

Functionalization of Conflict of Interest Construction in the Context of Corporate Governance of the JSC

The article analyzes the core of the corporate law, the main vector of the principal dilemma of corporate governance, which leads to a conflict of interests and obligations. The specific purpose of corporate law is to create a controlled legal area of conflict of interest between members of an affiliated corporate community or those associated with it. Preventing imbalances between entities with incompatible interests is a systemic part of corporate governance and is called the "owner-proprietor" problem.

The separation of ownership and control creates a conflict between rights, duties and interests. A conflict of interest is a potentially feasible threat that implies the possibility of giving an unlawful, personal motive advantage to one party to the transaction at the expense of the other party to the transaction. In corporate law, a potential risk is "translated" as the risk of investing or invested capital, and the risk is "the probability of losing something, expressed as a percentage". The economic consequence of an unlawful advantage is the acquisition of material, financial or other benefits.

The construction of a conflict of interest will be transformed into a corporate defense strategy in the context of a normatively regulated nature. The use of its content as a corporate strategy guarantees the purposeful functioning of the JSC, and in the event of a dispute, it enables the court to correctly determine the orientation of the judicial analysis. As a result, the regulatory structure of the conflict of interest at the legislative level creates a JSC-controlled buffer of conflict of interest.

Keywords: *conflict of interest, fiduciary duty, corporate governance, self-dealing, interested person, related person, openness of information.*

1. Introduction

In a capitalist society, the paradigm of corporate governance goes beyond the separation of ownership and control, as a result of which the "principal-agent"¹ relationship² creates the potential for opportunistic³ action and, consequently, the need to regulate its Ex Ante. Corporate law, in its broadest sense, on the one hand, forms the system of mechanisms for managing invested capital and on the other hand, it creates a network of indirect regulatory control of managerialism by legal category, which forms the legitimate foundation of balanced management and control of the entrepreneurial society. In the corporate legal dimension, the system of capital management mechanisms benefits protection in the spectrum of fiduciary duty, while in the legal category,

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¹ *Davies P.*, Introduction to Company Law, 2nd ed., Oxford University Press, 2010, 110-111.

² *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 26-29.

³ *Williamson E.O.*, The Modern Corporation: Origin, Evolution, Attributes, Journal of Economic Literature, Vol. XIX, 1981, 1537-1546.

indirect control of capital is embodied in the form of shareholder democracy⁴ and activism.⁵ In turn, the field protected by fiduciary duty is characterized by a variety of directional interactions,⁶ from which it is important to be loyal⁷ to the interests of the corporation by management, which includes, among other things, managerial behavior free from conflict of interest.⁸ The scope of action of a managerial *homo economicus*⁹ is regulated by corporate law¹⁰ governing conflicts of interest¹¹ and provides the basis for the transformation of action from *homo economicus to conventional behavior*.¹² As a result, conflict of interest is an immanent manifestation¹³ of corporate governance, which manifests itself in static (factual) and dynamic (transactional) forms containing manageable potential hazards. In corporate law, a potential risk is "translated" as the risk of investing or invested capital, and the risk is "the probability of losing something"¹⁴, expressed as a percentage."¹⁵ One of the goals¹⁶ of corporate governance is to identify risks and optimize costs in the direction of minimization. The question arises: a) How should the problem be iden-

⁴ *Gantchev N., Giannetti M.*, The Cost and Benefits of Shareholder Democracy: Gadflies and Low-Cost Activism, finance Working Paper №586/2018, 2020, 1-6.

⁵ *Bainbridge M. S.*, Shareholder Activism and Institutional Investors, Law and Economics Research Paper No. 05-20, 2005, 4-10.

⁶ In the event of a breach of fiduciary duty, including on the basis of a conflict of interest, some references to the New Testament are even obtained in certain literature. In particular, "No servant can slave for two masters: for either he will hate the one and love the other, or else he will hold to the one and despise the other." Luke 16:13. For an example, see *Pinto R.A.*, Understanding Corporate Law, 3rd ed., Lexisnexis, 2009, 242.

⁷ *French D., Mayson S., Ryan C.*, Company Law, 26th ed., Oxford University Press, 2010, 469.

⁸ *Jugheli G.*, Capital Protection in a Joint Stock Company, Tbilisi, 2016, 249 (in Georgian).

⁹ *Compare: Kiria A.*, Corporate Law System in Georgia, in Collection: Collection of Corporate Law I, *Burduli I. (ed.)*, Tbilisi, 2011, 29-31 (in Georgian).

¹⁰ Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Law of Georgia on the Securities Market, Departments of Parliament 1 (8), 24/12/1998 (in Georgian).

¹¹ In a managerial position *homo economicus* is better than an emotional *homo sapiens*, who makes rational decisions based on awareness but with his own interests in mind. However, with regard to financial matters, the followers of behaviorism prefer a person with realistic behavior. See *Bloomfield J.r.*, Traditional vs. Behavioral Finance, Jonson School Research Paper Series No. 22-2010, 2010, 2-10.

¹² There is a scientific view that applying the *homo economicus* model to a corporate executive is a fundamental mistake, as the corporation's governing body has positive expectations about the director and his or her experience. Also, on altruism, that because of their commitment to the corporation and shareholders, they will act in good faith, taking into account their interests. Accordingly, the content of the phenomenon of altruism must be taken into account in assessing the actions of the supervisor. See *Stout A.L.*, On the Proper Motives of Corporate Directors (or, Why You Don't Want to Invite *Homo Economicus* to Join Your Board), UCLA School of Law, Research Paper No. 04-7, 2004, 1-3.

¹³ *Compare: Order of the President of the National Bank of Georgia of September 26, 2018 215/04 "On the Approval of the Corporate Governance Code of Commercial Banks"*, Article 3, Paragraph 4, Legislative Herald, 27/09/2018 (in Georgian).

¹⁴ In turn, "loss" refers to an expense that is personally borne by another person (meaning the manager, the governing body), and the benefit is received at the expense of reducing the shareholder's property good. See *Pinto R.A.*, Understanding Corporate Law, 3rd ed., Lexisnexis, 2009, 241.

¹⁵ *Klein A.W., Coffee C.J. JR.*, Business Organization and Finance, 11th ed., Foundation Press, 2011, 45-47, 243-245.

¹⁶ As well as, in general, the purpose of corporate law is to define the forms of JSC-s and to settle conflicts between the participants of an enterprise. See *Armory J., Hansman H., Krackman R., Pargendler M.*, What is corporate justice? In the collection: Anatomy of Corporate Law: Comparative and Functional Approach, (Translators) *Kochiashvili A., Maisuradze D. (ed.) Gabelia T.*, 3rd Ed., Tbilisi, 2019, 35 (In Georgian).

tified? B) Once the problem has been identified, what legal framework should be used to reduce the optimal cost? The answers to the questions will be found in the legal analysis of the fiduciary duty "substandard"¹⁷, and the results obtained should be used to reduce administrative costs.

In order to reduce the costs of managerial functional activities and risk management, mechanism for managing and overseeing asymmetric information on a conflict of interest transaction is used as a preventive corporate legal construction.¹⁸ According to the new version of the Law of Georgia on Entrepreneurs (hereinafter - the LGE), the construction of the conflict of interest was applied to the joint stock company (hereinafter - the JSC¹⁹), where a separate article was dedicated to it.²⁰ Therefore, a conflict of interest that arises when a person with a fiduciary duty or related person has a conflict of interest with the corporation and there is a likelihood that personal interest may take precedence over the corporation's interest,²¹ should be analyzed in a unified legal dimension, for the source of which as *De Lege Lata* will be used the Law of Georgia on Entrepreneurs and the Law on the Securities Market,²² the "Code of Corporate Governance of Commercial Banks" approved by the President of the National Bank²³, and the so-called Soft Law²⁴ as a Source of Law "Corporate Governance Code for Commercial Banks."²⁵

2. Grounds for the Origin of the Conflict of Interest

2.1. Corporate-Legal Basis

Conceptually, the origins of the conflict of interest stem from the content of the corporate governance formation of the JSC. Corporate governance is the result of a separation of ownership and control, where a centralized management and a general meeting of shareholders are formed, thus, governing and "key strategies" defining bodies are established.²⁶

¹⁷ Accordingly, the conflict of interest is considered in direct connection with the part of the duty of loyalty of the manager as a fiduciary I. See *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 269-281.

¹⁸ *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 184.

¹⁹ The word "corporation" may be used as a synonym for a joint stock company.

²⁰ Law of Georgia on Entrepreneurs, Article 208, Legislative Herald, 04/08/2021 (in Georgian).

²¹ *Pinto R.A.*, Understanding Corporate Law, 3rd ed., Lexisnexis, 2009, 241.

²² For sources on corporate law, see *Armory J., Hansman H., Krackman R., Pargendler M.*, What is corporate justice? In the collection: Anatomy of Corporate Law: Comparative and Functional Approach, (Translators) *Kochiashvili A., Maisuradze D.*, (Ed.) *Gabelia T.*, 3rd ed., Tbilisi, 2019, 22-26 (in Georgian).

²³ Order of the President of the National Bank of Georgia of September 26, 2018 215/04 "On the Approval of the Corporate Governance Code of Commercial Banks", Legislative Herald, 27/09/2018 (in Georgian).

²⁴ The so-called Soft law is the principles of corporate governance that are largely based on best corporate governance practices. The set of principles mentioned in the document is called the "Code", which is usually of a recommendatory nature. See *Chanturia L.*, Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 181; *Makharoblishvili G.*, General Analysis of Corporate Governance, Tbilisi, 2015, 304-307 (in Georgian); *Beridze T., Burduli I., Makharoblishvili G., Kharaisvili A., Sikharulidze D., Kikutadze V., Lobzhanidze N.*, The Impact of Soft Law on the Effectiveness of Corporate Governance, Tbilisi, 2018, 53-61 (in Georgian).

²⁵ Corporate Governance Code for Commercial Banks, SBA, IFC, 2009 (in Georgian).

²⁶ *Bratton W., Watcher L. M.*, Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation, 34 J. Corp. L. 99, 2008, 118-122.

Centralized management is a body with delegated authority to exercise control, which, on the basis of the corporate trust of the levers of management of the entrepreneurial society,²⁷ appears in a fiduciary relationship with the JSC and the shareholders.²⁸ This duty is much more complete and specific than the institution of power of attorney defined by general private law. The fiduciary duty catalog implies the co-operation of obligations and interests in such a way, that the recipient of the fiduciary and its outcomes, when the issue of preference²⁹ of interests between the beneficiary is on the agenda, *the obligation*,³⁰ in favor of the JSC and the shareholders, will put the *interest* at the forefront of the ordinate of priority. The management should act on the basis of full awareness, in good faith, in the best interests of the corporation³¹ and the shareholder,³² and exclude asymmetries of the information provided to the JSC bodies.³³

The systematic analysis of corporate governance should be based on the management control of property (investment) and the supervisory process of such control. Transfer of control over the invested property to a third party³⁴ puts the right of direct control over the ownership of the JSC in the hands of management, while leaving the ability of shareholders to oversee³⁵ the management of the governing body forms the two main classifying bases of corporate governance, that is called the functional and substantive separation of ownership and control.³⁶

Giving management the competence to dispose the investment³⁷ in the interests of the entrepreneur community puts *Bona Fide* management in question. As a result, a logical circle is formed between corporate governance, separation of ownership and control, delegated authority, competition of interests of management and JSC,³⁸ which gives rise to the obligation of corporate

²⁷ *Burduli I.*, Fundamentals of Share Law, Vol. II, Tbilisi, 2013, 371 (in Georgian).

²⁸ *Cahn A., Donald D. C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge University Press, 2011, 335-337.

²⁹ *Gevurtz F. A.*, Corporation Law, West Group, 2000, 321.

³⁰ The obligation of a person with fiduciary duty is implied.

³¹ In UK court decisions, the interest of the company is conceived as an aggregate of the interests of the shareholders. See *Cahn A., Donald D. C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge University Press, 2011, 335.

³² G20/OECD Principles of Corporate Governance, VI. The Responsibilities of the Board, 2015, 45-46.

³³ *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 184.

³⁴ The governing body of the JSC is implied.

