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Some Significant Issues Related to Conduct of Due Diligence on the Example of Georgian and German Law

Mergers and Acquisitions are very important part of business transactions for many companies. Besides, transactions are unavoidable due to economic changes. There are plenty of methods to ensure successfulness of transactions, but among the Due Diligence Investigation has significant place. Due Diligence is an instrument, which gives possibility to buyer to analyze targeted company fully, to discover strengths and weaknesses of the company, to set real price and etc. As a result, interested company can make decision based on objective and real facts.

Due Diligence, as an instrument to analyze companies is broadly used all over the world. Although, despite of frequency of conducting different types of Due Diligence, there is always a dispute if interested party has a legal obligation to conduct Due Diligence before merging or acquiring a company, or on the other side, is Target Company obliged to let them conduct Due Diligence, as most sensitive information's are subject of analyzing. It's important to look at Due Diligence also as well-known commercial custom, as in some countries Due Diligence is considered to be commercial custom There are lot of issues regarding legal or procedural conduct of Due Diligence, but in the given paper will be discussed legal on non-legal obligation of conduction Due Diligence on behalf of Georgian and German Law.

Key words: *Due Diligence, legal obligation, commercial custom.*

1. Introduction

Due to the accelerated speed of modern world economic development, advancement of internationalized and globalized markets, one of the major activities of transnational companies became implementation of Mergers and Acquisitions (M&A).[1]

Along with the increase of the amount of M&A transactions, such transactions increase, which cannot achieve set target, synergy effect and fall into amount of so-called wrecked transactions.[2] Nonachievement of synergy effect may have various economic justifications, however, the reason of increase of wrecked transactions remains to be non-conduct or improper conduct of Due Diligence.[3]

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1 *Hagen Ch.,* Die Due Diligence bei Unternehmenstransaktionen, Studienarbeit, München, 2013, 1.

2 *Davis W. B. E.,* The Importance of Due Diligence Investigations: Failed Mergers and Acquisitions of the United States' Companies, ankarabarreview, 2009/1, 5, <https://edisciplinas.usp.br/pluginfile.php/302226/mod_resource/content/1/the%20importance%20of%20due%20diligence.pdf> [12.10.2020].

3 *Perry J. S., Herd T.*, Mergers and acquisitions: Reducing M&A risk through improved due diligence, Strategy and Leadership, Vol. 32, № 2 2004, 12, <https://imaa-institute.org/docs/m&a/atkearney_02_Mergers_and_acquisitions-Reducing_M&A_risk_through_improved_due_diligence.pdf> [12.10.2020].

Despite the internationally recognized huge role of Due Diligence in the M&A process, on the legislative level the obligation of its direct conduct is regulated almost nowhere. The mentioned issue is discussed among scientific society, as well as practicing lawyers. The article discusses the attitude of German legislation towards obligation of conduct of Due Diligence and what possible outcomes we may have in Georgia. The capital market is less developed in Georgia and our reality is not remarkable with the amount of transactions, however taking into account that there are regular ongoing talks about incoming investments and development of economy, sooner or later it will become necessary to improve discussion in practice and literature with regard to Due Diligence, as legal institute necessary for success of transactions. Hence, the purpose of article is to put forward some issues of practical essence and discussing perspectives of Georgian legislation in light of the obligations of conducting Due Diligence and considering as trade custom, using comparative legal research method.

2. General Overview of Due Diligence, as of Legal Institute

Due Diligence as standard for evaluating subject of sale-purchase is rooted in American Law.[4] Initial development of Due Diligence was facilitated by the Security Act[5] adopted in 1933, which included provisions regarding the emission of securities and imposed obligation for emissions improperly placed on the market on natural, as well as legal persons,[6] and the mentioned direction developed more by the adoption of Security Exchange Act in 1934, which regulated secondary relations of securities market.[7] In American Law there were no legislative guaranties during the purchase of defected item by the buyer, therefore buyer had to have more caution and circumspection. Despite American origin and roots, the practice of examining Due Diligence during implementation of M&A transactions was developed in Europe in short time.[8] Despite existence of codified legislations and certain legislative guaranties also in countries of continental Europe, while performing important transactions, the buyer (mostly investor) felt himself/herself more protected, if he/she could examine target, had comprehensive information and could realistically evaluate expectations.[9]

Experience gathered deriving from practice and discussion of Due Diligence as legal institute on a scientific level, resulted in development and extension of that function, that is imposed on Due Diligence. These are: functions of discovering risks[10] and their insurance, defining real price and value, and proving function.[11]

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4 *Beisel D.,* Beck'sches MandatsHandbuch Due Diligence, *Beisel D., Andreas F. E. (Hrsg.*), 3. Aufl., München, 2017, 2.

5 *Kavtaradze S.,* On Due Diligence, as Issue of Legal Notion, Journal of Law, № 2, 2016, 131.

6 *Picot G.,* Handbuch Mergers & Acquisitions, Stuttgart, 2000, 223.

7 *Robakidze S*., Contracts concluded with the abuse of insider information and private legal consequences, compilation: Corporate Law Compilation I, *Burduli I. (Ed.),* Tbilisi, 2011, 168 (in Georgian).

8 *Fatemi A.*, Die Obligenheit zur Due Diligence beim Unternehmenskauf, Eine Rekapitulation der Fahrlässigkeit, Düsseldorf, 2009, 16.

9 *Beisel D.,* Beck'sches MandatsHandbuch Due Diligence, *Beisel D., Andreas F. E. (Hrsg.*), 3. Aufl., München, 2017, 2.

10 *Klie M. A.,* Die Zulässigkeit einer Due Diligence im Rahmen des Erwerbs von börsennotierten Gesellschaften nach Inkrafttrete des Anlegerschutzverbesserungsgesetzes (AnSVG), Frankfurt am Main, 2008, 19.

11 *Berens W., Schmitting W., Stauch J.,* Due Diligence bei Unternehmensakquisitionen, *Berens W., Brauner H. U., Strauch J., Krauner T. (Hrsg.),* 7. Aufl., Stuttgart, 63 ff.

Moreover, its types are important, which developed and continue to grow constantly, as far as types in most part depend on the kind of target company, its activity, on which market it acts, etc. The variety of types[12] does not mean that all of them are using during each examination. The choice is made by the interested company based on what it wants to know and what is its aim. The most widespread types are: legal, financial, commercial, fiscal, environmental, technical, personnel management, information technologies, cultural and other types of Due Diligence.[13]

No matter how perfectly determined is the purpose to be achieved during conduct of Due Diligence, what kind of examination must be carried out, the central significance has the issue of obtaining information, as far as, for the interested party, the most sensitive and not publicly available information is interesting. Therefore, no matter which type of Due Diligence is planned to be conducted, it is important to ensure accessibility[14] to reliable information, otherwise it is impossible to talk about ideal Due Diligence.

3. On the General Obligation of Conducting Due Diligence

There are diverse opinions on the issues related to essence of Due Diligence, however, there is almost cohesion regarding the fact that there is no legislative obligation to conduct Due Diligence in the German legislation.[15] The mentioned is justified with arguments presented below. There are no specific legislative norms with regard to the sale and purchase of enterprise, hence, classical sale and purchase agreement norms are used in that case.[16] As a result of amendments introduces to the Civil Code of Germany in 2002[17] (obligations law reform), in the first paragraph of article 453 of the Civil Code of Germany the provision appeared, that respective articles of sale and purchase are also applied in case of sale-purchase of rights, as well as other objects („sonstige Gegenstände“).[18] By the mentioned definition and approach, provision of the named article puts sale and purchase of enterprise under the norms presented in the Civil Code,[19] this was intention of legislator, as far as it was impossible to reject problems and divergency related to the sale and purchase of enterprise.[20]

In case of purchase of object, in Georgian, as well as in German law, in pre-contractual relations seller has an obligation to provide and introduce to potential buyer information related to sale and

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12 *Ogonyants K.*, Der Unternehmenskauf und kartellrechtliche Probleme, Norderstedt, 2012, 17.

13 *Beisel D.,* Beck’sches MandatsHandbuch Due Diligence, *Beisel D., Andreas F. E. (Hrsg.*), 3. Aufl., München, 2017, 2.

14 *Volks M. –A.,* Haftungsrisiken beim Unternehmenskauf, Nordenstedt, 2009, 1.

15 *Töpperwien M., Henkel S.,* Der Effiziente M&A Prozess, *Klamar N., Sommer U., Weber I. (Hrsg.)*, Freiburg – München, 2013, 47.

16 *Möller J.,* Offenlegungen und Aufklärungspflichten beim Unternehmenskauf, NZG, Heft 22, 2012, 843.

17 *Lorenz S.*, Shuldrechtsreform 2002: problemschwerpunkte dre Jahre danach, München, NJW, Heft 27, 2005, 1889.

18 *Büdenbender U.,* BGB – Schuldrecht, *Dauner-Lieb B., Langen W. (Hrsg.),* 3. Aufl., BGB Anhang II, §§ 433–480: Unternehmenskauf – BGB, Baden-Baden, Berlin, 2016, Rn. 13.

19 *Faust F.,* BeckOK BGB, *Hau W., Poseck R. (Hrsg.)*, 55. Aufl., München, 2020, §453, Rn 1.

20 *Büdenbender U.,* BGB – Schuldrecht, *Dauner-Lieb B., Langen W. (Hrsg.),* 3. Aufl., BGB Anhang II, §§ 433–480: Unternehmenskauf – BGB, Baden-Baden, Berlin, 2016, Rn. 13.

purchase subject available to him/her.[21] However, deriving from particularities of issues related to enterprise as to specific object, it is arguable whether the seller is expected to disclose complete information on his/her own initiative.

Diverse types of purchase, except property and shared purchase, in particular in circumstances of bidding, the hostile and friendly takeovers are differentiated in literature.[22] The main difference between these two types mainly derives from the motive of acquirer.[23] In case of friendly takeover the purpose of acquirer is justification of positive expectations, he/she wants to attain more profit, effect of "synergy", and in case of "hostile" takeover this purpose changes radically and has negative basis.[24]

