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Bill on the Law on Entrepreneurs -

New Take on Capital Formation, Maintenance and Protection

In September 2020, amendments to the Law on Entrepreneurs was tabled in the Georgian parliament.

The bill implements EU directives required under the Association Agreement between Georgia and the EU and would contribute to harmonization of the Georgian legislation to that of the EU. The bill aims to entirely replace the existing Law on Entrepreneurs, rather than merely amending it.

The bill introduces many fundamental changes to the existing regulations, rectifying shortfalls in the existing law. One of the declared objectives of the new law is to better protect the interests of creditors and minority shareholders, introducing a number of amendments concerning the formation, maintenance and protection of the capital of an entity. Such amendments will be the primary focus of this article. Given that the most popular forms of doing business in Georgia are limited liability companies (LLC) and joint stock companies (JSC), we shall trim this down to the amendments relevant for such entities.

Subscribed capital

The draft law introduces the notion of **subscribed capital** - the amount agreed upon by the founding partners and indicated in the founding agreement.

Unlike in an LLC, having subscribed capital is mandatory in a JSC. The main function of subscribed capital is to form the initial capital of an entity at the time of its formation. Once the entity is registered, the subscribed capital should be used to maintain and increase the entity's property. In essence, it is the same as statutory capital, legal capital or charter capital of an entity.

Subscribed capital must be denominated in GEL in LLCs but no similar requirement is present with respect to JSCs.

According to the draft law, an enterprise (both JSC, as well as LLC) can issue shares at their nominal value or at the value which is different from the nominal value. Nominal value is the minimum price to be paid for the shares/stock. Subscribed capital shall be equal to the sum of the nominal value of the issued shares or, where they have no nominal value, exceed the sum of their accounting par value. In order to ensure compliance with the EU directive 2017/1132, the draft law sets the minimum capital requirement for a JSC at 100,000 GEL (roughly EUR 25,000). No such statutory minimum is established for a LLC.

Furthermore, the charter of a limited liability company may allow for the existence of different classes of shares, which is a novelty in Georgian company law and is designed to accommodate the interests of investors as it opens the door to various forms of equity financing.

The draft law introduced an important although not a compulsory mechanism for capital protection in the form of reserve capital. A JSC may have reserved capital of at least 10% of its subscribed capital. Reserve capital serves to cover the losses. Until the reserve capital reaches the above threshold, the JSC has to retain 5% of its annual net profit and direct it to the reserve capital.

Capital formation

Capital is formed by way of initial and further or additional contributions. The term "contribution" is defined as property transferred to the entrepreneurial entity in exchange for a share (participation interests) in an entity. A contribution to the capital of a JSC may not be considered the provision of services or performance of work. The limitation is due to the difficulty in objectively determining the monetary equivalent of the services/works performed and is in line with the EU Directive 2017/1132.

The contribution can be made by way of paying money (cash contribution), or transferring other tangible or intangible property (non-cash / in-kind contribution) to the entity. Such intangible property can also be a contractual or in rem right to use certain assets. If the value of the in-kind contribution made at the moment of registration of an entity is less than the agreed value

of the contribution, the shareholders have an obligation to pay the balance in cash. In-kind contribution to a JSC shall be evaluated by and independent auditor / valuator prior to contribution to the capital. The new bill restricts the right of a general meeting of shareholders in an LLC to release the shareholder from the obligation to make a contribution if the contribution is necessary to meet the obligations towards creditors or substantial for carrying out the company operations.

Unless specified in the charter, the contribution must be made within a reasonable time at the request of the JSC. However, such term shall not exceed a total of 5 years from the date of registration of the JSC or its capital increase, as applicable. At the time of registration of the JSC or increase of its capital, at least 25% of the nominal value of the shares must be paid in with cash contribution by the shareholders.

The draft law stipulates that in case of violation of the payment term by the shareholder, the annual interest will accrue on the overdue amount. The interest rate can be agreed upon in the company charter. In absence of such agreement, the fallback rate is double the NBG refinancing rate. In addition, in the event of breach of the time limit for a cash contribution by a shareholder, the management body of the company may initiate the process of foreclosure, which may result in the loss of the partially paid-in shares and related rights by the defaulting shareholder.

Capital maintenance and profit distribution

Arguably, the most important amendment introduced in the draft law concerns certain limitations on distributions. This serves to preserve capital adequacy and protect the creditors' interests.

The proposal to distribute dividends is made by the company management on the basis of financial statements, unless otherwise determined under the company charter. Both, LLCs and JSCs may distribute annual or interim dividends. The proposal has to be accompanied by a statement from the management that the proposed distribution will not cause the insolvency of the company and the company will be able to meet its obligations as they fall due in the course of the coming one year following the distribution. If the company is unlikely to meet such obligations or if as a result of distribution, the assets of the company are less than its liabilities and the subscribed capital, then such distribution is prohibited.

In other words, distribution is still allowed even if the company has not generated profit provided that the company has a positive net asset balance and in case the entity has subscribed capital - the net asset value exceeds the subscribed capital. The draft law also regulates the right of related parties, including shareholders, to have a contractual relationship with a company and receive compensation for the services they provide. This shall not be regarded as distribution and is generally allowed provided that such contracts are on arm's length basis.

In a JSC, distribution of dividends is allowed annually or semi-annually, unless:

prior to or as a result of the distribution of dividends, the net asset value of the JSC provided in the latest financial statements of the company, is less than the aggregate amount of the subscribed capital of the company and the reserves;

the aggregate amount of the distribution exceeds the financial indicators calculated in accordance with the draft law; or

as of the date of payment of the distribution or as a result of such distribution, the company becomes insolvent or is likely to become insolvent.

Change of Capital

The draft law introduces a complex mechanism for changes to subscribed capital.

Capital can be increased by way of issuing new shares or an increase of the nominal value of existing shares. The decision to increase the capital of the company shall be subject to a separate vote at least for each class of shareholder whose rights are affected by such decision. Such a decision is passed by a ¾ majority of votes. If the capital is increased by way of in-kind contribution, then such contribution shall be made within 5 years. The capital of a joint stock company may as well be increased by way of reinvestment of retained earnings or financial reserves of the entity, in which case the new shares issued as a result of such conversion shall be distributed to the existing shareholders pro rata to their share participation. ¶

Subscribed capital of the company can be decreased either by way of reducing the par value of shares or redemption of shares. Information on capital reduction must be published and reflected in the share registry. A decision to reduce subscribed capital is made by a ¾ majority of votes and is subject to a separate vote at least for each class of shareholder whose rights are affected by such decision. A decision to reduce capital can be made only on the basis of a proposal from management or the supervisory board if the JSC has one. Reduction of the subscribed capital is not allowed in certain cases, including if as a result of the reduction, the subscribed capital falls below the established statutory minimum of GEL 100,000.

The actual payments to the shareholders (or waiver of right to request paying in the unpaid portion of the capital contribution) during the capital reduction shall not be made earlier than 6 months after the publication of information on capital reduction. As a cumulative precondition, the actual payment can be made if the claims of the creditors derived prior to the publication of the decision on capital reduction are satisfied or secured by the company or dismissed by the court. No satisfaction or security is required if the financial condition of the company does not warrant the need to protect creditors. The latter enjoy a similar right to request security for their claims in case of reorganization of an entity jeopardizing the satisfaction of the creditors' claims.

The new Law on Entrepreneurs is planned to be enacted from 1 November 2021.

Existing entities shall be given 2 years to bring their respective capital in compliance with the requirements established under the new law. This is particularly relevant for JSCs where the new law establishes a minimum subscribed capital requirement. One way to avoid such obligation is to reorganize a JSC into a LLC, which does not require a minimum statutory capital.

Please apply for the professional advice prior to relying on the information given in this article. BLC and its team shall be ready and pleased to provide any information, legal advice and specific recommendations regarding the issues covered herein.


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