³⁵ The term "control" used by shareholders refers to the authority to appoint / dismiss members of the governing body, which is exercised by voting rights based on share ownership. This is valid in modern corporate legal systems. For example, see Revised Model Business Corporation Act, 2021, § 8.60 ("Control" (including the term "controlled by") means (i) having the power, directly or indirectly, to elect or remove a majority of the members of the board of directors or other governing body of an entity, whether through the ownership of voting shares or interests, by contract, or otherwise, or (ii) being subject to a majority of the risk of loss from the entity's activities or entitled to receive a majority of the entity's residual returns).

³⁶ *Makharoblishvili G.*, General Analysis of Corporate Governance, Tbilisi, 2015, 58-59, 68-76 (in Georgian).

³⁷ Subject to normative or statutory restrictions.

³⁸ According to a separate definition, a conflict of interest refers to a conflict of interests and obligations and a conflict between obligations. See *Tsertsvadze L.*, Duties of the Director in Merging the Company and Selling the Controlling Stake (Comparative-Legal Analysis on the Example of US, Predominantly Delaware, EU and Georgian Law), Tbilisi, 2015, 125 (in Georgian), see quote: *Mortimore S. (ed.)*, Company Directors Duties, Liabilities and Remedies, 2nd ed., Oxford University Press, 2013, 236.

legal regulation of the legal catalog of the governing body (person), as well as the need to regulate a particular opportunistic action³⁹ by such a standard as a conflict of interest.

The scale of authority⁴⁰ given to a manager by organic theory⁴¹ creates the risk of fraudulent, opportunistic action,⁴² which is balanced by defined legal strategies⁴³ and the general standard of conduct established by corporate law as a fiduciary duty.⁴⁴

The standard of conduct of a manager, which should resolve the conflict between obligations and interests, is combined under the systemic concept of "duty of loyalty"⁴⁵ to minimize the risk of misallocation of property and information.⁴⁶ Risk practice goes beyond the standard of good faith. *The form and content of a breach of the standard of good faith are shaped by actions*

³⁹ For one explanation of opportunistic action, see *Makharoblishvili G.*, General Analysis of Corporate Governance, Tbilisi, 2015, 80-81 (in Georgian).

⁴⁰ On the governing body as a representative body, see *Burduli I.*, Fundamentals of Share Law, Vol. II, Tbilisi, 2013, 360-370 (in Georgian).

⁴¹ *Chanturia L.*, Introduction to the General Part of Georgian Civil Law, Tbilisi, 2000, 238-241 (in Georgian).

⁴² A somewhat different perception of the conflict of interests is presented in the Corporate Governance Code approved by the order of the President of the National Bank of Georgia, which states in the basic principles of corporate governance that the bank should ensure the establishment of an organizational and governance structure where conflicts of interest are ruled out and no one enjoys indefinite decision-making authority. See Order of the President of the National Bank of Georgia of September 26, 2018 215/04 "On the Approval of the Corporate Governance Code of Commercial Banks", Article 3, Paragraph 4, Legislative Herald, 27/09/2018 (in Georgian). Forming an "organizational and governance structure" that excludes conflicts of interest is unattainable in terms of the fundamental grounds of corporate governance, because there will always be two different interests and only in rare cases will there be an altruistic manifestation, so the use of the word "exclusion" is appropriate in this context. Consequently, a conflict of interest does not require the re-establishment of an organizational and governance structure (which the bank cannot provide), but rather the existence of "internal policies and procedures that rule out a conflict of interest in the work of governing bodies." See Code of Corporate Governance for Commercial Banks, SBA, Conflict of Interest, IFC, 2009 (in Georgian). Ensuring the existence of internal policy and procedure is the main task that can be done even by a bank, which should be established in the legal form of the JSC (see Law of Georgia on Commercial Banks, Article 2, Paragraph 1, Parliamentary Agencies 003, 23 / 03/1996 (in Georgian), to determine at the internal organizational level. In this regard, it is possible to see a substantial difference between "establishing the organizational and governance structure of the JSC" and "the existence of internal policies and procedures". Compare: *Armory J., Hansman H., Krackman R., Pargendler M.*, What is corporate justice? In the collection: Anatomy of Corporate Law: Comparative and Functional Approach, (Translators) *Kochiashvili A., Maisuradze D.* (ed.) *Gabelia T.*, 3rd ed., Tbilisi, 2019, 35 (in Georgian).

⁴³ Legal strategies consider the conditions of affiliation, the incentive circumstances of the representative, the decision-making power and the limitation of the representative power. See *Enrique L., Hertig J., Kanda H., Pargendler M.*, Related party transactions, in the collection: Anatomy of Corporate Law: Comparative and Functional Approach, (Translators) *Kochiashvili A., Maisuradze D.* (ed.), *Gabelia T.*, 3rd ed., Tbilisi, 2019, 223 (in Georgian).

⁴⁴ *Chanturia L.*, Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 199-206 (in Georgian).

⁴⁵ *Burduli I.*, Fundamentals of Share Law, Volume II, Tbilisi, 2013, 432-441 (in Georgian).

⁴⁶ *Enrique L., Hertig J., Kanda H., Pargendler M.*, Related party transactions, in the collection: Anatomy of Corporate Law: Comparative and Functional Approach, (Translators) *Kochiashvili A., Maisuradze D.* (ed.), *Gabelia T.*, 3rd Edition, Tbilisi, 2019, 248 (in Georgian).

such as conflicts of interest, these include dealing with oneself,⁴⁷ dealing with related parties, seizing corporate (business) opportunity, and trading insider⁴⁸ information.⁴⁹

The last two cases constitute a management person in conflict with the interests of the JSC, but it doesn't have a sign of conflict of interest in classical understanding - a necessary party to the transaction must be a joint stock company,⁵⁰ which will enter into a legally binding relationship through the governing body and will be the beneficiary of the results obtained.⁵¹

2.2. Legal Basis of the Transaction

Conflict of interest, as an established standard of conduct for a person governing by corporate law, has historical,⁵² factual, and transactional underpinnings. The original record used more elements of forbidding competition⁵³ as descriptive content of the conflict of interest content, while technically calling it a conflict of interest.⁵⁴ The new edition of the LGE,⁵⁵ in contrast to its invalid version, sets the norm of regulating conflict of interest as a separate article for the private sector and specifies its area of operation with respect to the legal form of the joint stock company.⁵⁶

⁴⁷ *Palmiter A. R.*, *Corporations, Examples and Explanations*, 5th ed., Aspen Publisher, 2006, 231.

⁴⁸ Regarding the misuse of insider information, see *Robakidze S.*, *Transactions and Private-Legal Consequences of Misuse of Insider Information*, in *Collection: Collection of Corporate Law I*, *Burduli I. (ed.)*, Tbilisi, 2011, 159-260 (in Georgian); *Cahn A., Donald D. C.*, *Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA*, Cambridge University Press, 2011, 454-463.

⁴⁹ Compare: *Tsertsvadze L.*, *Duties of a Director in Merger and Alienation of a Company (Comparative Legal Analysis on the Example of US, Predominantly Delaware, EU and Georgian Law)*, Tbilisi, 2015, 119-124 (in Georgian).

⁵⁰ *Cahn A., Donald D. C.*, *Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA*, Cambridge University Press, 2011, 342.

⁵¹ Revised Model Business Corporation Act, 2021, § 8.60, Official Comment No. 1.

⁵² For the first time, such a terminological record appears with the 2005 amendment. See Law of Georgia on Entrepreneurs, SSM, 40, 18/07/2005 (repealed, 01/01/2022).

⁵³ It is interesting to compare the rule of prohibition of competition with the director's duty not to receive benefits from a third party related to his presence as director or acting or inaction as a director. See *French D., Mayson S., Ryan C.*, *Company Law*, 26th ed., Oxford University Press, 2010, 498.

⁵⁴ *Jugheli G.*, *Capital Protection in a Joint Stock Company*, Tbilisi, 2016, 249 (in Georgian).

⁵⁵ Law of Georgia on Entrepreneurs, Article 208, Legislative Herald, 04/08/2021 (in Georgian).

⁵⁶ It is noteworthy that other manifestations of breach of duty, such as prohibition of competition, misappropriation of business opportunity, are presented in the general part of the new version of the LGE, while in the draft law (Registration Code: 000000000.00.00.016578, Legislative Herald, 13/08/2020) conflict of interest was presented with them in the form of Article 56. A substantive and functional explanation can be found for the transfer of the conflict of interest from the general part to the private part and only to the regulatory norms of the JSC. In particular, the above-mentioned corporate legal basis for the conflict of interest relates substantively to the JSC when, among other things, a transaction with a related person is to be made public by a disinterested director. See *Enrique L., Hertig J., Kanda H., Pargendler M.*, *Related party transactions*, in the collection: *Anatomy of Corporate Law: Comparative and Functional Approach*, (Translators) *Kochiashvili A., Maisuradze D.*, (Ed.) *Gabelia T.*, 3rd ed., Tbilisi, 2019, 249 (in Georgian). The so-called The issue of an uninterested (invited) director is a positive manifestation of the separation of ownership and control and is usually related to the functioning of the corporate governance of an open (public) JSC. This distin-

The regulation of conflicts of interest, in its classical sense, was first reflected in the Law of Georgia on the Securities Market.⁵⁷ However, this law identifies the target subject of the conflict of interest as an accountable enterprise.⁵⁸ The accountable enterprise is defined by the Law of Georgia on the Securities Market, according to which, an issuer of public securities is considered an accountable enterprise, which is based on the Law of Georgia on Entrepreneurs.⁵⁹ A public security is a class of securities that has been placed on a public offering and / or admitted to trading on a stock exchange.⁶⁰ It is natural, that the content of securities trading provided for the specificity of the target entity, and it did happen so. However, the content of the capital market,⁶¹ it can be said, is an even more specific direction of corporate law (in its broadest sense) and it does not cover all types of JSCs - it includes (and included) only accountable JSCs.⁶² Accordingly, the

guishes it (JSC) from all other legal forms, which are considered to be so-called closed business enterprises, where the formation of the governing body takes place, predominantly, from the structure of partners. See *Makharoblishvili G.*, Implementation of fundamental changes in the structure of capital societies on the basis of corporate-legal actions (acquisition-merger), Tbilisi, 2014, 33 (in Georgian). In such a case, the identity of the partner and the member of the governing body makes it possible to enforce such a standard of corporate legal protection as (partner) loyalty, abuse of a dominant position, significant transaction and its conclusion, and other (e.g., additional protection provided by the statute) standards. Adding to the above-mentioned reasoning is the fact that, in accordance with the principle of disposition declared in the first article of the new version of the LGE, the substantive regulation of conflicts of interest may be provided for in the statutes of other legal forms. See *Burduli I., Makharoblishvili G., Tokhadze A., Zubitashvili N., Aladashvili G., Magradze G., Egnatashvili D.*, Corporate Law, Tbilisi, 2021, 186 (in Georgian). This assumption, together with the principle of disposition, falls within the scope of private autonomy of the will, which is a principle reinforced by general private law. See *Chanturia L.*, Commentary on the Civil Code, Book I, *Chanturia L. (ed.)*, Tbilisi, 2017, Article 1, Vol. 5, 8, 20 (in Georgian). In summary, the legislature has imperatively set a high standard of conflict of interest for the JSC as a legal form of organized management of large capital, thus confirming its special legal and economic content (encumbrance), including in this form.

⁵⁷ Law of Georgia on the Securities Market, Article 161, Departments of the Parliament of Georgia, 1 (8) 14/01/1999.

⁵⁸ For the content of the accountable enterprise, see *Makharoblishvili G.*, Implementation of Fundamental Changes in the Structure of Capital Societies on the Basis of Corporate-Legal Actions (Acquisition-Merger), Tbilisi, 2014, 34-42 (in Georgian).

⁵⁹ Law of Georgia on the Securities Market, Article 9, Paragraph 1, Departments of the Parliament of Georgia, 1 (8) 14/01/1999.

⁶⁰ Law of Georgia on the Securities Market, Article 2, Paragraph 36, Departments of the Parliament of Georgia, 1 (8) 14/01/1999.

⁶¹ *Burduli I., Makharoblishvili G., Egnatashvili D., Ebanoidze T.*, Capital Market Functionality: The Existing Reality and the Necessity of Reform, *Burduli I. (ed.)*, Tbilisi, 2017, 19-67 (in Georgian).

⁶² When conducting an analysis on this issue, an interesting observation should be made: the regulation of the Law of Georgia on the Securities Market does not cover all types of joint stock companies, as the content of the "accountable enterprise" is presented as a prescription. Accordingly, the new version of the Law of Georgia on Entrepreneurs has established a regulation regulating the conflict of interests, imperatively, only for the JSC, however, we should not consider an accountable enterprise among them, because the securities market legislation is even more specific and in such cases its regulation should be applied. However, the reasoning is gets complicated by the interpretation of the definition established by the Law of Georgia on the Securities Market of the accountable enterprise itself (see Article 9, paragraph 1), insofar as it focuses on any enterprise based on the LGE that issues public securities, ie places the security on the basis of a public offering or admits to trading on the stock exchange. Theoretically, this definition can apply to all legal forms, of course, taking into account the specific requirements of the secondary capital market. However, also theoretically, if the

new edition of the Law of Georgia on Entrepreneurs incorporated the norm of regulating conflict of interest in the part of the JSC and, in substantive and qualitative agreement, "shared" the spirit of regulating the securities market legislation.⁶³ The regulation of both laws is united by three sub-directions of one pathos: A) regulates the conflict between the interests of the entrepreneur community and the member of the governing body and prevents its consequences; B) refers directly to the transaction in which the interested person is involved; C) requires disclosure of information on a transaction involving a conflict of interest. As a result, both the existing Georgian legislation on conflicts of interest and the newly established regulation of the LGE regulate conflicts of interest in practice, which defined the transaction as an unconditional basis.⁶⁴

3. Categorization of Conflict of Interest

The corporate law system provides the necessary components for the functioning of an entrepreneurial society in the form of various institutions and strategies. Such institutional manifestations can be considered fiduciary duty and its subtype duty of loyalty, and as a strategy of conscientious protection of the duty of loyalty - a conflict of interest.⁶⁵ Its content is based on the motivated behavior of generating the personal benefit of the individual as a *homo economicus*. The functional purpose of corporate law regulation defined at the normative level is the preventive control of the motive of tangible or intangible property gain in *homo economicus*, which should consequently lead to an increase in its behavior to the conventional-rational level. Of course, this is only a regulatory area governed by positive law, which fails to cover the motive formed in the psycho-nervous part of an individual's behavior, an aspect of *Inter Alia* behavioral economics such as the doctrine of limited rationality,⁶⁶ but fully manages to prevent the threat of fraudulent activity and its economic-legal consequences. Therefore, it is important to analyze the direction that allows the classification of types of conflicts of interest.

LLC meets the criteria for qualification as an accountable enterprise, the requirements of Article 161 of the Law of Georgia on the Securities Market will apply directly to it and the effect of the above principle of disposition will be nullified and weighed (Based on the private autonomy of the will, the conflict of interest is regulated in the charter of the LLC similar to the JSC (Article 208 of the LGE)) in favor of the securities market legislation.

⁶³ It is logical that there is some differentiation between the purposes of two different laws.

⁶⁴ However, it should be noted that in Georgian law, the definition of a conflict of interest only at the transaction level is related to its relatively narrow understanding. The practical manifestation of a conflict of interest is not just about making a deal with "oneself", but it also deals with conflicts of interest in bidding, conflicts of interest in insider trading, and (potential) conflicts of interest in the acquisition of a business opportunity by an JSC. See *Pinto R.A.*, *Understanding Corporate Law*, 3rd ed., Lexisnexus, 2009, 241-242. An example of a so-called self-tender is analyzed in the case, *Unocal Corp. v. Mesa Petroleum Co*, 493 A.2d. 946 (Del. 1985), where the authenticity of the self-tender announced by the corporation for its own shares was discussed, which ruled out the possibility of the shareholder participating in a hostile tender offer.

⁶⁵ *Cahn A., Donald D. C.*, *Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA*, Cambridge University Press, 2011, 341.

⁶⁶ *Djibouti S.*, *Modern Legal Problems of Protecting the Interests of Small Investors in the Capital Market and Ways to Solve Them*, Tbilisi, 2016, 42-45 (in Georgian).

The classification of types of conflicts of interest is based on the form and content of the relationship between persons with different interests. Depending on the form, the construction of a conflict of interest may have two or more participating entities (its interest).

In the case of the first and all alternative modeling, one of the subjects of the relationship is JSC and its interest or potential interest as of an organizational entity.

Second, the person with the managerial authority of the JSC and its direct or indirect interest.

Third, the interaction of a related person with an interested person whose personal motive for the JSC could pose a potential economic threat.

In terms of content, all constructions are placed in the three above mentioned categories, which, in a narrow and broad sense, represent the subjects in it in the dimension of conflict of interest. In a broad sense and institutionally, a conflict of interest arises A) The so-called an attempt to seize⁶⁷ a business opportunity by corporation.⁶⁸ B) when trading insider information,⁶⁹ and in a narrow sense⁷⁰ - when making a deal with oneself⁷¹ or a related person.⁷²

It should be noted that the presence of JSC interest in any construct of conflict of interest does not imply the participation of JSC as a party to all probable transactions. For example, in case of misappropriation of a corporate opportunity,⁷³ the damage is done to the entrepreneur community,⁷⁴ although the person in charge of the transaction may act independently for personal gain and not on behalf of the JSC and in its favor.⁷⁵ A similar legal cause exists in the case of

⁶⁷ *Cahn A., Donald D. C., Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge University Press, 2011, 342.*

⁶⁸ *Zubitashvili N., The Doctrine of Corporate Opportunity in American and Georgian Law, Journal of Law, №2, 2013, 44-56 (in Georgian); Burduli I., Makharoblishvili G., Tokhadze A., Zubitashvili N., Aladashvili G., Magradze G., Egnatashvili D., Corporate Law, Tbilisi, 2021, 180-184 (in Georgian); Chanturia L., Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 341-350 (in Georgian).*

⁶⁹ For the purpose of this paper, the so-called broad understanding of conflict of interest is not subject to further analysis.

⁷⁰ It could otherwise be called the classical understanding of conflict of interest.

⁷¹ Among the types of "transaction", in relation to the JSC, the concept of the so-called significant transaction and the rule of its conclusion were distinguished, which, in theory, may contain signs of conflict of interest. However, in the presence of signs of conflict of interest, a special norm on conflict of interest should be applied. See Law of Georgia on Entrepreneurs, Articles 223, 224, Legislative Herald, 04/08/2021.

⁷² Compare: *Tsertsvadze L., Duties of the Director in Merging the Company and Selling the Controlling Stake (Comparative Legal Analysis on the Example of US, Predominantly Delaware, EU and Georgian Law), Tbilisi 2015, 132-133 (in Georgian); Gevurtz F. A., Corporation Law, West Group, 2000, 321.*

⁷³ *Davies P., Introduction to Company Law, 2nd ed., Oxford University Press, 2010, 162.*

⁷⁴ When seizing the opportunity of the corporation, there is also a so-called No Profit Rule. See *Davies P., Introduction to Company Law, 2nd ed., Oxford University Press, 2010, 177-182.*

⁷⁵ Conflicts of interest naturally occur in the case of misappropriation of corporate opportunity, however, in contrast to the conflict of interest in the classical sense, for example, a claim for the invalidity of a transaction gets more complicated, if the owner of the property is no longer the corporation itself. However, if the director seizes the opportunity of the corporation in such a way that he enters into a transaction with a corporation represented by him, then the corporation can claim the interest due to it without canceling the transaction. See *Palmiter A. R., Corporations, Examples and Explanations, 5th ed., Aspen Publisher, 2006, 241.*

insider trading.⁷⁶ As for the so-called classical conflict of interest in concluding a transaction with oneself or a related person, one of the parties to the transaction is always the JSC, which will have a direct legal and economic result from the concluded or to be concluded transaction.⁷⁷

4. The Essence of the Conflict of Interest and Modeled Variations of its Manifestation

4.1. The Basic Elements that Define the Essence of a Conflict of Interest

The motive for breach of fiduciary duty is personal economic gain, which is the result of a conflict of interest and obligation. One is to regard the conflict of interest as a ground for breach of fiduciary duty, and the other is its content. There are defining elements of the concept of conflict of interest and there are different cases of its practical manifestation.

The essence of the conflict of interest regulated at the legislative level in the JSC is based on several elements of a formal and material nature.⁷⁸ These elements are:

- A) transaction or conclusion of a transaction;
- B) manager;
- C) the grounds for inclusion of the manager as interested person;
- D) the notion of a person related to the interested person;⁷⁹
- E) the decision-making body on the approval of the transaction, the procedure and content of the decision;
- F) openness of information about the transaction;
- G) legal consequences of the transaction;
- H) Economic consequences of the transaction.⁸⁰

A conflict of interest can be defined as a situation in which a person or corporation is in a position to obtain personal or corporate benefits, which differs from the remuneration arising from the contractual relationship of the person with the JSC.⁸¹ The content of the conflict of interest is also presented in the principles of the Organization for Economic Co-operation and Development of Europe (hereinafter - OECD): conflict of interest is a qualitatively characteristic element of a

⁷⁶ For transactions involving the use of insider information and their private legal consequences, see *Robakidze S.*, Transactions with Abuse of Insider Information and Private-Legal Consequences, in Collection: Collection of Corporate Law I, *Burduli I. (ed.)*, Tbilisi, 2011, 226-255 (in Georgian).

⁷⁷ A relatively high standard is established by the Law of Georgia on the Securities Market, which not only concerns the conclusion of a transaction by an accountable JSC submitted by an interested person, but also includes a subsidiary of the Accountable JSC in which it owns more than 50%. See Law of Georgia on the Securities Market, Article 161, Paragraph 2, Departments of Parliament 1(8), 24/12/1998.

⁷⁸ *Cahn A., Donald D. C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge University Press, 2011, 338.

⁷⁹ For explanation of a related person, see Law of Georgia on the Securities Market, Article 2, Paragraph 11, Departments of Parliament 1 (8), 24/12/1998.

⁸⁰ Law of Georgia on Entrepreneurs, Article 208, Legislative Herald, 04/08/2021. Compare: Delaware General Corporation Law, § 144.

⁸¹ Corporate Governance Code for Commercial Banks, Conflict of Interest, SBA, IFC, 2009 (in Georgian).

related transaction, which, instead of being prohibited,⁸² should be properly managed in the interests of the corporation and shareholders.⁸³ Effective monitoring and openness of information should be used as its management mechanism.⁸⁴

4.2. Modeled Variations of Conflict of Interest

4.2.1. "Direct" Conflict of Interest

The so-called classical form of conflict of interest involves a transaction between an JSC and its manager⁸⁵ when both parties are the same person. It is also called a "direct"⁸⁶ conflict of interest.⁸⁷ In other words, the appearance of the mentioned conflict of interest is also called concluding a deal with the interested director, where it receives a type of income which, at the same time, is not shared and distributed in proportion to the shares of the shareholders,⁸⁸ i.e. the generation of benefits by the interested management person⁸⁹ is completed at the expense of the interests of the shareholders and the corporation.⁹⁰ Potential damage to the transaction arises from

⁸² *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 276.

⁸³ G20/OECD Principles of Corporate Governance, II. The Rights and Equitable Treatment of Shareholders and Key Ownership Function, 2015, 25-26. Compare: Order of the President of the National Bank of Georgia of September 26, 2018 215/04 "On the Approval of the Corporate Governance Code of Commercial Banks", Article 3, Paragraph 4, Legislative Herald, 27/09/2018.

⁸⁴ G20/OECD Principles of Corporate Governance, II. The Rights and Equitable Treatment of Shareholders and Key Ownership Function, 2015, 25-26. Compare: Order of the President of the National Bank of Georgia of September 26, 2018 215/04 "On the Approval of the Corporate Governance Code of Commercial Banks", Article 4, Paragraph 4, Legislative Herald, 27/09/2018.

⁸⁵ *Palmiter A. R.*, Corporations, Examples and Explanations, 5th ed., Aspen Publisher, 2006, 232. See also, *Bakakuri N., Gelter M., Tsertsvadze L., Jugheli G.*, Corporate Law, Handbook for Lawyers, Tbilisi, 2019, 103-106 (in Georgian).

⁸⁶ Revised Model Business Corporation Act, 2021, § 8.60, Official Comment No. 4.

⁸⁷ *Gevurtz F. A.*, Corporation Law, West Group, 2000, 351. See Law of Georgia on Entrepreneurs, Article 208, Paragraph 2, Subparagraph a), Legislative Herald, 04/08/2021.

⁸⁸ *Pinto R.A.*, Understanding Corporate Law, 3rd ed., Lexisnexis, 2009, 243.

⁸⁹ Unlike the Law of Georgia on Entrepreneurs, the securities market legislation also considers a shareholder who holds 20% or more of the total number of votes of the accountable JSC as an interested person. See Law of Georgia on the Securities Market, Article 161, Paragraph 1, Departments of Parliament 1 (8), 24/12/1998. Accordingly, additional emphasis is placed on the possibility of influencing the decision of the General Meeting of Shareholders and on the subject of the shareholder as an interested person. See *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 295-300.

⁹⁰ There are many discussed versions of potential conflict of interest in foreign court practice. In the case of *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) The basis for the litigation became the decision on the distribution of the dividend. Sinclair Corporation has decided to distribute a dividend to its wholly owned subsidiary Sinclair Venezuelan Oil Company (Sinven), the result was a situation where the decision to distribute the dividend was made in a corporation where the managing director owns shares in the same corporation and the director would receive the money as a shareholder. The shareholders of Sinven Corporation filed a diversion lawsuit against Sinclair, alleging breach of duty. In particular, Sinclair Corporation used its "power" and decided to distribute excessive dividends to Sinven Corporation because it needed additional funding. The main point of the question on the subject matter was why such a transaction should not be regarded as a conflict of interest

the presence of one person on both sides of it: In the presence of the same person on both sides of the transaction, negotiation and / or trade are excluded.⁹¹

A common variant of a conflict of interest transaction with oneself is the issue of remuneration⁹² when the corporation agrees with its supervisor on the issue of compensation.⁹³ This creates the basis for an expensive pay package to be agreed with the manager, which is achieved at the expense of the shareholders.⁹⁴ Without a defined set of remuneration, a person representing an JSC will not agree to a corporate position unless there is an exceptional case. For example, in a so-called closed joint stock company, a shareholder with a controlling stake aspires to the position of director in order to protect the invested capital without⁹⁵ additional remuneration.⁹⁶ However, in an open (public) JSC⁹⁷ where the shareholder structure is dispersed⁹⁸ and there is no shareholder with a controlling stake,⁹⁹ the motivational feeling of being the head of a small shareholder of JSC will be minimal.¹⁰⁰ The described data is directly regulated by the new edition of the LGE, which qualifies as a conflict of interest transaction the type of interest on the part of the manager when he, on the one hand, represents an JSC and, on the other hand, himself is

transaction or a transaction entered into with oneself. The court should have answered the question "Did the parent corporation receive anything by excluding minority shareholders and at their expense?" The court held that the decision on the dividend by Sinclair Corporation was not a deal with oneself, as the parent corporation received nothing at the expense of the minority shareholder of the subsidiary corporation - all shareholders were entitled to a proportional dividend. Another interesting fact is that in the present case, a fairness test of the dividend distribution decision would have subject all cases of dividend issuance to a similarly high standard of examination, leading to a utopian outcome in court.

⁹¹ *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 190.

⁹² *Cahn A., Donald D. C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge University Press, 2011, 338.

⁹³ The issue of director remuneration is a determinant of good corporate governance effectiveness. See *Bazghadze T.*, Remuneration of the Director as a Prerequisite for Effective Corporate Governance on the Example of Experience from the Global Economic Crisis, in Collection: Collection of Corporate Law III, *Burduli I. (ed)*, Tbilisi, 2015, 119-151 (in Georgian).

⁹⁴ It is considered that the content of the conflict of interest in such a transaction falls within the scope of ordinary business activities, which is why it is still separated from the content of the transaction by an interested director different from the ordinary business line. See *Pinto R.A.*, Understanding Corporate Law, 3rd ed., Lexisnexis, 2009, 255.

⁹⁵ The content of the Georgian norm, according to which, if the employment contract does not contain information on the remuneration of the manager's activities, then it is assumed that he / she performs his / her activities free of charge. See Law of Georgia on Entrepreneurs, Article 45, Paragraph 3, Legislative Herald, 04/08/2021.

⁹⁶ This is where the legal situation is considered, when the interests of the JSC, the shareholder and the manager are in relation to each other and / or fully coincide.

⁹⁷ *Burduli I.*, Fundamentals of Share Law, Vol. I, Tbilisi, 2010, 126-127 (in Georgian).

⁹⁸ "Dispersed Shareholder." See *Brudney V., Chirelstein M. A.*, Cases and Materials on Corporate Finance, Foundation Press, 1979, 708-710.

⁹⁹ The benefit of a shareholder with a controlling stake differs from the benefit of a minority shareholder: a controlling shareholder derives a so-called monetary and non-monetary private benefit. See *Kikvadze G.*, Mandatory Tender Offer, in Collection: Collection of Corporate Law III, *Burduli I. (ed.)*, Tbilisi, 2015, 60-66 (in Georgian).

¹⁰⁰ *Gevurtz F. A.*, Corporation Law, West Group, 2000, 357.

other party to the transaction.¹⁰¹ The nature of the parties to the transaction poses a threat of increased conflict of interest, but its prevention has been achieved through Georgian corporate law. In particular, it was directly and imperatively determined that the transaction entered into / concluded by the manager¹⁰² is subject to the supervisory board, or in its absence - prior approval by the general meeting of shareholders, where a person with such interest is prohibited from voting.¹⁰³ Imperative regulation neutralizes the potential threat of conflict of interest in its source. In practice, the record that an interested party must disclose information about a "concluded" transaction to the JSC will not work, as such a transaction is open at the stage of conclusion - the Chairman of the Supervisory Board or the Chairman of the General Meeting of Shareholders¹⁰⁴ enters into an employment contract with the JSC.¹⁰⁵ It should be emphasized that during the renewal / amendment of the employment contract, further approval of the transaction with the interested manager is excluded even theoretically. In any other case, for example, in a transaction of a manager selling or purchasing property from his own JSC,¹⁰⁶ taking¹⁰⁷ or lending a loan,¹⁰⁸ and other theoretically permissible transactions, the regulation of the said article shall apply in full to the period before and after the transaction.

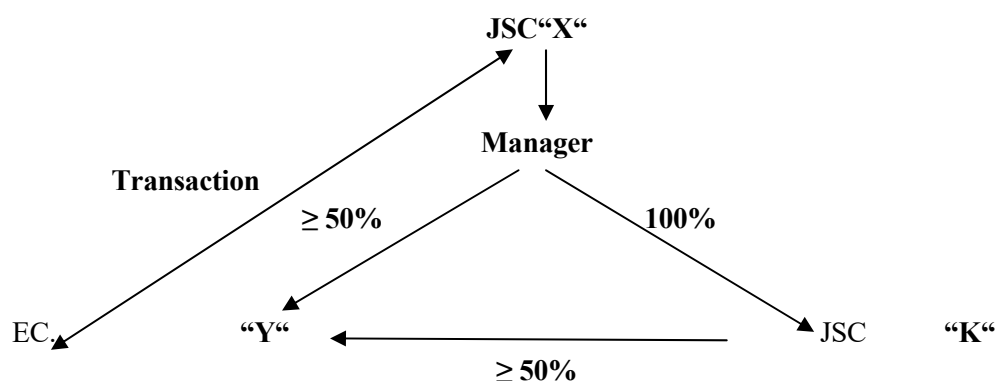


Figure №1.

¹⁰¹ Law of Georgia on Entrepreneurs, Article 208, Paragraph 2, Subparagraph a), Legislative Herald, 04/08/2021 (in Georgian).

¹⁰² It is noteworthy that the issue concerns only the revision of the concluded transaction, as the first invitation or appointment of the subject to a leadership position does not give rise to a conflict of interest in the described construction.

¹⁰³ Law of Georgia on Entrepreneurs, Article 208, Paragraph 4, Legislative Herald, 04/08/2021. It is similarly regulated in the securities market legislation. See Law of Georgia on the Securities Market, Article 161, Paragraph 5, Departments of Parliament 1 (8), 24/12/1998.

¹⁰⁴ In a general meeting of shareholders or, in a two-tier management system, the approval of a transaction to be entered into by the supervisory board is recognized as a so-called strong protection mechanism for a transaction involving a conflict of interest. See *Pinto R.A.*, Understanding Corporate Law, 3rd ed., Lexisnexus, 2009, 252-254.

¹⁰⁵ Law of Georgia on Entrepreneurs, Article 45, Paragraph 2, Legislative Herald, 04/08/2021.

¹⁰⁶ *Pinto R.A.*, Understanding Corporate Law, 3rd ed., Lexisnexus, 2009, 244.

¹⁰⁷ In the United States, the Sarbanes-Oxley Act, passed in 2002, effectively prohibited the lending of personal loans to executives. See *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 204-205.

¹⁰⁸ *Cahn A., Donald D. C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge University Press, 2011, 343.

4.2.2. Fundamentals of Enrollment as Interested Person

In order for a manager's action or alleged action to be subject to a normative settlement of a conflict of interest,¹⁰⁹ it is necessary to shift the vector of attention to the substantive elements of his interest. The transaction¹¹⁰ was analyzed as a "direct" conflict of interest with the JSC represented by its competence. As for the other grounds for charging a manager as interested person, their construction is even more complicated.¹¹¹

In contrast to the "direct" conflict of interest, there is an "indirect" conflict of interest,¹¹² when the head of the corporation represented in the transaction has some interest in the other party to the contract, for example, the other party to the transaction directly or indirectly owns¹¹³ 50 per cent or more than 50 per cent of the shares of that corporation.¹¹⁴ A different version of an "indirect" conflict of interest is the fact of a person related¹¹⁵ to the manager involved in the transaction.¹¹⁶

Another form of actual manifestation of a conflict of interest is a transaction between two or more corporations in which the managing director has an interest,¹¹⁷ for example, being the head of a JSC that is the other party to the transaction.¹¹⁸ There is not a conflict between the interests of

¹⁰⁹ For a comparative analysis, see UK Companies Act 2006, sections 175-231.

¹¹⁰ Securities market legislation also focuses on the substance of the transaction, such as its value. In particular, if 10% or more of the assets of the accountable enterprise are the value of the transaction in which the interested party participates, then it must be audited by an external auditor / certified accountant and approved by the Supervisory Board or the general meeting, and if the value exceeds 50% - the general meeting. See Law of Georgia on the Securities Market, Article 161, Paragraphs 51, 6, 7, Departments of Parliament 1 (8), 24/12/1998.

¹¹¹ *French D., Mayson S., Ryan C.*, Company Law, 26th ed., Oxford University Press, 2010, 491.

¹¹² Revised Model Business Corporation Act, 2021, § 8.60, Official Comment No. 4.

¹¹³ "JSC" means all legal forms defined by the Law of Georgia on Entrepreneurs, except for individual entrepreneur. See Law of Georgia on Entrepreneurs, Article 2, Paragraph 3; Article 208, paragraph 2, sub-paragraph b), Legislative Herald, 04/08/2021. Compare: Delaware General Corporation Law, § 144 (a).

¹¹⁴ Law of Georgia on Entrepreneurs, Article 208, Paragraph 2, Subparagraph b), Legislative Herald, 04/08/2021. See Scheme № 1. A different percentage is set by securities market legislation, which specifies the share and determines its content not only by the ownership of the share in general, but also 20% or more of the total number of votes. See Law of Georgia on the Securities Market, Article 161, Paragraph 2, Subparagraph b), Departments of Parliament 1 (8), 24/12/1998.

¹¹⁵ *Palmiter A. R.*, Corporations, Examples and Explanations, 5th ed., Aspen Publisher, 2006, 232.

¹¹⁶ *Chanturia L.*, Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 321 (in Georgian).

¹¹⁷ *Gevurtz F. A.*, Corporation Law, West Group, 2000, 351.

¹¹⁸ Law of Georgia on Entrepreneurs, Article 208, Paragraph 2, Subparagraph d), Legislative Herald, 04/08/2021(in Georgian). A different regulation is proposed by the securities market legislation, according to which a person will be considered interested if he / she is appointed / elected as a member of the governing body of this accountable enterprise nominated by the other party to the transaction or by the holder of 20% or more of the total votes of the other party to the transaction. See

the corporation and the management, but a competition between the responsibilities of the person¹¹⁹ holding the position of management in both contracting corporations.¹²⁰

For a transactional relationship to qualify as a conflict of interest, in order for an interested person to be the subject of its results, he must be involved in the negotiation and transaction process,¹²¹ otherwise the absence of a conflict of interest is emphasized.¹²² Echoing this aspect of the analysis is that any personal interest¹²³ cannot be the basis for qualifying as a conflict of interest of a transaction. If the managing director or shareholder with a controlling stake (if any) has substantially the same interests as the minority shareholders, then this should not be interpreted as a conflict of interest.¹²⁴ It is a logical consequence as long as the moral basis¹²⁵ of the conflict between interests goes beyond their different content and consequences. When the interests of the parties involved in a transactional relationship are consequently different from each other,¹²⁶ then a conflict of interests arises.

The more conflict of interests is lost in a multilevel relationship, the higher the risk carrier. The complex schematic expression of the managing person of the transaction as an interested person is the following: A person will be considered as interested if he / she directly or indirectly owns 50 percent or more than 50 percent of the shares of that JSC, the 50 per cent stake of which is in the ownership of other party to the transaction.¹²⁷ This content of the interested person consists of several interrelated elements.¹²⁸ In particular, a) direct (indirect) ownership by the management of a share with a percentage of 50% or more; B) an JSC independent of the transaction, in which the managing director owns a share; C) the other party to the transaction, D)

Law of Georgia on the Securities Market, Article 161, Paragraph 2, Subparagraph d), Departments of Parliament 1 (8), 24/12/1998 (in Georgian).

¹¹⁹ They are also called "Interlocking Directors". It is an interesting fact that in the case of a public joint stock company, where the persons invited to the governing body are also represented, the existence of interconnected, joint directors must be favorable to both corporations. See *Pinto R.A.*, Understanding Corporate Law, 3rd ed., Lexisnexis, 2009, 244.

¹²⁰ *Gevurtz F. A.*, Corporation Law, West Group, 2000, 352.

¹²¹ However, a fair transaction requires information disclosure at the relevant time, regardless of whether the manager is directly involved in the process of agreeing the terms of the transaction. See Revised Model Business Corporation Act, 2021, § 8.60, Official Comment No. 7.

¹²² A.L.I. Corporate Governance Project, §5.07.

¹²³ Emotional involvement in the transaction can not be qualified as a conflict of interest, there must be material-financial or other interest involved. See Revised Model Business Corporation Act, 2021, § 8.60, Official Comment No. 4. See *Bakakuri N., Gelter M., Tsertsvadze L., Jugheli G.*, Corporate Law, Handbook for Lawyers, Tbilisi, 2019, 102-103 (in Georgian).

¹²⁴ *Gevurtz F. A.*, Corporation Law, West Group, 2000, 353.

¹²⁵ The duty of loyalty is a highly moral category of behavior. See *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 184.

¹²⁶ The term "foreign interest to the corporation" is also used in the legal literature. See *Chanturia L.*, Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 324 (in Georgian).

¹²⁷ Law of Georgia on Entrepreneurs, Article 208, Paragraph 2, Subparagraph c), Legislative Herald, 04/08/2021

¹²⁸ Under Delaware General Corporation Law, a transaction entered into or to be entered into with an interested director, without a percentage, if the transaction is approved by the general meeting of shareholders or approved by the disinterested directors, is considered valid unless otherwise specified. See Delaware General Corporation Law, § 144.

the holding of a share by the other party to the transaction with a percentage of 50% or more in the JSC in which the manager holds a share. For a complete understanding of the described corporate relationship, it is advisable to express it in a schematic form (see Figure №2).

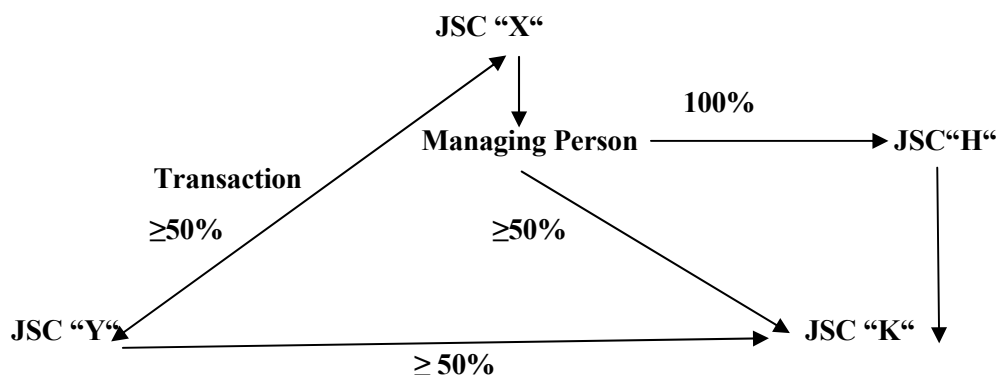


Figure №2.

Another element in shaping the content of an interested person is the postulate of conflict of interest where the manager receives a benefit as a result of the transaction, which is not related to owning a stake in the company or membership in a governing body.¹²⁹ Separate from the disposition of the norm are the legally recognized and permissible forms of receiving benefits. The manager may receive benefits in the form of remuneration on the basis of membership in the governing body and on the basis of an employment contract, but this relationship is usually free from conflict of interest¹³⁰ as long as the transaction is approved by one of the bodies defined by the law of the JSC.¹³¹

The distribution of the proportionate share in the net income of the JSC in the form of dividends, if the interests of all shareholders are equally considered, does not constitute a construction of a conflict of interest.¹³² Both types of benefits are defined as legally foreseeable. The legislator's goal is related to the multiplicity of relationships and such range of permissibility of the action, where multiple interactions and at least a few intermediate links may exist. The cornerstone of the discussion is the word "benefit" and the entities involved in the transaction, between which the transaction generates a benefit.

The first part of the transaction construction is as follows: The subject party to the transaction is the JSC of the manager (representative) and the third party, rather than the manager himself or a person related to him. Typically, the legal and economic consequences of the transaction benefit the JSC, but independently or in parallel, the managing person may receive the benefit as well.

¹²⁹ Law of Georgia on Entrepreneurs, Article 208, Paragraph 2, Subparagraph e), Legislative Herald, 04/08/2021

¹³⁰ Different legal data are available for JSCs operating in the secondary capital market. See *Cahn A., Donald D. C., Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA*, Cambridge University Press, 2011, 419-427.

¹³¹ *French D., Mayson S., Ryan C., Company Law*, 26th ed., Oxford University Press, 2010, 499.

¹³² *Cox J. D., Hazen T. L., The Law of Corporations*, Vol. 2, 3rd ed., St. Paul, 2010, 187, 194.

The second, basically, in corporate-legal "benefit" financial¹³³ or other interest is considered,¹³⁴ the realization of which may result in some material, economic income. The benefit, in terms of content, can also be legal and imply a legal advantage.

For theoretical demonstration, a transaction in favor of a third party¹³⁵ can be used.¹³⁶ As a rule, an agreement concluded between two or more parties creates rights and obligations for their participants.¹³⁷ However, the JSC may enter into a purchase agreement with the car dealer, under which the car will be transferred directly into the ownership of the manager.¹³⁸ A tripartite relationship (rather than a tripartite agreement) with a conflict of interest protection strategy emerges,¹³⁹ the information about which should be disclosed to the JSC as soon as it is understood and be subject to its ratification / approval procedure.¹⁴⁰

In addition to the above, the benefit may be the result of fraud, embezzlement or abuse of power.¹⁴¹

The last aspect of the normative provision of the interested person is the possibility to define new content for him / her, which the Law of Georgia on Entrepreneurs recognizes as permissible due to the principle of disposition.¹⁴² In addition to the normatively defined definition of the interested person, within the scope of statutory autonomy,¹⁴³ additional legal construction may be

¹³³ But not always. See *Davies P.*, Introduction to Company Law, 2nd ed., Oxford University Press, 2010, 161.

¹³⁴ Thus, for example, the norm of conflict of interest and disclosure of information of the Law of Georgia on the Securities Market refers to cash benefits as one type of interest. See Law of Georgia on the Securities Market, Article 161, Paragraph 2, Subparagraph e), Departments of Parliament 1 (8), 24/12/1998.

¹³⁵ Some jurisdictions impose on the director the obligation not to receive benefits from a third party. See *French D., Mayson S., Ryan C.*, Company Law, 26th ed., Oxford University Press, 2010, 498.

¹³⁶ Civil Code of Georgia, Article 349, Departments of Parliament, 31, 24/07/1997.

¹³⁷ In the notion of "benefit", the consequences of such an operational transaction as the result of a merger between two JSCs are permissible. If, given the consequences of the merger transaction, the head of the JSC receives certain remuneration from a third party for the dismissal or the success of the merger transaction, then the relationship may qualify as a conflict of interest. A precondition for such compensation is that the merger transaction approved by the General Meeting of Shareholders of the JSC should not take into account the issue of remuneration of the manager, otherwise there will be a formal and material conflict of interest transaction. See *Cahn A., Donald D. C.*, Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, Cambridge University Press, 2011, 338, 343.

¹³⁸ *Rusiashvili G., Aladashvili A.*, Commentary on the Civil Code, Book III, *Chanturia L. (ed.)*, Tbilisi, 2019, Article 349, V. 1. (in Georgian).

¹³⁹ *Ibid.*, F. 8, 19, 20, 21.

¹⁴⁰ Law of Georgia on Entrepreneurs, Article 208, Paragraph 4, Legislative Herald, 04/08/2021. See also, Revised Model Business Corporation Act, 2021, § 8.62.

¹⁴¹ Illegality or abuse of office for personal gain is a ground for breach of duty of loyalty and can be considered in the category of (acceptable) benefits received in a conflict of interest. See *Davies P.*, Introduction to Company Law, 2nd ed., Oxford University Press, 2010, 182. However, a transaction involving this type of conflict of interest, if the party is a JSC, with the approval of the general meeting of shareholders can not be converted into a real transaction. See *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 210-213.

¹⁴² Law of Georgia on Entrepreneurs, Article 208, Paragraph 2, Subparagraph f), Legislative Herald, 04/08/2021.

¹⁴³ *Burduli I., Makharoblishvili G., Tokhadze A., Zubitashvili N., Aladashvili G., Magradze G., Egnatashvili D.*, *Corporate Law*, Tbilisi, 2021, 47-48 (in Georgian).

established. Thus, for example, an interested person may be a person who directly or indirectly owns the "lock" minority¹⁴⁴ of the JSC that is the other party to the transaction, and the "lock" minority to agree on a minimum threshold of 30 percent.¹⁴⁵ Given the principle of disposition and the fact that no restriction on imposing a higher or lower demand is prescribed, the consideration of any similar model by the JSC charter will fall within the regulatory area of the norm.

4.2.3. Related Person to a Manager - "Indirect" Conflict of Interest

The positive legal basis of a conflict of interest is a normatively regulated transaction-legal relationship, where the participating entity is, on the one hand, the JSC, which acts as the governing body of the relationship, and the other, the contracting party, is represented by either an interested person or a person related to him. The content of the interest in the transaction determines the substance of the conflict of interest. However, there is a "third party" called a related person. In other words, the related person has a direct interest in the transaction, while the manager only indirectly generates an interest and, consequently, a conflict of interest arises, as far as the person related to him is the other party to the transaction¹⁴⁶ and because of this, he himself becomes the interested person. The manager does not appear to be the other party to the transaction. The existence of a related person to him transforms him into an interested person. As a result, a different entity but with similar content as interested person is formed.¹⁴⁷

The notion of a related person is used by both the Law of Georgia on Entrepreneurs and the Law on the Securities Market to define the substance of a conflict of interest.¹⁴⁸ Moreover, the first does not directly interpret and redirect it to the second law.¹⁴⁹

The related person reveals the functional purpose only in conjunction with the manager.¹⁵⁰ It can be said that the manager is a kind of mediator to the involvement of the related person, to classify a transaction as a carrier of a conflict of interest. The grounds for qualifying a manager as an interested person are applied in direct proportion to the related person.¹⁵¹ But, conflict of

¹⁴⁴ Blocking Minority. It should be noted that the "locked" minority is a characteristic of a JSC with a segregated shareholder structure, as no shareholder with a controlling stake is represented in such an JSC. See *Gilson R.*, *Controlling Shareholders and Corporate Governance: Complication the Comparative Taxonomy*, Law Working Paper №49/2005, 2005, 5-6.

¹⁴⁵ Without a percentage limit, but a similar construct is normatively defined in the definition of a related person. See Law of Georgia on the Securities Market, Article 2, Paragraph 11, Subparagraph b), Departments of Parliament 1 (8), 24/12/1998.

¹⁴⁶ *Gevurtz F. A.*, *Corporation Law*, West Group, 2000, 356-357.

¹⁴⁷ Revised Model Business Corporation Act, 2021, § 8.60.

¹⁴⁸ Law of Georgia on Entrepreneurs, Article 208, Legislative Herald, 04/08/2021; Law of Georgia on the Securities Market, Article 161, Departments of Parliament 1 (8), 24/12/1998 (in Georgian).

¹⁴⁹ Law of Georgia on Entrepreneurs, Article 208, Paragraph 3, Legislative Herald, 04/08/2021 (in Georgian).

¹⁵⁰ *Davies P.*, *Introduction to Company Law*, 2nd ed., Oxford University Press, 2010, 172-173.

¹⁵¹ Basics for qualification of the manager into interested person -being on the other side of the transaction, directly or indirectly owning 50 per cent or more than 50 per cent of the JSC on the other side of the transaction, directly or indirectly owning 50 per cent or more than 50 per cent of an JSC where at least 50 per cent of the ownership belongs to the other party to the transaction, membership of the Supervisory Board of the other party to the transaction or being a manager, receiving a benefit as a result of a transaction, which is not related to the ownership of a share or membership in a governing body, other cases defined by the charter - is fully applied to the related person.

interest prevention is more complicated as another link is added in schematic modeling, which enriches the multi-layered conflict of interest with a multidimensional construction. This complicates its detection and prevention.

Related persons are classified by the Law of Georgia on the Securities Market. In particular, the related person is:

A) a person related to a physical person who, according to the Civil Code of Georgia, is included in the first and second ranks of the circle of legal heirs;

B) an enterprise in which a person directly or indirectly owns a stake that enables him or her to influence the decisions of that enterprise;

C) a member of the governing body of an enterprise in which a person directly or indirectly owns a share which enables him / her a practical opportunity to influence the decisions of that enterprise;

D) in case of a legal entity:

D. A) a member of a person's governing body and / or a person authorized to represent;

D. B) the person's partner or founder, who has a practical means, to influence the decisions of this legal entity.¹⁵²

The Georgian normative design of the definition of "related person"¹⁵³ is mainly linked to owning a share in the enterprise, being a member of the governing body and being a partner of a legal entity.¹⁵⁴

The defining elements of a related person are separated at the level of physical and legal entities. Situational modeling and identification of participating subjects is essential for a proper understanding of the norm construction. In the case of a physical person, it could be a child, a spouse, a parent and a sibling.¹⁵⁵ The head of the JSC will be considered an interested person if the head of the JSC enters into a transaction with its parent, or sibling.¹⁵⁶ Also, a manager will be considered interested person if the other party to the transaction is an enterprise in which he or she directly or indirectly owns a stake that enables him or her to influence the decisions of that enterprise.¹⁵⁷ For example, an enterprise decision may be influenced by a so-called locked-in minority shareholder. According to another construction, the head of the JSC will be considered interested person if he or she is the member of the governing body of the enterprise to the other party of the transaction, in which he or she directly or indirectly holds a stake that allows him or her to influence the decision of that enterprise.¹⁵⁸

¹⁵² Law of Georgia on the Securities Market, Article 2, Paragraph 11, Departments of Parliament 1 (8), 24/12/1998.

¹⁵³ The definition of a related person is presented with almost the same content in the Company Law, 2006, Section 252. See *French D., Mayson S., Ryan C., Company Law*, 26th ed., Oxford University Press, 2010, 505.

¹⁵⁴ A more detailed definition is contained in the Model Law on Business Corporations. See Revised Model Business Corporation Act, 2021, § 8.60.

¹⁵⁵ Civil Code of Georgia, Article 1336, Departments of Parliament, 31, 24/07/1997.

¹⁵⁶ Law of Georgia on the Securities Market, Article 2, Paragraph 11, Subparagraph a), Departments of Parliament 1 (8), 24/12/1998.

¹⁵⁷ *Ibid.*, B) Subparagraph.

¹⁵⁸ It is possible to influence the decision of the enterprise in the form mentioned in the previous construction. See. Law of Georgia on the Securities Market, Article 2, Paragraph 11, Subparagraph c), Departments of Parliament 1 (8), 24/12/1998.

In parallel with a physical person, the definition of a related person also includes the case of a legal entity. The authority of the head of the JSC is vested in a legal entity. The head of the JSC legal entity will be considered as an interested person, if the other party to the transaction is a member of the governing body of the same legal entity and / or the person authorized to represent it, the partner or the founder, who has the practical means to influence the decision of the legal entity.¹⁵⁹ In turn, depicting legal entity in the general dimension needs to be explained. The issue concerns the division of a legal entity into a legal entity of public and private law, and as a legal entity of private law - non-entrepreneurial (non-commercial) and entrepreneurial legal entities.¹⁶⁰ Despite the reference to a legal entity without specification, it can still be argued that the concept of "related person" relates only to legal entities under private law, because the norm of conflict of interest concerns the legal form of a JSC and the Law of Georgia on the Securities Market, in fact, links all vectors of relations to the accountable enterprise. Naturally, given the teleological explanation of the law and its purposes,

an accountable enterprise is an JSC defined by the Law of Georgia on Entrepreneurs and the observance of the *Numerus Clausus* principle.¹⁶¹

5. Openness of Information

The existence of a transaction involving a conflict of interest or the preparation of such a transaction does not in itself mean either its prohibition,¹⁶² or its unconditional invalidity,¹⁶³ or its voidable.¹⁶⁴ The conclusion of a contract with a problem of conflict of interest is regulated at the legislative level, which implies its admissibility under certain circumstances. Legal regulation transforms it from a complex and problematic construction to a corporate strategy. There are two general mandatory prerequisites: A) Disclosure of information on conflicts of interest,¹⁶⁵ B) Approval of the transaction by the so-called superior¹⁶⁶ body of the JSC.¹⁶⁷

¹⁵⁹ Ibid, d) Subparagraph.

¹⁶⁰ *Chanturia L.*, Commentary on the Civil Code, Book I, Chanturia L., (ed.), Tbilisi, 2017, Article 8, v. 3, 4, 8, 9 (in Georgian).

¹⁶¹ Entrepreneurial society is: a society of solidary responsibility, Limited Partnership, Limited liability company, Joint Stock Company and Cooperative. See Law of Georgia on Entrepreneurs, Article 2, Paragraph 3, Legislative Herald, 04/08/2021. See *Burduli I., Makharoblishvili G., Tokhadze A., Zubitashvili N., Aladashvili G., Magradze G., Egnatashvili D.*, Corporate Law, Tbilisi, 2021, 78-81 (in Georgian).

¹⁶² Compare: *Enrique L., Hertig J., Kanda H., Pargendler M.*, Related party transactions, in: Anatomy of Corporate Law: A Comparative and Functional Approach, (Translators) *Kochiashvili A., Maisuradze D.* (ed.), *Gabelia T.*, 3rd ed., Tbilisi, 2019, 243-247 (in Georgian).

¹⁶³ The invalidity of the transaction becomes even more complicated if the third party involved in the transaction was in good faith. See *Davies P.*, Introduction to Company Law, 2nd ed., Oxford University Press, 2010, 166.

¹⁶⁴ Historically, in U.S. reality, in the 1800s, the court had a specific attitude toward a conflict of interest transaction: any contract in which there was a director's conflict of interest, in the event of termination by any shareholder, would be void. See *Gevurtz F. A.*, Corporation Law, West Group, 2000, 322; *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 282-283; *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 189.

¹⁶⁵ Revised Model Business Corporation Act, 2021, § 8.60, Official Comment No. 7.

¹⁶⁶ *Burduli I.*, Fundamentals of Share Law, Vol.II, Tbilisi, 2013, 195-247 (in Georgian).

¹⁶⁷ *Gevurtz F. A.*, Corporation Law, West Group, 2000, 341-346.

According to the systematic understanding¹⁶⁸ of corporate governance formed as a result of fragmented ownership,¹⁶⁹ balanced risk management through corporate-financial-marketing mechanisms is a utopia without the openness, openness or transparency of relevant information.¹⁷⁰

The obligation to disclose information¹⁷¹ is imposed by the normative legislation of the corporate law of this or that country, as well as by the so-called Soft Law Exhibitor under the Corporate Governance Code.¹⁷²

Disclosure of JSC related information is a multifunctional load as the information is diverse. Information openness of JSC data implies regular disclosure of information of legal and economic status,

verification of inaccurate information, shareholder structure, audit reports, management, organizational management system, charter and related content and scope of transactions.¹⁷³

Disclosure of information on conflicts of interest has internal and external legal aspects. In the domestic legal dimension, the manager interested person should submit to the Supervisory Board of the JSC or the General Meeting of Shareholders the nature of the interest, volume and other consequences of the transaction. This is an internal organizational regulation of the conflict of interest, hence the purely corporate legal regulation. However, the openness of information also has an external legal aspect. For a public JSC investor, it is essential to know that the JSC is functioning properly. This requires disclosing to the market participant all the circumstances surrounding the transaction involving a conflict of interest.¹⁷⁴ Although this section relates only to the "soft" legal obligation of the JSC operating in the open, public, capital market, but it clearly emphasizes the content of the transaction with the interested person - the purpose of resolving the conflict of interests is to create a buffer zone with the legal and economic protection of the JSC and its shareholder, i.e. the investor.¹⁷⁵

The circumstance to declare conflict of interest at the internal organizational level is divided into several directions. In the first stage, the subjective cognition and analysis of the nature of their

¹⁶⁸ *Coffee Jr. J., C.*, The Rise of Dispersed Ownership: The Role of in the Separation of Ownership and Control, Columbia Law School, Working Paper No. 182, 2001, 24-37.

¹⁶⁹ *Makharoblishvili G.*, General Analysis of Corporate Governance, Tbilisi, 2015, 54-90 (in Georgian).

¹⁷⁰ G20/OECD Principles of Corporate Governance, V. Disclosure and Transparency, 2015, 37 (The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company).

¹⁷¹ Mandatory disclosure of information is also called an affiliation strategy. See *Enrique L., Hertig J., Kanda H., Pargendler M.*, Related party transactions, in the collection: Anatomy of Corporate Law: Comparative and Functional Approach, (Translators) *Kochiashvili A., Maisuradze D. (ed.), Gabelia T., 3rd ed.*, Tbilisi, 2019, 223-232 (in Georgian).

¹⁷² *Beridze T., Burduli I., Makharoblishvili G., Kharashvili A., Sikharulidze D., Kikutadze V., Lobzhanidze N.*, Impact of soft law on the effectiveness of corporate governance, Tbilisi, 2018, 91-92 (in Georgian).

¹⁷³ Corporate Governance Code for Commercial Banks, Information Disclosure and Transparency, SBA, IFC, 2009, 19-22 (in Georgian).

¹⁷⁴ G20/OECD Principles of Corporate Governance, V. Disclosure and Transparency, 2015, 40.

¹⁷⁵ The statutory settlement of conflicts of interest should be simple and different and should function in such a way that any such transaction does not reach a court dispute. See *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 276.

own interest by an essentially important manager. Perception of the fact of interest at the stage of preparation of the transaction, gives rise to his fiduciary duty to immediately notify the JSC. The same requirement applies to the notification of a fact after the conclusion of the transaction. The conclusion is simple: the binding norms of conflict of interest, after knowing and analyzing the information about it, comes into force, more precisely, it activates the fiduciary obligation of the interested person, which focuses on the subjective side of the behavior.¹⁷⁶

It can be said, that the openness of information is the intermediate link that connects the stage of recognizing the conflict between interests or obligations¹⁷⁷ to the stage of transforming¹⁷⁸ it into a legally real relationship.¹⁷⁹ The latter involves a decision by the JSC Supervisory Board or the General Meeting of Shareholders.¹⁸⁰

In practice, openness of information has also been used as a criterion for assessing the fairness of a transaction. It is true that the transaction fairness test is related to the fair determination of conclusion and the price of transaction, but concealing information about a transaction involving a conflict of interest is, in itself, unfair.¹⁸¹ In the case of *State Ex Rel. Hayes Oyster Co. v. Keypoint Oyster Co.*¹⁸² The court found the concealment of information on the conclusion of a conflict of interest transaction to be a failure to meet the criteria of fairness and therefore unfair. Such an understanding of the concept of fairness by the court begs the question, why should not the criterion of fair value of the contract alone be sufficient for a fair qualification of a transaction without full disclosure of information?! The answer to the rhetorical question is simple: If the fair value, taken separately, without disclosure of information, was sufficient for the transaction to be fairly accounted for, then the right of decision making by the corporation would be transferred to the jurisdiction of the court and any such transaction would be subject to judicial review.¹⁸³ The result of a kind of analysis of the court decision is logically reflected in the modern regulations: If the contractor was aware of the conflict of interest and the absence of a JSC permit, the JSC has the right to terminate such an agreement,¹⁸⁴ or if the obligation to comply with the conflict of interest rules were violated, the JSC may claim damages from the infringer.¹⁸⁵ The

¹⁷⁶ It should be noted that the securities market legislation defines written notification as a form of disclosure of disclosed information. See Law of Georgia on the Securities Market, Article 161, Paragraph 3, Departments of Parliament 1 (8), 24/12/1998 (in Georgian).

¹⁷⁷ *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 186.

¹⁷⁸ *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 277.

¹⁷⁹ *Chanturia L.*, Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 328 (in Georgian).

¹⁸⁰ Law of Georgia on Entrepreneurs, Article 208, Paragraphs 1 and 4, Legislative Herald, 04/08/2021 (in Georgian).

¹⁸¹ *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 278. Concealment of information about a transaction with a conflict of interest should be considered a procedural violation of the transaction.

¹⁸² *State Ex Rel. Hayes Oyster Co. v. Keypoint Oyster Co.* 391 P.2d 979 (Wash. 1964).

¹⁸³ *Eisenberg M.*, Self-Interested Transaction in Corporate Law, Journal of Corporate Law №13, 1988, 997-1008.

¹⁸⁴ Law of Georgia on Entrepreneurs, Article 208, Paragraph 8, Legislative Herald, 04/08/2021 (in Georgian).

¹⁸⁵ *Ibid.* Paragraph 9.

result is the same: the fairness test protects both the procedural rules for making a transaction decision¹⁸⁶ and the price fairness criterion set by the transaction.¹⁸⁷ A similar explanation was made by the Delaware court in the case of *Weinberger v. UOP Inc.*¹⁸⁸ that justice is based on two fundamental aspects: concluding the transaction in accordance with the procedural rules and the fair price of the transaction.¹⁸⁹

A special part of disclosing information about conflicts of interest is the content of the information to be disclosed. General information on conflict of interest, is only a formal part of the self-deal.¹⁹⁰ Disclosed information on conflicts of interest should include data on all significant factual circumstances, which is called full disclosure.¹⁹¹

The decision to approve the transaction by the JSC must indicate the nature, scope¹⁹² and other important conditions of the interest.¹⁹³ This relates to the nature of the interest, i.e. direct or indirect conflict of interest categories; this is related to the quantitative interest rate, which can be the value of the transaction. Although the explanatory content of the information disclosure is the decision-making process of the JSC and the specific criteria of the interested person, but it should likewise be shared by the interested manager in terms of the type and content of the information to be submitted to the JSC for the first time. Such information should become the basis for the approval of the transaction by the General Meeting of Shareholders or the Supervisory Board of the JSC.

The last part of the normative provision is even more interesting because it includes "other important conditions", which must take into account any relevant factual circumstances that will have a practical impact on the decision-making body when approving the transaction. But the question is: should the information disclosure include, for example, the future intention of its use by the interested person after the acquisition of property by JSC. This record of Georgian corporate law, naturally, has a wide range. The record can be understood in much the same way as it was explained in the case of *Rosenblatt v. Getty Oil Co.*¹⁹⁴ In particular, a director with a conflict of interest must disclose "all material information" related to the transaction.

The reasoning and the result of the analysis reveal the legal significance of disclosing information on conflicts of interest at the intra-organizational level.

¹⁸⁶ *Davies P.*, Introduction to Company Law, 2nd ed., Oxford University Press, 2010, 164.

¹⁸⁷ Interestingly, the official commentary on the Business Corporation Model Law states that the fair value of a transaction and the disclosure of information about a conflict of interest may not be sufficient to protect and approve the transaction. See Revised Model Business Corporation Act, 2021, § 8.60, Official Comment No. 6.

¹⁸⁸ *Weinberger v. UOP Inc.*, 457 A. 2d. 701, 711 (Del. 1983).

¹⁸⁹ *Eisenberg M.*, Self-Interested Transaction in Corporate Law, Journal of Corporate Law №13, 1988, 1001.

¹⁹⁰ *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 280-281.

¹⁹¹ *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 201.

¹⁹² There is a separate regulation regarding the loan agreement, for example, in the Company Law, 2006. See *French D., Mayson S., Ryan C.*, Company Law, 26th ed., Oxford University Press, 2010, 503.

¹⁹³ Law of Georgia on Entrepreneurs, Article 208, Paragraph 6, Legislative Herald, 04/08/2021 (in Georgian).

¹⁹⁴ *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985).

6. Approval of a Transaction Containing a Conflict of Interest

A fundamental principle of corporate law is that it is inadmissible to approve by a majority vote the embezzlement, fraud and ultra vires action of a corporation.¹⁹⁵

The desire to control the process of managing¹⁹⁶ the invested property is called shareholder activism,¹⁹⁷ the first manifestation of which is the "exclusive" decision-making power in the form of a general meeting. The shareholder is interested in maintaining the value of the corporation.

Approving a conflict of interest transaction at a general meeting is a strong strategy¹⁹⁸ to protect against opportunistic consequences and a corporate form of control.¹⁹⁹

Most of jurisdiction of corporate law for a transaction involving a conflict of interest requires the approval of a majority of the disinterested directors and / or the support of the shareholders.²⁰⁰ In Georgian corporate law, a transaction in the presence of a two-tier corporate governance system²⁰¹ is approved in advance by the Supervisory Board, and in the case of a monistic²⁰² corporate governance system - by the General Meeting of Shareholders.²⁰³ Such a protection mechanism is due to the special powers of the general meeting of shareholders and the high standard of investment protection, although there are criticisms²⁰⁴ that it will be difficult to obtain consent, especially in a JSC with corporate groups. The main shortcoming of the consent of the general meeting of shareholders is the participation of the interested shareholder in the conflict of interest when the consent of the majority of the minority²⁰⁵ shareholders is not additionally defined.²⁰⁶ However, additional levels of protection under Georgian corporate law are provided: If the majority of the members of the Supervisory Board in a two-tier management system are interested persons, then the transaction, instead of the Supervisory Board, must be approved by the

¹⁹⁵ Cox J. D., Hazen T. L., *The Law of Corporations*, Vol. 2, 3rd ed., St. Paul, 2010, 210.

¹⁹⁶ Governing process of JSC by management.

¹⁹⁷ Makharoblishvili G., *General Analysis of Corporate Governance*, Tbilisi, 2015, 72 (in Georgian).

¹⁹⁸ Enrique L., Hertig J., Kanda H., Pargendler M., *Related party transactions*, in the collection: *Anatomy of Corporate Law: Comparative and Functional Approach*, (Translators) Kochiashvili A., Maisuradze D. (ed.) Gabelia T., 3rd ed., Tbilisi, 2019, 239 (in Georgian).

¹⁹⁹ Makharoblishvili G., *General Analysis of Corporate Governance*, Tbilisi, 2015, 73-75 (in Georgian).

²⁰⁰ For example, see Revised Model Business Corporation Act, 2021, § 8.62, §8.63 (a).

²⁰¹ Hopt K. J., *The German Two-Tier Board: Experience, Theories, Reforms*, in: *Comparative Corporate Governance: The State of the Art and Emerging Research*, (Edit.) Hopt K. J., Hideki K., Wymeersch R., Prigge S., Clarendon Press, 1998, 228.

²⁰² Hopt K. J., *The German Law and Experience with the Supervisory Board*, Working Paper №305/2016, 2-3.

²⁰³ Law of Georgia on Entrepreneurs, Article 208, Paragraph 4, Legislative Herald, 04/08/2021 (in Georgian).

²⁰⁴ Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1977). See Allen T. W., Kraakman R., Subramanian G., *Commentaries and Cases on the Law of Business Organization*, 4th ed., Wolter Kluwer Law & Business, 2012, 292-294.

²⁰⁵ Shareholders with no interest.

²⁰⁶ However, the approval of the deal by a majority of the minority is also considered in a negative context. See Enrique L., Hertig J., Kanda H., Pargendler M., *Related party transactions*, in the collection: *Anatomy of Corporate Law: Comparative and Functional Approach*, (Translators) Kochiashvili A., Maisuradze D. (ed.), Gabelia T., 3rd ed., Tbilisi, 2019, 239-240 (in Georgian).

General Meeting of Shareholders.²⁰⁷ Additionally, when approving a transaction in any body, the interested person is prohibited from voting.²⁰⁸

Determining the time of transaction approval is a strategic part of resolving a conflict of interest.

The issue concerns the preliminary approval of the transaction.²⁰⁹ The structure of the norm is formed in such a way that it mainly deals with the case of pre-approval and does not provide for further approval. The only indirect appeal is the right of withdrawal by the JSC, which requires two preconditions: A) The contractor must be aware of the conflict of interest when concluding the contract, and B) also, the absence of permission from the JSC should be known.²¹⁰ Targeted definition of the norm establishes the discretionary power of the JSC, insofar as it can exercise the right of withdrawal or leave it unused. Positively legally, the discretion of the JSC may be interpreted further as indirectly approved, if it does not exercise its right of withdrawal within the period of appeal.²¹¹ As a result, expiration of the withdrawal period²¹² can, in fact, be seen as an endorsement of a conflict of interest transaction.²¹³

The corporate strategy for approving transaction by general meeting of shareholders,²¹⁴ in corporate law, is considered to be a strategy for creating a safe zone²¹⁵ for the management.²¹⁶ In turn, shareholders must act in good faith in the approval process.²¹⁷ Historically, the creation of a "safe harbor" has been achieved by fully disclosing information about a conflict of interest

²⁰⁷ Law of Georgia on Entrepreneurs, Article 208, Paragraph 5, Legislative Herald, 04/08/2021.

²⁰⁸ Ibid, 4th point. This protection strategy imposes an objectively high standard of assurance on the well-being of the shareholders, to the extent that it excludes the participation of a manager who may at the same time hold the status of a shareholder. See *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 292.

²⁰⁹ The same is governed by the UK Companies Act 2006, which requires information to be disclosed prior to a transaction. See Company Act, S. 177 (4).

²¹⁰ Law of Georgia on Entrepreneurs, Article 208, Paragraph 8, Legislative Herald, 04/08/2021 (in Georgian).

²¹¹ The Law of Georgia on Entrepreneurs separates limitation and revocation. Limitation is mainly related to the legal category, claim, fact, and part of the appeal is related to the right of revocation defined by the charter or the law. The general statute of limitations is 5 years, and the general term of revocation is 6 months. See Law of Georgia on Entrepreneurs, Article 92, Legislative Herald, 04/08/2021. The Law of Georgia on the Securities Market establishes the right to request the invalidity and compensation of different and special 18-month transactions. Also, in general, the JSC does not determine the entity authorized to request, but specifies it and determines whether the enterprise is a joint stock company, a) a shareholder or a group of shareholders holding 5% or more of the accountable enterprise, and in the case of another legal form, b) each partner. See Law of Georgia on the Securities Market, Article 161, Paragraph 9, Departments of Parliament 1 (8), 24/12/1998.

²¹² The partner, the supervisory board, as well as another manager have the right to appeal the decision of the manager. See Law of Georgia on Entrepreneurs, Article 93, Paragraph 4, Legislative Herald, 04/08/2021.

²¹³ *Compare: Chanturia L.*, Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 329 (in Georgian).

²¹⁴ *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 197-198.

²¹⁵ The so-called "Safe Harbor". By the way, it is directly explained by the commentary on the US model law. See Revised Model Business Corporation Act, 2021, § 8.63 (a), Official Comment, No. 1.

²¹⁶ *Allen T. W., Kraakman R., Subramanian G.*, Commentaries and Cases on the Law of Business Organization, 4th ed., Wolter Kluwer Law & Business, 2012, 281-282.

²¹⁷ *Cox J. D., Hazen T. L.*, The Law of Corporations, Vol. 2, 3rd ed., St. Paul, 2010, 199.

transaction and complying with its approval requirements,²¹⁸ making it a real transaction.²¹⁹ However, this approach, due to its wide coverage area, with minority, still is criticized and pushes the court to analyze additional substantive elements (For example, is the fact of embezzlement of the corporation's property in the face of the purpose, nature, future plan of interest²²⁰).²²¹

The final aspect of approving a transaction is the number of votes required for a decision to be taken by the Supervisory Board, or the General Meeting of Shareholders.²²² The General Meeting of Shareholders makes its decision in accordance with the principle of a majority of votes,²²³ in particular by a majority vote of the participants in the voting,²²⁴ unless the charter provides for a larger number of votes to make a decision.²²⁵ From the point of view of the JSC's business and long-term strategic perspective, when ratifying a conflict of interest transaction, it is possible to determine a qualified majority decision, which will further strengthen the transaction approval strategy in the context of protecting the interests of the shareholder²²⁶ and the corporation.

7. Legal Consequences of a Transaction Involving a Conflict of Interest

The legal cause of a conflict of interest is such that it cannot always be considered as a basis for a priori receipt of certain benefits at the expense of the corporation. The niche for its settlement is in potential danger. According to court law,²²⁷ if a transaction is "fair", it should not be annulled.²²⁸ A transaction, including economically, is fair,²²⁹ if a) the decision-making procedure was followed and b) the price specified in the contract is fair.²³⁰ But these criteria are not the evaluation criteria defined at the legislative level of a conflict of interest transaction. They are used in litigation.²³¹ Based on the criteria set by the court, the formal²³² and material side of the

²¹⁸ *Palmiter A. R.*, *Corporations, Examples and Explanations*, 5th ed., Aspen Publisher, 2006, 239-240.

²¹⁹ *Allen T. W., Kraakman R., Subramanian G.*, *Commentaries and Cases on the Law of Business Organization*, 4th ed., Wolter Kluwer Law & Business, 2012, 284.

²²⁰ *Chanturia L.*, *Corporate Governance and the Responsibility of Managers in Corporate Law*, Tbilisi, 2006, 325 (in Georgian).

²²¹ *Cookies Food Product v. Lakes Warehouse*, 430 N.W. 2d 447 (Iowa 1988).

²²² *French D., Mayson S., Ryan C.*, *Company Law*, 26th ed., Oxford University Press, 2010, 491-492.

²²³ Regarding shareholder governance rights, see *Burduli I.*, *Fundamentals of Share Law*, Vol. I, Tbilisi, 2010, 355-365 (in Georgian).

²²⁴ Compare: Revised Model Business Corporation Act, 2021, § 8.62 (a).

²²⁵ Law of Georgia on Entrepreneurs, Article 195, Paragraph 1, Legislative Herald, 04/08/2021 (in Georgian). A similar decision-making capacity and the number of votes required for decision-making and statutory autonomy are imposed on the Supervisory Board. See *Ibid.*, Article 46, paragraph 3.

²²⁶ So-called Shareholder Wealth. See *Sharfman B. S.*, *Shareholder Wealth Maximization and its Implementation Under Corporate Law*, *Florida Law Review*, Vol. 66, 2014, 393-399.

²²⁷ *Gevurtz F. A.*, *Corporation Law*, West Group, 2000, 325-331.

²²⁸ *Allen T. W., Kraakman R., Subramanian G.*, *Commentaries and Cases on the Law of Business Organization*, 4th ed., Wolter Kluwer Law & Business, 2012, 276.

²²⁹ *Cahn A., Donald D. C.*, *Comparative Company Law, Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA*, Cambridge University Press, 2011, 346.

²³⁰ *Weinberger v. UOP, Inc.*, 457 A.2d. 701 (Del. 1983).

²³¹ *Chanturia L.*, *Corporate Governance and the Responsibility of Managers in Corporate Law*, Tbilisi, 2006, 325-326 (in Georgian).

transaction is examined, and in general, in the event of a conflict of interest, the manager should consider the corporation's interest as his own, personal interest.²³³ The formal side includes the procedural part of the transaction, and the material side - the content of the transaction. In the material part, the ratio between the economic goodness²³⁴ given and received by the JSC is checked.²³⁵ However, value category analysis²³⁶ alone is not helpful for fair justice and it is also criticized. In particular, if the court discusses the amount of interest received by the plaintiff (for example, a shareholder), it is entirely permissible for the plaintiff to receive benefits from a transaction involving a conflict of interest, but the transaction to be not fair.²³⁷ At the same time, a transaction cannot be unfair only if the interested person receives a substantial income from the transaction. This means that the benefits received from the transaction cannot be used as an absolute standard for the judicial evaluation of a transaction taken separately.²³⁸ For a transaction to be fair, it must be in the interest of the corporation, and the ratio of that interest expressed in the entity to the benefit received by the manager should not be used as a unit of fair qualification for the transaction.²³⁹ If the transaction is not beneficial to the corporation in either dimension,²⁴⁰ it may be considered unfair.²⁴¹

The legal Ex Post status of the transaction in Georgian corporate law is regulated, which must meet specific preconditions.²⁴² The established conflict of interest rule must be violated in order for the JSC to be able to exercise its right to claim (and not to withdraw).²⁴³ It would be a violation of the rule if the relevant and complete information²⁴⁴ on the conflict of interest is not disclosed and the relevant body of the JSC does not approve it in accordance with the rules established for the decision. But, just breaking the established rule is not enough to impose liability and the fact of harming the JSC is cumulatively necessary.²⁴⁵ This rule provides a logical exception to the reservation that the JSC will not be compensated for the damage if the transaction

²³² The mere presence of the director as a party to the transaction is not sufficient to invalidate the transaction. See *Palmiter A. R.*, *Corporations, Examples and Explanations*, 5th ed., Aspen Publisher, 2006, 235.

²³³ *Cox J. D., Hazen T. L.*, *The Law of Corporations*, Vol. 2, 3rd ed., St. Paul, 2010, 196.

²³⁴ The transaction must be of specific (economic) value to the JSC. See *Palmiter A. R.*, *Corporations, Examples and Explanations*, 5th ed., Aspen Publisher, 2006, 236.

²³⁵ *Lewis v. S.L. & E., Inc.*, 629 F.2d. 764 (2d Cir. 1980).

²³⁶ In a situation where there is a market value for the substance of the transaction, then the transaction entered into by the manager is easily assessed as to whether the transaction was entered into for better or worse terms. See *Gevurtz F. A.*, *Corporation Law*, West Group, 2000, 328.

²³⁷ For fairness assessment criteria relating to a transaction involving a controlling shareholder conflict of interest, See *Allen T. W., Kraakman R., Subramanian G.*, *Commentaries and Cases on the Law of Business Organization*, 4th ed., Wolter Kluwer Law & Business, 2012, 295-308.

²³⁸ *Gevurtz F. A.*, *Corporation Law*, West Group, 2000, 326.

²³⁹ *Fliegler v. Lawrence* 361 A.2d 218 (Del. 1976).

²⁴⁰ Revised Model Business Corporation Act, 2021, § 8.60, Official Comment No. 6.

²⁴¹ *Gevurtz F. A.*, *Corporation Law*, West Group, 2000, 327.

²⁴² Law of Georgia on Entrepreneurs, Article 208, Paragraph 9, Legislative Herald, 04/08/2021 (in Georgian).

²⁴³ Compare: *Chanturia L.*, *Corporate Governance and the Responsibility of Managers in Corporate Law*, Tbilisi, 2006, 329 (in Georgian).

²⁴⁴ *Cox J. D., Hazen T. L.*, *The Law of Corporations*, Vol. 2, 3rd ed., St. Paul, 2010, 217-222.

²⁴⁵ For a similar regulation, see: Law of Georgia on the Securities Market, Article 161, Paragraph 8, Departments of Parliament 1 (8), 24/12/1998 (in Georgian).

were concluded on the same terms as in the case of a conflict of interest. Naturally, this circumstance is not subject to internal scrutiny of the JSC and it must be considered by the adjudicating court. The Georgian court has the opportunity to use foreign, including the above examples, to correctly determine the orientation of the judicial analysis.²⁴⁶

The last part of the legal result of the transaction is aimed at the return of the interest received by the interested or related person to the JSC. Specifically, in return for damages, the JSC may request the infringer (or a person related to it) to transfer the benefit received²⁴⁷ from the transaction or to waive²⁴⁸ the right to receive such benefit, which is, in essence, a specific form of compensation.²⁴⁹ Additional legal sanctions against the manager will be at the discretion of the JSC. For example, the General Meeting of Shareholders of the JSC, or, if any, the Supervisory Board, may dismiss the governing body.²⁵⁰

8. Conclusion

The content of a systematic understanding of corporate governance lies in the separation of investor ownership and the ability to exercise direct control over it. Separation of ownership and control gives rise to a "principal-agent" relationship and, consequently, a conflict of interest. As a result, conflict of interest is an immanent legal construct of corporate governance, separation of ownership and control. Preventing or eliminating conflicts of interest is one of the goals of corporate law. Its absolute neutrality is completely contrary to the concept of corporate governance of the JSC, the corporate structure of property trust, and the content of the individual as a *homo economicus*. Therefore, conflict of interest is a qualitatively consistent and characteristic element of centralized, delegated management, and the purpose of corporate law is not to prevent it completely, but to create a controlled corporate structure, which will bring any of its situational manifestations into the supervisory area. Normally regulated conflict of interest acquires the importance of a corporate-legal strategy. This strategy puts the risk arising from the management of invested capital with "unknown hand" under de facto corporate and judicial control.

As a result of the structure and analysis of the article, it is possible to present a summary view: Using the content of the conflict of interest as a corporate strategy guarantees the purposeful functioning of the JSC, which allows the court to correctly determine the orientation of the judicial analysis in the event of a dispute.

²⁴⁶ Concluding a conflict of interest transaction by a manager, under U.S. model law, may not always be subject to litigation, damages, or other sanction, and lists specific circumstances. See Revised Model Business Corporation Act, 2021, § 8.61.

²⁴⁷ Similar content is provided by securities market legislation. See Law of Georgia on the Securities Market, Article 161, Paragraph 9, Departments of Parliament 1 (8), 24/12/1998 (in Georgian).

²⁴⁸ *Davies P.*, Introduction to Company Law, 2nd ed., Oxford University Press, 2010, 166-167.

²⁴⁹ *Palmiter A. R.*, Corporations, Examples and Explanations, 5th ed., Aspen Publisher, 2006, 241. *Compare: Chanturia L.*, Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 329-330 (in Georgian).

²⁵⁰ Law of Georgia on Entrepreneurs, Article 44, Paragraph 3, Legislative Herald, 04/08/2021. *Compare: Chanturia L.*, Corporate Governance and the Responsibility of Managers in Corporate Law, Tbilisi, 2006, 330 (in Georgian).

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