In case of friendly takeover, condition may be easier, as far as there is an agreement between managing bodies of enterprise and shareholders/partners on the reorganization of the company. In case of hostile takeover, as a rule, managing bodies do not participate in negotiations or classification of bids.[25] Acquirer is interested in absorbing target company and this is the easiest to perform, if the company is divided in such way that there is no well-defined majority shareholder. The scenario of hostile takeover is mostly implemented by bypassing classical management through direct contact with shareholders or without the contact.[26] It is noteworthy, that there is an increasing tendency of hostile takeover of companies.[27] In addition it is important, who is the potential acquirer and what is his/her purpose. It may be related to operative or purely financial interest from the side of investor. Investor having operative interest usually performs activity similar to the target enterprise, hence, he/she is interested to increase his/her share on the market, reach synergy effect, obtain access to particular raw material or learn/master particular manufacturing process, get license or expelling competitor from the market. Whereas the financial investor mostly is interested in increasing his/her own capital though short-term acquisition of the enterprise and selling it profitably in favorable time.[28] Along with the increase of hostile takeover tendency, the corporate legal measures of defense

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21 *Pfeifer E. Ch.,* Rücktritt wegen Schlechtleistung beim Unternehmenskauf, Frankfurt am Main, 2014, 56 ff.

22 *Schlitt M.,* Münchener Kommentar zum Aktiengesetz, *Goette W., Habersack M., Kalss S. (Hrsg.),* 4. Aufl., München, 2017, WpÜG §33, rn. 10-11.

23 In details see *Makharoblishvili G.,* Carrying out fundamental changes in the structure of capital companies based on the corporate-legal actions (Acquisition, Merger), dissertation, TSU, Tbilisi, 2014, 130 <http://press.tsu.ge/data/image_db_innova/disertaciebi_samartali/giorgi_maxaroblishvili.pdf> [12.10.2020] (in Georgian).

24 If acquirer is competitor of target company, the purpose could be expulsion of competitor from market, or its capturing and the existing management hinders that. Therefore, initial purpose is to change management and also expelling of major shareholders may be added. Finally, the unity of purposes and circumstances may show elements of "hostile" takeover.

25 *Maisuradze D*., The Implementation of Additional Rights of Shareholders (Poison Pills) as Defensive Measures within the Scopes of the Best Interests of the Corporation (Critical Analysis), Journal of Law, № 1, 2017, 60.

26 *Maisuradze D*., Corporate Legal Defensive Measures in the Process of Reorganization of Capital Entity (Comparative-Legal Study Predominantly on the Example of Delaware and Georgian Corporate Law), Dissertation, TSU, Tbilisi, 2014, 26-30 (in Georgian).

27 *Kusche M. S.,* Die aktienrechtliche Zulässigkeit der Durchführung einer Due Diligence anlässlich eines Unternehmenskaufs, Mit Due Diligence-Checkliste für die Zielgesellschaft, Studien zum deutschen und europäischen Gesellschafts- und Wirtschaftsrecht, Band 2, Frankfurt am Main, 2005, 69.

28 Ibid. 70.

developed. Similar transaction, as mentioned above, often takes place while evading directors and through establishing direct contact with shareholders.[29] In order to avoid mentioned, directors often use diverse defense mechanisms, for instance such tactics as "Poison Pill",[30] "Shark Repellant", "Golden Parachute" and "Greenmail".[31]

Because of the existence of certain agreement and communication with director during the friendly takeover, there are less problems evolving in the process of conducting Due Diligence, however, there is no guarantee of receiving comprehensive information in that case as well, because shareholders may apply serious resistance for interrupting this process. Moreover, it is important who is the person interested in receiving information and what relations he/she has with the target company, its managing bodies or shareholders.

As far as the hostile takeover may proceed in very unpredictable way and it is hard to talk about using Due Diligence tool in that framework, cases presented in the article mostly are used in time of friendly takeover, when interested person has to "fight" less for receiving proper information. However, because of non-existence of direct norms with regard to merger and acquisition of enterprises, receiving information does not become easier in case of friendly takeover as well. "Hostile" takeover based on its nature and purposes is less oriented on creation of common "better" future for the acquired and own enterprise, therefore in-depth analysis with regard to the target object mostly is no necessary for the acquirer.

We must divide obligation of Due Diligence into several directions. The first, whether the interested person is obliged to examine target object. In this direction it is interesting whether non-performance will violate his/her obligations, as of manager acting in bona fide. As in Germany, also in Georgia there is a requirement of acting in bona fide for managing persons in the Joint Stock Company and Limited Liability Company, in particular, the Director of the company has fiduciary duties before the company and along with other content, it implies that directors must care about company, as normal reasonable person would care in similar circumstances being on same position and must act with the belief that their actions are more beneficial for the company (duty of care).[32] The second, not less important, is whether respective responsible person or persons of the target company

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29 *Maisuradze D*., The Implementation of Additional Rights of Shareholders (Poison Pills) as Defensive Measures within the Scopes of the Best Interests of the Corporation (Critical Analysis), Journal of Law, № 1, 2017, 60.

30 Using "Poison Pills" means that Board gives to shareholders such right, "which at a time of appearance of specific circumstances of acquisition rejected by the board, gives special economic value to the important positions of company's owners, hence it is a defense tactics, which makes takeover transaction costly. Its expensiveness is in the high value of overcoming process of named tactics from executors of takeover." In details see *Maisuradze D*., The Implementation of Additional Rights of Shareholders (Poison Pills) as Defensive Measures within the Scopes of the Best Interests of the Corporation (Critical Analysis), Journal of Law, № 1, 2017, 61.

31 *Makharoblishvili G.*, Carrying out Fundamental Changes in the structure of capital companies based on the corporate-legal actions (Acquisition, Merger), Dissertation, TSU, Tbilisi, 2014, 130. <http://press.tsu.ge/data/image_db_innova/disertaciebi_samartali/giorgi_maxaroblishvili.pdf> [12.10.2020] (in Georgian).

32 Rulings of the Chamber of Civil Cases of the Supreme Court of Georgia № AS-1158-1104-2014 from 25 December 2014 and № AS-1307-1245-2014 from 6 May 2015.

are obliged to permit conduct of Due Diligence and provide information, who are connected to their own company with same obligations, as directors of interested company.

Despite the fact that in countries of Continental Law there is no direct legislative obligation of conducting Due Diligence, most part of opinions expressed in literature and practice share the approach that non conduct of Due Diligence may result in responsibility of Director (or other responsible person) from the side of purchaser.[33] In countries having codified legislation and firm legislative traditions, as it is in Germany, Due Diligence, as inorganic seedling, creates not only certain misunderstandings, but also problems, as far as the main dilemma while conducting Due Diligence is the issue of provision/non-provision of information. Without obtaining information, Due Diligence would be unity of actions lacking content and essence, which will have nothing in common with aims of Due Diligence to assess risks and after identification possibly avoiding or minimizing them. Therefore, the battle of interests related to its conduct and issues with regard to access to information.[34] The mentioned "misunderstandings" are expected in the Georgian Legal framework as well, as similar to Germany, this institute is not genuine and organic for Georgia as well, anyway at this stage.

4. Obligation to Conduct Due Diligence from the Perspective of German Legislation

In the German Law conduct of Due Diligence may become subject to dilemma not only because of the issue of possible responsibility of the director. But, if, as a result of conduct of Due Diligence, the risks are not discovered, acquirer loses possibilities envisaged in the article 442[35] of the Civil Code of Germany. In practice the mentioned issue is regulated relatively easily, the volumetric Disclosure Letter is drafted, where the responsibility for knowable defect and risks is taken by the seller or distribution of responsibilities among seller and purchaser takes place. In addition, in case of the agreement, responsibility is taken for potential defect, if it has significant impact on rights and interests of interested person.[36] Therefore, exclusion of possibilities envisaged in article 442 of the Civil Code of Germany, as a rule, does not put purchaser in worse situation, he/she practically is equipped with more possibilities and may negotiate individual guarantee terms with regard to every detail of his/her interest. However, it is important to have full information on all existing instruments,

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33 *Töpperwien M., Henkel S.,* Der Effiziente M&A Prozess, *Klamar N., Sommer U., Weber I. (Hrsg.)*, Freiburg – München, 2013, 47.

34 *Kresin T.,* Rechtliche Grenzen der Informationsweitergabe im Rahmen der Due diligence einer Aktiengesellschaft, Duisburg-Köln, 2008, 18.

35 § Knowledge of the buyer (1) The rights of the buyer due to a defect are excluded if he has knowledge of the defect at the time when the contract is entered into. If the buyer has no knowledge of a defect due to gross negligence, the buyer may assert rights in relation to this defect only if the seller fraudulently concealed the defect or gave a guarantee of the quality of the thing. (2) A right registered in the Land Register must be removed by the seller even if the buyer is aware of it. See *Kropholler J.,* Civil Code of Germany, Learning Commentaries, *Darjania T., Chechelashvili Z., (Trans.), Chachanidze E., Darjania T., Totladze L. (Eds.),* 13 Ed., Tbilisi, 2014, §442, para. 1 (in Georgian).

36 *Böttcher L.,* Verpflichtung des Vorstandes einer Aktiengesellschaft zur Durchführung einer Due Diligence beim Beteiligungserwerb, Zur Due Diligence als Verkehrssitte, 1. Aufl., Baden-Baden, 2005, 140.

in order to plan transactions reasonably. Deriving from this context, based on paragraph 1 of article 93 of the Stock Corporation Act of Germany, there is an opinion in literature that discretion of directorate of interested party, whether to conduct Due Diligence ot not, is decreased to zero taking into account increased risks.[37]

Except Civil Code, other legal acts may also include some direct or indirect provisions related to conduct of Due Diligence. In this regard, the Commercial Code of Germany is noteworthy. In comparison to Georgian law, the German law recognizes different legislative regulation of corporate law. In particular, first important legislative act is the Commercial Code of Germany (Handelsgesetzbuch).[38] The Commercial Code includes a lot of important regulations in light of the company relations. According to some opinions expressed in literature,[39] article 377 of the Commercial Code of Germany may be considered as legal basis for conducting Due Diligence. According to the mentioned article, if in the sale and purchase agreement both parties are entrepreneurs, the purchaser is obliged, upon receipt of goods, to examine it considering reasonable time and in case of discovering defect, notify seller immediately. The opinion of considering this article as basis for Due Diligence is rejected by the majority for several reasons. Firstly, article 377 of the Commercial Code applies only to the delivery of such goods, which falls into the scope of entrepreneurs' everyday activity,[40] moreover his/her actions start after delivery of goods, and purpose of Due Diligence is to identify risks before concluding agreement and envisage respective contractual guarantee obligations in the agreement, also it is impossible to equal enterprise with classical understanding of goods.[41] Hence, usage of article 377 of the Commercial Code as grounds for Due Diligence did not receive support. In addition, particularly problematic is nonexistence of special norms in the German legislation for withdrawal from the agreement related to enterprise.[42] In case, there would be need in practice to return purchased goods, enterprise, not only legal, but also practical misunderstandings and problems will appear. First of all, if the merger takes place, the enterprise does not exist with the same form as it was sold, maybe numerous other structural changes were implemented, which make it impossible to return enterprise in the same form, as it was before conclusion of the agreement. Besides, after complicated process of separation and return, the

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37 *Hörmann J.*, Due Diligence beim Unternehmenskauf, Transaktionen, Vermögen, Pro Bono: Festschrift zum zehnjährigen Bestehen von P+P Pöllath + Partners, *Birk D. (Hrsg.),* München, 2018, 147.

38 The Commercial Code of Germany (Handelsgesetzbuch) was adopted by the legislative body of Germany on 21 May of 1897. However, it was enacted along with the enactment of the Civil Code of Germany, in particular from 1st January 1990. From the day of its enactment, there were numerous changes introduced to the Commercial Code, some parts were separated from it, for example Stock Corporation Act, etc. But the idea that it should have regulated commercial relations, remained the same. In details see *Oetker H.,* HGB Handelsgesetzbuch Kommentar, *Oetker H. (Hrsg.),* 4. Aufl., Müunchen, 2015, 3-7.

39 *Beisel W.,* Der Unternehmenskauf, *Beisel W., Klumpp H. -H. (Hrsg.),* 7. Aufl., München, 2016, §2 Due Diligence, Rn. 8-10.

40 *Koch R.,* HGB Handelsgesetzbuch Kommentar, *Oetker H. (Hrsg.),* 6. Aufl, München, 2019, §377, rn. 7 ff.

41 *Hörmann J.*, Due Diligence beim Unternehmenskauf, Transaktionen, Vermögen, Pro Bono: Festschrift zum zehnjährigen Bestehen von P+P Pöllath + Partners, *Birk D. (Hrsg.),* München Beck, 139.

42 Ibid.

substance of the enterprise may destroy entirely and it can be threat not only to its position on the market,[43] but also to its existence.

Based on the legislative formulation discussed above, German legislation does not recognize explicit obligation of conducting Due Diligence, however deriving from complexity and difficulty of transactions it practically is conducted during each one, which is the best representation of how important is information obtained in the framework of Due Diligence and, mainly, its proper assessment. Moreover, the issue of possible responsibility of the Director, person entitled for management and representation in case of non-conduct of Due Diligence, should not be disregarded.[44] As a result, it may be noted that by conducting Due Diligence directorate insures not only chance of successful execution of transactions, but also risk deriving from his/her position. Despite non-existence of legislative obligation all these creates such factual condition, that conduct of Due Diligence is quasi obligatory, its admission brings more benefit for the interested company than harm. As it was mentioned above, while conducting Due Diligence huge importance is given to the issue of Director's responsibility. On the one hand, the behavior of director of target object becomes subject to assessment in light of the information that was provided by him/her to the interested party, whether the secret information was disclosed, and on the other hand how correctly the Director of interested party carried out the Due Diligence process. Therefore, there is a collision of interests of directorates of two companies that are worthy to be protected and practically there is no clear answer whose interest will be prioritized in critical moment.[45] Only one thing is clear, similar as Director has huge role in the functioning of the company in general and has respective responsibility, this responsibility is at least doubled when planning merger/acquisition transaction, he/she must protect company, as well as shareholder and himself/herself. Based on the abovesaid, obligation to conduct Due Diligence lies on the responsibility of Director and is issue to be considered case by case.

5. Possible Outcomes of Legislation of Georgia in Light of the Conduct of Due Diligence

Even though Georgian law is not widely discussing Sue diligence at this stage, it is possible to make some conclusions based on the analysis of the existing legislation. The Civil Code of Georgia (hereinafter referred as CCG) enforces obligation of seller to transfer a thing free of material and legal defects to the buyer (CCG 487-489). According to paragraph two of article 494 of the CCG, no rights shall accrue to the buyer on the grounds of a defect of the thing if at the time of execution of the contract he/she had the knowledge of the defect. In such case the doubt is casted on the fact of existence of defect, as far as the agreement was concluded on defected thing and it was defined as the

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43 *Hörmann J.*, Due Diligence beim Unternehmenskauf, Transaktionen, Vermögen, Pro Bono: Festschrift zum zehnjährigen Bestehen von P+P Pöllath + Partners, *Birk D. (Hrsg.),* München, 139.

44 *Ehring P.,* Die Due Diligence im Spannungsverhältnis zwischen kaufrechtlichem Haftungssystem und vertraglicher Gestaltung, Frankfurt am Main, 2010, 19.

45 Director's liability is one of the key issues in relation to the conduct of Due Diligence, but its study does not represent the purpose of this paper.

subject of agreement.[46] Due to the fact that based on Georgian legal regulation enterprise is also regarded as thing and relevant articles of sale and purchase agreement are applied, if Due Diligence is conducted and no defect will be found, after concluding the agreement it would be impossible to notify about defect, as far as the agreement will be reached on "defected" enterprise. This rule does not apply if it is confirmed that the buyer provided false information and hided defect intentionally.

It was mentioned in the Paper, that there is less discussion on necessity, essence and purpose of Due Diligence in the Georgian legal sphere. However, Partner of one of the leading Georgian law firms touched upon legal or business/ethical problems related to merger/acquisition agreements of enterprises in details.[47] In the mentioned monography there is a discussion on the necessity of conduct of Due Diligence, its benefit and functions, as well as, in general, on nuances related to merger/acquisition transactions. In the Georgian reality the customer of Due Diligence, as a rule, is buyer, and seller almost never uses such possibility, the reason of which is stated in the paper, that the Georgian companies lack or inexistence of experience. Also, attention is stressed on difficulty to adjust provisions of sale and purchase envisages in Civil Code, or provisions of general obligation law with the acquisition/merger of enterprise and in most cases non-existence of theoretical, as well as practical discourse (judicial).

Comparing to German legislation, Georgian legislation recognizes legislative act similar to Commercial Code. Issues related to legal persons are gathered in Law of Georgia "on Entrepreneurs." The named law does not include special reservation with regard to Due Diligence, which is absolutely understandable, but article 9 paragraph 6 of the law "on Entrepreneurs" determines standard of Directors' behavior. The mentioned implies that the Director must act in bona fide, care about enterprise based on its best interests. If we discuss fiduciary duties in the context of making decision of conduct of Due Diligence, in Georgian reality we can receive answer, that Director must act so cautiously in order to make transaction successful without conduct of Due Diligence, without prior examination of enterprise. Otherwise, his action, as of Director acting in bona fide, will be questioned. Moreover, ruling of the Chamber of Civil Cases of the Supreme Court of Georgia №as-1307-1245-2014 of 6 May 2015 is important. By the mentioned decision, the Court stated that Company Director, who at the same time was company's Partner, though tax evasion violated duty of care before the company, which caused putting question of his/her personal liability. This does not directly invoke Director's responsibility for non-conduct of Due Diligence, but it is important, as it defined grounds for Director's personal liability and has put a line between Director's personal liability and company's responsibility with the reasoning, that the regression of Company, unsuccessfulness, was essentially caused by the decision of Director, and such decisions exceeded those to be made in the framework of corporate freedom. As in judicial practice, as well as in literature it is necessary to have constant

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46 *Chachava S.,* Commentaries on Georgian Civil Code, *Chanturia L. (ed.),* §494, field 29, <http://www.gccc.ge> [28.10.2020] (in Georgian).

47 *Kipiani V*., Short Overview of Certain Legal Risks Related to Acquisition of Georgian Company by the Buyer and Ways of its Reflection in the Agreement, Tbilisi, 2009, <http://www.mkd.ge/geo/comp_shedzenis_samartlebrivi_riskebi.pdf> [12.10.2020] (in Georgian).

discussion on Director's liability and scale of behavior. This develops culture of corporate governance, which finally will increase the possibility of success of Georgian companies not only on Georgian, but also international market.

6. Due Diligence as a Commercial Custom

It is impossible to talk about obligation to conduct Due Diligence, without discussing principle of Caveat Emptor. In the Anglo-American law by influence of the mentioned principle it became important to conduct Due Diligence. Because of non-existence of legal guarantee norms in the American law, only purchaser was liable to care about searching for information on the item or to convince seller to give any kind of guarantee.[48] Therefore, we encounter fewer complex agreements, where guarantee norms are not defined.[49] Correct formulation of guarantee obligations is very difficult without full examination of the object, as far as exactly with the Due Diligence tool it is possible to manifest possible defects and positive side.[50] Consequently, it is not surprising that in USA potential buyer saw conduct of Due Diligence as important measure for protecting his/her interests. That is why, in USA process of conducting Due Diligence is part of natural process of acquisition and merger of enterprise for years and is not considered as special event. Hence, it will be completely fair if we consider conduct of Due Diligence as a commercial custom in USA.[51]

In German literature there is dispute on whether obligation to conduct Due Diligence is considered as commercial custom or tradition. This question is current for the reason that, according to empirical studies, during majority of enterprise acquisition and merger transactions, Due Diligence is conducted.[52] Therefore it must be though through whether we have already established tradition. If there is a positive answer to the question if this is a developed commercial custom, deriving from article 442 of the Civil Code of Germany, non-conduct of Due Diligence will be considered as gross negligence of purchaser and he/she will lose right to claim correction of item's defect.

Existence of commercial customs and traditions, and their usage in law is widely recognized in countries of continental Europe.[53] Commercial custom is not developed in normative form and does not substitute imperative norm of the law, however, as a rule, stands above the dispositive norm and is preferable used,[54] and if parties do not regulate certain circumstances by the agreement, in case of

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48 *Töpperwien M., Henkel S.,* Der Effiziente M&A Prozess, *Klamar N., Sommer U., Weber I. (Hrsg.)*, Freiburg – München, 2013, 48.

49 *Knöfler K.,* Rechtliche Auswirkungen der Due Diligence bei Unternehmensakquisitionen, Frankfurt am Main, 2001, 72.

50 Ibid.

51 Ibid, 73.

52 *Böttcher L.,* Verpflichtung des Vorstandes einer Aktiengesellschaft zur Durchführung einer Due Diligence beim Beteiligungserwerb, Zur Due Diligence als Verkehrssitte, 1. Aufl., Baden-Baden, 2005, 157.

53 *Kereselidze D.,* Der Allgemeine Teil des Georgischen Zivilgesetzbuches von 1997, Eine rechtsvergleichende Untersuchung, Frankfurt am Main, 2005, 79.

54 *Chanturia L*., Commentaries to the Civil Code of Georgia, Book Third, Tbilisi, 2001, 168 (in Georgian).

dispute the commercial custom and tradition is used in first place, and then dispositive norm of the law.[55]

For considering particular action as commercial custom and tradition, it is necessary to satisfy several criteria, in particular it must be practically carried out by representatives or any field of Corporate activity with more or less priorly determined pattern, in mutual agreement and during long period.[56] Besides, it must be recognized by all participants.[57]

As it was mentioned above, according to conducted studies, absolute majority of enterprises considers it necessary to conduct Due Diligence and implements that in practice during enterprise acquisition and merger transactions.[58] The role of commercial customs and traditions is definitely immense in international commercial relations,[59] and Due Diligence is mainly used in the aspect of international trade. Number of enterprise acquisition and merger transactions increases for various reasons and one of the most important of them, is market globalization.[60] However, part of authors considers that despite of big number and importance of conducted Due Diligence, this may not be deemed as ground for confirmation of commercial custom and tradition.[61]

Part of authors goes further and for qualifying particular action as commercial custom, applies article 276 of the Commercial Code of Germany, according to which, enterprises are divided to small, medium and large enterprises.[62] According to some opinions, when acquiring large enterprise, conduct of Due Diligence is ordinary event. Large companies may conduct thorough Due Diligence, in order to protect themselves, but we cannot say the same on small and medium enterprises.[63]

Majority of opinions directed against Due Diligence, as of commercial custom, are based on the viewpoint, that despite frequency of its conduct in practice, there is no established, determined flow and general, minimal part of the necessary standard for its conduct.[64] Besides that, for considering particular action as a commercial custom and tradition, the consent of all representatives of the field or business circle is necessary on the fact that the rule will be protected and applied unconditionally.[65]

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55 Ibid.

56 *Chanturia L. (ed.),* Commentaries to the Civil Code of Georgia, Book First, Tbilisi, 2017, article 52, area 16, 307 (in Georgian).

57 *Chanturia L.*, Commentaries to the Civil Code of Georgia, Book Third, Tbilisi, 2001, 168 (in Georgian).

58 *Fatemi A.*, Die Obligenheit zur Due Diligence beim Unternehmenskauf, Eine Rekapitulation der Fahrlässigkeit, Düsseldorf, 2009, 170.

59 *Chanturia L. (ed.),* Commentaries to the Civil Code of Georgia, Book First, Tbilisi, 2017, article 52, area 15, 307 (in Georgian).

60 *Büdenbender U.,* BGB – Schuldrecht, *Dauner-Lieb B., Langen W. (Hrsg.),* 3. Aufl., BGB Anhang II zu §§ 433–480: Unternehmenskauf – BGB, Baden-Baden, Berlin, 2016, Rn. 13.

61 *Fatemi A.*, Die Obligenheit zur Due Diligence beim Unternehmenskauf, Eine Rekapitulation der Fahrlässigkeit, Düsseldorf, 2009, 171-172.

62 *Böttcher L.,* Verpflichtung des Vorstandes einer Aktiengesellschaft zur Durchführung einer Due Diligence beim Beteiligungserwerb, Zur Due Diligence als Verkehrssitte, 1. Aufl., Baden-Baden, 2005, 157.

63 Ibid, 158.

64 Ibid.

65 *Chanturia L.*, Commentaries to the Civil Code of Georgia, Book Third, Tbilisi, 2001, 166 (in Georgian).

It must be noted that agreement concluded during modern acquisition and merger transactions rarely fall under the scope of legal regulation of one country. Parties upon starting pre-contractual relations agree on the law of country that will be used in case of dispute. Also, they exclude such norms form particular law, which in their opinion will damage the agreement (naturally, it is related to dispositive and not imperative norms). Parties also can exclude, by the agreement, validity of particular or generally all commercial customs and traditions.[66] Article 442 of the Civil Code of Germany, already discussed above, plays relatively modest role in the process of acquiring enterprises, as far as during such agreements validity of article 442 is excluded (at least implicatively).[67] The international nature of acquisition and merge transactions and diversity of the law to be used in relation thereto, makes it more difficult to consider Due Diligence as commercial custom and tradition, as in most cases validity of commercial customs and traditions is limited to certain territory,[68] and international character of Due Diligence excludes such reservation.

Once again it is important to notice, that comparing to USA, German entrepreneur has no urgent necessity for conducting Due Diligence research, as there is threat that without conduct of Due Diligence it will remain without aby guarantee norms.[69]

Moreover, according to German law, conduct of Due Diligence may have negative impacts instead of positive one, in case when Due Diligence will not be conducted with special sensitivity.[70] Such cases happen when target of interested person is just one direction of the enterprise (part), and for other directions he/she is forced by buy them. Hence, he/she does not show special sensitivity towards parts that are not interesting to him/her. Similar case may be qualified as gross negligence and party will be deprived of possibility to use legislative guarantee norms.[71] It is natural that similar occasions may happen during acquisition of large enterprises, however it may happen while purchase of small (family type) enterprises as well. Despite the risk, as it was mentioned above, percentage of conduct of Due diligence in Germany increases during acquisition/merger of enterprises and not on the contrary.[72] This also results from the fact, that pure German transactions are fewer and foreign element is in place during acquisition/merger of enterprise, especially when the issue relates to large enterprises.[73] Although, searching for investors is not unfamiliar for small or medium enterprises.[74] Here it

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66 Ibid. 167.

67 *Fatemi A.*, Die Obligenheit zur Due Diligence beim Unternehmenskauf, Eine Rekapitulation der Fahrlässigkeit, Düsseldorf, 2009, 45.

68 *Chanturia L*., Commentaries to the Civil Code of Georgia, Book Third, Tbilisi, 2001, 167 (in Georgian).

69 *Knöfler K.,* Rechtliche Auswirkungen der Due Diligence bei Unternehmensakquisitionen, Frankfurt am Main, 2001, 73.

70 Ibid.

71 Ibid, 74.

72 Ibid. 75.

73 *Böttcher L.,* Verpflichtung des Vorstandes einer Aktiengesellschaft zur Durchführung einer Due Diligence beim Beteiligungserwerb, Zur Due Diligence als Verkehrssitte, 1. Aufl., Baden-Baden, 2005, 32.

74 *Büdenbender U.,* BGB – Schuldrecht, *Dauner-Lieb B., Langen W. (Hrsg.),* 3. Aufl., BGB Anhang II zu §§ 433-480: Unternehmenskauf – BGB, Baden-Baden, Berlin, 2016, Rn. 13.

must be mentioned that genuine Due Diligence with its individual particularities was not established, but it's almost all characteristics are transposed from Anglo-American law.[75]

There is a significant difference among German and American law, which is expressed by the fact that in US further rights of byer depend only on the conduct or non-conduct of Due Diligence, which is differently in Germany. Besides, existence of possible negative effect in the German law significantly reduces necessity for declaring Due Diligence as commercial custom.[76]

As a summary it must be said that, nowadays, there is no ground and solid evidence, that in countries of continental Europe Due Diligence is considered as developed commercial custom and tradition. Besides, it is hard to consider satisfied elements necessary for commercial custom and tradition, as well as it is practically incredible to attain conduct Due Diligence to any business circle or any particular field, as it is equally used in acquisition/merger transactions carried out in any field.

It is natural, especially deriving from the Georgian reality, we cannot talk on consideration of Due Diligence as commercial custom and tradition. Nowadays existing practice does not give possibility to generalize and conduct proper analysis for considering it as commercial custom and tradition. There is no proper study for discussion on this particular topic, however, hopefully, this paper will somehow contribute to opening and development of the mentioned discussion.

7. Conclusion

In this paper issues related to the obligation of conducting Due Diligence, as well as short description of Due Diligence as a important tool for M&A transactions were discussed in accordance with Georgian and German law. Due to research can be said, that Due Diligence is common practice while conducting M&A transactions, but by the time rate of unsuccessful transactions is also increasing. Main purpose of Due Diligence is discovering risks and avoiding them, which minimizes possibilities of unsuccessful transactions. Meanwhile, during the years many arts of Due Diligence were formed and this gives to parties chance to analyze Target Company in a desirable manner. Even though, even very well planned Due Diligence could go wrong, if access to necessary information won't be guaranteed. Getting information is linked to different challenges whether its hostile or friendly takeover. Friendly takeover gives more chances to get parties interests closer, while during hostile takeover it's almost impossible. Despite the great importance of analyzing different scenarios how to get information, it's not a main topic of this paper.

Agreement of buying a company can be closed only within the given law regulations according to both, German and Georgian legislation, but however, only the law regulations give very little chance to ensure all the risks. Therefore, parties always prefer to put forward their interests via Due Diligence investigation. As there is no strict obligation to conduct Due Diligence according to German and Georgian legislation before transaction, into consideration should be taken duties of directors, as

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75 *Böttcher L.,* Verpflichtung des Vorstandes einer Aktiengesellschaft zur Durchführung einer Due Diligence beim Beteiligungserwerb, Zur Due Diligence als Verkehrssitte, 1. Aufl., Baden-Baden, 2005, 32.

76 *Knöfler K.,* Rechtliche Auswirkungen der Due Diligence bei Unternehmensakquisitionen, Frankfurt am Main, 2001, 75.

they are obliged to act always in the best interest of company. Best interest of company is almost in each and every case to conduct Due Diligence, especially from buyer's side.

Despite several differences between Georgian and German regulations, based on legislative analysis, almost similar outcomes may be received. In particular, Due Diligence does not represent legal institute established through law, but because of its immense international importance in light of the acquisition/merger transactions, it became strong instrument in hands of companies in order to achieve purposes of the transaction. Because of sustainable increase of M&A transactions, there is high possibility that Due Diligence will be announced as a trade custom and tradition is some legal areas, as done in the US. Nowadays, Due Diligence is not supported as a trade custom, because there is always law regulations standing behind the parties, but this doesn't mean time can't change gives situation. As there is very minor discussions and also practice on Due Diligence in Georgia, acknowledging Due Diligence as a trade custom comes not even in consideration.

Despite the fact that at this stage legal environment is not loaded with discussions on similar issues in Georgia, it is necessary to start talking about the mentioned topics and certain framework must exist at least in the legal literature, which later on will ease its practical application.

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