

III EDITION, 2014

# GEORGIAN COMMERCIAL LAW REVIEW JOURNAL

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# COMPARATIVE CONTRACT DAMAGES AND PENALTY PROVISIONS

Presented at Free University of Tbilisi, Georgia,  
Commercial Law Week  
May 17, 2013

Professor Andrea J. Boyack  
Washburn University School of  
Law, Topeka, KS, USA

## INTRODUCTION

Uniformly foundational to every legal system is the concept of *pacta sunt servanda* – agreements are binding.<sup>1</sup> But the precise parameters of this concept differ across legal systems based, in part, upon available remedies for contract breach. Many European legal systems, including Georgia's Civil Code, characterize the breach of a valid obligation as wrongful, and remedies for breach may therefore be punitive.<sup>2</sup> In the American legal system, however, courts and legal scholars have avoided characterizing a contract breach as wrongful,<sup>3</sup> and contract remedies are limited to reimbursement of a non-breaching party's financial loss.<sup>4</sup> In addition to generally calculating damages in a way that avoids imposing a penalty, courts in the U.S. will even strike down agreed-upon liquidated damages provisions in contracts if they implicitly punish breach.<sup>5</sup>

The disparity between U.S. and Georgian legal treatments of breach-penalizing contract provisions discloses an illuminating conceptual distinction. In Georgia, contract breach is considered socially and economically disruptive and costly. Private measures discouraging breach therefore create a public benefit, and the Civil Code mandates that they be generally upheld.<sup>6</sup> In the U.S., alternately, contract breach is viewed as an expression of party autonomy that may even, in appropriate circumstances, create a positive externality.<sup>7</sup> Contract provisions that effectively punish breach are therefore invalidated as imposing a public and private harm.<sup>8</sup>

**1** This phrase is the common shortened version of the Roman adage of *pacta sunt servanda ex fide bona* found in the Justinian Code. K.M. Sharma, *From "Sanctity" to "Fairness": An Uneasy Transition in the Law of Contracts?*, 18 N.Y.L. SCH. J. INT'L & COMP. L. 95, 97 (1999). See also I.I. Lukashuk, *The Principle Pacta Sunt Servanda and the Nature of Obligation Under International Law*, 83 AM. J. INT'L L. 513 (1989) (explaining the principle that treaty obligations must be fulfilled as a baseline concept in international law). See also the Vienna Convention of 11 April 1980 on Contracts for the International Sale of Goods (CISG).

**2** Georgian Civil Code Article 417 allows parties to designate a pecuniary penalty for contract breach. Absent judicial invalidation of this "Penalty" as "disproportionately high," this punitive provision will be upheld. See Ketevan Meskhishvili, *Penalty (Theoretical Aspects, Case Law)*, GEORGIAN COMMERCIAL L. J. (2014).

**3** See, e.g., Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) (characterizing breach of contract as "amoral").

**4** See *infra* Part I.B.

**5** See *infra* Part I.C.

**6** Meskhishvili, *supra* note 2.

**7** American law and economics theorists have promoted a theory of efficient breach, holding that "it is uneconomical to induce completion of performance of a contract after it has been broken." RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 149-151 (8<sup>th</sup> ed. 2010).

**8** See *infra* notes 24-25 and accompanying text.

The reality of contract breach is somewhere between these two perspectives. Breach frustrates expectations and can impose costs – both tangible and intangible, and some such costs may not be reimbursed through the American approach to damage calculation.<sup>9</sup> Although the American approach protects party autonomy and allows for changing economic realities, it does so at the expense of the non-breaching party. Contractual uncertainties create social costs. The U.S. legal system should reconsider whether and when contract breach is wrongful and consider expanding enforceability of liquidated damages in cases where parties have truly agreed to such terms.

## I. CONTRACT DAMAGES AND PENALTY POLICING IN U.S. COURTS

### A. Contractual Theories of Autonomy and Efficiency

Both American and European contract law purport to be based on “Freedom of Contract” rationale.<sup>10</sup> This theory posits that courts should enforce bargained-for exchanges freely entered into by parties both because such agreements are expressions of party autonomy<sup>11</sup> and because they create economic efficiencies by representing “win-win” transactions.<sup>12</sup> Freedom of Contract Theory meshes well with American primacy of personal freedom,<sup>13</sup> and it explicitly reflects the self-determination goals underlying European theories of contract enforcement.<sup>14</sup> The *ex ante* freedom of parties to choose with whom to contract and the freedom to choose the content of a contract are foundational to both U.S. and European law.<sup>15</sup> In the U.S., contracting party autonomy is protected *ex post* as well; parties generally may freely breach a contract upon the payment of monetary damages.<sup>16</sup>

**9** See *infra* notes 33-35 and accompanying text.

**10** Courts in Ohio, for example, have called freedom of contract “fundamental to our society.” *Royal Indem. Co. v. Baker Protective Services, Inc.*, 33 Ohio App.3d 184, 186 (1986). Freedom of contract is a Constitutionally protected liberty right in the United States. *Board of Regents v. Roth*, 408 U.S. 564, 572 (1972). U.S. case law is replete with citations to freedom of contract as a primary public policy underlying the law. See, e.g., *Venegas v. Mitchell*, 495 U.S. 82, 87 (1990) (requiring, and not finding, specific direction by Congress to limit freedom of contract); *Chambers Dev. Co. v. Passaic County Utilities Auth.*, 62 F.3d 582, 589 (3d Cir. 1995) (“The sanctity of a contract is a fundamental concept of our entire legal structure. Freedom of contract includes the freedom to make a bad bargain.”); *Monahan v. County of Chesterfield*, 95 F.3d 1263, 1284 (4th Cir. 1996) (“we believe that freedom of contract between an employer and an employee is one of the precepts of the free market economy upon which this nation was founded”); *City and County of Denver v. The District Court of Denver*, 939 P.2d 1353, 1361 (Colo. 1997) (“The right of parties to contract freely is well developed in our jurisprudence.”); *DeVetter v. Principal Mutual Life Ins.*, 516 N.W.2d 792, 794 (Iowa 1994) (Freedom to contract is a “weighty societal interest.”); *Weber v. Tillman*, 913 P.2d 84, 89 (Kan. 1996) (“The paramount public policy is that freedom to contract is not to be interfered with lightly.”); *Adloo v. H.T. Brown Real Estate Inc.*, 686 A.2d 298 (1996) (holding in accordance with “the public policy of freedom of contract.”).

**11** See, e.g., Brian A. Blum, *Contracts* § 1.4.1 (2d ed. 2001) (“[t]he power to enter contracts and to formulate the terms of the contractual relationship is ... an integral part of personal liberty”); Duncan Kennedy, *From the Will Theory to the Principle of Private Autonomy: Lon Fuller’s Consideration and Form*, 100 COLUM. L. REV. 94 (2000); Michel Rosenfeld, *Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769, 825 (1985); E. Alan Farnsworth, *The Past of Promise: An Historical Introduction to Contract*, 69 COLUM. L. REV. 576 (1969).

**12** P. S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 10 (Clarendon Press 1979). See, also A CONTRACTS ANTHOLOGY (Peter Linzer ed. 1995); Jay M. Feinman, *The Significance of Contract Theory*, 58 U. CIN. L. REV. 1283 (1990); FOUNDATIONS OF CONTRACT LAW (Richard Craswell & Alan Schwartz eds. 1994); ROBERT A. HILLMAN, *THE RICHNESS OF CONTRACT LAW* (1997); Michel Rosenfeld, *Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769, 825 (1985).

**13** Richard Epstein calls freedom of contract an essential aspect of individual liberty, and guaranties “to individuals a sphere of influence in which they will be able to operate, without having to justify themselves to the state or to third parties.” Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293 (1975).

**14** Freedom of contract is the first of three pillars underlying European contract law (along with contractual fairness and contractual certainty), and is a foundational piece of the contract jurisprudence of all Member States of the European Union. *Guiding Principles of European Contract Law*, par. 3-4, available at <http://iuccommonsproject.wikispaces.com/file/view/Guiding+principles+of+European+Contract+law.pdf>. Article 1:102(1) of the PECL provides that “Parties are free to enter into a contract and to determine its contents, subject to the requirements of good faith and fair dealing, and the mandatory rules established by these Principles.” THE COMMISSION ON EUROPEAN CONTRACT LAW, ed. Ole Lando & Hugh Beale, THE PRINCIPLES OF EUROPEAN CONTRACT LAW PART I AND II, Art. 1:102 (2000), 99-102. The Russian Civil Code (in a break from Soviet-period law) “grants parties almost complete freedom to set the parameters of their agreement.” Kathryn Hendley, *Coping With Uncertainty: The Role of Contracts In Russian Industry During the Transition to the Market*, 30 NW. J. OF INT’L LAW & BUS. 417, 421 (2010) (citing The Civil Code of the Russian Federation, Art. 421).

**15** See REINHARD ZIMMERMANN, *THE NEW GERMAN LAW OF OBLIGATIONS: HISTORICAL AND COMPARATIVE PERSPECTIVES* 205 (Oxford U. Press 2005) (“it has long been recognized that freedom of contract is not an end in itself. Rather, it must be regarded as a means of promoting the self-determination of those who wish to conclude a contract.”). German law specifically cites “the freedom to shape the content of the contract (*Gestaltungsfreiheit*) as a key aspect of freedom of contract. *Guiding Principles of European Contract Law supra* note 14 at par. 21.

**16** See *infra* notes 26-31 and accompanying text.

American contract law is shaped by capitalist economic theories of market self-regulation.<sup>17</sup> Economic theories of personal or subjective utility assume that there is no “right” price or “right” value for entitlements subject to market exchange.<sup>18</sup> Market valuation is not objective and can only be judged by the parties own ordering of preferences.<sup>19</sup> As the best judges of their own interests, parties create terms of exchange that naturally maximize their collective returns. Any barriers to exchange frustrate this free market and impair optimal efficiency. Judicial enforcement of contracts that are freely entered into promotes and preserves this inherent market efficiency and increases societal wealth.<sup>20</sup>

Because contractual bargains theoretically represent mutually beneficial, efficient allocations of entitlements, contractual enforcement should be the norm. A breach of contract imposes costs on a non-breaching party, namely that party’s unrealized expected profit from the contract, and the breaching party must reimburse such costs regardless of the reason for breach.<sup>21</sup> This strict liability approach to contract breach preserves the efficient outcome from freely negotiated contracts, but because liability for breach does not require any fault or intent on the part of the breaching party, breach is not necessarily a wrongful – or even deliberate – act.

Courts sometimes struggle with the characterization of breach as generally amoral. In some situations, a breach is, in fact, intentional or reasonably avoidable. Some parties may even use breach as a weapon, deliberately breaching in order to vindictively impose costs. But in the U.S. legal system, an intentional breach is not typically viewed as a tort. Even though U.S. common law has somewhat incorporated the European concept of “good faith” into all contracts, the “good faith” of U.S. contract law is used as an adverbial modifier (“in good faith”). “Good faith” therefore constrains *how* a party performs its contractual duties, but it does not create an affirmative duty to actually perform them.<sup>22</sup>

Since breach is compensable – but not typically wrongful – U.S. courts are hesitant to uphold barriers to breach. Protecting the right to breach reflects both broad protection of individual autonomy in U.S. contract law as well as the possibility of “efficient breach.” Contract enforceability presents a temporal autonomy paradox; an individual who exercises her freedom of contract today binds her future self, necessarily limiting her later freedom.<sup>23</sup> But because specific performance is an exceptional remedy in U.S. contract law,<sup>24</sup> a contracting party who wishes to leave the

**17** Capitalism famously incorporates Adam Smith’s theory of an “invisible hand” of market self-regulation which justifies an essentially unregulated market (the French call this *laissez-faire* economics). ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (Edwin Cannan ed., 1976). See G.H. TREITEL, AN OUTLINE OF THE LAW OF CONTRACT 3-5 (6<sup>th</sup> ed. 2004) (“[L]aissez-faire” economic theory advises that government “do nothing, and let the market resolve any problem that arises.”).

**18** To a large extent, courts in the United States refrain from exercising any oversight with respect to the substance of a contract. While some contracts are deemed unenforceable on substantive public policy grounds, this is a rather exceptional result. See E. ALLAN FARNSWORTH, CONTRACTS, § 5.1 (4<sup>th</sup> ed. 2004); RESTATEMENT (SECOND) OF CONTRACTS § 179 (1981); Swaverly v. Freeway Ford Truck Sales, 700 N.E.2d 181 (Ill. App. Ct. 1998) (finding that public policy strongly favors freedom to contract and enforcement should only be avoided if a contract clearly contravenes articulated public policy).

**19** FREDERICH A. HAYEK, STUDIES IN PHILOSOPHY, POLITICS AND ECONOMICS.

**20** LAWRENCE M. FRIEDMAN, CONTRACT LAW IN AMERICA: A SOCIAL AND ECONOMIC CASE STUDY, 22-23 (University of Wisconsin Press 1965); Brief Amicus Curiae of Pacific Legal Foundation in Support of Petitioner at 4, Hall St. Associates, L.L.C. v. Mattel, Inc., 552 U.S. 1035 (2007) (No. 06-989) (“the consistent and predictable enforcement of voluntary agreements fosters social and economic prosperity, because it encourages entrepreneurship, investment, innovation, and exchange”). See also, HERNANDO DE SOTO, THE MYSTERY OF CAPITAL 157 (2000) (“[L]aw is the instrument that fixes and realizes capital”); NATHAN ROSENBERG & L. E. BIRDZELL, JR., HOW THE WEST GREW RICH: THE ECONOMIC TRANSFORMATION OF THE INDUSTRIAL WORLD 116-17 (1986) (“a system of law which seeks to make the legal consequences of human action coherent and predictable .... reduce[s] the risks of trading and investing” and is essential to economic growth). Wealth maximization through contract enforcement is a foundational concept in the law. See, e.g., Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 562-63 (1933) (“[A] regime in which contracts are freely made and generally enforced gives greater scope to individual initiative and thus promotes the greatest wealth of a nation.”).

**21** English common law, on which U.S. contract law is based, allows for a different measure of damages in cases of fault-less breach of real estate contract. But the “American Rule” for computing damages and liability for contract breach rejects this approach and awards full expectation damages regardless of assigning blame or fault for breach in a real estate contract. See CHARLES L. KNAPP, NATHAN M. CRYSTAL, AND HARRY G. PRINCE, PROBLEMS IN CONTRACT LAW, 860-861 (7<sup>th</sup> ed. 2012) (noting that the American Rule for real estate contract breach is conforms with the traditional general U.S. rule of contract law “that unless the cause of nonperformance falls within one of the recognized categories of legal excuse, an expectation-based remedy will normally be available.”).

**22** The one exception to this rule has been insurance contracts, where an ever-increasing number of states have adopted the approach that breach by an insurer should be compensable as a breach of the duty of good faith. See, e.g., Linda Curtis, *Damage Measurements for Bad Faith Breach of Contract: An Economic Analysis*, 39 STAN. L. REV. 161 (1986) (discussing contract breach as a tort in the context of insurance contracts).

**23** See James L. Winokur, *The Mixed Blessings of Promissory Servitudes: Toward Optimizing Economic Utility, Individual Liberty, and Personal Identity*, 1989 WIS. L. REV. 1, 50 (1989) (explaining this concept in terms of Ulysses tying himself to his ship’s mast, deliberately robbing his future self of the freedom to react to the sirens’ song).

**24** The default remedy in contract breach actions in the United States is a monetary award of expectation damages, but under civil law, breach of contract is typically remedied by an order of specific performance rather than a monetary calculation of damages. Zapata Hermanos Sucesores, S.A.

contractual relationship may do so upon payment of an exit fee in the amount equal to the other party's lost expectation. Thus a party is rarely "trapped" in a contract under U.S. law. Instead, a release of contractual obligation may be purchased for the economic equivalent of performance. Efficiency also justifies the freedom to breach a contract in certain circumstances. If the cost to the non-breaching party, in terms of expectation damages, is outweighed by gains from the breach, economic theory posits that the law should actually encourage breach. Freedom to bind and freedom to breach supports the dual values of efficiency and personal liberty and solves the temporal autonomy paradox of contract law.

## B. The Economic Equivalent of an Expectation

U.S. courts generally award monetary damages for a breach of contract.<sup>25</sup> The damage award is calculated to be equal to the economic difference between what the non-breaching party expected to obtain from the breaching party's performance of the contract and what actually was obtained in light of the breach<sup>26</sup> (plus foreseeable costs resulting from the breach<sup>27</sup> and less any cost savings from reciprocal non-performance and from loss mitigation).<sup>28</sup> The theory behind expectation damages has been explained as best approximating the value of both retrospective and prospective reliance and as the economic equivalent of the bargained-for interest of the contracting parties.<sup>29</sup> It is reversible error for a trial court to award a non-breaching party more than his lost expectation under the contract.<sup>30</sup> A monetary equivalent to a plaintiff's expectation is therefore not only the floor (minimum) recovery for breach of contract; it is also the ceiling (maximum).

The amorality of contract breach is apparent in the damage calculation methodology used by U.S. courts. Based on a strict liability model, damages are awarded at the same level regardless of subjective intent to breach. Damages flowing from a breach are not assessed to punish bad behavior, but rather merely to compensate the non-breaching party by putting him in the financially equivalent position as he would have been in had the contract been fully performed.<sup>31</sup> Not only do courts use this approach to calculate damages in cases where contractual terms are silent with respect to remedies for breach, they use the lodestar of expectation damages as a benchmark to police contractually specified damages provisions to prevent overreaching.

The expectation damages approach allows for continuing party autonomy and efficient behavior in a fluid marketplace, but it has significant drawbacks as well. Even though expectation damages purport to achieve economic equivalence to full performance, limitations on recovery result in systemic under-compensation of non-breaching

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v. *Hearthside Baking Company, Inc.*, 313 F.3d 385, 389 (7<sup>th</sup> Cir. 2002), *cert. denied*, 540 U.S. 1068 (2003) ("[T]he civil law grants specific performance in breach of contract cases as a matter of course."). The general rule is that if a liquidated damages clause is enforceable, it is the exclusive remedy available to a non-breaching party. Some courts, however, hold that equitable remedies like specific performance may still be sought in applicable cases. See U.C.C. §2-719. See also Michael Pressman, *The Two-Contract Approach to Liquidated Damages: A New Framework for Exploring the Penalty Clause Debate*, 7 VA. L. & BUS. REV. 651, 659 (2013).

**25** E. ALLAN FARNSWORTH, *CONTRACTS* §12.9, 764-768 (4th ed. 2004). Specific performance is available in certain specific contexts, such as the sale of unique goods, UNIFORM COMMERCIAL CODE §2-716(1) (2005), and transfers of interests in specific land. RESTATEMENT (SECOND) OF CONTRACTS §360 cmt. e (1981).

**26** RESTATEMENT (SECOND) OF CONTRACTS §347. Foreseeability is also a requirement for recovery of losses caused by the breach under CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS §2, Art. 74.

**27** Foreseeability is measured as of the time of contracting based on what costs would naturally flow from a breach and any other special circumstances communicated to the breaching party. *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (1854); RESTATEMENT (SECOND) OF CONTRACTS §351; UNIFORM COMMERCIAL CODE §2-715(2).

**28** "The plaintiff may not recover for those injurious consequences of the defendant's breach that the plaintiff herself could by reasonable action have avoided." *KNAPP ET AL.*, *supra* note 23, at 891-892.

**29** Lon L. Fuller & William R. Purdue, Jr., *The Reliance Interest in Contract Damages (Pt. 1)*, 46 YALE L.J. 52, 57-62 (1936); David W. Barnes, *The Net Expectation Interest in Contract Damages*, 48 EMORY L.J. 1137, 1139 (1999).

**30** See, e.g., *Wright v. Stevens*, 445 So. 2d 791 (Miss. 1984) (holding it was error to award damages of \$13,000 based on jury's verdict for defects in swimming pool construction when evidence only supported recovery of something less than \$10,000).

**31** Punitive damage awards are scrupulously avoided in breach of contract actions, and only arise in the limited circumstances of a breach of contract that is simultaneously a tort (for example, the breach causes a physical injury), or in the special case of insurance companies breaching a covenant to provide benefits to the insured party. See *Erlich v. Menezes*, 981 P.2d 978 (Cal. 1999) (discussing the difference between tort and contract damages and the general unavailability of punitive damages for breach of contract).

parties.<sup>32</sup> For example, if a non-breaching party truly suffers emotional or mental distress resulting from the breach, such costs are generally non-compensable.<sup>33</sup> And unlike most of the rest of the world, in the U.S., the default rule for attorney's fees in breach of contract litigation is that each party pays his own costs.<sup>34</sup> This rule can be modified by explicit contractual provision (mandating that the loser pays), but if not specifically provided otherwise, a non-breaching party must bear the costs of bringing a lawsuit to enforce his contractual rights. In such circumstances, full compensation for a non-breaching party's expectation will never be achieved: the non-breaching party that bears its own attorney fees is left financially worse off after "full" recovery than he would be had the contract been fully performed.

Another objection to the U.S. damages approach is the sheer expense and difficulty involved in calculation of expectation. The proper measure of the breach of an obligation to pay may be easily fixed, but many breaches are not so easily monetized. Assigning value for delay in performance or qualitative differences in performance is difficult, and market price for replacement goods is problematic for unique subject matter. In addition to valuation difficulties, damage calculation involves fact-finding with respect to what losses could be reasonably avoided and what damages were foreseeable and non-speculative. The process of obtaining a judicial determination of the economic equivalent of a party's economic expectation is lengthy, costly and uncertain. For these reasons, well-counseled parties often include a provision in their contracts establishing the proper measure of damages *inter se*.<sup>35</sup> Such agreed-to damages provisions are typically called "liquidated damage clauses" or "stipulated damage clauses" rather than "penalties," because the American legal system eschews penalizing contractual breach.<sup>36</sup> Judicial opposition to contract breach penalties is so strong that if a court finds the agreed-to remedy for breach of contract overly punishes or discourages breach, it will declare such provision unenforceable.<sup>37</sup>

### C. Negotiated Remedies

American judicial treatment of stipulated damages provisions presents an interesting legal dichotomy.<sup>38</sup> U.S. courts almost never scrutinize the content of a contract, preferring to rely on parties' own assessment of their values. But in spite of generally upholding contractual terms without judicial substantive oversight, courts will not enforce stipulated damages provisions unless they are non-penalizing and therefore "reasonable."<sup>39</sup> Substantive oversight of agreed-to damages provisions reflects the public policies underlying contract law generally – freedom (including the freedom to exit a contractual relationship) and efficiency (including the possibility of efficient breach).<sup>40</sup> In the U.S., damages for breach of contract exist merely to reimburse the non-breaching party's expectation, not to punish the breach.<sup>41</sup>

**32** See John A. Seberty, Jr., *Punitive and Nonpecuniary Damages in Actions Based upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565 (1986); Samuel A. Rea, Jr., *Nonpecuniary Loss and Breach of Contract*, 11 J. LEGAL STUD. 35 (1982).

**33** RESTATEMENT (SECOND) OF CONTRACTS §353.

**34** *Zapata Hermanos Sucesores, S.A. v. Hearthside Baking Company, Inc.*, 313 F.3d 385, 385 (7<sup>th</sup> Cir. 2002), cert. denied, 540 U.S. 1068 (2003). See W. Kent Davis, *The International View of Attorney Fees in Civil Suits: Why Is the United States the "Odd Man Out" in How It Pays Its Lawyers?* 16 ARIZ. J. INTL. & COMP. L. 361 (1999).

**35** James Arthur Weisfield, "Keep the Change!": *A Critique of the No Actual Injury Defense to Liquidated Damages: Lind Building Corp. v. Pacific Bellevue Developments*, 55 Wash. App. 70, 776 P.2d 977 (Div. 1), Review Denied, 113 Wash. 2d 1021, 781 P. 65 WASH. L. REV. 977, 978 (1990).

**36** For an interesting historical account of the evolution of this American judicial hostility to penalty clauses, see William H. Lloyd, *Penalties and Forfeitures: Before Peachy v. The Duke of Somerset*, 29 HARV. L. REV. 117 (1915).

**37** Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977).

**38** "The law of liquidated damages is unique within the common law of contracts because it overtly affronts freedom of contract." Larry A. Dimatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 634 (2001).

**39** *Wassenaar v. Panos*, 331 N.W.2d 357, 360-62 (Wis. 1983) (explaining why courts will not enforce liquidated damages clauses without "scrutinizing" them). See *United States v. Bethlehem Steel Co.*, 205 U.S. 105, 119 (1907) (discussing the traditional judicial tendency to construe stipulated damages as a presumptive penalty and the evolution of a countervailing judicial impulse to enforce liquidated damages *unless* they effect a penalty). See also Saul Levmore, *Stipulated Damages, Super-Strict Liability, and Mitigation in Contract Law*, 107 MICH. L. REV. 1365 (2009) (discussing how enforcement of stipulated damages allows contract breach to be completely based on strict liability because there is no countervailing requirement that the non-breaching party act reasonably to mitigate avoidable losses).

**40** *Wassenaar*, 331 N.W.2d at 362 ("The reasonableness test strikes a balance between the two competing sets of policies by ensuring that the court respects the parties' bargain but prevents abuse."). See also Ian Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 495 (1962).

**41** "When these damages are 'too high,' measured either by actual damages expected at the time of contract formation or damages suffered by

In exercising their unique oversight in the context of liquidated damages, courts typically apply some variation of a three-pronged test to see whether the damages provision is really a permissible estimate of expectation loss (and therefore enforceable) or whether it is really a penalty clause (and therefore unenforceable).<sup>42</sup> First, in crafting the clause, the parties must have intended to create a good faith estimate of actual expectation damages.<sup>43</sup> If a court finds that the purpose of the stipulated damages clause was to impose a penalty, it will refuse to enforce the provision.<sup>44</sup> Second, the interest protected by the liquidated damages clause must be something that is particularly difficult to calculate. Third, the agreed-to damage amount must be a “reasonable forecast” of expectation damages a non-breaching party would suffer. The second and third prong of this test may seem contradictory: How can a clause be a “reasonable forecast” of damages when it is required that damages be particularly difficult to calculate? But in effect these two requirements work in tandem. The more problematic actual calculation of damage is, the more likely it is that parties are stipulating damages for a valid purpose.<sup>45</sup> But even if calculation difficulties legitimize the stipulation goal, the agreed-to amount of damages still must be reasonable.

In certain types of contracts courts are more likely to find a legitimate difficulty in calculating actual damages.<sup>46</sup> For example, expectation damages are problematic in situations where a non-breaching party’s damages would be non-recoverable speculative profits.<sup>47</sup> It is also difficult to calculate true damages when collateral harm from a breach would be widespread, such as the ill-effects of one shopping center tenant breaching, because contract performance by each tenant creates positive externalities for the other occupants.<sup>48</sup> Other situations that are commonly accepted as presenting damage calculation difficulties include real estate transactions,<sup>49</sup> employment contracts,<sup>50</sup> and lost profits from volume sellers.<sup>51</sup> Essentially, if a court finds that the subject matter of a contract involves a greater-than-normal difficulty in establishing damages or proving loss, the court is receptive to the *ex ante* decision of the parties on how damages will be calculated.<sup>52</sup>

The third prong of the test is more difficult to apply. Courts will only enforce stipulated damages provisions that represent a reasonable estimate of true expectation damages. There is a split among jurisdictions in the U.S. as to whether the reasonableness of the damage estimate is determined as of the time of contracting or whether the estimated

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breach, courts will often disregard them as ‘penalty damages.’” Levmore, *supra* note 39, at 1366. See also Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. COLO. L. REV. 683, 692 (1986) (“[T]he purpose of contract remedies is to induce the parties to act efficiently).

**42** In a nod to freedom of contract, the party seeking judicial invalidation of a clause typically bears the burden of proving that the clause is unreasonable. See, e.g., *Ramada Franchise Sys., Inc. v. Cusack Dev., Inc.*, 1999 WL 165702 (S.D.N.Y. Mar. 24, 1999); *Westhaven Associates, Ltd. v. C.C. of Madison, Inc.*, 652 N.W.2d 819 (Wis. 2002). C.f. *Pacheco v. Scoblionko*, 532 A.2d 1036, 1038 (Me. 1987) (assigning to the party seeking enforcement of the provision the burden of proving it enforceable).

**43** Intent can be determined based on language used in the contract as well as other circumstances surrounding the negotiation of the provision.

**44** The U.S. Supreme Court long ago confirmed that provisions in a contract purportedly punishing default – rather than estimating actual damages – are unenforceable. *Taylor v. Sandiford*, 20 U.S. 13 (1822) (striking down as an unenforceable penalty a provision in a homebuilding contract that stated liquidated damages for failure to meet a prescribed deadline as “a penalty of 1000 dollars.”). This is why savvy contract drafters avoid using words such as “penalty” and “forfeiture” and instead stress that stipulated damages are a “reasonable estimate” of actually anticipated party losses.

**45** “[W]hen losses are easy to calculate *ex post*, as they are when a defendant breaches the promise to deliver a good with an easily determined market price, there is no reason to encourage stipulation....” Levmore, *supra* note 39, at 1371.

**46** See generally *Id.* (discussing several types of contracts for which damage calculation is understood to be difficult and in which courts routinely enforce stipulated damages provisions). One common situation where liquidated damages are employed is with respect to damages resulting from a delay in contract performance. See *Carrothers Const. Co., L.L.C. v. City of S. Hutchinson*, 207 P.3d 231 (2009).

**47** See, e.g., *XCO Int'l, Inc. v. Pac. Scientific Co.*, 369 F.3d 998 (7th Cir. 2004) (upholding \$100,000 per year in liquidated damages where assignee allowed assignor’s patent to expire, and noting that it was sensible for parties to stipulate damages where damages are difficult to determine).

**48** E.g., *Westhaven Associates, Ltd. v. C.C. of Madison, Inc.*, 652 N.W.2d 819, 819 (Wis. 2002); not readily ascertainable; *Bistro of Kansas City, Mo., LLC v. Kansas City Live Block 125 Retail, LLC*, 2013 WL 4431292 (D. Md. Aug. 16, 2013).

**49** E.g., *Uzan v. 845 UN Ltd. P’ship*, 10 A.D.3d 230 (N.Y. Sup. Ct. 2004); *Naporano Associates, L.P. v. B & P Builders*, 706 A.2d 1123, 1128 (N.J. App. Div. 1998).

**50** E.g., *Wassenaar v. Panos*, 331 N.W.2d 357, 359 (Wis. 1983); *CAS Severn, Inc. v. Awalt*, 213 Md. App. 683, 75 A.3d 382 (2013).

**51** See Levmore, *supra* note 39 (discussing the particular utility in using stipulated damages provisions to clarify the lack of mitigation requirement in the context of lost volume sellers).

**52** See, e.g., *Samson Sales, Inc. v. Honeywell, Inc.*, 465 N.E.2d 392, 394 (Ohio 1984) (striking down a liquidated damages provision based, in part, on a finding that the damages would be “readily ascertainable”). This test does not require impossibility of damage calculation. *Sun Printing & Publ’g Ass’n v. Moore*, 183 U.S. 642, 659-60 (1902) (explaining that stipulated damages may be upheld even if expectation damages could be calculated).

damages must also be reasonable compared to the actual damages caused by the breach.<sup>53</sup> The Restatement of Contracts rather unhelpfully opines that liquidated damages provisions “will not be enforced and will be void as a penalty unless the amount it fixes as damages is *reasonable in light of anticipated or actual harm* caused by the breach.”<sup>54</sup> The Uniform Commercial Code uses identical language.<sup>55</sup> The disjunctive phrasing in the code and restatement has only fueled the debate about whether or not a damages estimate must be reasonable when viewed with the benefit of hindsight.<sup>56</sup>

The additional requirement that forecasted loss be reasonable in light of actual harm is problematic. It is impossible for parties to prophesy exactly what losses will be, and even if a liquidated damages clause truly endeavors to accurately predict losses, it may turn out that the predicted harm vastly undercompensates or overcompensates a plaintiff.<sup>57</sup> The retrospective approach is also unnecessarily costly, because comparing estimated to actual damages requires calculating actual damages, which is the same costly and difficult endeavor that parties likely were attempting to avoid in stipulating damages to begin with. The second-look approach thus undercuts two of the most important rationales underlying contract law. It creates inefficiencies by requiring damage calculation when parties have created a more streamlined way to determine damages, and it impairs autonomy by disallowing parties the ability to set a binding good-faith estimate of damages.

A recent Kansas case presents a typical example of how courts analyze stipulated damages clauses and supports the proposition that the validity of a liquidated damages provision should be based on a prospective consideration of reasonableness and not a second look-back.<sup>58</sup> In *Wahlcometroflex v. Westar*, the court considered a written contract that set damages for delayed delivery of equipment to be used in a construction contract.<sup>59</sup> Wahlco delivered the equipment more than two months late and Westar deducted the liquidated damages amount from payment to Wahlco. Wahlco sued for breach of contract, asserting that the withholding of liquidated damages was wrongful in this case because Westar had failed to show that it suffered any actual harm from the breach. The plaintiff had argued that in the absence of any harm to the non-breaching party, enforcing the liquidated damages provision was akin to imposing an unlawful penalty for breach. The court disagreed. Applying Kansas law, the federal court found that where contract language was clear and where a liquidated damages provision when viewed prospectively (at the time of contracting) appeared to be a reasonable non-penalty, the provision would be enforced without first requiring proof of any actual harm.<sup>60</sup>

This approach to validating liquidated damages has been adopted by a majority of states, basing validity of liquidated damage clauses on whether the type of damages involved are difficult to calculate and whether the parties at the time of contract acted in good faith to craft a reasonable forecast of.<sup>61</sup> Some other states, however, have refused to enforce stipulated damages provisions unless the non-breaching party can show it suffered actual harm from the

**53** See Gregory Scott Crespi, *Measuring “Actual Harm” for the Purpose of Determining the Enforceability of Liquidated Damages Clauses*, 41 HOUS. L. REV. 1579 (2005); James M. Fischer, *The Puzzle of the Actual Injury Requirement for Damages*, 42 LOY. L.A. L. REV. 197 (2008).

**54** RESTATEMENT (SECOND) OF CONTRACTS § 356 (emphasis added).

**55** The U.C.C. provides that agreed-to remedies will not be valid unless they are “reasonable in light of anticipated or actual harm.” UNIFORM COMMERCIAL CODE §2-718.

**56** *California & Hawaiian Sugar Co. v. Sun Ship, Inc.*, 794 F.2d 1433, 1437 (9th Cir. 1986) *opinion amended on denial of reh'g*, 811 F.2d 1264 (9th Cir. 1987) (discussing the difficulties caused by the disjunctive phrasing and finding that no second look at reasonableness is required). Compare *Kelly v. Marx*, 705 N.E.2d 1114, 1116 (Mass. 1999) (evaluating reasonableness at the time of contract formation) with *Wassenaar v. Panos*, 331 N.W.2d 357, 367 (Wis. 1983) (holding that if liquidated damages are “grossly disproportionate to the actual harm” then they may be found unreasonable). For more discussion of differing applications of “reasonableness” in the context of damage estimates, see Pressman, *supra* note 24, at 708.

**57** Courts are vastly less concerned about under-compensation in liquidated damages provisions, and typically only over-compensation leads a court to strike down a liquidated damages provision as a penalty. See Levmore, *supra* note 39. Perhaps that is because under-compensation does not risk penalizing breach. See Pressman, *supra* note 24, at 708.

**58** *Wahlcometroflex, Inc. v. Westar Energy, Inc.*, \_\_\_ P.3d \_\_\_, 2012 WL 2366693 (D. Kan. 2012) (applying the rule announced in *Carrothers Const. Co., L.L.C. v. City of S. Hutchinson*, 207 P.3d 231 (2009)).

**59** *Id.*

**60** *Id.*

**61** *E.g., Carrothers* 207 P.3d at 231; *Guiliano v. Cleo, Inc.*, 995 S.W.2d 88 (Tenn. 1999); *Barrie Sch. v. Patch*, 933 A.2d 382, 389 (Md. 2007); *Naporano Associates, L.P. v. B & P Builders*, 706 A.2d 1123, 1128 (N.J. App. Div. 1998).



breach.<sup>62</sup> A comment to the Restatement appears to support invalidation of stipulated damages when no actual harm is proven: “If, to take an extreme case, it is clear that no loss at all has occurred, a provision fixing a substantial sum as damages is unenforceable.”<sup>63</sup> Freedom of contract and freedom to breach directly conflict in such cases, and courts get torn between their role of enforcing contractual terms and “doing justice.”<sup>64</sup>

The policy of striking down clauses that penalize breach seems to be motivated by the desire to protect a party’s ability or willingness to breach rather than judicial preference for the “right” measure of damages. This must be the case because even though courts police liquidated damages provisions for overreaching, party settlements of contract disputes are routinely enforced without analysis of relationship between the settlement terms and actual harm.<sup>65</sup> This suggests that it is the *in terrorem* effect of a penalty clause that the law finds primarily objectionable, and not the disconnect between harm actually incurred and harm estimated to occur.

In practice, courts may be more willing to enforce liquidated damages than the Restatement suggests, particularly when the non-breaching party had less bargaining power at the outset.<sup>66</sup> In addition, market norms can drive a court’s determination of what amount of damages is reasonable, and even significant liquidated damages amounts can be upheld if they represent market norms.<sup>67</sup> Theoretically, whether or not a party’s breach was intentional should be legally irrelevant to the question of liquidated damages clause validity; but in reality, courts can be more sympathetic to a party who did not deliberately breach. Generally, U.S. legal scholars favor broader enforcement of agreed-to damages provisions on the basis of freedom of contract and efficiency, and recent academic literature advocates a less intrusive judicial role with respect to determining whether such clauses are unenforceable penalties.<sup>68</sup>

## II. CONTRACT BREACH PENALTIES: A COMPARATIVE PERSPECTIVE

### A. Georgian Civil Law of Contract Penalties

The Georgian Civil Code specifically provides for enforceable penalty clauses in contracts.<sup>69</sup> Such contract clauses establish a monetary amount that will be assessed to and payable by the breaching party as penalty for breach.<sup>70</sup> Under Georgian law, this “penalty” is conceived as a security for a contract’s promised performance,<sup>71</sup> much as pledged collateral secures the promised repayment of a loan in U.S. secured transactions law.

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**62** *E.g.*, *Grand Bissell Towers, Inc. v. Joan Gagnon Enterprises, Inc.*, 657 S.W.2d 378 (Mo. Ct. App. 1983); *Equitable Lumber Corp. v. IPA Land Dev. Corp.*, 344 N.E.2d 391, 395 (N.Y. 2d App. Div. 1976); *Vanderbilt Univ. v. DiNardo*, 174 F.3d 751, 753 (6th Cir. 1999) (applying Tennessee law prior to *Guiliano*, 955 S.W.2d at 88).

**63** RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b.

**64** *Barrie Sch.*, 933 A.2d at 396-97 (J. Bell *dissenting*). Interestingly, although not typically articulated as a basis on which to uphold (or strike down) damage stipulations, courts sometimes cite party sophistication as a factor in their decisions. *Wallace Real Estate Inv., Inc. v. Groves*, 881 P.2d 1010, 1018 (Wash. 1994).

**65** *KNAPP ET AL.*, *supra* note 23, at 891-892. Unless a settlement agreement is invalid, prohibited by statute, clearly against public policy or unconscionable, settlement agreements are enforced.

**66** *Wassenaar v. Panos*, 331 N.W.2d 357, 362 (Wis. 1983) (allowing an employee to recover the full measure of liquidated damages even when the employee had fully mitigated harm from the breach).

**67** *Uzan v. 845 UN Ltd. P’ship*, 10 A.D.3d 230, 230 (N.Y. Sup. Ct. 2004).

**68** *See, e.g.*, Kenneth Clarkson, Roger Miller, & Timothy Muris, *Liquidated Damages v. Penalties: Sense or Nonsense?* 1978 WIS. L. REV. 351; Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428 (2004); Goetz & Scott, *supra* note 37.

**69** Georgian Civil Code Article 417.

**70** *Meskhishvili supra* note 2. *Meskhishvili* distinguishes between an obligor’s guarantee of performance and a penalty provision. A “debtor’s guarantee” provides for an alternative minimum performance from the obligor under a contract. A “penalty,” on the other hand, provides for payment of a sum certain upon breach. *Id.*

**71** *Id.*

Penalty clauses in Georgian contracts set a minimum, or floor, for damages from a breach.<sup>72</sup> Upon breach of contract, the non-breaching party is therefore guaranteed a certain minimum recovery, regardless of actual injury caused from the breach. Although the Georgian civil code prohibits recovery of the penalty amount in addition to an award of specific performance,<sup>73</sup> a non-breaching party can obtain reimbursement for actual damages suffered even beyond the amount of the penalty.<sup>74</sup> Unlike a liquidated damages clause in US contracts – which function both as a floor and a ceiling of recovery and substitute for expectation damages as the remedy for contract breach – the penalty provision in Georgian contracts sets only a guaranteed minimum recovery and does not cap a damage award.<sup>75</sup>

Penalty provisions in Georgian contracts are presumptively enforceable, subject only to some easily achieved formality requirements. For example, the underlying obligation must be enforceable under Georgian law, and the penalty promise must be made in writing.<sup>76</sup> Validly created and evidenced penalty provisions will be enforced unless a Georgian court concludes that the minimum damages set by the penalty provision is “disproportionately high” relative to actual damages suffered by a non-breaching party.<sup>77</sup> Judge Meskhishvili is careful to explain the parameters of such judicial interference with freedom of contract in this context. Although a court can reduce a disproportionately high penalty, there is no judicial authority to reduce a penalty that is merely “high.”<sup>78</sup> When reducing a penalty provision, a court will consider not only the ratio of actual damages (or value of the performance) to the penalty but also the financial situation of the breaching party.<sup>79</sup>

A Georgian court will not exercise any oversight with respect to the proportionality of a penalty in cases involving two sophisticated parties or in cases where a debtor was represented by legal counsel during contract negotiation.<sup>80</sup> This differs markedly from the oversight exercised by American courts over liquidated damages provisions. Whereas Georgian courts police penalties for unconscionable overreaching only with respect to parties who were unable to protect themselves during contract negotiation, US courts scrutinize remedies stipulations for hidden penalties even in contracts between sophisticated, well-represented parties. For example, in one case, a New York court carefully examined a liquidated damages provision in a real estate sale provision between a famous US real estate tycoon, Donald Trump, and two Turkish billionaire brothers.<sup>81</sup> Although not articulated as the basis for invalidation, however, US courts also do appear more willing to strike down liquidated damages provisions in contracts involving less sophisticated parties.<sup>82</sup>

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**72** *Id.*

**73** Georgian Civil Code Article 419(1).

**74** Meskhishvili, *supra* note 2; Georgian Civil Code Article 419.

**75** Meskhishvili, *supra* note 2. While creating a minimum recovery amount for contract breach, Meskhishvili is careful to distinguish a penalty from a “pecuniary fine (Reugeld) for avoidance of contract.” This latter concept is a liquidated amount set forth in a contract for which a party can avoid the contract. *Id.*; See Georgian Civil Code Article 353. She also distinguishes the penalty clause from “earnest money” under Georgian Civil Code Article 421. “Earnest Money” is an amount paid upon contract formation to prove the existence of obligation.

**76** Meskhishvili, *supra* note 2; Georgian Civil Code Article 418(2). The writing containing the penalty provision is typically the contract itself, but Georgian law allows the penalty to be created by a separate written promise as well. Meskhishvili, *supra* note 2. Notwithstanding the writing requirement, the terms of a penalty may be implied through party acknowledgement. *Id.*

**77** Meskhishvili, *supra* note 2.

**78** *Id.* Judge Meskhishvili explains that the penalty is not designed to enrich a creditor but rather ensure compensation for injury resulting from the breach.

**79** *Id.*

**80** *Id.* (“The statutory entitlement to reduction of “penalty” serves protection of the “weak” party of the contractual obligations, who do not realize content and entailed legal or economic implications of “penalty” when signing the contract.”).

**81** *Uzan v. 845 UN Ltd. P’ship*, 10 A.D.3d 230, 230 (N.Y. Sup. Ct. 2004).

**82** See, e.g., *id.* (noting the fact that the parties were well-represented and sophisticated as one of the reasons suggesting clause validity in that case).

## B. Contract Penalties and Obligations

Although touted by several law and economics theorists,<sup>83</sup> many other scholars have criticized the American theory of “efficient breach” of contract.<sup>84</sup> For one thing, efficient breach “assumes a world without transaction costs,” and of course reality diverges markedly from this construct.<sup>85</sup> In addition, the various limitations on recovery under US expectation damages jurisprudence, including limits on lost profits and unforeseeable costs, systematically work to undercompensate non-breaching parties.<sup>86</sup> Finally, the American Rule for attorney fees in contracts – that mandates each party pay his own lawyer costs absent a specific contractual provision or statute to the contrary – operates to deprive non-breaching parties of full economic equivalency to performance through expectation damages.<sup>87</sup> One scholar summed up the problem thus: “It is true that efficient breach is rarely efficient; the winning party must pay the cost of recovering contract damages.”<sup>88</sup> The reality of uncompensated costs for nonperformance and the unreimbursed costs for bringing an action for breach of contract undercuts the theory of economic breach.<sup>89</sup>

In light of the problems associated with the expectation damage approach, some legal theorists have suggested that US courts uphold even penalizing liquidated damages clauses as party elected remedies which may achieve better economic parity in cases of breach.<sup>90</sup> The Georgian Civil Code goes even further, explicitly permitting contract penalties unless the penalty is imposed by a party with superior bargaining position and also is “disproportionately high” compared to actual injury suffered by the non-breaching party. Because of the many costs of breach, including reduction of marketplace confidence and reliance, US courts should consider taking a step toward the Georgian approach.

## CONCLUSION

Freedom of contract is undercut when courts refuse to enforce penalty clauses that parties have legitimately and freely negotiated.<sup>91</sup> In the name of amorality of contract breach and efficiency theories, US courts scrutinize stipulated damages clauses and refuse to enforce any that appear to be punitive. This approach diverges from the approach of most civil law countries. For example, Georgian law provides that penalties for contract breach are enforceable unless there was some bargaining inequity and gross disparity of the penalty amount counsels judicial reduction.

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**83** E.g., Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and A Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 558 (1977).

**84** E.g., John A. Sebert, Jr., *Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565, 1566 (1986); Frank J. Cavico, Jr., *Punitive Damages for Breach of Contract-A Principled Approach*, 22 ST. MARY'S L.J. 357, 367-73 (1990); Dawinder S. Sidhu, *The Immorality and Inefficiency of an Efficient Breach*, 8 TRANSACTIONS: TENN. J. BUS. L. 61, 62 (2006); Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 948-49 (1982); Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 13-18 (1989); David Campbell, *The Relational Constitution of Remedy: Co-Operation As the Implicit Second Principle of Remedies for Breach of Contract*, 11 TEX. WESLEYAN L. REV. 455, 464 (2005); PETER LINZER, A CONTRACTS ANTHOLOGY 605-07 (2d ed. 1995); Peter Linzer, *On the Amorality of Contract Remedies--Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111, 114 (1981); Peter Linzer, *Hadley v. Baxendale and the Seamless Web of Law*, 11 TEX. WESLEYAN L. REV. 225, 237 (2005). Some scholars claim that the efficient breach theory has been generally rejected by US courts as well. Craig S. Warkol, *Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach*, 20 CARDOZO L. REV. 321, 353 (1998).

**85** E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 447 (Del. 1996) (“The economic theory supporting the notion of efficient breach assumes a world without transaction costs. In some cases, particularly those involving relatively large proportionate transaction costs such as lawsuits involving small amounts, the theory may have less application.”).

**86** Macneil, *supra* note 84.

**87** Sebert, *supra* note 84, at 1569-70; Warkol, *supra* note 84, at 349.

**88** Thomas A. Diamond, *The Tort of Bad Faith: When, If At All, Should It Be Extended Beyond Insurance Transactions?*, 64 MARQ. L. REV. 425, 439-43 (1981).

**89** Cavico, *supra* note 84; Sebert, *supra* note 84. This was even admitted by one of the strongest proponents of efficient breach theory, Judge Richard Posner. *Patton v. Mid-Continent Sys., Inc.*, 841 F.2d 742, 751 (7th Cir. 1988).

**90** E.g., Campbell, *supra* note 84, at 464; Warkol, *supra* note 84, at 327-29; Gregory S. Crespi, *Good Faith and Bad Faith in Contract Law: Reflections on a Cautionary Tale and Border Wars*, 72 TEX. L. REV. 1277, 1283 (1994); Sidhu, *supra* note 84, at 62.

**91** Macneil, *supra* note 84, at 948-49.

Extant US legal doctrines, such as the doctrine of unconscionability that which permits judicial invalidation of a contract provision that is both substantively unfair and created through unfair bargaining procedures,<sup>92</sup> already would provide adequate protection against unfair penalty clauses in contracts. Accordingly, liquidated damages provisions should be presumptively enforceable and not be uniquely subjected to judicial scrutiny. Nor should US courts require that such clauses approximate expectation damages, because expectation damages may not indicate the true economic equivalent of full performance of contract. It is therefore both logical and efficient to permit parties to contract for recovery in case of breach, even if the recovery includes a contract breach penalty.

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**92** "Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party." *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965).

# LIQUIDATED DAMAGES (THEORETICAL ASPECTS AND COURT JURISPRUDENCE)

Ketevan Meskhishvili<sup>1</sup>

Liquidated damages are one of the topical issues in the jurisprudence of Georgian courts. Such topicality is conditioned by vigorous application of liquidated damages in contractual relations as an additional means of securing a claim. Liquidated damages are interesting from academic, as well as from practical perspective because the amount of such damages is regulated through active participation of a court. Liquidated damages are one of those substantive legal institutions, the amount of which is determined through active intervention from the court. In this respect there is a rich and to some extent inconsistent case-law. Because the issue is important from practical perspective this has created a need to explore it from theoretical perspective as well. This article generalizes the court jurisprudence with respect to liquidated damages and analyzes those theoretical issues, which from practical perspective require theoretical study. For comparative purposes, the article actively uses German law and case-law, which is mainly due to similarity in the respective provisions and rich case-law of German courts with respect to this matter.

## a) Legal definition of liquidated damages

According to Article 417 of the Civil Code of Georgia, liquidated damages – the amount set by an agreement of the parties - shall be paid by the debtor in cases of nonperformance or defective performance of an obligation.

## b) The concept, function and features of liquidated damages

Liquidated damages is a means for securing claim, through which, the debtor pays an amount agreed by the parties for delayed performance or for other types of breach of obligation. Therefore, for the application of liquidated damages clause there are range of preconditions, one of them being that pursuant to the Civil Code of Georgia, liquidated damages can only be in the form of **monetary amount**. Further, the **amount** to be paid shall be identified; there shall be an **agreement of the parties**; the agreement shall be **in writing**; the precondition for application of liquidated damages, as a means of claim security, is nonperformance or breach of obligation. The purpose of the liquidated damages is **to prevent nonperformance or breach of obligation**, while in the event of breach, it provides for compensation of so called **“minimum presumptive damages”**, which is of course not equivalent to actual damages and does not intend to

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<sup>1</sup> Doctor of Law, Associate Professor at Free University, Judge at Tbilisi Appellate Court, Civil Law Chamber.

compensate such. Therefore, it is **not acceptable to claim performance of the obligations simultaneously to liquidated damages**, unless of course, breach is in the form of delay in performance. Compensation of damages along with liquidated damages is completely possible.

**The function of liquidated damages** is to secure performance of an obligation. It is a kind of leverage from the side of creditor used to put pressure on debtor to perform an obligation. In the event of nonperformance or defective performance, for the purposes of liquidated damages, the creditor is released from the burden of proving the damages.<sup>2</sup>

### c) Accessorial nature of liquidated damages

**Liquidated damages are accessorial in nature.** Its validity is dependent on the validity of the obligation which it secures. In case of invalid (void) obligation, there is no obligation, which is secured by liquidated damages and therefore, there is no obligation to pay liquidated damages. The claim for liquidated damages exists until there is an obligation to perform. Therefore, in case of termination of a contract there is no obligation to pay liquidated damages<sup>3</sup>, unless of course the parties provide otherwise in the agreement (for analysis of fines for termination of a contract, see Reugeld).

An accessorial nature of the liquidated damages is conditioned by the fact that liquidated damages can only be awarded in case of fault in breach of an obligation. Thus, liquidated damages shall be awarded irrespective of whether there is a damage to the creditor, but only in case when nonperformance of an obligation was caused by debtor's fault. Further, in case of liquidated damages for delay in performance, impossibility of performance of an obligation in the agreed time, which is not cause of debtor's fault, is not deemed as delay and thus breach of obligation. Such regulation is provided under Article 401 of the Civil Code, according to which, there is no delay, in case when an obligation was not performed due to such circumstances that are not caused by the fault of a debtor.

The accessorial nature of liquidated damages results also in statutes of limitations for liquidated damages provision to expire when statutes for claim of performance of obligation expires.<sup>4</sup> According to Article 145 of the Civil Code, once statutes of limitation for the primary obligation expires, the statutes of limitation shall be deemed to have expired in relation to supplementary claim, even when term of limitations for such claim has not expired. In the context of Article 145 of the Civil Code, supplementary claims include such rights, which under the law or agreement secure performance of an obligation and do not exist independently of a claim. Such are: pledge, personal guarantee, liquidated damages and other means for securing a claim. Apart from this, supplementary claim may be other claims, such as for example right to claim interest.<sup>5</sup>

Because liquidated damages are accessorial in nature, same rules apply with respect to place of performance as with respect to place of performance for the primary obligation. The same rule applies in relation to judicial examination of the dispute related to liquidated damages.<sup>6</sup>

The person who has right to claim performance of obligation, also has right to claim liquidated damages. Therefore, a third person may claim liquidated damages if he/she has right to claim performance of an obligation.<sup>7</sup>

<sup>2</sup> BGH MDR 2000, 827; OLG Celle BauR 2001, 1108; OLG Rostock NZM 2004, 460, 461 nach *Janoschek*, Beck'scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.1.

<sup>3</sup> BGHZ 109, 230, 232 = NJW 1990, 832; BAG NJW 1992, 1646; OLG Naumburg VIZ 2004, 246, 248, nach *Janoschek*, Beck'scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.2.

<sup>4</sup> *Erman/Westermann* Rn 4; *Soergell/Lindacher* Rn 29 nach *Janoschek*, Beck'scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.2.

<sup>5</sup> Z. Akhvlediani, Commentaries on the Civil Code of Georgia, Book 1, pg 338-339, Tbilisi, 1999.

<sup>6</sup> *Janoschek*, Beck'scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.1.

<sup>7</sup> *Janoschek*, Beck'scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.1.

#### d) distinguishing liquidated damages from debtor's guarantee

It is a requirement under law that liquidated damages can be only in the form of monetary damages. Liquidated damages – an amount agreed by the parties – shall be paid by the debtor in case of nonperformance or defective performance of an obligation (CCG 417 I).

It is noteworthy to address the issue whether substitute, “other type of performance” could accomplish the same function as liquidated damages. For example the German Civil Code allows for such possibility. According to Article 342 of the German Civil Code, in the event there is a promise from the debtor to perform other obligation as a substitute to “liquidated damages”, then Articles 339-341 are applicable<sup>8</sup>, i.e. the provisions regulating liquidated damages. According to the Civil Code of Georgia, liquidated damages as an agreed amount between the parties, may not be substituted by “other type of performance” and application of the same provisions regulating liquidated damages to it is not allowed.

The Civil Code of Georgia includes as a means of securing claim a concept of debtor's guarantee, which is nothing else other than unconditional promise for different type of performance in case of nonperformance or breach of the primary obligation. The debtor's guarantee may or may not substitute performance.<sup>9</sup>

Therefore, although it is true that Georgian law does not provide for “other type of performance” instead of liquidated damages, but it does allow for different type of performance from the primary obligation, in the form of debtor's guarantee and in contrast to German civil code, it is not regulated by the same provisions as liquidated damages.

#### e) Liquidated damages - form requirements

The agreement on liquidated damages requires mutual expression of will. Unilateral acknowledgement of liquidated damages will not make it valid and will not create claim for such damages<sup>10</sup>. An agreement shall include expressly main terms, including the primary obligation and monetary amount for breach.<sup>11</sup>

In agreements, liquidated damages are not always referred to as liquidated damages. Often the security for performance of an obligation is referred to in agreement as fine, penalty, payment .,etc. which are typically synonyms for liquidated damages. However, in each specific case, it is important to understand their meaning, function and role in light of the agreement. Application of liquidated damages provision under law to such terms is only possible once it is established that they are identical to liquidated damages.

Agreement on liquidated damages shall be in writing (CCG 418 II). In the absence of written form, the agreement shall be invalid for noncompliance with the form requirements. In practice there is often a case of liquidated damages without respective written agreement. For example, a legal claim for liquidated damages, the grounds of which are not disputed or even are confirmed by the other party, does not provide for factual precondition for awarding liquidated damages, because there is no evidence of such agreement and therefore there is no legal ground for awarding liquidated damages.

The payment terms of liquidated damages are typically included in the main agreement. However, it is possible, that an agreement on liquidated damages be separate document from the main agreement. The main terms of such agreement shall include reference to the amount of liquidated damages as well as reference to the obligation, which

<sup>8</sup> German Civil Code, translator Z. Chechelashvili, as of March 1, 2010, Siesta, Tbilisi, 2010.

<sup>9</sup> T. Darjania, Secured Cession and Debtor's Guarantee, Student Law Journal, Tbilisi, 2012, pg. 76-77.

<sup>10</sup> BGHZ 21, 370, 372 NJW 1956, 1793; OLG Brandenburg NJW-RR 2012, 982; KG WRP 1986, 680, nach *Janoschek*, Beck'scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.2.

<sup>11</sup> *Palandt/Grüneberg* Vor § 339 Rn 3, nach *Janoschek*, Beck'scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.2.

is secured by liquidated damages.<sup>12</sup> Having liquidated damages agreed in a separate agreement does not make such agreement valid, if the main agreement is invalid, because validity of liquidated damages is dependent on validity of the primary obligation, which is secured through liquidated damages.

#### **f) Breach of obligation as a necessary precondition for award of liquidated damages**

The precondition for obligation to pay liquidated damages is breach of obligation. Occurrence of actual damages because of breach of obligation does not affect validity of claim for liquidated damages. Claim of liquidated damages can be made even in the case when there are no actual damages as a result of breach of obligation. Therefore, the only precondition for liquidated damages in this respect is breach of obligation. An obligation can be in the form of action or inaction. Breach of obligation can be as a nonperformance or defective performance. At the same time, insignificant breach, in light of good faith principle, shall not be taken into account<sup>13</sup>. This rule is not applicable to liquidated damages for delay in performance, in case of which the time of delay does not affect claim for liquidated damages. Characterizing breach as either “significant” or “insignificant” requires judgment and assessment shall be made by court on a case by case basis. On the one hand, so-called “insignificant” breach may not turn out to be ground for termination, but it may be “significant” breach for the purposes of awarding liquidated damages. This issue was examined by court, in particular breach of obligation (delayed performance) which was deemed as “insignificant” by court and for this reason it did not allow for termination of a contract, at the same time the court rules that such breach was ground for awarding liquidated damages. It is clear that in the event of delay, the preconditions for awarding liquidated damages is breach of obligation in the form of delay and therefore, such breach (delay) in the event of respective agreement (in written form) is a ground for awarding liquidated damages. Under such circumstances duration of delay is not relevant. Duration of delay may be considered if a party requests termination on such grounds.<sup>14</sup>

Right to claim liquidated damages is not created only by breach of obligation in fault<sup>15</sup>. An obligation to pay liquidated damages is created even when nonperformance is caused by legal representatives of the debtor or by actions of those persons, whom he used as agents to perform the obligation.<sup>16</sup> (CCG 396) The same rule applies when the debtor should have received the object of performance from other person and this latter did not perform (CCG 397). In case of mutual breach of obligations, both parties have claims on liquidated damages, unless nonperformance from one party was caused due to breach of another party. In such case, party having the claim for liquidated damages is the one who has breached the obligation, not because of its fault but because of a breach by another party<sup>17</sup>.

With respect to distribution of burden of proof, the creditor shall prove breach of obligation and that an agreement on liquidated damages was made in writing, while the debtor shall prove due performance or impossibility of performance, which is not a fault of the debtor. From comparative perspective, the German Civil Code includes special provision regulating burden of proof, in particular, according to Article 345 of the German Civil Code, if debtor disputes obligation to pay liquidated damages, by arguing that he performed his obligation, then he shall prove performance of such obligation unless such obligation is not to act<sup>18</sup>.

**12** Е. Ю., б. Валявина, А.К. Губаева и др. 2005. Комментарий к Гражданскому Кодексу Российской Федерации. Часть II. Издательство Проспект. Москва, С:659.

**13** *Janoschek*, Beck’scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.6.

**14** Decision of the Civil, Entrepreneurial and Bankruptcy Chamber of the Supreme Court of Georgia, 17 October 2011, N 1326-1346-2011.

**15** *Janoschek*, Beck’scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.3.

**16** *Janoschek*, Beck’scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.6.

**17** *Janoschek*, Beck’scher Online-Kommentar, BGB Stand, 01.05.2014, Edition 31, &339, Rn.6.

**18** Kropholer, Study Commentaries, 13<sup>th</sup> edition, Beck, 2013, pg.240



### **g) Distinguishing liquidated damages from other similar legal institutions**

Liquidated damages shall be distinguished from penalty usually included in the agreements for termination of contract. The difference is that penalty for termination is not a “penalty” for breach of obligation, but rather an alternative to staying within the contractual relations, in other words it serves a purpose to buy out exit from a contract. It is noteworthy, that Article 353 of the German Civil Code provides for a penalty for termination of contract, according to which parties may agree on the right to terminate for the penalty amount<sup>19</sup>. The Georgian Civil Code does not provide for penalty for termination of a contract. It provides for the right of termination only on the ground of breach of obligation (CCG 352 I). Therefore it is up to parties, whether a penalty for termination of contract, without there being breach of obligation, would become liquidated damages or not. If parties agree on the right of termination without there being a breach of obligation and stipulate penalty amount for such termination, such amount will not be liquidated damages, because parties by mutual agreement stipulated right to termination and its legal consequence, therefore, in the event of such agreement, termination of an agreement will not be deemed as legal consequence of breach of obligation, which means that agreed upon penalty amount will not be deemed liquidated damages.

Liquidated damages shall be distinguished from earnest money as well, which is also a means for securing a claim under the Civil Code of Georgia (CCG 421). However, earnest money, in contrast to liquidated damages, is not applicable in the event of breach of contract. The payment of earnest money confirms conclusion of a contract, therefore, person paying earnest money, confirms conclusion of a contract and the burden of proving otherwise is on the opposing party.

Liquidated damages shall also be distinguished from an agreement on a certain lump sum for the purposes to compensate damages. It is noteworthy, that liquidated damages can be in the form of periodic payments, as well as in the form of single lump sum but it is important to identify what purpose such lump sum serves. If by agreeing on a certain lump sum, parties intend to set a compensation for damages, which hypothetically can be incurred by party in case of breach of obligation, then such amount shall not be deemed as liquidated damages. The damages are a disputable category and require proving in case of a breach of obligation. Therefore, if agreed upon a sum that is intended to compensate damages, the person having right to claim damages has to prove that damages occurred and give estimate of monetary value of such damages<sup>20</sup>. Such difference has significant practical meaning, because if such lump sum is liquidated damages, then court may decrease its value, and provisions of liquidated damages shall not apply to damages. Damages require proving. A lump sum amount stipulated in the agreement as a compensation of damages may not be decreased by court under German Civil Code as well<sup>21</sup>.

### **g) Liquidated damages, performance of obligation and compensation of damages**

In the event of breach of obligation, the creditor is entitled to claim performance, compensation for damages and liquidated damages. Claiming performance and liquidated damages at the same time is not allowed, while liquidated damages can be claimed together with compensation for damages (CCG 419). Therefore, the creditor shall choose between performance and liquidated damages. In both cases creditor may claim compensation of damages. The only exception when creditor may claim liquidated damages along with performance, is breach of obligation in the form of a delay (CCG 419 I). The same rule applies to receipt of performance in time (CCG 390).

Liquidated damages are so called “minimum damages” which parties stipulate in the contract. The function of liquidated damages is to prevent breach of obligation and compensation of potential minimum damages. Therefore, if liquidated damages are agreed upon by the parties, there is no need to prove minimum damages. The actual damages incurred as a result of breach does not always correspond to so called “minimum damages”. Furthermore, actual

<sup>19</sup> See German Civil Code (BGB), translated and edited by Z. Tchechelashvili, Article 353

<sup>20</sup> Brox/Walker, Allgemeines Schuldrecht, C.H.Beck München, 2010, S:109.

<sup>21</sup> BGH NJW 1970, 29, 32 nach Brox/Walker, Allgemeines Schuldrecht, C.H.Beck München, 2010, S:112.

damages often exceed minimum damages secured by liquidated damages, or could be less than the latter, but this does not effect the amount of liquidated damages. In case the actual damages exceed liquidated damages, creditor has right to claim compensaton for damages, and burden is on him to prove actual damages<sup>22</sup>.

#### **h) decreasing disproportionately high liquidated damages**

As mentioned above, awarding liquidated damages does not prevent compensation of damages, furthermore, if actual damages exceed liquidated damages, a party may claim compensation of such excess damages. The Civil Code of Georgia provides for a possibility to decrease liquidated damages through judiciary. This is an exception when law allows for intervention in the contractual freedom of the parties. However, such intervention is subject to certain limitations. According to law just high liquidated damages are not subject to decrease, but only “**disproportionally high**” liquidated damages. Whether liquidated damages are disproportionately high or not is subject to assessment and should be decided on a case-by-case basis. For this purposes disproportionality of liquidated damages shall be taken into account in light of consequences of breach of obligation, this shall be result of high interest rate, insignifanct damages, a very short period of delay in performance and so on. A person requesting decrease of liquidated damages shall prove “explicit disproportionality”.

The purpose of liquidated damages is to remedy violation of creditor’s rights, and not to enrich creditor, therefore, liquidated damages shall be proportional to breach of obligation and reasonable<sup>23</sup>. Award of liquidated damages is to compensate creditor’s loss and not to enrich him/her. This justifies compensation of damages above that of liquidated damages. Based on the aforementioned, a court shall compare liquidated damages to the consequences of breach of obligation by debtor. Such consequences include not only pecuniary damages, but non-pecuniary damages to creditor’s rights as well<sup>24</sup>.

While decreasing liquidated damages, the court takes into account economic conditions of the party and other circumstances, in particular comparison among value of performance, damages from nonperformance or defective performance to that of liquidated damages and creditor’s economic interest. These issues will be reviewed by court only on the basis of motion from the party and only after due consideration of validity/invalidity of liquidated damages can the court act under its discretion to decrease disproportionately high liquidated damages<sup>25</sup>.

The legal possibility for decrease of disproportionately high liquidated damages serves as a protection of the interests of a weak party in the contractual relations, who does not fully understand, while signing the contract, the meaning of liquidated damages and its consequences. Therefore, during review of liquidated damages it is important to take into account facts regarding whether the party, while signing the contract, fully understood such terms. Therefore, if a party is represented by lawyer, is experienced in business relations and so on, it is presumed that liquidated damages agreed under such circumstances, even if disproportionately high, is in accordance to the intentions of the parties and is not subject to decrease. For example, for comparative purposes, according to commercial code of Germany, it is not allowed to decrease liquidated damages in favour of a company<sup>26</sup>; decrease of liquidated damages is not allowed also when liquidated damages was willfully paid<sup>27</sup>.

**22** Brox/Walker, Allgemeines Schuldrecht, C.H.Beck München, 2010,S:111.

**23** Decision of Civil, Entrepreneurial and Bankruptcy Chamber of the Supreme Court of Georgia, 15 November 2011, No. #სს-988-1021-2011

**24** Е. Ю.,б Валявина, А.К. Губаева и др. 2005. Комментарий к Гражданскому Кодексу Российской Федерации. Часть II. Издательство Проспект. Москва, С:658.

**25** Decision of Civil, Entrepreneurial and Bankruptcy Chamber of the Supreme Court of Georgia, July 2012, No. სს-819-771-2012.

**26** German Commercial Code, Art. 348

**27** Brox/Henssler, Handelsrecht, C.H.Beck München, 2009,Rn:380.

One more significant aspect from practical perspective is that the court will review liquidated damages only by motion of a party and submission of the relevant evidence. If a party does not request decrease of disproportionately high liquidated damages or requests it on such stage of proceedings, in which he cannot put forward new claim, the court may not under its initiative decrease liquidated damages, even if it is disproportionately high. Further, a party shall prove as to why liquidated damages are disproportionately high. Therefore, under the circumstances when a party requests award but the other party fails to provide response or fails to appear on the hearing, will automatically result in award of liquidated damages, even if such is disproportionately high, because acknowledging liquidated damages as disproportionately high requires proving from the other party. What happens when respondent does not dispute the amount of liquidated damages, but disputes the existence of legal preconditions for general award of liquidated damages? If the court rules that proper preconditions for awarding liquidated damages exist, the issue raises, whether with respect to amount of liquidated damages, without the other party disputing such, can the court decrease it. In such case, the governing principle shall be intention of the party with respect to whether he/she disputes amount of liquidated damages or whether he generally disputes validity of liquidated damages. Therefore, in such case liquidated damages shall be deemed to be disputed and if court rules, that there are proper pre-conditions for awarding liquidated damages, examination shall shift to issue of proportional amount<sup>28</sup>.

## CONCLUSION

Based on all the aforementioned, liquidated damages are means for securing a claim, which serves as a compensation of minimal damages or hypothetically presumed damages and its purpose is not to compensate actual damages, but rather ensure performance of an obligation. The pre-condition for application of liquidated damages is a breach of obligation. It shall be used even when breach is insignificant and when there are no actual damages. On the other hand liquidated damages do not rule out compensation of actual damages, if of course, as a result of breach there are actual damages that have not been compensated by liquidated damages award. The amount of liquidated damages does not require proving, but party may dispute its amount through court proceedings.

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<sup>28</sup> This is a position of the author and not an established practice of the court.

# AN OVERVIEW OF THE UNITED STATES PERSPECTIVE ON INTERNATIONAL TAXATION

Presented at Free University of Tbilisi, Georgia,  
Commercial Law Week  
May 17, 2013

William E. Foster<sup>1\*</sup>

## INTRODUCTION

Like most countries whose citizens are engaged in extensive international commerce, the primary concerns for international tax policymakers in the United States are (1) how to regulate the division of gains from bilateral (or multilateral) trade, (2) how and when the U.S. tax should reach individuals engaged in economic activities overseas, and (3) how to prevent U.S. taxpayers from using international tax havens and intricate multinational structures to deplete the tax base.

Two recent high profile cases highlight the chief threats to the American tax base from foreign transactions. On May 2, 2013, news outlets reported that Apple, Inc. (“Apple”) issued \$17 billion in corporate bonds.<sup>2</sup> This debt issuance was peculiar on the surface because Apple has over \$100 billion in cash overseas.<sup>3</sup> However, if Apple brought that money back to the U.S., it would incur a U.S. tax on foreign repatriations of up to 35%.<sup>4</sup> By opting instead to issue bonds, Apple could deduct the interest costs, which were estimated to be around \$308 million per year.<sup>5</sup> In other words, Apple saved billions of dollars in taxes, at least in the short run, by borrowing instead of bringing the cash home.<sup>6</sup> In fact, it is becoming quite common for U.S. corporations to “park” huge stores of cash overseas instead of taking the tax hit for repatriation.<sup>7</sup> Obviously, the loss of tax revenue related to these stagnant funds is troubling to the U.S. government. Moreover, the relative immobility of earned capital is perhaps equally frustrating to corporations with large sums accumulated overseas.

<sup>1</sup> \*Associate Professor, Washburn University School of Law; Visiting Assistant Professor, University of Arkansas School of Law. The author would like to thank Howard W. Weinman for his insights and guidance and Michael Fessinger for his valuable research assistance on this project.

<sup>2</sup> Katy Burne & Mike Chorney, *Apple’s Record Plunge into Debt Pool*, WALL ST. J. Apr. 30, 2013, <http://online.wsj.com/article/SB10001424127887324482504578454691936382274.html>; Peter Burrows, *Apple Avoids \$9.2 Billion in Taxes with Debt Deal*, BLOOMBERG (May 2, 2013, 11:01 PM), <http://www.bloomberg.com/news/2013-05-02/apple-avoids-9-2-billion-in-taxes-with-debt-deal.html>; Sarika Gangar, *As Warren Buffett and Bill Gross Shun Corporate Bonds, Others Pile In*, FINANCIAL POST (May 20, 2013, 11:45 AM), <http://business.financialpost.com/2013/05/20/us-corporate-bonds/>.

<sup>3</sup> Burrows, *supra* note 1.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> As explained later in this article, the tax consequences of Apple’s repatriation have been overstated by the media. Apple would get a foreign tax credit for the repatriated funds, possibly reducing its effective U.S. tax rate.

<sup>7</sup> Cisco’s chief executive officer John Chambers recently stated that he “cannot” repatriate over \$47 billion his company holds overseas until the United States lowers its corporate tax rates. Deepanshu Bagchee, *Cisco CEO: US Tax System Is Broken*, CNBC (June 20, 2013, 4:46 AM), <http://www.cnbc.com/id/100830545>.

Another noteworthy illustration is Google's tax showdown with the United Kingdom. In the spring of 2013, Google drew scathing criticism from the U.K. Parliament for basically claiming its advertising sales and invoices ran through Ireland and not the U.K.<sup>8</sup> Google's position was that "no money changes hands" in Britain, even though Google maintains a sales staff there.<sup>9</sup> Google's annual advertising sales in the U.K. are worth around £3.2 billion, but most of those sales are routed through Dublin,<sup>10</sup> where Google maintains 3,000 employees.<sup>11</sup> In 2011, Google paid £6 million in U.K. corporation tax.<sup>12</sup> In effect, by sourcing its sales through Ireland,<sup>13</sup> Google has reportedly paid less than 0.1% in taxes to the U.K. on income from U.K. customers.<sup>14</sup>

The aggressive tax planning of Apple, Google, and other similarly situated companies demonstrates the concern of the U.S. and other governments: their most profitable companies can avoid taxes through sophisticated international maneuvers and thereby gut the country's revenue stream. This article will discuss the general landscape of the U.S. approach to international taxation and will note some of the strategies employed by the U.S. to prevent significant tax losses to foreign jurisdictions.

## A. Taxing Bilateral Trade in a Borderless Economy

Bilateral trade requires coordination among governments in order to avoid double taxation of transactions and to provide a proper revenue division among the nations whose citizens engage in the trade.<sup>15</sup> For example, if a U.S. company manufactures and sells a tablet computer to a Georgian citizen in Georgia, both the U.S. and Georgia have significant connections to the transaction and could claim taxing authority. Similar concerns arise when a Georgian citizen earns a salary in the U.S. or a U.S. citizen has earnings from work performed in Georgia. If both countries impose tax on a single transaction or relationship, the cost for all parties involved increases dramatically, and an otherwise economically efficient transaction may not take place. Accordingly, it is imperative that taxing states coordinate with each other to establish exclusive or reasonably complementary taxing jurisdiction and to provide mechanisms to avoid multiple levels of tax on a single transaction.

The concept of national trade borders is quickly evolving in an age of rapid digital information dissemination, especially given that intellectual property such as patents, licenses, and trademarks are the most valuable assets of many companies. This property is easily moveable and can be located with minimal costs<sup>16</sup> in any physical jurisdiction on the globe. A company no longer has to relocate a manufacturing plant and hundreds of employees in order to shift its operations overseas. The costs to develop and market intellectual property and the revenue from licensing this property among related companies severely complicate taxing jurisdiction and allocation questions and create tax-planning opportunities particularly for technology-driven firms.

**8** COMMITTEE OF PUBLIC ACCOUNTS, TAX AVOIDANCE-GOOGLE, 2013-6, H.C. 112, at 3 (U.K.), available at <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf>.

**9** Google Defends UK Tax Arrangements, BBC (May 16, 2013, 7:06 AM), <http://www.bbc.co.uk/news/business-22554545>.

**10** Ireland has a relatively low 12.5% corporate tax rate. IDA IRELAND, available at <http://www.idaireland.com/invest-in-ireland/tax-regime/> (last visited Apr. 10, 2014).

**11** MPs Challenge Google over UK Tax Reporting, BBC (May 16, 2013, 12:33 PM), <http://www.bbc.co.uk/news/business-22551401>. [hereinafter "MPs Challenge Google."]

**12** *Id.*

**13** These results are accomplished in part through a complex intellectual property holding and licensing strategy known as a "Dutch Irish sandwich." See generally Stephen C. Loomis, *The Double Irish Sandwich: Reforming Overseas Tax Havens*, 43 ST. MARY'S L.J. 825 (2012).

**14** *MPs Challenge Google*, *supra* note 10..

**15** See Eduardo Jose Fernandez, Note, *La Isla Del Escape: America's Escape from Corporate Taxes & Puerto Rico's Taxed Future*, 19 FLA. J. INT'L L. 311, 328-30 (2007) (discussing the United States's tax relationship with various foreign countries).

**16** The non-tax costs are relatively minimal. As explained herein, when intellectual property is moved from the U.S. to a foreign corporation, a "commensurate with income" amount must be taken into income. To avoid this result, a number of companies enter into cost sharing arrangements with foreign affiliates to develop intellectual property ("IP"), so that each takes an ownership interest and, although the IP is being used abroad, no transfer occurs.

A different issue is whether U.S. citizens or companies are parking their earnings from international transactions in low tax jurisdictions to avoid U.S. tax. Generally the U.S. does not tax profits of a foreign subsidiary corporation unless the cash is “repatriated,” or brought back into the U.S. in the form of a dividend.<sup>17</sup> If offshore cash is never repatriated, then it is possible that certain gains will go forever untouched by U.S. taxation. Obviously, firms will not be satisfied for long with simply allowing cash to accumulate in offshore bank accounts. International corporations are finding more and more ways to leverage their foreign cash reserves presently without taking the tax hit from repatriation.

## B. Heightened Scrutiny of Offshore Assets

Lurking in the background of the current international tax discussion in the U.S. are enforcement issues. These concerns relate primarily to bank secrecy and reining-in jurisdictions that accommodate individuals and companies holding assets abroad without threat of disclosure of the accounts and resources to the U.S. government. The U.S. is concerned not only with taxing the earnings of its citizens, but also uncovering any nefarious sources of these funds. With varying degrees of success, the U.S. has recently implemented numerous measures aimed at increasing international cooperation and information disclosure with respect to the foreign assets of its citizens.<sup>18</sup> The Internal Revenue Service (“IRS”) is becoming increasingly aggressive in pursuing those who are hiding assets (and the institutions that are facilitating the asset hiding), but arguably is overreaching and penalizing (or threatening to penalize) U.S. citizens living abroad, or those who are either innocent or merely negligent in their failure to disclose.<sup>19</sup>

## C. The International Tax Context

Before exploring these current issues in any depth, I will explain some of the big picture concepts at play in various international tax regimes.<sup>20</sup> Initially, there is no single body of international tax law. Instead, international tax consists of both unilateral domestic legislation (e.g., Internal Revenue Code in the United States)<sup>21</sup> and bilateral treaties (e.g., Tax Convention, U.S. – U.S.S.R., Jan. 29, 1976, 27.1 U.S.T. 1.).<sup>22</sup>

To understand the tax consequences of any international transaction, one must know which jurisdictions potentially have taxing authority, how the particular transaction is taxed in the relevant jurisdictions’ domestic regimes, and whether there are any modifications or relief provisions available via bilateral treaties to which those countries are parties.

Establishing jurisdictional basis for taxation is perhaps the most critical step in analyzing international tax issues. The two primary approaches to jurisdictional taxing authority are based on (1) the territorial source of the transaction

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**17** CHARLES I. KINGSTON & CYNTHIA A. BLUM, INTERNATIONAL TAXATION 345 (1998).

**18** For example, the Foreign Account Tax Compliance Act (“FATCA”) has been enacted to prevent U.S. persons from evading U.S. tax by holding income producing assets through accounts at foreign financial institutions (“FFIs”). FATCA imposes a 30% withholding tax on certain payments (FDAP WHAT IS FDAP? income and sales proceeds from assets that generate interest or dividends) to certain foreign entities. Relevant portions of FATCA are scheduled to take effect July 1, 2014, subject to exceptions for FFIs that enter into agreements with the IRS to identify and report on their U.S. accounts. IRS Notice 2013-43 (July 12, 2013). This law essentially forces FFIs to participate in account reporting to the IRS. For an examination of the historical context and alternative regimes for reaching foreign financial information see Itai Grinberge, *The Battle over Taxing Offshore Accounts*, 60 UCLA L. REV. 304 (2012).

**19** For a critical examination of FATCA, see Frederick Behrens, Comment, *Using a Sledgehammer to Crack a Nut: Why FATCA Will Not Stand*, 2013 Wis. L. REV. 205 (2013). “Due to this widespread opposition and numerous practical problems, Congress must consider alternatives to the continued implementation of FATCA.” *Id.* at 211.

**20** For an excellent and concise overview of international tax issues, see RICHARD L. DOERNBERG, INTERNATIONAL TAXATION IN A NUTSHELL (9th ed. 2012).

**21** I.R.C. §§ 1–9834 (2011).

**22** “Since the end of the nineteenth century, many States have supplemented their domestic legislation with bilateral tax treaties because domestic legislation may, in some cases, be inadequate to avoid double taxation and non-taxation.” Jason A. Hoida, *Toward A Uniform Interpretation of Article 14 of the Norway-America Double Taxation Treaty: Avoiding the Double Whammy on American Employees’ Income in Norway*, 20 HAMLINE L. REV. 691, 696 (1997).

or (2) the residence of those earning the income.<sup>23</sup> “Thus, U.S. taxing jurisdiction rests on two distinct bases. As to U.S. residents and domestic corporations, jurisdiction to tax is based on their *personal* connection with the United States (in personam jurisdiction [or residence-based taxation]) and is world-wide; as to non-residents and foreign corporations, jurisdiction to tax is based on the *territorial* connection of their income to the United States and is limited to income from U.S. sources (in rem jurisdiction [or source-based taxation]).”<sup>24</sup>

Generally, U.S. individual residents and citizens are taxed on their worldwide income no matter where the income is earned.<sup>25</sup> In some cases, a capped amount of foreign income can be excluded for some who are foreign residents and those who spend essentially the entire tax year abroad.<sup>26</sup> Likewise, U.S. corporations (those incorporated in the U.S.) are taxed on their worldwide income, wherever earned.<sup>27</sup> However, if the U.S. corporation has a foreign subsidiary, the parent corporation is usually not taxed until a dividend is paid by the subsidiary.<sup>28</sup>

The following example demonstrates the potential for double taxation. If the U.S. taxes a U.S. company on its profits on the sale of a tablet computer occurring in Georgian territory at 35% (asserting residency jurisdiction) and Georgia taxes the income from the transaction at 30% (asserting territorial jurisdiction), then the total tax on the transaction could in theory be 65%. Both governments clearly have an interest in asserting taxing jurisdiction, but international tax norms and treaties ensure that most transactions are not subject to full double taxation. To prevent or ease the impact of double taxation, nations can employ a variety of relief mechanisms including (1) deductions for foreign taxes imposed by the source country, (2) dollar-for-dollar credits against the tax the country of residence would otherwise impose for amounts paid to the source country in tax, (3) exemptions for foreign-sourced income, and (4) bilateral income tax treaties.<sup>29</sup> The United States primarily relies on both a foreign tax credit and tax treaties to avoid double taxation. One significant goal of international tax policy is to promote tax-neutral rules. Tax neutrality is achieved when the tax results do not dictate transactions and when markets function as they would without tax.<sup>30</sup> Instead, transactions occur because they make business sense and not because the tax laws either encourage or discourage certain activities. Tax neutrality is promoted when countries coordinate their tax systems to prevent double taxation.<sup>31</sup>

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**23** REUVEN S. AVI-YONAH, U.S. INTERNATIONAL TAXATION CASES AND MATERIALS 19 (2002).

**24** *Id.*

**25** JOEL D. KUNTZ & ROBERT J. PERONI, US INTERNATIONAL TAXATION, ¶ B1.03 Taxation of Worldwide Income, at \*1 (2013). “In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States.” Treas. Reg. 1.1-1(b) (2013).

**26** See I.R.C. § 911(d)(1)(A), (B). Section 911 allows an individual to opt out of the taxation of their foreign-earned income and their foreign housing costs. *Id.* § 911(a). There are various situations in which someone may not except their foreign earned income from U.S. taxation, such as income in the form of a pension or annuity, working for a U.S. agency while living abroad, or if the income is the result of previous work performed in the U.S. *Id.* § 911(b)(1)(B). With regards to the foreign housing exception, the housing costs must be “reasonable” and may include attributable expenses such as insurance or utilities. *Id.* § 911(c)(3).

In 2013, a qualified individual can exclude approximately \$97,600 of foreign earned income, as a reasonable foreign housing expense, from taxable gross income as well. *Id.* § 911(c)(3).

**27** KUNTZ & PERONI, *supra* note 24, ¶ B1.03 at \*2.

**28** “Profits earned abroad by American firms operating through foreign subsidiaries are, under present tax laws, subject to United States tax only when they are returned to the parent company in the form of dividends.” Samuel C. Thompson, Jr., *Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption, and Imputation*, 53 HOW. L.J. 337, 366 (2010); see also I.R.C. §§ 951–960.

**29** CHARLES H. GUSTAFSON, ROBERT J. PERONI, & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS MATERIALS, TEXT AND PROBLEMS 304-306 (4th ed. 2011).

**30** See Fadi Shaheen, *International Tax Neutrality: Reconsiderations*, 27 VA. TAX REV. 203, 206–07 (2007).

**31** Tax neutrality can viewed according to at least four different approaches. Capital-export neutrality is achieved when “the U.S. investor pays the same total (U.S. and foreign) tax on all income, regardless of where the income is earned[.]” capital-import neutrality is achieved when “[a]ll firms operating in the same industry in a particular country, whether owned by local or foreign interests, are taxed at the same level[.]” national neutrality is achieved when “the same amount of current tax [is] payable to the U.S. Treasury whether the earnings are from income U.S. investment or from foreign investment[.]” and capital-ownership neutrality “requires that the international tax rules of a country not distort ownership patterns of assets.” GUSTAFSON ET AL., *supra* note 28, at 20-22.

## D. The U.S. Approach to International Taxation

Broadly speaking, transactions can be viewed as either “inbound” or “outbound” from a particular country’s perspective.<sup>32</sup> When U.S. citizens and residents conduct business abroad, that transaction is considered outbound from the U.S. perspective.<sup>33</sup> When foreign citizens and residents conduct business in the U.S., that transaction is considered inbound from the U.S. perspective.<sup>34</sup>

### 1. OUTBOUND TRANSACTIONS

With respect to outbound transactions, the initial concern for the U.S. is avoiding double taxation of its citizens. The source country, applying territorial jurisdiction, will often claim taxing authority over any transaction that takes place in its territory.<sup>35</sup>

#### a. Foreign Tax Credit

The primary mechanism for eliminating double taxation of U.S. citizens is the foreign tax credit.<sup>36</sup> The foreign tax credit decreases the U.S. tax liability on foreign source income dollar-for-dollar by the amount paid in tax to the foreign country. There are labyrinthine restrictions on the availability of this credit<sup>37</sup> and the types of taxes it applies to,<sup>38</sup> but broadly speaking, the foreign tax credit eliminates double income taxation on most outbound transactions by U.S. taxpayers.

The foreign tax credit works as follows. If a U.S. individual earns \$100,000 of income in Georgia, under international tax norms, the source country, i.e., where the income is earned, has taxing priority over the country of residence.<sup>39</sup> Georgia would therefore get the first bite at the tax apple. The U.S., in turn, would tax the \$100,000 earned by its citizen in Georgia but allow a credit against the U.S. tax liability for income taxes paid to Georgia on that income.<sup>40</sup> If the Georgian tax rate on that income is 30% and the U.S. rate is 35%, the taxpayer would ultimately pay \$30,000 to Georgia and \$5,000 to U.S.<sup>41</sup>

**32** DOERNBERG, *supra* note 19, at 12; JOSEPHN ISENBERGH, INTERNATIONAL TAXATION 4 (3d ed. 2010). “More technically, the taxation of these two classes is called ‘taxation of foreign person’ and ‘taxation of foreign income.’” *Id.*

**33** ISENBERGH, *supra* note 31, at 4, 131.

**34** *Id.*

**35** “Americans pursuing income outside the United States are bound to encounter tax collectors asserting their own national claims.” *Id.* at 10.

**36** “The fundamental policy of the foreign tax credit is to alleviate the international double taxation that occurs when income earned in a foreign country is taxed both by the country from which it is derived and by the United States.” Ronald A. Worley, *The Indirect Foreign Tax Credit: A Policy Analysis of Section 902*, 13 INT’L TAX & BUS. LAW. 176, 181-82 (1996); *see also* I.R.C. §§ 901–909.

**37** The credit is available to U.S. citizens and corporations, resident aliens (if their home country allows a similar offset), and foreign individuals and corporations with effectively connected income in the U.S. The credit is also limited based on the proportion the taxpayer’s foreign taxable income bears to his entire taxable income for the same year and based on the total amount of income of certain types (i.e., passive or general) under a so-called “basket” system. *See* I.R.C. § 901(b).

**38** The tax must be a compulsory levy paid to the government and not a payment for a special benefit. Treas. Reg. § 1.901-2(e)(5) (2013); *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999). It also must be an income tax, which is designed to tax net gain.

**39** “Just as the United States taxes the U.S.-source income of foreign persons, other countries to which Americans are themselves foreigners tax income arising within them.” ISENBERGH, *supra* note 31, at 137.

**40** “The foreign tax credit rests on a simple idea: income taxes paid to the U.S. Treasury are reduced . . . by the amount of income taxes paid by U.S. persons to foreign governments.” *Id.*

**41** DOERNBERG, *supra* note 19, at 209–16. If instead the Georgian rate were higher than the U.S. rate and the taxpayer had other U.S. income, the taxpayer would not be allowed to use the income taxes paid to Georgia to reduce income taxes on U.S. source income. *Id.* at 213.



## b. Transfer Pricing

As briefly mentioned above, a growing concern with respect to outbound transactions is attempts by U.S. taxpayers to place foreign income beyond U.S. tax jurisdiction. U.S. firms can do this by shifting foreign income to a related corporation incorporated abroad.<sup>42</sup> The U.S. company can then avoid U.S. taxation by structuring transactions with the foreign subsidiary or sister corporation in a non-arm's length manner.<sup>43</sup> To prevent rampant abuse of these structures, the U.S. has transfer pricing rules by which the IRS can make pricing adjustments to more closely reflect arm's length transactions and controlled foreign corporation rules, which require current taxation of certain (generally passive) foreign income that might otherwise be deferred until it is repatriated.<sup>44</sup> I will discuss a few big-picture transfer pricing and controlled foreign corporation income issues in turn.

Transfer pricing is focused on related party transactions.<sup>45</sup> With corporations that share management and shareholders, there is often a strong incentive to structure intercompany purchases, licenses, and other transactions in a way that locates the bulk of the tax liability in a low tax jurisdiction. Likewise, multinational corporations are careful to source income to low-tax jurisdictions when selling, leasing, or licensing to third parties. Transfer pricing rules attempt to ensure that the tax consequences of related party transactions are similar to those in unrelated situations in order to prevent gutting the U.S. tax base.<sup>46</sup> The transfer pricing rules seek to require taxpayers to report transactions in a way that "clearly reflects income"<sup>47</sup> attributable to related company dealings.

Income from intangible assets like patents and trademarks is particularly subject to taxpayer manipulation across borders. Intangible property can easily be located abroad without significant infrastructure and support costs. The United States Code requires that income from a related party for a license or transfer of an intangible be "commensurate with the income" attributable to that intangible.<sup>48</sup> Accordingly, the IRS can frequently adjust royalty arrangements between related parties to reflect changing market conditions.<sup>49</sup>

The bedrock principle guiding the IRS's adjustments of related party transactions is the "arm's length principle," which attempts to recast the transaction in a way that reflects the value that the parties would have reached if the relationship did not exist.<sup>50</sup> Various transfer pricing methods are employed to achieve arm's length prices depending on the particular related party transaction involved. These methods may compare the *amounts charged* between related companies to those charges to third parties, the *gross margins* earned in the controlled transactions to that earned in comparable uncontrolled transactions, or the *mark-up* earned by a manufacturer selling to a related party compared to unrelated dealings.<sup>51</sup>

Taxpayers engaged in cross-border dealings with related entities should maintain extensive contemporaneous documentation supporting the pricing method employed. If the IRS concludes that a transfer pricing adjustment is needed, the taxpayer may be subject to severe transactional penalties of 20% to 40% of the underpayment of tax.<sup>52</sup> To avoid penalties, some companies seek advance pricing agreements with the IRS that apply an agreed-upon transfer pricing methodology to particular related party transactions.<sup>53</sup>

**42** ISENBURG, *supra* note 31, at 67–68.

**43** *Id.*

**44** See I.R.C. § 482 (2012).

**45** "Transfer pricing" refers to "the pricing of goods and services transferred between related persons not dealing at arm's length." ISENBURG, *supra* note 31, at 67.

**46** See I.R.C. § 482.

**47** "[T]he Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or *clearly to reflect* the income of any of such organizations, trades, or businesses." *Id.* (emphasis added).

**48** See *Id.*

**49** "Known as the 'superroyalty' provision, this sentence [of § 482], greatly simplified, allows for continuing annual adjustments after transfers of intangible property to make the results 'commensurate with income.'" ISENBURG, *supra* note 31, at 77.

**50** "Section 482 is aimed at the unilateral advantage related taxpayers could otherwise obtain through unchecked transfer prices. Its goal, broadly stated, is to recast transactions among affiliates on arm's length terms and adjust U.S. taxation accordingly." *Id.* at 71.

**51** *Id.* at 74–77.

**52** GUSTAFSON ET AL., *supra* note 28, at 759.

**53** "An APA is an agreement between the Service and the taxpayer on the [transfer pricing methodology] to be applied to any apportionment or allocation of income, deductions, credits, or allowances between or among two or more organizations, trades, or businesses owned or controlled,

### c. Controlled Foreign Corporations

When a U.S. taxpayer conducts business overseas through a legally distinct foreign corporation, the earnings of that foreign corporation typically are only taxed by the United States when they are distributed to the U.S. taxpayer.<sup>54</sup> When the foreign subsidiary is formed in a relatively low tax jurisdiction, the U.S. taxpayer enjoys deferral of U.S. taxation on its foreign income.<sup>55</sup>

Subpart F of the U.S. tax code is designed to prevent U.S. taxpayers from employing foreign corporations to park their earnings in low tax jurisdictions.<sup>56</sup> Subpart F operates by requiring that certain U.S. taxpayers be immediately taxed on income earned by “controlled foreign corporations.”<sup>57</sup> These provisions generally apply to passive investment income and income from dealings with these related corporations, and they seldom touch active income from third-party business operations.<sup>58</sup> Subpart F essentially treats U.S. shareholders as having received a current distribution from the controlled foreign corporation of its share of Subpart F income plus any non-Subpart F foreign earnings invested in U.S. property.<sup>59</sup> With a broad swath of related-company income potentially subject to immediate taxation, U.S. taxpayers have diminished incentives to park their earnings in foreign subsidiaries.

## 2. Inbound Transactions

With respect to nonresident aliens and foreign corporations that invest in the United States, the way in which they will be taxed depends on whether their U.S.-sourced income is derived from the conduct of a U.S. trade or business or from passive sources.<sup>60</sup> If a foreign individual or company engages in business in the U.S., it will be subject to the usual U.S. tax rates on net taxable income that is effectively connected with the conduct of that trade or business.<sup>61</sup> Whether a foreign taxpayer is engaged in a U.S. trade or business involves both quantitative and qualitative investigation, but overall, the activities in the U.S. must be “considerable,” “regular,” and “continuous.”<sup>62</sup> Income will be considered effectively connected to the U.S. trade or business if the income is derived from assets used in that trade or business or if the activities of the trade or business are a material factor in the realization of the income.<sup>63</sup> For example, if a Georgian corporation sells wine in the U.S. through an American branch, any income generated by that branch would be effectively connected to the U.S. activities.

In addition to U.S. business activities, certain types of recurring investment income may also subject nonresident aliens and foreign corporations to U.S. taxation. The U.S. imposes a flat 30% withholding tax rate on amounts received from U.S. sources that are “fixed or determinable annual or periodical gains, profits, and income,” (or simply, “FDAP”

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directly or indirectly, by the same interests. The [transfer pricing methodology] thus represents the application to the taxpayer's specific facts and circumstances of the best method within the meaning of the income tax regulations under § 482 . . . as agreed pursuant to negotiations between the Service and the taxpayer.” Rev. Proc. 96-53, 1996-2 C.B. 375 (1996)

**54** MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 217 (2003).

**55** ISENBERGH, *supra* note 31, at 187.

**56** DOERNBERG, *supra* note 19, at 340. “Subpart F . . . substantially limits deferral for controlled foreign corporations operating in conspicuously favorable tax environments . . . .” ISENBERGH, *supra* note 31, at 190-91.

**57** I.R.C. § 957. A controlled foreign corporation is one in which U.S. shareholders own over 50% of the total combined voting power or over 50% of the value of the corporation. *Id.* § 957(a).

**58** “Subpart F extends to what Congress considers to be ‘tax haven’ income . . . and not (with significant exceptions) to active business operations. . . . [T]ax haven income includes passive income arising in no-tax or low-tax environments and income artificially shifted to such an environment when it has no indigenous economic connection there.” ISENBERGH, *supra* note 31, at 192.

**59** “The core of Subpart F . . . impos[es] current U.S. tax on the ‘pro rate share’ of a ‘United States shareholder’ in various types of income of a ‘controlled foreign corporation.’” *Id.* at 191.

**60** DOERNBERG, *supra* note 19, at 15; GUSTAFSON ET AL., *supra* note 28, at 141.

**61** GUSTAFSON ET AL., *supra* note 28, at 141.; I.R.C. § 864(c)(1)(A).

**62** GUSTAFSON ET AL., *supra* note 28, at 143.

**63** PAUL R. McDANIEL, HUGH J. AULT, & JAMES R. REPETTI, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 59 (5th ed. 2005).

income).<sup>64</sup> Among other items, FDAP income includes dividends, rents, interest, royalties, and pensions.<sup>65</sup> It typically does not include capital gains transactions unless the gain is generated by the sale of U.S. real property.<sup>66</sup>

One of the most critical decisions for foreign businesses and investors with U.S. activities is whether to conduct their U.S. operations through a branch office or a subsidiary. While a branch is merely an unincorporated division of the foreign corporation, a subsidiary is a separate wholly-owned corporation formed under the laws of a U.S. state. Historically, it was better for foreign companies to conduct U.S. operations via branch offices, which would avoid double corporate taxation.<sup>67</sup> However, since 1987, the U.S. has imposed a branch profits tax,<sup>68</sup> which requires the foreign corporation to pay a 30% tax to the extent that its U.S. branch repatriates (or is deemed to repatriate) its earnings from the U.S. to its home country.<sup>69</sup> The branch profits tax eliminates much of the incentive to conduct U.S. operations through branches, and instead the current trend is to form a U.S. subsidiary in order to avoid mandatory disclosure of all operations, foreign and domestic, to the U.S. taxing authorities.

## E. Income Tax Treaties

In addition to its domestic tax code, the U.S. is a party to numerous bilateral income tax treaties with foreign governments, which can override the standard treatment of tax items. These treaties are designed to promote tax neutrality and accommodate international trade and investment.<sup>70</sup> Bilateral tax treaties can provide mechanisms to resolve potential conflicts over sourcing and residency of taxpayers, and can ease double-taxation burdens.

U.S. treaties frequently differ from international models in several important respects. As explained above, the U.S. employs a credit against taxes paid to foreign jurisdictions, whereas many countries use an exemption model, or both.<sup>71</sup> Further, state and local taxes are not usually addressed by U.S. treaties, requiring trading partners to navigate a more complex tax regime.<sup>72</sup> A significant incentive for foreign investment built into most U.S. bilateral treaties is a tax rate break for investment income.<sup>73</sup> Without the treaty, dividends, rents, royalties, and interest paid from U.S. sources are subject to a withholding tax of 30%.<sup>74</sup> U.S. bilateral treaties often reduce this rate to 15% or less.<sup>75</sup> Typical treaty provisions also include promises by each party to refrain from taxing citizens and residents of the other nation more heavily than its own in exercising territorial or residency based jurisdiction and dispute resolution mechanisms for resolving issues governed by the treaty.<sup>76</sup>

With respect to Georgia, the U.S. continues to recognize the Tax Convention of January 29, 1976, between the U.S. and the Soviet Union, which was made available to all former Soviet territories after the break-up of the Union.<sup>77</sup> This treaty includes some significant exemptions for income from the following: certain intellectual property rentals and

**64** GRAETZ, *supra* note 53, at 323; *see* I.R.C. § 871 (nonresident alien individuals); *id.* § 881 (foreign corporations).

**65** GRAETZ, *supra* note 53, at 323.

**66** McDANIEL ET AL., *supra* note 62, at 70.

**67** GUSTAFSON ET AL., *supra* note 28, at 222.

**68** I.R.C. § 884.

**69** GUSTAFSON ET AL., *supra* note 28, at 222.

**70** “The fundamental goal of tax treaties is to promote international movement and exchange of persons, goods, services, and capital and international trade and investment by removing tax barriers. Tax treaties also aim to create legal certainty as to tax ramifications of international transactions for the benefit of taxpayers and contracting States.” Hoida, *supra* note 21, at 696.

**71** DOERNBERG, *supra* note 19, at 125-27.

**72** *Id.* at 127.

**73** *See* U.S. Model, 2006, Art. 10.

**74** GUSTAFSON ET AL., *supra* note 28, at 222; *see* I.R.C. § 871(a); § 881.

**75** *See* U.S. Model, 2006, Art. 10.

**76** *See* McDANIEL ET AL., *supra* note 62, at 192-94 (describing nondiscrimination articles). Common issues for treaty dispute resolution involve income attribution, allocation of income between related persons, characterization of particular items of income, and source rule application. *See* U.S. Model, 2006, Art. 25 (Mutual Agreement Procedure)

**77** *See* U.S. Treasury Publication 901 U.S. Tax Treaties (Rev. April 2013).

royalties; payments for engineering, architectural, and other technical services; interest on indebtedness in connection with the financing of trade between the two countries; reinsurance premiums; income from the sale of goods effected through an agent; income from shipping and aircraft operations; and income from personal services if present in the host state six months or less (and longer if the taxpayer is an educator or student).<sup>78</sup> Thus, there are several very attractive provisions in the Soviet treaty that may be worth trying to retain into the future.

## CONCLUSION

This article has attempted to highlight a few of the most important features of the U.S. approach to international taxation. In no way has comprehensive treatment been given to any particular provision, but this article serves as a guidepost for those seeking a basic understanding of the U.S. perspective on technical and policy issues implicated in international taxation. With a rapidly changing and extremely mobile global economy and with international competition for tax dollars at an all-time high, the U.S. will have to continue to adapt its domestic laws and treaty obligations in order to shore up its tax base and prevent taxpayer abuse. The U.S. should also continue to consider the tax structures it can employ through treaties to encourage trade development with emerging economies. These goals are broad and the challenges daunting, but prudent and thoughtful international tax policies can serve as one of the most effective tools for fostering international trade.

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**78** See Convention with the Union of Soviet Socialist Republics on Matters of Taxation (Eff. Jan. 1, 1976).

# SELECTED ISSUES OF INTERNATIONAL TAX LAW OF GEORGIA

Ruslan Akhalaia<sup>1</sup>

## INTRODUCTION

This article offers basic overview of the selected issues of Georgian international tax Law. With this goal, firstly the article describes basis of taxing rights of Georgia in cross-border situations. Afterwards, the article overviews causes of double taxation. Next section of the article describes Georgia's approach to the determination of residency status of individuals and enterprises (except partnerships). Two separate sections are dedicated to the description of Georgian tax treatment of outbound and inbound situations. Within said sections special focus is placed on the taxation of the non-Georgian tax residents (the "Non-residents") conducting business activities in Georgia with and without a permanent establishment (the "PE"). The last section of the article briefly describes Georgian tax treatment of the transactions conducted by Georgian tax resident (the "Resident") enterprises with the offshore enterprises.

As a part of an introduction it is worth of noting that practice of the Revenue Service of Georgia (the "GRS") is not in the public domain. Besides, the jurisprudence on the issues of international tax law of Georgia is scares. In light of these facts, this article offers to the readers the views of the author on the possible development of the Georgian tax law practice on some of the pressing issues of international double taxation.

### 1. Basis of Taxing Rights of Georgia in Cross-border Situations

Generally, there are two basis of taxation in cross-border situations: residency of the tax-payer and source of taxable income. The residents are usually taxed on their world-wide income in the countries of their residency (residency based taxation). The non-residents who derive income from the specific jurisdiction are usually taxed in this jurisdiction on the said income (source based taxation). It should be noted that residency of the tax-payer and the source of income is acknowledged as the basis of taxation in many jurisdictions.

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<sup>1</sup> Senior Associate at Dechert Georgia LLC and an Academic Co-Director, National Center of Business Law, Free University of Tbilisi  
The views expressed in this article are those of the author and do not necessarily represent the views of, and should not be attributed to, any of his employees

Tax Code of Georgia (the “Tax Code”) embodies both principles: residency based as well as sourced based taxation. Specifically, Tax Code makes individuals and enterprises liable to, respectively, Georgian personal income tax (the “PIT”) and corporate profit tax (the “CPT”) only if:

- (a) Person receiving income is Resident of Georgia or
- (b) Income received by the Non-resident is Georgian source income.

## 2. Causes of Double Taxation

There are two types of international double taxation: juridical double taxation and economic double taxation. International juridical double taxation, which is the focal point of this article, can be described as the imposition of comparable taxes in two States on the same tax-payer in respect of the same income or capital and for identical periods.<sup>2</sup> Unlike this, economic double taxation can be described as the taxation of the same income in the hands of different persons. The issues relating to the economic double taxation fall out of scope of this article.

Following example illustrates problem of juridical double taxation: Company A the resident of Country A receives interest payments from Company B the resident of Country B. Said interest payment is taxed in the Country A as the recipient of the income (Company A) is the resident of the Country A. The same income is also taxed in the Country B as the source of interest payment is in the Country B. Once both countries tax subject matter interest payments the result is the juridical double taxation.

Usually juridical double taxation arises in one of the falling instances:

- (i) Resident of State A receives an income sourced in State B;
- (ii) Both, state A and state B consider the same income as their source income; and
- (iii) Both, state A and state B consider the recipient of the income to be their own resident.

The preceding example about double taxation of interest payments illustrates the problem specified under item (i) in the above list.

In relation to other two causes of double taxation specified in the above list, following should be noted: Each individual state itself determines who will be considered as its own resident and which income will be considered as its own source income. This creates likelihood that two or more states may regard (a) the same income derived from their own source or (b) the same persons as their residents. Any of these two instances creates high likelihood of double taxation of the same income in two different jurisdictions.

Following example illustrates problem of two states considering the same income derived from their own source in a Georgian context: According to the Tax Code the income received from the alienation of the shares of the Non-resident company may qualify as the Georgian source income if assets of such company directly or indirectly derive more than 50% of their value from the immovable property located in Georgia.<sup>3</sup> It is highly likely that state of residency of the said company will also consider subject matter income as its source income. Thus, the income from the alienation of the subject matter shares may be deemed sourced, along with Georgia, in another state too. Respectively, capital gains realized on such sale may be taxed in two different states resulting in double taxation of the same income.

<sup>2</sup> Paragraph 1, Introduction, commentary on 2008 Model Tax Convention on Income and on Capital of the Organization for Economic Co-operation and Development

<sup>3</sup> Article 104(1)(n), Tax Code

Juridical double taxation creates barriers for the movement of capital and people. Therefore, it is considered as the hindrance to international trade. For these reason, states are trying to avoid double taxation by unilateral, bilateral (e.g. conclusion of treaties on the avoidance of double taxation) or multilateral (conclusion of same type of treaties between three or more states) means.

Approach of Georgia to the avoidance of double taxation is briefly described in one of the following sections.

### 3. Georgia's Approach to Taxing Non-residents

Georgia, like many other countries in the world, taxes the residents and the Non-residents in a different ways. Non-residents are liable to CPT or PIT in Georgia only if they derive income from Georgian source, while Georgian Residents are liable to pay CPT or PIT in Georgian on their world-wide income.<sup>4</sup> Thus, the residency status of the tax-payer is key in establishing its tax liabilities in Georgia. Respectively, following section of this article outlines major rules governing the residency status of the individuals and enterprises (except partnerships) for Georgian tax purposes.

#### 3.1. Residency of the Individuals

For individuals, the residency status is established (subject to few exceptions) in reference to number of days they factually spend in Georgia. Specifically, individual is considered as a resident of Georgia for any given tax period, if this individual was present in Georgia for 183 or more days within any uninterrupted 12 months period which ends in this tax period.

Following is included in the period of "factual presence in Georgia" for the purposes of establishment of individual's tax residency status:<sup>5</sup>

- (i) Days of physical presence in Georgia (notwithstanding the length of the stay in Georgia within a day)<sup>6</sup>;
- (ii) Days spent outside Georgia specifically for the purposes of:
  - Healthcare;
  - Travelling;
  - Business trip;
  - Education.

Following is *not* included in the period of "factual presence in Georgia" (even if the person was actually present in Georgia) for the purposes of establishment of his/her tax residency status:<sup>7</sup>

- (i) Period, during which the individual was present in Georgia as a person having diplomatic or consular status or family member of such person;
- (ii) As an employee of the international organization acting under the international treaty of Georgia, or as a person being in the public service of foreign state in Georgia or the family member of such person (except Georgian nationals);

<sup>4</sup> Article 80 in relation to PIT and Article 97 in relation to CPT, Tax Code

<sup>5</sup> Article 34(3), Tax Code

<sup>6</sup> Article 34(4) and Article 34(5), Tax Code

<sup>7</sup> Article 34(3), Tax Code

- (iii) Persons in transit from one state to another through the Georgian territory;
- (iv) Persons traveling to Georgia for healthcare and recreational purposes;

Individual may also be deemed the Resident of Georgia if he/she had been in the Georgian public services outside of Georgia within a given tax year.<sup>8</sup> Notably, Tax Code is not clear as to how much time the individual should spend in public services of Georgia in a foreign state to be considered as a Resident of Georgia. This provision of the Tax Code is subject to varying interpretations in practice.

If it is impossible to establish the residency of the individual per above rules, upon the request of such individual he/she may be regarded Georgian Resident if he/she is a Georgian national.<sup>9</sup>

The Residency status of the individual is established in relation to each particular tax period. At the same time, the days counted for the purposes of recognition of the Georgian tax residency status of the individual in any one tax period, are not counted for the same purposes in another tax period.<sup>10</sup>

Georgian tax residency status may be granted to the persons having “significant wealth” per terms and conditions jointly defined by the Minister of Justice and the Minister of Finance.<sup>11</sup> The person is deemed to have a “significant wealth” if proved amount of assets of the said person exceeds three (3) million Georgian Lari or annual income for the last three years exceeds two hundred thousand (200,000) Georgian Lari.

Contrary to Georgian approach, in the US the residency status of the individual is established in reference to the nationality of the person.<sup>12</sup> It is worth noting that unlike the US approach to the residency of individuals, the Georgian approach to the same subject matter is based on the principles widely acknowledged and relied on by other states (i.e. most states establish tax residency of individuals in reference of the days the individuals spend on their territory).

Peculiarities of the rules of different jurisdictions governing tax residency of individuals may lead to the situation whereby two different states consider the same person as their own resident in the same tax period. Such dual residency usually leads to double taxation. For the purposes of ruling out dual residency and respectively double taxation of individuals, 2008 Model Tax Convention on Income and on Capital of the Organization for Economic Co-operation and Development (the “OECD MC”) envisages so called tie breaker rules (the “Tie Breaker Rules”).

Under the Tie Breaker Rules envisaged in the OECD MC, an individual, which is considered as the resident of both contracting states, shall be regarded as a resident of the following state:<sup>13</sup>

- (i) state, in which he has a permanent home;
- (ii) if she/he has a permanent home available in both states, he/she shall be deemed to be the resident only of the state where that person has a center of vital interests, i.e. closer personal and economic relations;
- (iii) if the state in which he/she has his centre of vital interests cannot be determined, or if he/she has no permanent home available to him/her in either state, he/she shall be deemed to be the resident only of the state in which he has an habitual adobe;
- (iv) if he/she has an habitual adobe in both states or in neither of them, he/she shall be deemed to be a resident only of the state of which he is a national;

**8** Article 34(2), Tax Code

**9** Article 34(6<sup>1</sup>), Tax Code

**10** Article 34(8), Tax Code

**11** Article 34(6), Tax Code

**12** *Classification of Taxpayers for US Tax Purposes*, IRS, <http://www.irs.gov/Individuals/International-Taxpayers/Classification-of-Taxpayers-for-U.S.-Tax-Purposes>, the day of last visit: 23 March, 2014

**13** Article 4(2), OECD MC 2010



(v) if he/she is a national of both states or of neither of them, the competent authorities of the contracting states shall settle the question by mutual agreement.

If it is impossible to establish residency of the person with reference to the above criteria, then according to the OECD MC the competent authorities of the contracting states shall settle the question by mutual agreement.

Notably, most double tax treaties of Georgia (the “DTT”) follow above described Article 4(2) of the OECD MC. Therefore, Tie Breaker Rules are relevant for Georgia too.

### 3.2. Residency of the Enterprise

Under the Tax Code, the tax residency of the enterprise (except partnerships) is established in reference to the place of activities and/or place of management of the enterprise.<sup>14</sup> According to the Tax Code, place of activities of the enterprise (except partnerships) is:<sup>15</sup>

(i) place of state registration of the enterprise, or in the absence of such, legal address indicated in the founding documents of the enterprise (e.g. articles of association);

(ii) place of major activities of the enterprise, if it carries on business without state registration and its founding documents do not identify the legal address of the enterprise;

(iii) in the absence of pertinent information or impossibility of determination of the place of major activities of the enterprise, place of management of the enterprise.

According to the Tax Code, place of management of the enterprise (except partnerships) is:<sup>16</sup>

(i) place of actual management of the enterprise which is the place where the management or other similar governing body of the enterprise fulfills its managerial function in accordance with company’s founding documents (e.g. articles of association);

(ii) if the enterprise is managed by a manager (another enterprise or an individual), the place of activity of the managing enterprise or the residence of a managing natural person respectively;

(iii) if the enterprise does not have a managing body or the governing body of the enterprise does not have a permanent place of activity or if the manager does not carry out direct management of the enterprise, the place of activity of the body managing enterprise (administration, management, board, central accounting, or other similar body).

The criteria specified under item (iii) in the above list is somewhat ambiguous and controversial. In particular, said criteria have to be used in the event the enterprise does not have a managing body. However, strangely enough, in such instances the Tax Code instructs to establish the place of residency of the enterprise in reference to the (again) managing body of the enterprise. Thus, the deficiency of the respective article of the Tax Code is clear.

The place of activities of the enterprise, as defined by the Tax Code, is similar to the so called place of incorporation accepted in international practice as the criteria for the determination of the tax residency status of the enterprise. Another tax residency criteria used in the Tax Code (specifically, place of management) is rather similar to the so called

**14** Article 22(1), Tax Code

**15** Article 27, Tax Code

**16** Article 27, Tax Code

place of effective management which is also accepted in international practice for the purposes of determination of tax residency of the enterprise.

Use of different criteria for the establishment of the tax residency of enterprise in different states may lead to the recognition of dual residency of the enterprise (i.e. the same enterprise may be regarded as the tax resident of two or more states) and respectively to their double taxation.

Tax Code does not contain special rules for the exclusion of dual residency status of the enterprises. However, many of the Georgian DTTs follow the OECD MC in respect of residency of enterprises. Under Article 4(3) of the OECD MC, in case of dual residency, the enterprise shall be deemed to be the resident of the state where it has a place of effective management.

#### 4. Outbound Situations: Georgian Residents' Having Taxable Activities Abroad

For the purposes of avoidance of double taxation in outbound situations, Tax Code provides special rule for the enterprises. In particular, under the Tax Code the profit tax paid by Georgian Resident outside Georgia may be credited against profit tax payable by the same Resident on the same profit in Georgia.<sup>17</sup> However, foreign taxes credited this way shall not exceed taxes which would have accrued on such income in Georgia.<sup>18</sup> Operation of this rule is illustrated in the following example:

Georgian Resident company Geo Co receives income in the amount equivalent to GEL30,000 from the source of Country A. Geo Co paid CPT in Country A in the amount equivalent to GEL 9,000 while it would have been required to pay only GEL 4,500 on the same income in Georgia. Tax Code obligates Geo Co to calculate its Georgian CPT liabilities on its world-wide income (including income from Country A). Let's assume that tax payable on the world-wide income (without deducting foreign paid CPT) for Geo Co in Georgia in a given tax period is GEL 120,000. However, Geo Co is entitled to deducted part of the corporate profit paid in Country A in the amount of GEL 4,500 from the GEL 120,000 payable in Georgia. Respectively, Geo Co is obliged to pay in Georgia only GEL 115,500.

It is worth noting that above discussed rule envisaged in the Tax Code applies only to CPT paid abroad. Respectively, the PIT paid by Georgian resident individual in foreign jurisdiction may not be credited against same tax payable in Georgia under the Tax Code.

However, another provision of the Tax Code helps to alleviate double taxation of Georgian Resident individuals. In particular, the foreign source income received by Georgian Resident individual is exempt from PIT in Georgia.<sup>19</sup> Thus, the risk of double taxation of foreign source income of such individual is substantially decreased.

As noted above, in addition to domestic regulations, the DTTs also help tax-payers to avoid double taxation in the instances falling within the scope of such treaties. DTT network of Georgia covers 47 countries<sup>20</sup> which provide important guarantees for the avoidance of double taxation in relevant situations.

<sup>17</sup> Article 124(1), Tax Code

<sup>18</sup> Article 124(2), Tax Code

<sup>19</sup> Article 82(u), Tax Code

<sup>20</sup> Official web-page of the Ministry of Finance of Georgia, <http://mof.ge/4793>, the date of last visit: 16 September, 2014

## 5. Inbound Situations: Non-residents Having Taxable Activities in Georgia

Non-residents are taxed in Georgia only if they receive a taxable income from Georgian source.

In-bound situations carry an inherent risk of double taxation for Non-residents as they may be taxed in Georgia on their Georgian source income in addition to being taxed on their world-wide income (including, Georgian source income) in their country of residency.

Certain type of entities or certain type of income derived from Georgian source are exempt from taxation in Georgia thus helping the Non-residents to avoid double taxation in respective instances. However, such exemptions are granted only in a limited number of cases. Besides, Tax Code does not provide general rules for the avoidance of double taxation for Non-residents conducting taxable activities in Georgia. Therefore, in case of inbound situations DTTs may be the only instrument for non-Georgian tax residents saving them from double taxation.

Notably, method of taxation as well as tax rate applicable to the Georgian source income of Non-residents under the Tax Code largely depends on whether the Non-resident has a PE in Georgia or not. Besides, the Georgian tax ramifications of inbound situations may substantially differ if any DTT of Georgia becomes applicable to such situation. Therefore, next three sub-sections separately outline Tax Code treatment of Non-residents conducting business activities in Georgia with and without a PE. In addition to this, the article further describes tax treatment of inbound situations falling within the scope of the DTTs.

### 5.1. Tax Code Treatment of Non-residents Deriving Income through the PE in Georgia

If Non-resident individual receives Georgian source income connected with the PE of such non-resident in Georgia, then the profit taxable in Georgia shall be gross income received in connection with the PE from Georgian source within one calendar year minus related deductions allowable under the Tax Code.<sup>21</sup>

Notably, there are substantial similarities between taxation of the Non-resident's Georgian PE and the Georgian resident subsidiaries of the Non-residents: firstly, both of them are taxed on the net income (i.e. profit) which is largely calculated in the same way; secondly, same tax rate applies to the net income generated by the PE and the Georgian Resident company.

However, there are substantial differences too between taxation of the Georgian PEs and the Georgian subsidiaries of the Non-residents: firstly, Resident subsidiaries of Non-Residents are taxed on their world-wide income, while the PEs are taxed only on their Georgian source income; secondly, the PE is not taxed on the repatriation (transfer) of profits to its head office. Contrary to this, repatriation of the profits by the Georgian subsidiaries to their Non-resident parent companies may be qualified as the dividend distribution and taxed accordingly.<sup>22</sup>

### 5.2. Tax Code Treatment of Non-residents Deriving Georgian Source Income without a PE in Georgia

If the non-resident derives income from Georgian source without triggering the PE in Georgia, then non-resident is taxed at the source of the payment of the income. Depending on the facts of the case, applicable tax rate may vary from 4 to 15 per cents. In this case (unlike the instances involving income received through the PE) entire Georgian source income is subject to the said tax rates. Taxes are withheld at source and paid to the state budget at the time the payment is made in favor of the Non-resident.

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<sup>21</sup> Article 80(2), Tax Code

<sup>22</sup> Article 8(12) and Article 130(1), Tax Code

Importantly, Tax Code entitles Non-resident to register as a tax-payer in Georgia even if such Non-resident does not have a PE in Georgia, to declare its Georgian source income and expenses allowable under the Tax Code and calculate its tax liability on net bases. Afterwards, said non-resident is allowed to credit taxes withheld at the source of payment against his tax liabilities calculated on net basis.<sup>23</sup> However, non-resident enjoys said right till 1<sup>st</sup> April of the year following the year of the taxation of his income at source of payment.

### 5.3. DTT Treatment of Non-residents Deriving Georgian Source Income

Previous two sub-sections considered tax treatment of inbound situations under the Tax Code in the absence of relevant DTTs. However, if the DTT comes into play in the cases discussed in the said sub-sections, the outcome from tax perspective may be substantially different. For this reason certain issues of application of DTTs to the discussed inbound situations is briefly considered below.

One of the substantial limitation usually set by the DTTs on the source state is that said state is prevented from taxing the non-resident's business income from its source if such income is not attributable to the PE of said non-resident in that source state. Thus, under the DTT existence of the PE in certain instances is precondition for the source state taxation of the business income of the non-resident. In light of this fact it is worth of mentioning that usually DTTs limit right of state to recognize existence of the PEs on their territory. Said limitations are briefly discussed below in reference to the profits received by Non-residents through a construction project carried out in Georgia.

### 5.4. Certain Aspects of Recognition of Construction Site PEs in Georgia

According to the OECD MC<sup>24</sup> a building site or construction or installation project constitutes a PE only if it lasts for more than twelve months. Unlike this, the building site is automatically equated with the PE by the Tax Code.<sup>25</sup> Thus, under the Georgian DTTs modeled upon the OECD MC, Georgia cannot recognize a Non-resident's building site on Georgian territory as a PE unless such building site exists for more than 12 months. Non-recognition of the PE in this case will mean that the profit derived by the Non-resident from Georgian source in connection with the building site shall not be taxable in Georgia.<sup>26</sup>

Interplay of the provision of the Tax Code and the DTTs modeled on the OECD MC gives rise to number of questions of high practical importance.

Firstly, the question is how the above referenced 12 months period should be calculated. This question is of highly practical importance for the Resident as well as the Non-resident companies. Sadly Tax Code does not provide any direct guidance on subject matter issue. However, said questions may still be discussed in light of general provisions of the Tax Code.

It should be noted that per OECD MC commentary, any time spent on the construction preparatory works as well as time span during which works had been suspended for unfavorable weather conditions may be included in the discussed 12 months period of construction works.<sup>27</sup>

The OECD commentary is not part of the Georgian tax legislation. Respectively, it may not serve as the legal basis of assessment of particular cases in Georgia. However, the discussed part of the OECD commentary will likely have influence on GRS in the interpretation of the DTTs of Georgia modeled on the OECD MC.

**23** Article 134(3), Tax Code

**24** Article 5(3), OECD MC

**25** Article 29(2), Tax Code

**26** Article 7(1), OECD MC

**27** Paragraph 19, Commentary on Article 5, OECD MC

Another question of high practical importance relating to the discussed subject matter is the following: What happens if the construction works which was planned to complete within 8 months took more than 12 months to complete? Neither the DTT nor the domestic tax regulations of Georgia give any specific answer to this question. Therefore, the answer to the question posed should be deduced from the general provisions of the Tax Code and applicable DTT.

Likely, if non-resident's building site lasts for more than 12 months in Georgia, Georgia may recognize PE from the moment of opening of the building site. This conclusion may be drawn from the following line of reasoning: the DTT sets 12 months period merely as a test for the recognition of the PE and the DTT does not govern the question as to from which moment the PE should be recognized. Therefore, moment of the PE coming into existence must be decided solely on the basis of domestic legislation of Georgia.

From the perspective of determination of the moment of the PE coming into existence, Article 29(10) of the Tax Code should be considered. According to the said provision, the PE is deemed to come into existence from the moment of: (i) registration of the PE in Georgia, (ii) grant of the representation rights or (iii) commencement of exercise of representation.

The above referred article 29(10) of the Tax Code, which refers to the moment of transfer of representation rights and commencement of exercise of representation, likely, initially was intended *only* for so called agency PEs i.e. PEs which come into existence as a result of representation (agency) carried out in Georgia. However, it should be noted that in practice the GRS applies said article differently. In particular, construction works performed by the employees of the Non-resident in Georgia is deemed to be a representation of the said Non-resident by its construction workers. Further to this interpretation of the Article 29(10) of the Tax Code, the PE is deemed to come into existence from the moment of commencement of such "representation" notwithstanding the moment of registration of the PE in Georgia.

Following question is also worth of discussion in the above context: What shall be the tax treatment of the part of the consideration for construction works paid prior and after the expiration of the 12 months period from the commencement of the construction works? How such consideration shall be taxed if the Non-resident does not register its PE in Georgia even after expiration of said 12 months period? For the illustration of these issues following example may be drawn up:

Georgian Resident company (the "Geo Co") contracts Non-resident Company (the "Foreign Co") for the construction of office building in Georgia. There's a DTT applicable to this case and this treaty follows the OECD MC. The construction work is scheduled to last only for 8 months. However, the works actually complete after 14 months from the date of commencement of the works. The contract price is to be paid by Geo Co to Foreign Co in two equal installments: First, at the beginning of construction works, second (final) installment at the end of the works. Question is what should be a Georgian tax treatment of these payments.

While considering the above question, we should recall the fact that primary goal of the DTT is the allocation of taxing rights between two states. So, setting 12 months period for the acknowledgement of the PE in case of construction site may be understood as the acknowledgement of Georgia's taxing rights with regard of construction projects lasting for more than 12 months. If the DTT is understood this way, then following conclusions may be drawn:

- (i) After the passage of 12 months period from the day of commencement of construction, the GRS shall likely acknowledge existence of the PE under the DTT and the Tax Code from the day of commencement of the construction;
- (ii) Therefore, Georgia may claim taxing rights over the first payment made in the above example even before expiration of the discussed 12 months period;
- (iii) If the payments were made by Geo Co before registration of the PE in Georgia, but after expiration of the discussed 12 months period, the Geo Co is obliged to withhold the taxes from payments made in favor of the Foreign Co;

(iv) Foreign Co is entitled to register as a tax-payer in Georgia even after the tax is withheld, self-assess its tax liability and demand refund of the excess tax payments by 1 April of the year following the relevant tax period.

## 6. Tax Code Treatment of Transactions with Offshore Companies

Offshore companies have long been used for the purposes of tax avoidance quite successfully in Georgia and elsewhere. These practices became so wide-spread, that different jurisdictions started introduction of special legislation targeting transactions specifically with offshore companies. Georgia followed the same path. As of the date of this article Tax Code provides that any transaction carried out by Georgian resident company with offshore companies, is automatically deemed a controlled transaction notwithstanding whether or not the parties to the transaction are actually associated. Respectively, arm's length principle is applied to all transactions carried out with offshore companies.

In addition to above stated, much of Georgian sourced payments in favor of offshore residents are subject to 15% withholding taxes. Notably, same type of payments effected by Georgian Residents in favor of other Non-residents (i.e. non offshore residents) are only subject to taxes varying from 4% to 10%.

For the purposes of taxation the list of the offshore companies is endorsed by the Government of Georgia.<sup>28</sup>

## CONCLUSION

This article has briefly discussed some of the issues of Georgian international tax Law. Regrettably, as of now the body of jurisprudence on international tax Law of Georgia is scarce. Furthermore, practice of the GRS in this area is not publicly available. Neither has the GRS ever issued any official clarification (e.g. public ruling) on the problems of international tax Law. Such obscurity results in the uncertainties in the area of international taxation of Georgia harming the investment profile of the country and the legal interest of the tax-payers. Issuance of the public rulings by the GRS on the issues of international taxation of Georgia probably is the single most effective and potent way of delivering the clarity in this area of Georgian tax law system.

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<sup>28</sup> Article 134(5), Tax Code; Decree 132 of the Government of Georgia (dated 30 May, 2013) about determination of the list of the tax heavens/offshore countries

# STILL “TAKIN’ CARE OF BUSINESS”? A COMPARATIVE ANALYSIS OF AMENDMENTS TO THE GEORGIAN LABOR CODE

Presented at Free University of Tbilisi, Georgia,  
Commercial Law Week  
May 17, 2013

Joseph P. Mastro Simone\*

## INTRODUCTION

Geographically, Georgia sits at the crossroads between Western Asia and Eastern Europe.<sup>1</sup> Economically, Georgia sat decidedly further west with its American model of labor and employment law<sup>2</sup> since its 2003 Rose Revolution.<sup>3</sup> In 2006, Georgia’s labor code, which was based on the old Soviet-style labor law, was substantially amended to “strip away almost all protection for employees, in order to attract more foreign business.”<sup>4</sup> Based at least in part on this employer-friendly<sup>5</sup> labor code, Georgia was ranked twelfth on the World Bank Group’s “Doing Business Ranking” at the

**1** \*Associate Professor of Law, Washburn University School of Law, Topeka, Kansas; J.D., 1998, The George Washington University School of Law. The author wishes to thank his friends at Free University of Tbilisi, the National Center for Commercial Law and East West Management Institute for inviting and making it possible for him to participate in Georgia’s 2013 Commercial Law Week. The material in this article is a summary of the presentation “A Comparative Analysis of the Proposed Amendments to the Georgian Labor Code.” The author particularly thanks his co-presenters Archil Giorgadze and George Svanadze for their help in understanding the scope of the proposed changes and their possible interpretation. Finally, the author wishes to thank Washburn Law student Laura Oblinger who performed much of the research necessary to present this material and has assisted with finalizing this article.

See *Georgia Profile*, BBC NEWS EUROPE (Aug. 14, 2013), <http://www.bbc.co.uk/news/world-europe-17301647>. In fact, it is unclear whether Georgia is located in Europe or Asia. Joel Achenbach, *Georgia Is in Europe?*, WASH. POST (Aug. 18, 2008), [http://voices.washingtonpost.com/achenblog/2008/08/georgia\\_is\\_in\\_europe.html](http://voices.washingtonpost.com/achenblog/2008/08/georgia_is_in_europe.html). Based solely on a map, it would appear Georgia is located in Asia because the border between Europe and Asia is rendered by the Caucasus Mountains which comprise Georgia’s northern border. *Id.* But, Europe is not just a geographical continent. *Id.* Some argue that, because Georgians speak European languages and are culturally and historically European, Georgia is best located in Europe. *Id.* Scholars continue to disagree as to whether Georgia is a European or Asian country. Matt Rosenberg, *Georgia, Armenia, and Azerbaijan in Asia or Europe?*, ABOUT.COM GEOGRAPHY (June 6, 2006), <http://geography.about.com/b/2006/06/06/georgia-armenia-and-azerbaijan-in-asia-or-europe.htm>.

**2** Georgia’s ties to the U.S. are most easily seen by the casual observer by a drive down George W. Bush Highway connecting the international airport with the capital, Tbilisi and by a visit to Rike Park and its bronze statue of President Ronald Reagan sitting on a park bench. See Rich Shulman, *Georgian President Unveils Monument to Ronald Reagan*, NBC NEWS (Nov. 23, 2011), [http://photoblog.nbcnews.com/\\_news/2011/11/23/8979293-georgian-president-unveils-monument-to-ronald-reagan?lite](http://photoblog.nbcnews.com/_news/2011/11/23/8979293-georgian-president-unveils-monument-to-ronald-reagan?lite).

**3** The Rose Revolution essentially represented a global victory for democracy. Lincoln Mitchell, *Georgia’s Rose Revolution*, CURRENT HISTORY 342 (Oct. 2004), available at [https://academiccommons.columbia.edu/download/fedora\\_content/download/ac:138699/CONTENT/rose\\_revolution.pdf](https://academiccommons.columbia.edu/download/fedora_content/download/ac:138699/CONTENT/rose_revolution.pdf). It “demonstrated that, by aggressively contesting elections, exercising basic freedoms of speech and assembly, and applying smart strategic thinking, a democratic opposition can defeat a semi-democratic kleptocracy.” *Id.* Following the revolution, “Georgian parliament passed constitutional amendments which strengthened the presidency at the parliament’s expense, and gave the country a cabinet and a prime minister for the first time.” *How the Rose Revolution Happened*, BBC NEWS (May 10, 2005), <http://news.bbc.co.uk/2/hi/4532539.stm>. Georgians elected Mikheil “Misha” Saakashvili as their new leader. *Id.* Saakashvili had led the protest demonstrations on parliament and demanded the former president’s resignation. *Id.* Until Saakashvili’s takeover, President Eduard Shevardnadze had been leader of Georgia for almost thirty years. Mitchell, *supra*.

**4** DF Watch Staff, *New Stronger Labor Code Comes Into Force*, DEMOCRACY & FREEDOM WATCH (July 5, 2013), <http://dfwatch.net/new-stronger-labor-code-comes-into-force-77486>.

**5** “The Georgian labor code, widely considered one of the most pro-business in the world, has been a source of contention between the International Labor Organization (ILO) and the Georgian government since it was adopted in 2005.” Molly Corso, *Georgia: Is Libertarian Reform Philosophy Driving Rising Wave of Labor Discontent?*, EURASIANET.ORG (Oct. 30, 2012), <http://www.eurasianet.org/node/66126#>.

end of 2012.<sup>6</sup> Under that version of the code, an employer could terminate an employee for nearly any reason so long as the employer paid the terminated employee one month's pay.<sup>7</sup> This aspect of Georgia's labor code was criticized in a 2011 report from the Georgian Young Lawyer's Association. Given the economic dependence of the employee on his or her employer, the report concluded that the original versions of Articles 37 and 38, allowing for termination of employment without grounds, were "completely unjustified."<sup>8</sup>

Georgia's most recent national election brought the new Georgian Dream coalition to power and with it, promises of major reforms.<sup>9</sup> Key among those reforms was a substantial rewriting of Georgia's labor code that would shift its policy groundings from an American employment-at-will model to a European just-cause model. Early drafts of the code generated opposition from employer groups suggesting that the reforms would damage the prospects for future hiring and Georgia's general investment climate.<sup>10</sup> While objections from the business community may have been expected, more surprising, were the objections that came from Georgia's new prime minister. Echoing the business community's concerns, Prime Minister Ivanishvili called the initial drafts of the new labor code "terrible" and warned that the proposed code must balance the human needs of employees against the investment needs of employers and the country – with that balance at the end of the day being struck in favor of employers.<sup>11</sup> There is at least some concern that the proposed changes may be contributing factors to Georgia's recent economic slowdown.<sup>12</sup>

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**6** *Business Environment Snapshots: Country Snapshot-Georgia*, THE WORLD BANK, <http://rru.worldbank.org/BESnapshots/Georgia/default.aspx> (last visited Oct. 25, 2013).

**7** LABOR CODE OF GEOR., art. 37(d) & 38(3) (2012). For example, a news report from May 2012, describes the plight of employees who were being terminated based on their political views leading up to the October 2012 national elections. As reported: "A teacher from a local village in the Gori region was fired because of her husband's political views. The headmaster of the school openly declared in open court that he fired her 'because she doesn't love Mikheil Saakashvili.'" Mari Nikuradze, , DEMOCRACY & FREEDOM WATCH (May 18, 2012), <http://dfwatch.net/georgia%E2%80%99s-labor-code-allows-firing-someone-for-political-views-79291>.

**8** Sophio Chachava, , GEORGIAN YOUNG LAWYERS' ASSOCIATION 22 (2011), [http://www.qartuli.net/gyla.ge/attachments/1160\\_GYLA%20-%20shromis%20prezentacia%20ENG.pdf](http://www.qartuli.net/gyla.ge/attachments/1160_GYLA%20-%20shromis%20prezentacia%20ENG.pdf). The report, in relevant part, concluded:

Based on the essence of labor relations, an employee both personally and economically is significantly depended on an employer, which triggers the state's authority and obligation to neutralize the threat of abusing the dependence by an employer. It is important to rightfully perceive and practice of institute of termination of labor contract in the legal aspect of labor relations.

In consideration of the noted principle, Articles 37 and 38 of the Labor Code of Georgia stipulating that an employee has the right to terminate a labor contract without any grounds and under any circumstances is completely unjustified.

*Id.*

**9** Margarita Antidze & Steve Gutterman, , CHRISTIAN SCIENCE MONITOR (Oct. 1, 2012), <http://www.csmonitor.com/World/Latest-News-Wires/2012/1001/Georgia-s-ruling-party-and-opposition-claim-parliamentary-election-win>; Neil MacFarlane, , POLITICS IN SPIRES (Oct. 22, 2012), <http://politicsinspires.org/georgias-election-georgian-dream-won-a-shock-victory-but-perhaps-we-should-have-seen-this-coming/>.

**10** Baia Dzagnidze, *Georgia's New Labor Code Alarms Businesses*, GEORGIA TODAY (April 18, 2013), [http://www.georgiatoday.ge/article\\_details.php?id=11029](http://www.georgiatoday.ge/article_details.php?id=11029).

Parliament's decision to change the Labor Code of Georgia has raised concerns within Georgia's business community. Representatives of the business community say the new labor code may have negative effects on employment, business growth, investment and the people's well being as a whole. They note that any changes to the labor code has its economic and social consequences, and this might be reflected in job creation, employment levels, unemployment, salaries and social security to name a few.

*Id.*

**11** , CIVIL.GE (May 7, 2013), <http://www.civil.ge/eng/article.php?id=26031>. Prime Minister Ivanishvili's full remarks included the following:

Actually all the possible rights can be given to an employee and it is normal, but we should stay in touch with reality and we should not forget that . . . the greatest injustice that we are now facing is that Georgian citizens cannot find jobs; total unemployment is the biggest problem for our country. Business, investors are those who can employ people; so if we tip scales in favor of opposite side and give excessive rights to employees . . . we will eventually remain in unemployment

I told [Georgian Dream] parliamentarians about my stance over this issue; I told them that when there is a debate about . . . what kind of labor code we should have and whether there should be 50/50 [in rights between employers and employees] or in favor of which side scales should be tipped – in favor of an employee or an employer, my position is that it should be in favor of employers . . . . At this stage we should be in favor of employers in order for investors to have desire to invest.

What we should do at this stage is to create human conditions for employees, by not to discourage investors.

*Id.*

**12** At least one Tbilisi merchant noted: "I wanted to open more shops in Tbilisi and probably other cities, but the situation right now is not so good. It is not clear . . . whether there will be changes in the tax code, the labor code, in attitudes to foreign investors." Margarita Antidze, , REUTERS (June 5, 2013), <http://www.reuters.com/article/2013/06/05/us-georgia-economy-idUSBRE9540V120130605>.



Over those objections and concerns, the Georgian Labor Code was substantially amended in many respects. This article examines only one aspect of those changes – the codification of approved reasons for termination of employees. Part II of this article lays out the relevant changes to the Georgian Labor Code and notes that these changes represent a significant shift away from American employment-at-will principles and towards a European just-cause model. Part III then examines how the new general termination provisions could operate in practice. While many of the enumerated reasons for termination are straight-forward, three appear to be more nuanced in how they would apply. This part explores the amended Code’s provision for termination for (1) gross violation of an employee’s obligation requiring no advance warning of discharge, (2) misconduct or negligence of the employee requiring previous warning or sanction prior to discharge, and (3) “any other objective reason.” The article applies concepts from American labor law to provide an analytical framework and guidance on how the new termination provisions could be applied. Part IV concludes that the changes will be far reaching and will require significant training for Georgian employers. However, given the added employment security and the fact that the new code still permits employers to make personnel changes upon sufficient proof of misconduct, it may be too soon to conclude that Georgia may not be taking care of business as much as it had in the recent past.

## I. BACKGROUND: FROM NO CAUSE TO JUST CAUSE

The changes to the Georgian Labor Code’s termination provisions fundamentally shifted Georgian labor and employment law from an employment-at-will model to a just-cause regime. Under the previous version of the Code, an employer could terminate an employee based on such things as the completion of the planned work, the expiration of the employment contract, a violation of the contract terms, the agreement of the parties, the death of the employer or employees, the employee’s long-term disability, and the insolvency of the employer.<sup>13</sup> Of the reasons outlined for terminating employment under the old Code, the provision that allowed for termination upon the “derangement of the contract” was the broadest.<sup>14</sup> Former Article 38 explained that an employment contract could be “deranged” at the initiation of either party and the only limitation on this right was the requirement for either (1) thirty-days’ written notice if the employee ended the contract or (2) one-month’s pay if the employer initiated the termination.<sup>15</sup> Further, Article 38

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**13** Former Article 37 read:

### The Ground for Termination of Labor Relations

The grounds for termination of labor relations can be:

- a) Fulfillment of a job stipulated in the contact;
- b) Expiration of the contract;
- c) Violation of the contract terms by either party;
- c) Derangement of the contract;
- d) Agreement between the parties;
- e) Legally effective court judgment or decision eliminating the possibility to fulfill the work;
- f) Unless otherwise provided by a labor contract, long term disability if its duration exceeds 30 calendar days in sequence, or disability for the period exceeding 50 calendar days per 6 months and if along with that, employee has used the entitled to a leave envisaged by the Article 20;
- g) Death of an employer or en employee;
- h) Launching of liquidation process of the employer, who is a legal entity.

LABOR CODE OF GEOR., art. 37 (2012).

**14** *Id.*

**15** Former Article 38 read:

### Derangement of the Contract

1. According to the provisions of this article, labor contract can be deranged at the initiative of one of the parties.
2. If the initiator of the contract derangement is the employee, s/he shall notify the employer in writing, at least 30 calendar days prior to derangement, unless otherwise envisaged by the contract.
3. If the contract is deranged at the initiative of the employer, the employee shall be given at least a one-month pay unless otherwise envisaged by the contract.
4. If one of the parties violates his/her liabilities as determined by the labor contract, the provisions of paragraphs 2 and 3 of this article shall not apply.

LABOR CODE OF GEOR., art. 38 (2012).

made it clear that if either party had cause to terminate the contract, the notice or pay requirements would not apply.<sup>16</sup> Accordingly, Article 38 contemplated that employment could be terminated without cause by either the employer or the employee so long as the notice or pay requirements were fulfilled.

Former Articles 37 and 38's no-cause termination rule was very similar to the American employment-at-will rule. First articulated in 1877 by American treatise writer Horace Gray, the employment-at-will doctrine allows an employer or an employee to terminate the employment relationship for any reason or no reason, without notice.<sup>17</sup> This rule, which allows for immediate termination of even of the longest of employment relationships absent a contractual provision to the contrary, is a harsh rule from the perspective of employees and eliminates any real notion of job security for the vast number of American workers. Instead of fundamentally altering this rule and affirmatively requiring employers to have a just cause for termination, the at-will rule's application has been blunted by a series of negative limitations on the general right to hire and fire at will.<sup>18</sup> Thus, most state court systems have crafted a so-called "public policy" exception to the employment-at-will doctrine. This exception prohibits an employer from taking an adverse employment action against an employee for refusing to comply with an order that would require an illegal act, "blowing the whistle" on suspected employer wrong doing, and for generally acting in a manner that the state's public policy would encourage.<sup>19</sup> In addition to that common law limitation on employment-at-will, both the federal Congress and state legislatures have passed a growing mountain of anti-discrimination laws that restrict an employer's ability to take adverse employment actions based on the protected classifications in the particular statute.<sup>20</sup> For example, under various federal laws an employer cannot terminate, fail to hire, or otherwise discriminate against an employee based on the employee's, race, color, sex, national origin, or religion;<sup>21</sup> disability;<sup>22</sup> genetic information;<sup>23</sup> veterans' status;<sup>24</sup> age;<sup>25</sup> own or a close family member's serious illness;<sup>26</sup> or pregnancy.<sup>27</sup> And, those are only a few examples of the protections provided by federal and state laws. In addition, employees have the choice of altering the at-will nature of their employment by joining a union and negotiating a collective-bargaining agreement with their employer under the National Labor Relations Act<sup>28</sup> or by applying common law contract principles to convert their employment from an indefinite at-will term to a contract (either formal or implied) for a definite term of employment or to a contract that otherwise limits the employer's discretion to terminate it at will.<sup>29</sup>

**16** *Id.* at art. 38(4) (2012).

**17** Horace Gray's original statement of the rule provided:

With us the rule is inflexible, that a general or indefinite hiring is *prima facie* a hiring at will, and if the servant seeks to make it a yearly hiring, the burden is upon him to establish proof . . . . [I]t is an indefinite hiring and is determinable at the will of either party, and in this respect there is no distinction between domestic and other servants.

MARK A. ROTHSTEIN ET AL., *EMPLOYMENT LAW* 1 (4th ed. 2010) (quoting Horace G. Wood, *A Treatise on the Law of Master and Servant* § 134, at 272 (1877) (footnotes omitted); *see also, e.g.*, *Sivigliano v. Harrah's N. Kan. City Corp.*, 188 S.W.2d 46, 48 (Mo. Ct. App. 2006) (noting that the employment-at-will doctrine permits "an employer to discharge an at-will employee, for cause or without cause, without liability for wrongful discharge, provided that the employee is not otherwise protected by a contrary statutory provision.").

**18** ROTHSTEIN ET AL., *supra* note 17, at § 1.1, at 5–6 ("As discussed in the introduction, modern employment law has limited traditional employer prerogatives essentially in a negative way. Especially in the private, nonunion sector, in which employment is regulated neither by civil service laws nor collective bargaining agreements, the law has been more proscriptive than prescriptive – prohibiting employers from engaging in certain practices rather than requiring that they behave in certain ways.").

**19** *See, e.g.*, *Drury v. Mo. Youth Soccer Ass'n*, 259 S.W.2d 558, 556 (Mo. Ct. App. 2008). Under the Missouri version of the public policy exception, an employee has a cause of action for wrongful discharge if he or she was discharged for "(1) refusing to perform an act contrary to a strong mandate of public policy or an illegal act, (2) reporting wrong doing or violations of law or public policy by the employer or fellow employees to superiors or third parties, (3) acting in a manner public policy would encourage, or (4) filing a workers' compensation claim." *Id.*

**20** *See* ROTHSTEIN ET AL., *supra* note 17, at 3 (noting a number of federal anti-discrimination laws).

**21** 42 U.S.C. § 2000e-2(a)(1)–(2) (2013).

**22** 29 U.S.C. § 701(2013); 42 U.S.C. § 12112(a) (2013).

**23** 42 U.S.C. § 2000ff-1(a)(1)–(2) (2013).

**24** 38 U.S.C. § 4311 (2013).

**25** 29 U.S.C. § 623(a)(1)–(3) (2013).

**26** 29 U.S.C. §§ 2614, 2615 (2013).

**27** *See* 42 U.S.C. § 2000e(k) (2013); 42 U.S.C. § 2000e-2 (2013).

**28** 29 U.S.C. § 157 (2013).

**29** ROTHSTEIN ET AL., *supra* note 17, at §§ 9.2-9.6, at 815–37.

While Georgian and American employment law concepts were originally close cousins, the passage of the amendments to the Georgian Labor Code has pushed them apart. Under the revised Labor Code, the general at-will like provision allowing for the derangement of employment relationships upon 30-days' notice or payment has been eliminated. In its place, the new Code provides for a list of exclusive reasons that an employer may terminate the employment relationship.<sup>30</sup> Three general provisions allowing discharge for, (1) only gross violation of an employee's obligation, (2) misconduct or negligence of an employee after prior warning or discipline, and (3) for "any other objective reason," have essentially converted Georgian employment law from an at-will model to one requiring an affirmative showing of just cause prior to termination. In essence, those amendments have moved the analysis of Georgian employment law issues from the American body of at-will employment law to the American body of traditional labor law which regulates the relationship between labor and management at unionized sites of employment.<sup>31</sup> Unlike employment-at-will, just cause limits an employer's ability to discipline or discharge an employee. As stated by one American labor arbitrator:

[I]t is common to include the right to suspend and discharge for "just cause," justifiable cause," "proper cause," "obvious cause," or quite commonly simply for "cause." There is no significant difference between these various phrases. These exclude discharge for mere whim or caprice. They are, obviously, intended to include those things for which employees have traditionally been fired. They include the traditional causes of discharge in the particular trade or industry, the practices which develop in the day-to-day relations of management and labor and most recently they include the decisions of courts and arbitrators. They represent a growing body of "common law" that may be regarded either as the latest development of the law of "master and servant" or, perhaps, more properly as part of a new body of common law of "management and labor under collective bargaining agreements." They constitute the duties owed by employees to management, and, in their correlative aspect, are part of the rights of management. They include such duties as honesty, punctuality, sobriety, or, conversely, the right to discharge for theft, repeated absence or lateness, destruction of company property, brawling and the like. Where they are not expressed in posted rules, they may very well be implied, provided they are applied in a uniform, non-discriminatory manner.<sup>32</sup>

**30** The new Labor Code provides:

Grounds for Termination of Employment Relations

1. The grounds for termination of an employment contract are:
  - a. Economic circumstances, technological or organizational changes entailing a reduction of the workforce required for production or service;
  - b. Expiration of an employment contract;
  - c. Performance of the work considered under the employment contract;
  - d. Resignation of the employee;
  - e. Joint agreement of the employer and the employee;
  - f. Incapacity of an employee to occupy his/her position due to a lack of qualification, professional skills and experience;
  - g. Gross violation of the employee's obligations imposed by an employer under employment contract, internal regulation or collective agreement;
  - h. Misconduct or negligence of an employee in violation of his/her employment contract, internal labor regulations or collective agreements which took place after previous warning or disciplinary sanction;
  - i. Unless otherwise provided in the employment contract, long-term disability of the period of incapacity exceeds more than 40 consecutive calendar days or of, within 6 months, the period of incapacity exceeds more than 60 calendar days. In addition, the employee is entitled to take a paid as well as unpaid leave of absence as provided by the Labor Code;
  - j. Illegal strike determined by the Court;
  - k. Enforcement of a court judgment or decision which makes performance of work impossible;
  - l. Death of the employer being a physical person or death of employee;
  - m. Commencement of liquidation of the employer being a legal entity;
  - n. Any other objective reason.
2. It is prohibited to terminate an employment contract if the principle reason for it involves:
  - a. Ground other than specified in the first paragraph of this article;
  - b. Discrimination as prohibited in Article 2;
  - c. Due to a call up of an employee for military service in reserve or/and while an employee is in active military service;
  - d. Due to or/and while pregnancy, child delivery, adoption and/or child care leave;
  - e. Jury service.

LABOR CODE OF GEOR., art. 37 (2013).

**31** See ELKOURI & ELKOURI: HOW ARBITRATION WORKS 931 n.36 (Alan Miles Ruben et al. eds., 6th ed. 2003) [hereinafter ELKOURI & ELKOURI] (noting that nearly all union collective-bargaining agreements "require cause or just cause for discharge or discipline").

**32** *Id.* at 932 (quoting Worthington Corp., 24 Lab. Arb. Rep. (BNA) 1, 6-7 (1955) (McGoldrick, Sutton & Tribble, Arb.)).

The adoption of those three just-cause provisions raises a number of fundamental questions with which Georgian employers, employees, and employment lawyers will soon struggle. What standards of proof will Georgian employers be held to when seeking to justify termination decisions? What kind of employee misconduct will rise to the level of a “gross violation” of duties that would support summary termination as opposed to merely misconduct or negligence that would require prior warning before discharge? What might constitute “any other objective reasons” for discharge under Georgian’s new just-cause rule? Given the recent changes, Georgian law currently provides little guidance on these issues. However, we can look to American labor law’s extensive body of arbitral decisions under collective-bargaining agreements applying just-cause termination provisions to provide some initial guidance to Georgian lawyers and courts as to how these new code provisions could be interpreted.

## II. ANALYSIS: USING AMERICAN LABOR LAW AS AN ANALYTICAL FRAMEWORK FOR INTERPRETING AND APPLYING THE NEW JUST-CAUSE TERMINATION PROVISIONS

While the default rule of American employment law is that an employee can be discharged for no reason or any reason unless the reason contravenes some statutory or common law protection, a significant percentage of the American workforce works under union collective-bargaining agreements. Standard in those agreements is the negotiation of a provision which eliminates the employer’s discretion to discharge or discipline employees unless for “just cause.” Disputes over the meaning of the contractual “just-cause” provisions are decided largely by a growing body of private arbitration decisions and not by state or federal courts. However, because many of those decisions are published and available for research a growing body of “common law” has developed that can guide employers, employees, unions, and arbitrators on how these provisions should be applied. American arbitrators have already faced many of the challenges that Georgian courts will soon face under the new Labor Code. This Article looks at three of the most critical areas where American law can provide some guidance: the burden and quantum of proof required in just-cause cases, the distinction between the type of employee conduct that would support summary discharge and that would only support discharge after prior warning or discipline, and the kind of general conduct that would fall within the catch-all “any other objective reason” requirement.

### a. Procedural Issues in a Just-Cause Regime

The movement from employment at-will to a just-cause regime not only limits an employer’s discretion to discipline or discharge an employee, but it also fundamentally changes the procedure for sustaining such discipline or discharge. The discharge of an employee can no longer be sustained simply because the employer did not have some unlawful motive. Instead, under a just-cause system, important preliminary issues regarding the allocation and quantification of the burden of proof arise. And, even earlier in the process, employers must be aware that general standards of “due process” may be applied by an arbitrator to ensure that internal investigations are fair and that accurate information is gathered on which the employer can act.

Under a just-cause regime, the burden to prove that the employee engaged in whatever conduct served as the basis for the discipline or discharge falls squarely on the employer.<sup>33</sup> Under employment-at-will rules, if an employee were to challenge his or her discharge as being unlawfully discriminatory or contrary to some contract provision or public policy the burden would fall squarely on the employee to provide sufficient proof to sustain the allegation.<sup>34</sup> Thus,

<sup>33</sup> ELKOURI & ELKOURI, *supra* note 31, at 949 (“The burden of proof is generally held to be on the employer to prove guilt of wrongdoing, and probably always so where the agreement requires just cause for discipline.”); GRIEVANCE GUIDE 19 (Bureau of National Affairs ed., 9th ed. 1995). It should be noted, the in labor arbitration cases addressing alleged contract violations rather than employee discipline or discharge, the burden of proof is generally placed on the union to prove the allegation. ELKOURI & ELKOURI, *supra* note 31.

<sup>34</sup> American courts have developed an often-used burden shifting analysis to determine whether an employee has been unlawfully discriminated against under the many anti-discrimination statutes. In general, an employee has the burden to prove a *prima facie* case of unlawful discrimination. *McDonnell Douglas Corp. v. Green*, 411 U.S. 972, 802 (1973). Once proven that creates a presumption of unlawful discrimination. The employer then bears the burden only to produce evidence of a nondiscriminatory reason. *Id.* Assuming it can meet that burden of production, the employee then must prove that the employer’s proffered reason is a pretext of unlawful discrimination. *Id.* Throughout the shifting of burdens, the employee at all times has the ultimate burden of persuading the finder of fact that the adverse employment action was the result of unlawful discrimination. St.

it is not enough for the employer to merely believe the reason given for the discharge or discipline, the employer must prove that the facts support the reason.<sup>35</sup>

The recent decision in *In re Department of Health*,<sup>36</sup> provides a nice example of the effect of placing the burden of proof on the employer. In that case, the employer imposed an unpaid disciplinary suspension on an employee based on her verbal threats to another employee. The employer took the position that because the employee was “angry, red-faced and loud” when interacting with her supervisor her actions amounted to a threat of violence. The employer also provided testimony that the other employees feared for their safety in an attempt to prove that the threat was real. However, the arbitrator rejected that argument finding that the employer failed to prove the threat:

The Agency is understandably concerned about workplace violence and I recognize that employer should not have to wait until a violent act occurs before disciplining a potentially violent employee. However, when dealing with an accusation of a verbal threat, the employer has to show some basis for believing reasonably that the employee intended to threaten a co-worker, or could be violent, such as past experience with the employee, other employee behavior, the nature of the language or any other threat made. In this case, neither the words nor the behavior indicated violence, and the participants in the events themselves were split over whether there was any danger. The Agency has the burden of proof on this issue and the evidence just did not show it was more likely than not that L\_\_ was threatening anyone or posed any type of danger.<sup>37</sup>

While the allocation of the burden of proof to the employer in discipline and discharge cases is routine and uncomplicated, the amount of proof that the employer must provide to sustain the action is open to much debate. Arbitrators have traditionally used one of three potential quanta of proof in discipline and discharge cases: (1) preponderance of the evidence, (2) clear and convincing evidence, or (3) evidence beyond a reasonable doubt.<sup>38</sup> Most labor arbitrators apply the preponderance of the evidence standard because the arbitrator is not sitting as a court of law in a criminal matter.<sup>39</sup>

In cases of employee misconduct that would not amount to a criminal violation or other “stigmatizing behavior,” arbitrators almost uniformly apply a preponderance of the evidence standard.<sup>40</sup> Under such a standard, the employer is required to provide evidence that would convince the arbitrator that “the employee, more likely than not, committed the alleged offense.”<sup>41</sup> Another arbitrator used *Black’s Law Dictionary* to define a preponderance of the evidence as:

The greater weight of the evidence, not necessarily established by the greater number of witnesses testifying to a fact but by evidence that has the most convincing force; superior evidentiary weight that, though not sufficient to free the mind wholly from all reasonable doubt, is still sufficient to include a fair and impartial mind to one side of the issue rather than the other.<sup>42</sup>

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Mary’s Honor Center v. Hicks, 509 U.S. 502, 511 (1993).

**35** *In re Dep’t of Health*, 132 Lab. Arb. Rep. (BNA) 585, 590 (2013) (Gelernter, Arb.).

**36** *Id.*

**37** at 590; Clearwater Paper Corp., 132 Lab. Arb. Rep. (BNA) 465 (2013) (Gaba, Arb.) (noting that burden of proof in a discharge case “resides with the employer”); Reliable Churchill, LLP, 127 Lab. Arb. Rep. (BNA) 535 (2009) (Hockenberry, Arb.) (finding that employer failed to meet its burden of proof in an employee suspension case); Borden Italian Foods, 113 Lab. Arb. Rep. (BNA) 13, 15 (1999) (Marino, Arb.) (“The Arbitrator agrees with both the Union and Company that the Company bears the burden of proof and the burden to establish, “just cause” for this discharge of C\_, and the existence of cause “must stand or fall on the reasons known to and relied upon by the Company at the time of the disciplinary action.”).

**38** ELKOURI & ELKOURI, *supra* note 31, at 949–50.

**39** *Id.* at 950–51.

**40** *Id.*; GRIEVANCE GUIDE 19 (Bureau of National Affairs ed., 9th ed. 1995) (noting that a “higher degree of proof, however, may be required where the alleged misconduct is punishable under criminal law or regarded as morally reprehensible”).

**41** KIK Ind., 131 Lab. Arb. Rep. (BNA) 817, 822 (2013) (Imes, Arb.).

**42** Crown Cork & Seal USA, 130 Lab. Arb. Rep. (BNA) 1015, 1021–22 (2012) (Gaba, Arb.) (quoting BLACK’S LAW DICTIONARY (8th ed. 2004)); see also 5 C.F.R. § 1201.56 (c)(2) (defining preponderance of the evidence as the “degree of relevant evidence that a reasonable person, considering the record as a whole, would accept as sufficient to find that a contested fact is more likely to be true than untrue”).

Where the alleged misconduct would constitute a crime or the behavior would be viewed as moral turpitude such that it would seriously damage an employee's reputation, arbitrators generally require a higher quantum of proof to sustain the employer's action – either clear and convincing evidence or proof beyond a reasonable doubt. Arbitrators deciding cases involving allegations of drug abuse,<sup>43</sup> dishonesty,<sup>44</sup> sexual harassment,<sup>45</sup> violence,<sup>46</sup> and similar allegations, have required the employer to prove the reasons for the discharge by clear and convincing evidence. If a preponderance of the evidence requires essentially 50.1% of the relevant evidence to support a factual finding, clear and convincing evidence requires substantially more evidence; but, less than the criminal standard of proof beyond a reasonable doubt.<sup>47</sup> Under the clear and convincing standard, "the truth of the facts asserted [must be] highly probable"<sup>48</sup> The distinctions between the burdens of proof are not clearly defined with scientific precision. Instead, the fact finder necessarily employs his or her own judgment to determine whether the proof is sufficiently clear and convincing that it makes it highly probable that the employee engaged in the alleged misconduct.<sup>49</sup> Fewer arbitrators hold the employer to the criminal law standard of proof beyond a reasonable doubt.<sup>50</sup>

At some basic level there may be something counter-intuitive with providing employees with more protection if they allegedly engaged in more and more serious misconduct. Those alleged to have engaged in criminal or morally reprehensible misconduct will have a greater chance of their discharges being overturned than those who were fired for more mundane infractions, such as being habitually late. This outcome, where some "guilty" employees will be reinstated because of the employer's failure to meet a particularly high burden of proof, is recognized and accepted by arbitrators as a necessary component to the growing system of industrial justice. As Arbitrator Smith noted a half-century ago:

[I]t seems reasonable and proper to hold that alleged misconduct of a kind which carries that stigma of general social disapproval as well as disapproval under accepted canon of plant discipline should be clearly and convincingly established by the evidence. Reasonable doubts raised by the proofs should be resolved in favor of the accused. This may mean that the employer will at time be required, for want of sufficient proof, to withhold or rescind disciplinary action which in fact is fully deserved, but this kind of result is inherent and in any civilized system of justice.<sup>51</sup>

**43** Mail Contractors of Am., 122 Lab. Arb. Rep. (BNA) 649, 653 n.3 (2006) (Hoffman, Arb.) (adopting a clear and convincing burden of proof in a drug testing case "in light of the stigmatizing impact a ruling could have on the character of the employee").

**44** Solutia, Inc., 121 Lab. Arb. Rep. (BNA) 26 (2005) (Szuter, Arb.) (adopting a clear and convincing burden of proof where employee allegedly filed a false disability claim); United Parcel Serv., 121 Lab. Arb. Rep. (BNA) 207 (2005) (Wolff, Arb.) (requiring employer to prove facts with clear and convincing evidence of employee dishonesty because dishonesty is considered "opprobrious or shameful, and make[s] it very difficult for such employee to find other employment").

**45** Ohio Dep't of Pub. Safety, 119 Lab. Arb. Rep. (BNA) 1050 (2003) (Brookins, Arb.).

**46** Rose of Sharon Manor Nursing Home, 103 Lab. Arb. Rep. (BNA) 711 (1994) (Berquist, Arb.) (requiring clear and convincing evidence to prove that an employee slapped a nursing home resident).

**47** City of Bartlesville, 131 Lab. Arb. Rep. (BNA) 1502, 1507(2013) (Williams, Arb.).

**48** City of Sandy, 129 Lab. Arb. Rep. (BNA) 669, 672 (2011) (Calhoun, Arb.).

**49** As Arbitrator Henry Sisk noted:

Much has been written in legal and arbitral literature in an attempt to define the various degrees of proof required. The arbitrator cannot agree with the paper cited by the Company in its brief to the effect that lawyers are "playing games with words" when defining different quantum of proof. At the same time we know that the degrees of proof are not subject to precise measurement and description. Even judges in criminal proceedings caution jurors that "beyond a reasonable doubt" does not mean absolute certainty. In the last analysis an evaluation of evidence and the assignment of weight to that evidence is a value judgment. The values of a counselor making a summation or writing a brief may be quite different than the values of the trier of fact (arbitrator) who has to differentiate between the various bits of evidence received and assign an overall weight to that evidence. Additionally the weight assigned to a given piece of evidence varies dependent upon the industrial context within which it occurs. In the present case the management of the Company and members of the bargaining unit who perform the work bear an unusual responsibility -- the safety of the flying public and those who fly in government owned planes. The final determination of the weight of evidence, like beauty, is in the eyes of the beholder. This arbitrator prefers that in a case such as the one under consideration that the evidence presented by the prevailing party approach the level of "clear and convincing".

Aviall, Inc., 94 Lab. Arb. Rep. (BNA) 721, 723–24 (1990) (Sisk, Arb.).

**50** ELKOURI & ELKOURI, *supra* note 31, at 951–52 ("In cases of potentially unlawful conduct, the greater weight of authority favors 'clear and convincing evidence' or 'preponderance of the evidence,' as opposed to 'beyond a reasonable doubt.'").

**51** *Id.* at 951 (quoting Kroger Co., 25 Lab. Arb. Rep. (BNA) 906, 905 (1955) (Smith, Arb.)).

Employers must be aware of the potential burdens of proof to which they may be held because the internal investigation of the employee’s misconduct is the most likely source for that information. That investigation must not only produce sufficient relevant information to sustain the discharge, but the investigation itself must also comport with “basic notions of fairness or due process.”<sup>52</sup> Similar to the constitutional due process required when the government threatens a citizen’s liberty, the “industrial due process doctrine” requires both that the employee be given a fair opportunity to present his or her side of the story before the employer imposes discipline and that the employer conduct a fair and full investigation before taking action.<sup>53</sup> Where the employer’s conduct fails those requirements, its discipline of employees will not be sustained even if the evidence indicates that employee actually engaged in the alleged misconduct.

For example, in *Cr/PL Ltd. Partnership*,<sup>54</sup> the arbitrator found that the employer did not have just cause to discharge an employee who allegedly pulled a knife on a coworker at the facility in an attempt to collect a gambling debt. The arbitrator’s decision to reinstate the employee turned largely on the employer’s substandard investigation of the alleged incident. The employer failed to interview the grievant, but instead decided to wait for the grievance and arbitration process to hear his side of the story.<sup>55</sup> The arbitrator noted that “[e]lemental fairness” would have required that the employer interview the grievant before discharge.<sup>56</sup> Given that there were no other eyewitnesses to the presence of the knife beyond the grievant and the alleged victim, “the failure to interview the Grievant as part of the investigation . . . must be held to have made the Grievant’s discharge the following day to have been without just cause.”<sup>57</sup>

Moreover, employers operating under a just-cause system must also ensure that their investigations of employee misconduct are fair. Thus, no just cause was found to sustain the employee’s discharge where the employer permitted neither the employee nor the union to interview the witnesses against the discharged employee prior to the hearing.<sup>58</sup> The arbitrator in that case noted that:

Procedural fairness requires an employer to conduct a full and fair investigation of the circumstances surrounding an employee’s conduct and to provide an opportunity for him to offer denials, explanations, or justifications that are relevant before the employer makes its final decision, before its position becomes polarized.<sup>59</sup>

Accordingly, an employer is required to do more than simply collect the information that would support its decision to discharge or to discipline an employee. The employer must instead conduct a full and fair investigation that would provide the employer with the necessary information, including statements from the employee alleged to have engaged in misconduct, to make a decision whether discharge or discipline is appropriate. Failing to conduct that sort of investigation makes it very likely that there will be no just cause to sustain the action.

## **b. Gross Misconduct v. Negligence: What Would Support Discharge Without Warning?**

Aside from the burden of proof and due process concerns, the amendments to the Labor Code raise a central question: what is the difference between “gross” misconduct under Article 37(1)(g) supporting summary discharge and mere “misconduct or negligence” under Article 37(1)(h) supporting discharge only after prior warning? American labor arbitrators have struggled with the same problem under just-cause termination clauses in collective-bargaining

**52** *Id.* at 967.

**53** *Id.* at 967–68.

**54** 107 Lab. Arb. Rep. (BNA) 1084 (1996) (Fullmer, Arb.).

**55** *Id.* at 1087.

**56** *Id.*

**57** *Id.*

**58** ELKOURI & ELKOURI, *supra* note 31, at 969 (citing Shaefer’s Ambulance Serv., 104 Lab. Arb. Rep. (BNA) 481, 486 (1995) (Calhoun, Arb.)).

**59** *Id.*

agreements: when is the employee's misconduct sufficiently severe to warrant immediate discharge or less serious allowing the employer to only discipline or warn the employee?

Arbitrators struggling with that question find guidance from two axioms. First, "the degree of penalty should be in keeping with the seriousness of the offense."<sup>60</sup> Second, employee discipline should be corrective and not punitive.<sup>61</sup> Accordingly, it is generally expected that employers will follow a system of progressive discipline – meting out light penalties for first offenses and stiffer penalties for later offenses.<sup>62</sup> However, it is understood that progressive discipline is not appropriate in every case, otherwise an employee who brutally beat a supervisor could only be issued a written first warning.<sup>63</sup> Instead, there are generally understood to be two broad classifications of employee misconduct. The first are extremely serious offenses that warrant summary discharge without prior warning or corrective discipline. The second are less serious offenses that do not justify discharge on the first offense or even later offenses, but instead permit only a lesser form of corrective discipline.<sup>64</sup> What constitutes a "serious offense remains elastic."<sup>65</sup> Accordingly, employers always take on a certain level of risk that what they consider to be an extremely serious infraction may not be viewed as warranting summary discharge by an arbitrator. However, infractions such as willfully sleeping on duty, bringing a dangerous weapon to work, fighting in the workplace, using or selling drugs, and serious workplace negligence will generally support summary discharge.

Generally, arbitrators will uphold summary discharge where an employee intentionally sleeps while on duty and takes steps to avoid detection. Accordingly, in *Valspar Corp.*,<sup>66</sup> the arbitrator upheld the discharge of an employee without warning. In that case, the employee was seen by the employer's security officers sleeping in a supervisor's office. The sleeping employee had hid himself away in the office and turned out the lights to better conceal his sleeping on duty. The employer produced records that the employee had slept an average of 59 minutes a shift for ten consecutive workdays.<sup>67</sup> However, the same arbitrator in the same case reversed the discharge of another employee who was also loafing on the job. That employee was seen in a supervisor's office when he should have otherwise been working three times during one week – for 6 minutes, 8 minutes, and 112 minutes. The employee was also seen talking to other employees in the supervisor's office and was even observed rifling through the supervisor's desk and personal effects. However, the arbitrator put that employee back to work, even though he had been unproductive for a longer period of time in one shift than the other employee whose discharged was upheld. The only difference being that the second employee made no attempts to conceal his misdeeds and had worked for the employer for 11 years with only one prior recorded rule infraction.<sup>68</sup>

**60** ELKOURI & ELKOURI, *supra* note 31, at 964.

**61** Senyo M. Adjabeng, *Progressive Discipline of Employees*, CORP. AIMS SERVS. LTD., <http://coraims.com/progressive-discipline-of-employees/> (last visited Oct. 22, 2013).

**62** ELKOURI & ELKOURI, *supra* note 31, at 966.

**63** Alliance Mach. Co., 48 Lab. Arb. Rep. (BNA) 457, 463 (1967) (Dworkin, Arb.).

**64** One arbitrator explained:

Offenses are of two general classes (1) those extremely serious offenses such as staling, striking a foreman, persistent refusal to obey a legitimate order, etc., which usually justify summary discharge without the necessity of prior warnings or attempts at corrective discipline; (2) those less serious infractions of plant rules or of proper conduct such as tardiness, absence without permission, careless workmanship, insolence, etc., which call not for discharge for the first offense (and usually not even of the second or third offense) but some milder penalty aimed at correction.

ELKOURI & ELKOURI, *supra* note 31, at 969 (quoting Huntington Chair Corp., 24 Lab. Arb. Rep. (BNA) 490, 491 (1955) (McCoy, Arb.).

**65** *Id.* at 965.

**66** 113 Lab. Arb. Rep. (BNA) 1111 (1999) (Hayford, Arb.).

**67** *Id.* at 1117.

**68** It should be noted that American arbitrators give great weight to an employee's longevity. Thus, to discharge a long-term employee with a relatively clean work record generally requires substantially egregious conduct established by clear and convincing evidence. See King County Dept. of Transp., 2001 WL 36504886 (2001) (Axon, Arb.) (overturning discharge of employee with 26 years of service because of lack of clear and convincing evidence that he, among other things, slept while on duty). However, an arbitrator will occasionally use an employee's long term of service as evidence that the employee was aware of the rules that he or she disregarded. See Baker Hughes, 128 Lab. Arb. Rep. (BNA) 37 (2010) (Baroni, Arb.) ("Grievant, a long-term employee and apparently savvy member of the Union's Grievance and Bargaining Committees, was certainly



Further, bringing a dangerous weapon onto the employer's premises in violation of a work rule will generally support the summary termination of the employee. Thus, in *San Diego Trolley*,<sup>69</sup> an arbitrator upheld the summary discharge of an employee who had a loaded gun in his work locker. The employee was under investigation for making threats of physical harm against supervisors and co-workers.<sup>70</sup> During the course of that investigation, the employer searched the locker and discovered the loaded revolver.<sup>71</sup> The arbitrator noted that the employer had a "duty to protect the health and safety of its employees."<sup>72</sup> In finding that summary discharge was permitted, the arbitrator noted that the violation of the rule barring weapons at work "was most serious and inexcusable, and any discipline short of termination would establish and condone a standard of conduct which is clearly unacceptable."<sup>73</sup>

Relatedly, it is generally understood that fighting at work is "inherently improper" and warrants severe discipline – including summary discharge.<sup>74</sup> Fighting will particularly support summary discharge where the employee engages in a physical fight with a supervisor or manager.<sup>75</sup> However, employers are still held to the burden to prove that the employee actually fought at work. Further, arbitrators will consider whether the fighting employee was acting in self-defense or was provoked by another employee. For example, in *CHAC, Inc.*,<sup>76</sup> an arbitrator overturned the discharge of an employee who was accused of fighting. In that case, a supervisor testified at the hearing that she saw the discharged employee with her hand on the other employee's throat, but that eyewitness account was discredited by the supervisor's earlier statements which omitted that detail. In finding insufficient evidence of fighting, the arbitrator noted that the supervisor did not see whether the other employee "had provoked" the discharged employee or whether the discharged employee was "acting in self-defense."<sup>77</sup>

Moreover, arbitrators will examine the seriousness of the alleged fighting. Thus, incidents involving "lots of pushing and shoving" as opposed to "inflicted blows" on a co-worker will not be viewed as fighting justifying summary discharge.<sup>78</sup> In *Way Bakery*, the arbitrator first noted that

Actual fighting among employees, that is the deliberate striking of blows with fists, or other instruments, with the intent to do bodily harm, must result in an automatic termination of those engaged in such behavior. Violence in society, particularly at the workplace, is a pressing social problem.<sup>79</sup>

However, the arbitrator found that the employee's discharge was without just cause. He relied on evidence that the grievant had jumped up on a conveyor belt and then down close to a co-worker causing a "pushing and shoving" match close to nearby machinery. Despite recognizing that the employee "created a dangerous situation," the arbitrator found that because there were no "blows inflicted upon the body of another person," the employee could not be discharged for fighting.<sup>80</sup>

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familiar with Company anti-discrimination and anti-harassment policies, as well as Company rules.") .

**69** 112 Lab. Arb. Rep. (BNA) 323 (1999) (Prayzich, Arb.).

**70** *Id.* at 324.

**71** *Id.*

**72** *Id.* at 327.

**73** *Id.*; see also *Colo. Springs Transit Mgmt.*, 131 Lab. Arb. Rep. (BNA) 644 (2012) (DiFalco, Arb.) (listing "possession of a firearm or other weapon while on duty on Company property" as "cause for immediate dismissal without proper warnings"); *Red Lobster*, 130 Lab. Arb. Rep. (BNA) 805 (2012) (Nicholas, Arb.) (employee handbook listed "[b]ringing a weapon of any kind into the workplace or having a weapon on restaurant premises" as serious enough to result in disciplinary action without utilizing progressive discipline); *Ill. Educ. Ass'n*, 127 Lab. Arb. Rep. (BNA) 545 (2010) (Petersen, Arb.) (bringing a weapon to work qualifies for immediate discharge); *Jackson General Hosp.*, 113 Lab. Arb. Rep. (BNA) 1040 (2000) (Sharpe, Arb.) (carrying a concealed weapon on the premises warrants discharge on the first offense).

**74** ELKOURI & ELKOURI, *supra* note 31, at 966.

**75** See, e.g., *GFC Crane Consultants*, 122 Lab. Arb. Rep. (BNA) 801, 803 (2006 (Abrams, Arb.)) ("If you physically assault your supervisor without provocation, you don't get a second chan[ce].").

**76** 114 Lab. Arb. Rep. (BNA) 173 (2000) (Berman, Arb.).

**77** *Id.* at 179.

**78** *Way Bakery Div. of Perfection Bakeries, Inc.*, 119 Lab. Arb. Rep. (BNA) 1633 (2004) (Allen, Arb.).

**79** *Id.* at 1638.

**80** *Id.* at 1640; see also *Titan Tire Corp.*, 132 Lab. Arb. Rep. (BNA) 45 (2013) (Neigh, Arb.) (finding that employee could be discharged for violating the employer's "zero tolerance" policy against workplace violence where employee threw a knife down and it landed inches from a co-worker's feet).

Selling or distributing illegal drugs at work easily supports summary discharge. Thus, in *Burger Iron Co.*<sup>81</sup> the arbitrator sustained the discharge of five employees who were caught selling and using marijuana in an employer initiated undercover sting operation. While the employer had no policy or rule banning the use or sale illegal drugs on the premises, the arbitrator easily sustained the discharges and noted that:

A suspension is simply not an adequate corrective action in this situation. Given the potential profit involved in providing drugs, the risk of suspension provides little deterrent to one who might engage in this activity. This is particularly true given the known difficulty of actually proving such involvement. The only effective, and appropriate corrective action is to separate the provider from his “market.”<sup>82</sup>

While rare, an isolated act of workplace negligence can also support summary discharge. Generally, to support discharge and not some lesser form of discipline, the employer will need to prove that the employee’s gross negligence led to some significant loss or threat to employee safety or to the business as a whole. Usually, an employee’s simple negligence will not support discharge.

In *Sabreliner Corp.*,<sup>83</sup> an arbitrator sustained the discharge of an employee whose workplace “gross negligence” damaged costly merchandise. There, the employee left airplane parts in stripping solution for twenty-eight hours instead of the necessary twenty minutes. That longer exposure to the solution caused \$13,000 in damage to the parts. The arbitrator relied in part on the employee’s admission that he had neither working knowledge of the stripping process nor the proper use of the solution. Under those circumstances, performing that work was a “conscious and voluntary act without regard for consequences.”<sup>84</sup>

Likewise, in *Southwestern Electric Power Co.*,<sup>85</sup> an arbitrator sustained a power company “trouble man’s” discharge for gross negligence. The employee was responsible for finding and marking the location of energized underground power lines. While marking power lines at a construction site, the employee failed to follow instructions, neglected to mark a number of power lines, and caused a power outage at a nearby airport when the contractor accidentally cut one of the unmarked power lines. The employee’s gross negligence in willfully failing to follow instructions was made worse by the damage and the risk of serious injury. The risk of catastrophic loss was also a factor that supported the discharge of an employee in *BHP Petroleum/Gasco*.<sup>86</sup> In that case, the employee failed to perform a required pressure test and failed to find a gas leak. The risk of fire and explosion justified the summary discharge.

Arbitrators find it particularly easy to sustain a discharge where the negligence is serious and the employee takes some steps to cover up the mistake. Thus, in *Afton Chemical Co.*,<sup>87</sup> a production worker at a chemical manufacturing plant negligently mixed the wrong chemicals together and caused a risk of fire or explosion. The employee then falsified documentation to cover up his mistake. While the arbitrator noted that the negligent mixing was not done maliciously, his actions in covering up the mistake were intentional, voluntary, and willful. Likewise, in *Weir Minerals*,<sup>88</sup> an arbitrator upheld the discharge of a forklift driver who negligently ran into a sprinkler system flooding the area and causing work in that area to stop. The arbitrator relied heavily on both the seriousness of the accident and the employee’s fabricated story to avoid responsibility it to support the employee’s summary discharge.

While the severe consequences of an employee’s negligence will often support immediate termination, a number of arbitrators have looked beyond the outcome and examined the employee’s intent. Where the employee did not

**81** 92 Lab. Arb. Rep. (BNA) 1100 (1989) (Dworkin, Arb.).

**82** *Id.* at 1107.

**83** 129 Lab. Arb. Rep. (BNA) 1533 (2011) (O’Reilly, Arb.).

**84** *Id.*

**85** 130 Lab. Arb. Rep. (BNA) 1541 (2012) (Walker, Arb.).

**86** 102 Lab. Arb. Rep. (BNA) 321 (1994) (Najita, Arb.).

**87** 130 Lab. Arb. Rep. (BNA) 1321 (2012) (O’Brien, Arb.).

**88** 130 Lab. Arb. Rep. (BNA) 379 (2012) (DiFalco, Arb.).

intentionally ignore a workplace safety rule, arbitrators have found that summary discharge was inappropriate. Thus, in *Howard Industries, Inc.*,<sup>89</sup> the arbitrator found that a forklift accident did not support summary discharge even though the accident was caused by employee's failure to follow the employer's work rules. There, the employee failed to slow down or to blow the forklift horn as required by the employer's safety rules. As a result, the employee struck and dragged another employee with her forklift. In ordering that the driver be reinstated, the arbitrator found that the employer failed to "show that the Grievant willfully and intentionally chose to disregard the Company's legitimate safety requirements. Instead, the Company showed that she was guilty of simple negligence, albeit with serious consequences, and this was not sufficient."<sup>90</sup> Likewise, in *Rite Aid, Inc.*,<sup>91</sup> an arbitrator ordered an employee back to work where she lost \$2,780 of the employer's money. There, the employee, who had worked for the employer for eighteen years, failed to follow the employer's protocol regarding the recording of deposits and balancing the cash in the safe which resulted in the lost funds. The arbitrator noted that the employee had merely "slipped up" and the mistake was due to inadvertence and was not the product of intentionally choosing to ignore protocol.

**c. "Any Other Objective Reason" Supporting Discharge Without Warning.**

New Article 37's list of reasons supporting discharge ends with a catch-all provision allowing for termination of an employment contract with 30-day's pay for "any other objective reason."<sup>92</sup> Obviously, this provision was intended to capture employee misconduct less severe than that covered by the gross negligence provision. And, it is likely that it was intended to capture reasons unrelated to the employee's work performance because that conduct is already covered by other, more specific, subsections. The issue of discharging an employee for misconduct, apart from actual workplace misconduct, has vexed American labor arbitrators. In general, the conduct must be connected in some way to the employee's ability to perform the job, the employer's reputation in the community, or to the exposure to potential liability. The types of employee behaviors that could be covered by such a provision are as numerous as the types of employers and the unlimited number of ways in which employees run afoul of work rules. Nevertheless, a few examples are helpful to provide some general outlines to a broad concept.

First, criminal acts committed by the employee are generally considered to be reasonable bases for discharge where they have an impact on the employee's ability to perform his or her job.<sup>93</sup> Importantly, an employer is not necessarily required to await formal adjudication and conviction before at least suspending the employee where the nature of the alleged crime is severe enough to raise concerns about the safety of other employees, property, or the business in general.<sup>94</sup>

Obviously, criminal threats or assaults of supervisors while off duty would support discharge.<sup>95</sup> However, crimes which reflect poorly on either the employee's ability to perform or on the employer's reputation also support discharge.

**89** 131 Lab. Arb. Rep. (BNA) 1193 (2013) (Apern, Arb.).

**90** *Id.* at 1198.

**91** 125 Lab. Arb. Rep. (BNA) 254 (2008) (Gentile, Arb.).

**92** LABOR CODE OF GEOR., art. 37 (2013).

**93** ELKOURI & ELKOURI, *supra* note 31, at 944.

**94** At least one arbitrator framed the issue this way:

But whether we consider this type of action as disciplinary or not, and notwithstanding the presumption of innocence in a criminal proceeding, the employer must have the right to protect his business from the adverse effects flowing from public accusation and arrest for serious crime, supported by a judicial finding of probable cause in a preliminary hearing, when the nature of the charge with its attendant publicity reasonably gives rise to legitimate fear for the safety of other employees or of property, or of substantial adverse effects upon the business.

*Id.* (quoting *Pearl Brewing Co.*, 48 Lab. Arb. Rep. (BNA) 379, 390 (1967) (Howard, Arb.)).

**95** Tex. ARAI, 113 Lab. Arb. Rep. (BNA) 750 (1999) (Neas, Arb.) (finding just cause to support discharge of employee who assaulted a supervisors at a gas station away from worksite and noting that "[a]ssault of a supervisor is universally recognized as one of the extremely serious types of conduct for which discharge is a proper penalty").

In *CSX Hotels*,<sup>96</sup> a hotel maintenance employee was discharged because he stole items from a nearby service station. While the employee was not accused of stealing anything from the hotel where he worked, he was caught stealing tires from a service station near the hotel where he worked. Because his primary duty at the hotel was cleaning and replacing air filters in hotel rooms, he had access to guest rooms without direct supervision. The arbitrator relied heavily on the nature of the employee's job and the access to guest rooms in upholding the discharge.

The nature of the Employer's business, along with the Grievant's unobserved access to the guests' rooms, demands that his character be beyond reproach. His admitted unlawful taking of the four tires from Dixon's casts grave doubts on his fitness to carry out his assigned duties without justifiable concern on the part of the Employer. The very nature of the Grievant's job assignments calls for a degree of unchallenged honesty not presently possessed by the Grievant.<sup>97</sup>

Second, misconduct short of criminal acts may support discharge where there is some clear relationship between the conduct and the employer's legitimate interests such as the company's reputation, the inability of the employee to perform the work, the refusal of other employees to work with the employee accused of misconduct, or the ability of the employer to generally direct the workforce.<sup>98</sup> This connection between the off-duty misconduct and work must be "reasonable and discernible and not merely speculative."<sup>99</sup> For example, unless it affects job performance or creates a conflict of interest, an employer would not be permitted to discharge an employee for simply moonlighting.

In *Southern Bell Telephone & Telegraph Co.*,<sup>100</sup> an arbitrator upheld the discharge of a telephone repairman based on his off duty conduct. There, the repairman made obscene and harassing phone calls while off duty. While not necessarily rising to the level of criminal misconduct, given both the employee's access to customer homes and the employer's status as a regulated public service company, the arbitrator sustained the discharge as based on just cause.<sup>101</sup>

Generally, immoral or even illegal sexual activity will not support discharge unless the sexual misconduct is job related. Thus, a part-time maintenance employee at a Catholic residential college with a large female student population was properly discharged after he was arrested for domestic abuse and criminal misconduct.<sup>102</sup> The arbitrator specifically noted that the employer was not required to "wait and see" if there would be similar misconduct at work.<sup>103</sup> However, in sustaining the discharge the arbitrator noted that if the employee had worked in any other setting, such as an industrial plant, he would have reversed the discharge.<sup>104</sup>

Employee disloyalty can also support just cause for termination of employment. That disloyalty often manifests itself through evidence that the employee is or is preparing to compete directly with the employer. Accordingly, in *Stokes v. Dole Nut Co.*,<sup>105</sup> a California court in an employment contract case found that the termination of the contract was justified. There, managerial and supervisory employees were working to establish a competing business while continuing to the work for the employer. While working, the employees had access to confidential company information and there was evidence that the employees intended to rely on their contacts with the employer's customers to open their new business. The court found that such divided loyalty supplied cause to terminate their employment contracts.

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**96** 93 Lab. Arb. Rep. (BNA) 1037 (1989) (Zobrak, Arb.).

**97** *Id.* at 1041; *see also* Phx. Transit Sys., 121 Lab. Arb. Rep. (BNA) 1601 (2005) (Armendariz, Arb.) (sustaining the discharge of a bus driver convicted for driving under the influence of alcohol while off-duty); N. Oakland Med. Ctrs., 106 Lab. Arb. Rep. (BNA) 488 (1996) (Daniel, Arb.) (finding just cause to discharge food service worker who had been convicted of stabbing his ex-wife's boyfriend with a knife given his history of confrontations with employees and the presence of sharp objects in the kitchen).

**98** ELKOURI & ELKOURI, *supra* note 31, at 939.

**99** *Id.* at 944.

**100** 75 Lab. Arb. Rep. (BNA) 409 (1980) (Siebel, Arb.).

**101** *Id.*; *see also* Airtran Airways, 131 Lab. Arb. Rep. (BNA) 254 (2012) (Howayeck, Arb.) (upholding discipline where employee used profanity on Facebook to complain about scheduling and to threaten schedulers that they "better watch their backs" and that they were "dead" to the employee).

**102** Coll. of St. Scholastica, 96 Lab. Arb. Rep. (BNA) 244 (1991) (Berquist, Arb.).

**103** *Id.* at 254.

**104** *Id.*

**105** 41 Cal. App. 4th 285 (1995).

Finally, employees who conceal criminal records and who lie on their initial employment application are subject to discharge for cause. Thus, in *Sarvis v. Vermont State Colleges*,<sup>106</sup> the Vermont Supreme Court found that the government employer had sufficient cause to terminate a college instructor for omitting his prison term from his resume and instead claiming that he was president of a company during the time of his incarceration.

### III. CONCLUSION

The recent changes to the Georgian Labor Code have drastically altered the relationship between Georgian employers and Georgian employees. While employees enjoyed little protection under the prior code, the new code provides strong protection against arbitrary discharge. It will take some time to determine the precise effects of the new law. Employees may be slow to recognize and attempt to enforce their new rights, and employers may be slow to recognize and comply with those new rights. The new law will certainly add compliance costs to employers doing business in Georgia, but how those costs will be allocated is uncertain. Some are likely to be passed on through higher prices. Other employers may decide to scale back expansion to offset the costs. However, the net benefit of the added security to Georgian employees should not be lightly discounted. With new job protections, Georgian employees and Georgian consumers may feel freer to spend on items that they would have otherwise forgone. It is simply too soon to tell how all this will affect the Georgian economy.

This time of change presents challenges and opportunities for Georgian labor and employment lawyers. While employee claims of wrongful termination under the old code would not have been attractive to pursue, the new code provisions would make it attractive for lawyers to take and to litigate those claims. This is likely to open up or to greatly expand the practice of representing employees in disputes against their employers. There may be even more opportunities for Georgian lawyers representing Georgian companies. Those companies will need to be trained on the implications of the new code provisions. That training should not only outline the new limitations of the employer's discretion to discharge employees, but should also counsel employers on the need to document employee misconduct in anticipation of proving the reasons for the discharge.

While the new code represents a shift away from the employer friendly labor law, it is not necessarily the case that we must conclude that Georgia is no longer taking care of business. Although the discretion is now more limited, if proper procedures are followed and documents are collected and maintained, Georgian employers are likely to find that they still have the ability to manage and direct their businesses. Employers, employees, and Georgian labor and employment lawyers should embrace this time of change and find ways to mold how the new law will be applied in the future. One potential guide offered above is American labor arbitration law. While the new code provisions have caused Georgian employment law to diverge from American employment law, they have at the same time brought Georgian employment law closer to American labor law and its just-cause termination principles. Accordingly, for at least large employers with a tradition of hiring unionized employees, the changes will not be so foreign and radical as it might otherwise seem. And, Georgia's American friends are still able to provide guidance and advice on how these changes could be applied in practice. I for one look forward to the opportunity.

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<sup>106</sup> 772 A.2d 494 (Vt. 2001).

# A COMPARATIVE APPROACH TO COMPETITION LAW IN THE UNITED STATES AND GEORGIA: REGULATING UNILATERAL ACTS AND HORIZONTAL AGREEMENTS THROUGH PREDICTABLE RULES AND CREDIBLE ENFORCEMENT

Professor Mary Kreiner Ramirez,<sup>1</sup>

Presented at Free University of Tbilisi, Georgia, Commercial Law Week  
May 17, 2013

## INTRODUCTION

Competition law, known as Antitrust Law, in the United States regulates unilateral acts as well as horizontal agreements. Central to understanding and interpreting US Antitrust laws is appreciating its competing goals in light of the legislative language and stated purposes of the key statutes. As Georgia develops its competition laws, it has the benefit of drawing from many resources to shape its law. The Draft Law on the Free Trade and Competition<sup>2</sup> will bring more parallels between United States and Georgia competition law. Significant features of well-crafted commercial law are the protection of rights through clear and predictable rules and the credible efficient enforcement of such legal rules. The amendments to Georgia's competition law should operate to further these features.

## II. THE COMPETING GOALS OF US ANTITRUST LAWS

United States antitrust laws are set forth in a number of statutes. The Sherman Act of 1890<sup>3</sup> is the earliest federal antitrust law enacted in the United States. There are two key provisions in the Sherman Act. Section 1<sup>4</sup> of the act

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**1** Professor Ramirez teaches Antitrust Law at Washburn University School of Law in Topeka, Kansas, USA. I would like to thank Free University of Tbilisi, Georgia, for inviting me to present at the Commercial Law Week in conjunction with Manana Shurghulaia. My gratitude extends to the faculty and staff at Free University who have worked diligently to promote the Commercial Law program at Free University in Tbilisi, especially David Kapanadze, Archil Giorgadze, Natia Khantadze, Nino Balanchivadze, and Eka Oniani. I also appreciate the assistance of my research assistant, Raymond James, the comments of Professor Andrea Boyack, and the dedication of Professors Patricia Judd and Bill Rich in facilitating my participation in both the presentation and publication of this article. Finally, my participation would not have been possible without the generous support of the United States Agency for International Development and the East-West Management Institute—Judicial Independence and Legal Empowerment Project.

**2** Draft Law on the Free Trade and Competition (Legislative Herald of Georgia ([www.matsne.gov.ge](http://www.matsne.gov.ge)), 25.05.2012, registration code: 2401400000.05.001.016710) (English translation) [hereinafter Georgia Draft Competition Law]. As of May 17, 2013, the date of presentation of this article, the law had not yet been adopted.

**3** 15 U.S.C. § 1, *et seq.*

**4** Section 1 of the Sherman Act, Combinations in restraint of trade illegal, provides the following: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony . . ." 15 U.S.C. § 1.

prohibits agreements among competitors that unreasonably restrain trade, in effect, regulating horizontal and vertical agreements. Section 2<sup>5</sup> of the Act prohibits monopolization, attempted monopolization, or conspiracy to monopolize. Additional laws regulating competition developed later on.<sup>6</sup>

The Sherman Act was enacted in response to the emergence of large corporations, known as “trusts,” that were dominating key industries either as monopolists or oligopolists. Consequently some scholars and early court interpretations of the Sherman Act identified the goal of the law to be dispersing economic power and stimulating access to free markets. This approach looked to maximize consumer protection by ensuring a broad measure of competition in the marketplace.<sup>7</sup> Benefits of this approach to the antitrust laws included protecting competition by protecting a marketplace of competitors, making consumers happy by offering many choices to address different consumer needs or desires, and spurring innovation to address competition. Because this approach offers these benefits through expanded competitive choices, it effectively favors small businesses.<sup>8</sup>

Over the last thirty-five years, courts have followed the lead of some scholars in a shift to an economic efficiency model.<sup>9</sup> This approach, fostered by and known as the Chicago School of Economics,<sup>10</sup> purports to enhance consumer welfare by creating efficiency in the marketplace. Economic efficiency is broken out into productive efficiency, that is, maximizing use of resources and avoiding waste through economies of scale, and allocative efficiency, devoting resources to optimal products or users.<sup>11</sup> Economic efficiency also has the goal of protecting competition, but not necessarily competitors. Supporters of the Chicago School maintain that the market, unhampered by governmental interference, will naturally find its peak economic efficiency.<sup>12</sup> The asserted risk in regulating markets through antitrust law is that it will stifle business innovation through rigid rule application. Because economies of scale are usually achieved through expanding organizations, this approach favors larger businesses dominant in industry.

As Georgia develops its competition law and moves to amend and substantially strengthen regulatory oversight of competition, Georgian policymakers—like their counterparts in the United States—appear to be struggling with defining the goals of competition law as a means to strengthen predictability and efficiency in ways consistent with the approaches of both the United States and the European Union.<sup>13</sup> Creating predictable regulatory oversight should advance the effort to encourage foreign business investment while avoiding overly rigid demands on business interests.

The proposed changes in the Georgia Draft Competition Law would make the law much more similar to US antitrust law than the current Georgia Competition Law that is more limited in its scope.<sup>14</sup> Two significant features of law in a flourishing commercial environment are the protection of rights through clear and predictable rules, and credible efficient enforcement of such legal rules. In comparing the Georgia Draft Competition Law to the US Sherman Act three key similarities emerged that I will focus on below. The first is the restriction on unilateral activity that would

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**5** Section 2 of the Sherman Act, Monopolizing trade a felony, provides the following: “Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony. . . .” 15 U.S.C. § 2.

**6** See, e.g., Federal Trade Commission Act §5, 15 U.S.C. §45 (unfair methods of competition are unlawful); Robinson-Patman Act, 15 U.S.C. §13(a) (prohibits anticompetitive price discrimination).

**7** Barak Y. Orbach, *The Antitrust Consumer Welfare Paradox*, 7 J. COMPETITION L. & ECON. 133, 135-36 (2010).

**8** See, e.g., *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962).

**9** PATRICK A. McNUTT, LAW, ECONOMICS AND ANTITRUST: TOWARDS A NEW PERSPECTIVE 119 (2005).

**10** Harvey J. Goldschmid, *Comment on Herbert Hovenkamp and the Dominant Firm: The Chicago School Has Made Us Too Cautious About False Positives and the Use of Section 2 of the Sherman Act*, in *HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST* 123, 124 (Robert Pitofsky ed., 2008).

**11** ROBERT BORK, *THE ANTITRUST PARADOX* 63 (1978). See, e.g., *Nat'l Collegiate Athletic Ass'n v. Bd. Of Regents of Univ. of Okla.*, 468 U.S. 85, 107 (1984); *Arizona v. Maricopa County med. Soc'y*, 457 U.S. 332, 367 (1982).

**12** See *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407-08 (2004).

**13** This article compares the changes in Georgia's competition laws to US antitrust laws. The European Union's competition laws appear in the Treaty on the Functioning of the European Union, Part Three, Title VII, Common Rules on Competition, Taxation and Approximation of Laws, Chapter 1, Rules on Competition, Section 1, Rules Applying to Undertakings, Articles 101-103, available at <http://www.ecb.europa.eu/ecb/legal/1341/1342/html/index.en.html>.

**14** Georgia Draft Competition Law, Explanatory Memorandum on the Amendments to the Law of Georgia on the Draft Law of Georgia on Free Trade and Competition.

create a dominant position in a relevant market, or tend toward monopolization as that term is understood in US law. The second is the prohibition against horizontal agreements, known as conspiracies in restraint of trade in the United States. The third similarity, an enforcement mechanism, is the proposed Cooperation Program in the Draft Law that is similar to the US Department of Justice Antitrust Division Leniency Program.

### III. CLEAR AND PREDICTABLE RULES STRENGTHEN CONFIDENCE IN MARKETS

When it comes to competition law, clear and predictable rules may strengthen confidence and competition in the marketplace, but in avoiding rigidity, flexible rules will often lead to complicated and costly litigation due to needed economic analysis in defining markets and weighing competitive considerations. Two such areas in antitrust law where rule interpretation has led to significant, and often unpredictable litigation in the United States are in assessing unilateral activity by dominant firms<sup>15</sup> and the definition of market power, and in applying the “rule of reason” to horizontal agreements restricting competition. Both areas require delving into interpretations of US law through legal guidelines and US Supreme Court cases, as well as trudging through the complexity of applying economic concepts to real world cases.

#### A. Georgia’s “Dominant Position” and United States’ “Monopolization”

Rules are just the starting point. Agencies charged with protecting the public interest and courts charged with interpreting the law must evaluate potential antitrust claims. Central to that analysis is the concept of “market power.” In particular, the question is whether unilateral activity by a firm gives it market power in a relevant market, that is, a market capable of being dominated or monopolized. Both the Georgia Draft Competition Law and US law seek to limit firms from using a dominant position in the marketplace to unfairly harm consumers, typically through higher prices or restricted output.

Georgia’s Draft Competition Law defines “dominant position” as an economic agent in the relevant market possessing market power “giving them the opportunity to act independently from competing economic agents, suppliers, customers and end-consumers” that allows them “to have a substantial impact in the market on goods movement” in setting relatively high prices in comparison to competitive prices and maintaining that supra-competitive price “for a long-term,” and having the ability to restrict competition.<sup>16</sup> A significant market share is defined as holding at least 40% of the market share in the relevant market, but the definition allows for exceptional circumstances.<sup>17</sup> The 40% threshold allows for flexibility and depends upon fragmentation in the market. An entity that holds a dominant position or is part of a dominant group violates the draft Georgia law if the economic agent abuses that dominant position in one of the following ways: (a) setting unfair prices, trading conditions, or regulations; (b) limiting production, markets, or technical development to the detriment of consumers; (c) imposing certain discriminatory trading conditions; (d) preconditioning contracts that impose obligations unrelated to the subject of the transaction; or (e) engaging in other actions restricting competition.<sup>18</sup>

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**15** The Georgia Draft Competition Law uses the term “dominant” position in much the same manner as US Antitrust Law uses the term “monopolization.” Compare Article 1(i), Georgia Draft Competition Law to Robert Pitofsky, *Some Predictions About Future Antitrust Enforcement*, 16 GEO. MASON L. REV. 895, 897 (2009) (discussing the pursuit of dominant firms such as Microsoft and Intel by the Antitrust Division under the Clinton administration).

**16** Georgia Draft Competition Law, Article 1(i). The definition also recognizes the possibility of a dominant group of two or more economic agents that do not experience significant competition from each other. Georgia Draft Competition Law, Article 1(i). The definition applies to groups of no more than 3 economic agents, with a market share of at least 15% each and a total market share of at least 50%, and to groups of no more than 5 economic agents, with a market share of at least 15% and a total market share that exceeds 80%. Georgia Draft Competition Law, Article 1(i) (a), (b).

**17** Georgia Draft Competition Law, Article 1(j).

**18** Georgia Draft Competition Law, Article 7.



In the United States, the Sherman Act prohibits monopolization and attempted monopolization.<sup>19</sup> The US Supreme Court has defined monopolization as “the possession of monopoly power in the relevant market, and the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.”<sup>20</sup> A monopoly is a market dominated by a monopolist, holding market power sufficient to shift prices for a meaningful period. To have a monopoly in the United States, one need not be the only competitor in the relevant market, nor is holding a monopoly, so defined, illegal.<sup>21</sup> In contrast, the Georgia Draft Competition Law defines “monopoly status” as an “economic agent who has *no competitor* in the relevant market or has the exclusive right to carry out certain kinds of activities.”<sup>22</sup> With no statutory guidance on this issue, US courts have generally interpreted a market share of 75% or higher to be sufficient for a *de facto* monopoly, and less than 50% to be insufficient, absent some exceptional circumstance,<sup>23</sup> with the court necessarily having to assess what is sufficient on a case-by-case basis. An attempted monopolization charge allows for a lower market share percentage of the relevant market<sup>24</sup> provided there is proof of a specific intent to monopolize, anticompetitive or predatory conduct in furtherance of that intent, and a dangerous probability of success.<sup>25</sup>

Raising prices due to holding a dominant position or a monopoly position in a market may create an umbrella effect for other competitors in the market, who may also decide to increase prices (albeit not always to the same level as the dominant player) because they are protected from price competition due to the dominant player’s increased prices.

## B. Dominant Position and Its Defining Criteria: Defining Market Power

Market power is central to both the Georgia Draft Competition Law on unilateral activity and the US antitrust laws.<sup>26</sup> “Market power is the power to raise prices above marginal cost, which is the incremental cost of producing the last unit of output.”<sup>27</sup> Requiring proof of market power serves as a screen to sift through and identify cases in which the abuse of market power is most likely to have the greatest anticompetitive effects.<sup>28</sup> Concurrently, the high costs associated with establishing market power may also limit enforcement against anticompetitive conduct.<sup>29</sup> On the other hand, requiring proof of market power may act as a sword to cut off the need for greater proof of abuse because courts are willing to accept the inference that anticompetitive conduct coupled with significant market power is likely to have an anticompetitive effect on the market, or to accept other proof of anticompetitive conduct lacking in procompetitive effects because the costs of proving market share is so high.<sup>30</sup>

Many factors are considered in assessing market power, but market share is often used as a proxy for assessing market power.<sup>31</sup> Calculating market share starts with defining the relevant market or markets, and this often requires

**19** 15 U.S.C. §2.

**20** *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966).

**21** See *Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004).

**22** Article 3(y), Georgia Draft Competition Law (emphasis added).

**23** HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 293-94 (4<sup>th</sup> ed. 2011).

**24** Market share percentage in attempted monopolization cases varies widely. *Compare*, *White & White, Inc. v. Am. Hosp. Supply Corp.*, 540 F. Supp. 951 (W.D. Mich. 1982) (market share in mid-twenties sufficient to support “dangerous probability of success”) *with* *United States v. Empire Gas Corp.*, 537 F.2d 296 (8<sup>th</sup> Cir. 1976) (47-50% market share is insufficient to prove dangerous probability of success).

**25** *Swift & