legal terminology as a fiduciary duty to the corporation and the shareholder/partner. In legal doctrine, there are two key components to the fiduciary duties of the manager, in particular: duty of care and duty of loyalty.<sup>121314</sup>

The duty of care requires the director to make decisions that would be made by a normally sane person in a similar position and under similar circumstances. Under clarification of the Court of Cassation of Georgia, the decisions of the management must serve to increase the profit of the company.<sup>15</sup> However, decisions might be a high-risk train.<sup>16</sup> In such a case, the courts assess the decision as a „business judgment“, which is a kind of immunity from liability of the management of the company. Moreover, companies are entitled to include exculpatory provisions in the articles of association that protect the manager from monetary damages for breach of the duty of care, unless it is established that the manager acted intentionally or against good faith.<sup>17</sup>

The duty of loyalty implies making decisions based on the best interests of the corporation. When making a decision, the manager shall act not in its interests, but in the interests of the company, which means avoiding conflicts of interest.<sup>18</sup> For instance, if management is considering a transaction with a company in which the manager has a significant financial interest, the duty of loyalty requires that the

<sup>9</sup> *Larcker D., Tayan B., Corporate Governance Matters: a Closer Look at Organizational Choices and their Consequences*, Pearson, New Jersey 2011, 66.

<sup>10</sup> The G20/OECD Principles of Corporate Governance, 23/12/2015.

<sup>11</sup> *Larcker D., Tayan B., Corporate Governance Matters: a Closer Look at Organizational Choices and their Consequences*, Pearson, New Jersey 2011, 80.

<sup>12</sup> In the United States “duty of candor” is also part of the Fiduciary Duties.

<sup>13</sup> *Larcker D., Tayan B., Corporate Governance Matters: a Closer Look at Organizational Choices and their Consequences*, Pearson, New Jersey 2011, 80.

<sup>14</sup> *Ibid*, 81.

<sup>15</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1158-1104-2014, May 16, 2015.

<sup>16</sup> *Ibid*.

<sup>17</sup> *Larcker D., Tayan B., Corporate Governance Matters: a Closer Look at Organizational Choices and their Consequences*, Pearson, New Jersey 2011, 80.

<sup>18</sup> According to the Law of Georgia on Entrepreneurs, conflict of interest in a joint-stock company is regulated by Article 208.

terms of the transaction protect/prioritize the interest of the company over the interests of the manager. Also, if a manager finds a business opportunity in the process of functioning a company, the duty of loyalty requires that the manager refrains from taking advantage of the opportunity, etc.<sup>19,20</sup>

Part of the duty of loyalty is to prohibit competition in entrepreneurial law, which means restricting the authority of the manager, not to carry out the same entrepreneurial activity, and/or to be the manager of the business entity operating in the same industry, including after leaving a managerial position.<sup>21</sup> However, it shall be noted that the prohibition of competition is not absolute and the manager may carry out "competitive" activities with the consent of the general meeting.<sup>22</sup> Thus, despite the prohibition, if the manager still carries out such activities, it implies that it, as a fiduciary, violates its duty of loyalty to the business entity.<sup>23</sup>

Prohibiting competition for a manager is logical, due to working for a competing company, a manager may spend more time with one company and provide substantial information than another.<sup>24</sup> Considering fact that the manager has the opportunity to be the first to receive information about a new business opportunity (offer) from the company, it can utilize this information in a competing community before the company evaluates the opportunity and makes a decision,<sup>25</sup> which also creates the disposition composition of the business opportunity appropriation.

Prohibition of competition might be regulated at both the legislative and contractual levels. In practice, despite the existence of a legislative framework, its comprehensive regulation under the agreement is common. In the United States, for example, in addition to a prohibition of competitive activities under the service agreement with a director, a termination agreement is entered into between the corporation and the director.<sup>26</sup> One research reveals that a service agreement termination agreement was entered into with 80 percent<sup>27</sup> of the executive directors,

---

<sup>19</sup> According to the Law of Georgia on Entrepreneurs, Prohibition of misappropriation of business opportunities is regulated by Article 54.

<sup>20</sup> *Larcker D., Tayan B.*, Corporate Governance Matters: a Closer Look at Organizational Choices and their Consequences, Pearson, New Jersey 2011, 81.

<sup>21</sup> *Tchanturia L.*, Corporate Governance and Responsibilities of Managers in Corporate law, Tbilisi, 2006, 336 (in Georgian).

<sup>22</sup> *Ibid*, 337.

<sup>23</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-457-436-2015, June 6, 2016.

<sup>24</sup> *Kraakman R.*, The Anatomy of Corporate Law: A Comparative and Functional Approach, 3<sup>rd</sup> ed., Oxford, Oxford University Press, 2017, 159.

<sup>25</sup> *Cahn A., Donald C. D.*, Comparative Company Law (Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA), New York, Cambridge University Press, 2010, 338.

<sup>26</sup> So called "severance agreement".

<sup>27</sup> The average cost of contracts is \$ 5.4 million.

30% of which contained a reservation prohibiting competition even in the period following the termination of the business relationship between the corporation and the director.<sup>28</sup>

### **3. Prohibition of Competition - in Accordance with the New Version of the Law of Georgia on Entrepreneurs**

#### **3.1. General Overview of the Reform**

Under the Association Agreement, Georgia has undertaken the obligations to bring national legislation in line with European standards, including the approximation of corporate law to the requirements of European directives.

Chapter 6 of the Agreement defines corporate law,<sup>29</sup> also, the key matters of corporate governance. In particular, Article 316 of the Agreement indicates the importance of effective provisions and practices in the field of corporate law and corporate governance for the creation of a fully functioning market economy and trade. Furthermore, it defines the obligation of Georgia to lay down appropriate legislation for the protection of shareholders, creditors, and other business partners, to ensure the further development of corporate governance policies in accordance with international standards and a gradual approximation to EU rules and recommendations in this field of law.

In accordance with this commitment, Georgian experts in close cooperation with their foreign counterparts drafted a new version of the law of Georgia on Entrepreneurs, which was adopted by the Parliament of Georgia on August 2, 2021, and entered into force on January 1, 2022. The new version of the law contains comprehensive regulations, including the issue of entities and liabilities of management. One should highlight that the law in the form of separate provisions clearly stipulates the so-called elements of fiduciary duties, in particular, the constituent components of the duties of care and loyalty are laid down in different provisions and the characteristics of each of these obligations are individually defined. For instance, the duty of loyalty of a manager is defined as the prohibition of competition (Article 53) and the prohibition of misappropriation of business

---

<sup>28</sup> *Larcker D., Tayan B., Corporate Governance Matters: a Closer Look at Organizational Choices and their Consequences*, Pearson, New Jersey 2011, 230.

<sup>29</sup> As well as accounting and auditing issues.

opportunity (Article 54). Breach of this obligation by the manager causes a liability to the business entity.<sup>30</sup>

### **3.2. Peculiarities of Competition Prohibition Considering the New Regulation**

Article 53 of the new version of the Law of Georgia on Entrepreneurs prohibits a manager from carrying out the same activities without the consent of the company, which is carried out by a business entity and/or being the head of the business entity functioning in the identical industry. The duty of loyalty requires the manager not to act against the interests of the business entity in the event of a conflict of interest,<sup>31</sup> nor to take actions that are contrary to the interests of the entity (profit maximization).<sup>32</sup> The concept of a conflict of interest, in the context of a breach of the prohibition of competition, refers to a variety of cases, which shall be assessed in the light of a thorough analysis of all the circumstances, taking into account the constituent elements of the action.

The regulation of the above-stated provision is of an imperative nature. It means that the manager needs the consent of the company to carry out the same activity and/or to be a manager in a similar industry, except when the partners are well aware that the manager of the business entity was carrying out the similar activity, but thereof did not require to terminate it. In this case, consent to the implementation of the activity is considered granted.<sup>33</sup> As previously stated, prohibition of competition does not mean the complete exclusion of entrepreneurial activities containing elements of competition, but a breach exists only when the manager engages in parallel entrepreneurial activities without the consent laid down by law.<sup>34</sup> In such a circumstance, any action that may bring profit to the management and the company may otherwise incur a loss shall be considered a breach of the director's

---

<sup>30</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-959-1161-08, February 24, 2009.

<sup>31</sup> For the purposes of Article 53, Law of Georgia on Entrepreneurs.

<sup>32</sup> *Ribstein L., Alces K.*, Directors' Duties in Failing Firms, 1 J. Bus. & Tech. L., Chicago, 2006, 529 -536.

<sup>33</sup> Law of Georgia on Entrepreneurs, the 3<sup>rd</sup> paragraph of Article 53, 04/08/2021.

<sup>34</sup> *Tchanturia L.*, Corporate Governance and Responsibilities of Managers in Corporate law, Tbilisi, 2006, 332 (in Georgian).

duty of loyalty. The manager is obliged to do everything possible to avoid a loss or to refrain from actions that could have negative consequences for the company.<sup>35</sup>

It should be pointed out that the reference to „similar activities“ in the provision may be the subject of dispute between the company and the manager, as the provision does not clarify what is meant by such activities, in particular, what criteria should be used to assess how similar activities are to the business entity. Therefore, the detailed regulation of this issue must be defined under the service agreement concluded between the parties.

The new version of the law also prohibits competition in a similar industry in the event that the manager of a company is the manager of a company operating in the same or/and similar industry.

The director is obliged to use his power in good faith, with the primacy of the interests of the business entity, and not to act against the interests of the entity in order to contribute to the success of the company.<sup>36</sup> The advantage of the interest of a business entity is primarily the inadmissibility of using the position for exclusion and the avoidance of conflict of interest.<sup>37</sup> The interests of the business entity should be treated by the manager as a trusted person (fiduciary).<sup>38</sup>

The previous version of the law<sup>39</sup> included broader regulation and also extended the prohibition of competition in cases where the manager was personally responsible partner or director of a company operating in a similar field, although the current version only establishes the liability of the manager. Thus, the law laid down two independent grounds for prohibition: carrying out the same activities without the consent of the company or the performance of the duties of a manager in another similar company. Correspondingly, the existence of one of the circumstances is sufficient to assess it as a breach of the prohibition of competition provision.<sup>40</sup>

---

<sup>35</sup> *Welch E. P., Turezyn A. J.*, *Folk on the Delaware General Corporation Law, Fundamentals*, Aspen Publishers, New York, 2005, 83.

<sup>36</sup> *Allen W., Kraakman R., Subramanian G.*, *Commentary and Cases on The Law of Business Organization*, 2<sup>nd</sup> ed., Aspen Publishers, New York, 2007, 241.

<sup>37</sup> *Maisuradze D.*, *The Business Judgment rule in Corporate Law (Example of US and Georgian Law)*, *Collection of Corporate Law I, Burduli I. (ed.)*, Tbilisi, 2011, 116 (in Georgian).

<sup>38</sup> *Jugeli G.*, *Preservation of Capital in A Joint-stock Company*, Tbilisi, 2010, 178 (in Georgian).

<sup>39</sup> *Law of Georgia on Entrepreneurs*, The 5<sup>th</sup> paragraph of Article 9, 21-22, 28/10/1994.

<sup>40</sup> Tbilisi Court of Appeal, Chamber of Civil Cases, Decision №2B/6340-14, June 9, 2015.



Paragraph 2 of Article 53 of the Law of Georgia on Entrepreneurs stipulates who may be considered an authorized person to give consent to a manager to conduct competitive activities/management. In particular, in the joint and several liability companies and the limited partnership, the general meeting may approve, while in the limited liability company, the joint-stock company, and the cooperative, the consent shall be given by the body appointing the manager.

In practice, consent is frequently a strategic step by the business entity. To demonstrate, relatively small or start-up companies are forced to allow experienced and competent managers to work for another company as well. For large corporations, such an agreement may even be part of a strategy to get information from managers working at competing companies in other companies regarding the formula of success.<sup>41</sup>

Consent may be given for both general and specific activities, the type of transaction, and participation in the business entity. The body authorized to give consent has a legal obligation to substantiate the decision made by it - to refuse to give consent, in the absence of which, the person in charge is entitled to dispute the legality of the decision made by the body. However, considering the issue that concerns the activities of a manager in a competing business entity, it should not be difficult for the person authorized to give consent to substantiate the expected risk to the business entity.

Concerning the form of consent or refusal to give consent, the stated provision does not contain an indication of the form in which the consent or refusal to give consent may be given. However, given that the entity authorized to give such consent is usually the general meeting, the decision shall be reflected in the minutes of the general meeting laid down in Article 38 of the Law.

The obligation to prohibit competition exists during the term of a manager,<sup>42</sup> although the provision allows for this obligation to exist even after the resignation or dismissal of the manager, but for a period not exceeding 3 years, which shall be agreed upon in the service agreement.

---

<sup>41</sup> *Kraakman R. et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 3<sup>rd</sup> ed., Oxford, Oxford University Press, 2017, 159.

<sup>42</sup> *Jugeli G., Giguashvili G.*, *Interpretation on The Draft Law of Georgia on Entrepreneurs*, 2021, 77 (in Georgian).

## **4. Liability for Breach of the Provision Regarding the Prohibition of Competition**

### **4.1. General Standard of Liability**

To establish the liability of a manager, it is mandatory that the person performs the managerial function.<sup>43</sup> A fiduciary is a person who has undertaken to act in the interests of another in circumstances that arise as a consequence of a relationship based on trust.<sup>44</sup>

Concerning the entitlement to claim, it is considered that the manager, as fiduciaries, has an obligation to a business entity and not to any specific group participating in it. Therefore, thereof is responsible for the breach of these duties towards the business entity and not its partner (s).<sup>45</sup> The core objective of the institute of liability of managers is to protect the property of the business entity and prevent damage.<sup>46</sup> If the company is harmed due to the actions of a manager who breaches its duties, the company is entitled to sue the manager.<sup>47</sup> In that case, the company itself does not submit the claim, the partners are entitled in the interest of the company, to claim appropriate damages, which includes compensation for all losses caused by a gross breach of duty.<sup>48</sup>

### **4.2. Types of Liability**

#### **4.2.1. Compensation or Transfer of Benefits or Concession of the Entitlement to Receive Benefits**

Compensation, the amount of its payment, and the method of payment may be provided for the breach of the competition, both within the framework of the service agreement and the additional agreement concluded between the company and the manager.<sup>49</sup> To be specified, the business entity may, instead of compensating, request

---

<sup>43</sup> *Kokrashvili K.*, Business Law, Tbilisi, 2005, 103-113 (in Georgian).

<sup>44</sup> *Dine J.*, The Governance of Corporate Groups, New York, Cambridge University Press, 2003, 190.

<sup>45</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-457-436-2015, June 6, 2016.

<sup>46</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1412-1332-2017, November 14, 2018.

<sup>47</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-457-436-2015, June 6, 2016.

<sup>48</sup> *Bevans R. N.*, Business Organizations And Corporate Law, New York, 2007, 265.

<sup>49</sup> Law of Georgia on Entrepreneurs, the 1<sup>st</sup> paragraph of Article 53, 04/08/2021.

the infringer to transfer the benefit received by the infringer from the transaction concluded on behalf of thereof or a third party to the business entity or to concession the right to receive such benefit.

The option of types of liability and comprehensive regulation relies on the parties to the contract, especially the company. Throughout choosing, the business entity needs to consider the possibility of concession the claim and the provision of distribution of the burden of proof in Private Law.

Under the Georgian Civil Code (Hereinafter referred to as „GCC“), the claimant (the creditor) has the right to assign the claim to a third party without the consent of the debtor, unless it contradicts the substance of the obligation, thereof agreement with the debtor or the law.<sup>50</sup> For instance, a legal prohibition is to transfer the work to be performed by one person to another. The contradiction of the substance of the obligation is when the obligation is related to an action that cannot be performed by a third party.<sup>51</sup>

In accordance with the Georgian Code of Civil Procedure, each party must prove the circumstances on which it relies its claims.<sup>52</sup> The burden of proof rests with those who argue and not with those who deny it.<sup>53</sup> Therefore, if a business entity decides to demand that the infringer, instead of compensating, transfer the benefit received to the business entity or relinquish the right to receive such benefit, it is of utmost importance to consider both the possibility of relinquishing the claim and the burden of proof of benefit.

It should be pointed out that the regulation of the law does not explicitly state the obligation of the business entity, in the event of a transfer of interest received in exchange for compensation or the waiver of the right to receive such benefit, to claim an equivalent amount of compensation agreed upon by the party. In practice, in this regard, the realization of the burden of proof by the business entity will be relevant again. The Company, as a claimant, shall be obliged to prove the existence of the damage and present evidence to prove the fact of material loss of the business entity, which is the consequence of the fault of the manager and exceeds the compensation agreed in the contract.<sup>54</sup> Thus, the claimant must prove the causal link between the

---

<sup>50</sup> Civil Code of Georgia, the 1<sup>st</sup> Part of Article 199, 31, 24/07/1997.

<sup>51</sup> *Totladze L., A Commentary on The Civil Code of Georgia, Book II, Law of Things (Property), Tchaturia L. (ed.)*, Tbilisi, 2018, 182 (in Georgian).

<sup>52</sup> Civil Procedure Code of Georgia, Article 102, 47-48, 31/12/1997.

<sup>53</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1294-1214-2015, June 27, 2016.

<sup>54</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-245-230-2014, October 23, 2015.

action and the damage caused, and the burden of proving the absence of guilt and breach of duty will be borne by the manager.<sup>55</sup> If the company proves that the damage caused exceeds the amount determined by the compensation, then it has the right to demand the concession of the benefit or claim received in proportion to the damage.

#### 4.2.2. Penalty

In accordance with the first paragraph of Article 53 of the Law of Georgia on Entrepreneurs, in case of breach of the competition prohibition provision, the business entity may demand the payment of the agreed penalty in addition to compensation for the damage caused to the entity.

Pursuant to Article 417 of the Georgian Civil Code, the debtor must pay the penalty - the amount of money specified in the agreement of the parties - for non-performance or improper performance of the obligation. The agreement on the penalty is the consequence of at least a mutual expression of will.<sup>56</sup> A penalty is, on the one hand, a means of encouraging the contractor to perform the obligation in a timely and proper manner,<sup>57</sup> and, on the other hand, its function is manifested in the imposition of an appropriate sanction in case of breach of the contract by the contractor.<sup>58</sup> By its very nature, a penalty rather than a means of security can be considered a sanction.<sup>59</sup>

In accordance with Article 417 of the GCC, the penalty is a monetary amount determined under the agreement of the parties. Accordingly, Georgian legislation allows for the imposition of penalty only in monetary form money. Thus, a claim for his / her remuneration must also be made in the same form.<sup>60</sup>

To be clear, the penalty is of an accessory nature, which implies that it, in its essence, depends entirely on the basic claim.<sup>61</sup> Consequently, the authenticity of the

<sup>55</sup> *Tchanturia L.*, Corporate Governance and Responsibilities of Managers in Corporate law, Tbilisi, 2006, 459 (in Georgian).

<sup>56</sup> *Dzlierishvili Z., Svanadze G., Tsertsvadze G., Janashia L., Robakidze I.*, Contract Law, Tbilisi, 2014, 589-592 (in Georgian).

<sup>57</sup> *Jorbenadze S.*, A Commentary on The Civil Code of Georgia, Book III, Article 417, Tbilisi, 2019, 781 (in Georgian).

<sup>58</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-459-438-2015, October 7, 2015.

<sup>59</sup> *Tchanturia L.*, Law of Credit Provision, Tbilisi, 2012, 235 (in Georgian).

<sup>60</sup> *Kvinikadze K.*, Reduction of Penalty by The Court, as “Judicial Intervention” in The Principle of Contractual Freedom, Journal of “Justice and Law”, №2, 2016, 87 (in Georgian).

<sup>61</sup> *Tchanturia L.*, Law of Credit Provision, Tbilisi, 2012, 236 (in Georgian).

basic claim is a prerequisite for the realization of the penalty claim.<sup>62</sup> In the present case, the basic claim, as stated in the previous chapter, is defined as a claim for compensation or a claim for the transfer of benefits received by the infringer from a transaction entered into on behalf of himself or a third party to the business entity or a waiver.

Free establishment of the amount of the penalty implies its determination in any amount (within the limits laid down by law) and periodicity,<sup>63</sup> albeit, it should be mentioned that Article 420 of the GCC grants the court the power to reduce an inappropriately high penalty taking into consideration the circumstances of the case.

One of the essential preconditions for claiming a penalty is a breach of obligation. The latter may be manifested both in improper performance of the obligation and in its non-performance,<sup>64</sup> which in this case is manifested in the breach of the duty of loyalty by the manager, in particular, the provision of prohibition of competition.

For the legitimacy of the penalty agreement, the law imperatively stipulates the protection of the written form, which means that in case of breach of the obligation, the right to claim payment of the penalty is lawful and permissible only under the conditions of compliance with this mandatory form. Otherwise, in accordance with the first sentence of Article 59 of the GCC, the agreement of the parties on the penalty will be invalid. Considering the fact that the amount and method of payment of compensation as a basic claim is determined under the service agreement or under the additional agreement of the parties, the agreement related to the penalty should be established in the same manner.

## 5. Conclusion

The legal framework for prohibiting competition provision is fundamental to both effective corporate governance and the commercial interests of the business entity. It is obvious, that the legislature with the new version of the Law on Entrepreneurs has expanded the scope of the duty of loyalty as a fiduciary obligation and allowed the business entity to have a minimum legal framework and, within a certain disposition, to ensure risks related to the activities of the manager.

---

<sup>62</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №BS-1611-1585 (K-11), January 26, 2012.

<sup>63</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1488-1408-2017, February 15, 2018.

<sup>64</sup> Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1432-1351- 2012, May 20, 2013.

The business entity, within the framework of the so-called service agreement or additional agreement with the manager, should consider the following legal aspects and perspectives of the prohibition of competition:

1. A manager is not entitled to carry out the same activities carried out by the business entity without its consent or to be the manager of the company operating in the same industry. The managers should carry out such activities only with the consent of the entity that must make a decision of consent at the general meeting and draws up written minutes of meeting on the decision in accordance with the law.
2. The business entity may extend the obligation to prohibit competition by a service agreement concluded with a manager for the period after him/her dismissal, for a period not exceeding 3 (three) years. Besides the time interval, during the drafting of the contract, from the side of the entrepreneurial company, it is of utmost importance to take into account the geographical area of prohibition of competition and the field of activity, which should not be too wide and unreasonable.
3. The business entity is also authorized to establish the compensation for the breach of the obligation, its amount, and the method of payment under the service agreement or additional agreement. However, in addition to compensation under the same agreement, the infringer can impose a fine as a penalty sanction, which also requires the prior written agreement of the parties.
4. It is noteworthy that the legal framework proposed the company another legal formula of liability in case of breach of obligation, according to which the business entity is entitled to claim compensation from the infringer instead of compensation, however. In giving preference to this formula of liability, the company should take into consideration both the risks of conceding the claim, as well as the burden of proof of benefit received by the manager imposed on it and the equivalence of the latter concerning compensation.

Georgian case law is not yet aware of cases of non-compete obligations, nor is the Georgian legal literature abundant in this regard, albeit, ground on the comparative analysis of this article, demonstrated that in international practice, the agreement to prohibit competition with managers is not only common but also fundamental to the successful management of the company and maximizing the profit. Consequently, the issue is relevant for both practicing lawyers and business entities, and the National Court has a pretty interesting way to establish new practices in this area.

## Bibliography:

1. Civil Code of Georgia, 31, 24/07/1997.
2. Civil Procedure Code of Georgia, 47-48, 31/12/1997.
3. Law of Georgia on Entrepreneurs, 21-22, 28/10/1994.
4. Law of Georgia on Entrepreneurs, 04/08/2021.
5. The G20/OECD Principles of Corporate Governance, 23/12/2015.
6. *Armour J., Hansmann H., Kraakman R.*, The Essential Elements of Corporate Law, Oxford Legal Studies Research Paper, Oxford, №20, 2009, 26.
7. *Allen W., Kraakman R., Subramanian G.*, Commentary and Cases on The Law of Business Organization, 2<sup>nd</sup> ed., Aspen Publishers, New York, 2007, 241.
8. *Bevans R. N.*, Business Organizations And Corporate Law, New York, 2007, 265.
9. *Burduli I., Makharoblishvili G., Tokhadze A., Zubitashvili N., Aladashvili G., Maghradze G., Egnatashvili D.*, Corporate Law, Tbilisi, 2021, 57 (in Georgian).
10. *Cahn A., Donald C. D.*, Comparative Company Law (Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA), New York, Cambridge University Press, 2010, 338.
11. *Dine J.*, The Governance of Corporate Groups, New York, Cambridge University Press, 2003, 190.
12. *Dzlierishvili Z., Svanadze G., Tsertsvadze G., Janashia L., Robakidze I.*, Contract Law, Tbilisi, 2014, 589-592 (in Georgian).
13. *Jorbenadze S.*, A Commentary on the Civil Code of Georgia, Book III, Article 417, Tbilisi, 2019, 781 (in Georgian).
14. *Jugeli G., Giguashvili G.*, Interpretation on the Draft Law of Georgia on Entrepreneurs, 2021, 76-77 (in Georgian).
15. *Jugeli G.*, Preservation of Capital in a Joint-stock Company, Tbilisi, 2010, 178 (in Georgian).
16. *Kraakman R.*, The Anatomy of Corporate Law : A Comparative and Functional Approach, 3<sup>rd</sup> ed., Oxford, Oxford University Press, 2017, 159.
17. *Kokrashvili K.*, Business Law, Tbilisi, 2005, 103-113 (in Georgian).
18. *Kvinikadze K.*, Reduction of Penalty by The Court, as “Judicial Intervention” in The Principle of Contractual Freedom, legal Journal “Justice and Law”, 2/2016, 87 (in Georgian).
19. *Larcker D., Tayan B.*, Corporate Governance Matters: a Closer Look at Organizational Choices and their Consequences, Pearson, New Jersey 2011, 66.
20. *Lawrence D., Brown J., Robinson M., Caylor M.*, Corporate Governance and Firm Performance, State of Georgia, Georgia State University, 2004.
21. *Maisuradze D.*, The Business Judgment rule in Corporate Law (Example of US and Georgian Law), Collection of Corporate Law I, *Burduli I. (ed.)*, Tbilisi, 2011, 116 (in Georgian).

22. *Ribstein L., Alces K.*, Directors' Duties in Failing Firms, 1 J. Bus. & Tech. L. Chicago, 2006, 529 -536.
23. *Spencer W. W.*, Corporate Governance and Competition Policy, Chicago, Loyola University Chicago, School of Law, 2011, 4.
24. *Tchanturia L.*, Law of Credit Provision, Tbilisi, 2012, 235 (in Georgian).
25. *Tchanturia L.*, Corporate Governance and Responsibilities of Managers in Corporate law, Tbilisi, 2006, 331-459 (in Georgian).
26. *Totladze L.*, A Commentary on The Civil Code of Georgia, Book II, Law of Things (Property), *Tchanturia L. (ed.)*, Tbilisi, 2018, 182 (in Georgian).
27. *Welch E. P., Turezyn A. J.*, Folk on the Delaware General Corporation Law, Fundamentals, Aspen Publishers, New York, 2005, 83.
28. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1488-1408-2017, February 15, 2018.
29. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1412-1332-2017, November 14, 2018.
30. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1294-1214-2015, June 27, 2016.
31. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-457-436-2015, June 6, 2016.
32. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-245-230-2014, October 23, 2015.
33. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-459-438-2015, October 7, 2015.
34. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1158-1104-2014, May 16, 2015.
35. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-1432-1351-2012, May 20, 2013.
36. Supreme Court of Georgia, Chamber of Civil Cases, Decision №BS-1611-1585 (K-11), January 26, 2012.
37. Supreme Court of Georgia, Chamber of Civil Cases, Decision №AS-959-1161-08, February 24, 2009.
38. Tbilisi Court of Appeal, Chamber of Civil Cases, Decision №2B/6340-14, June 9, 2015.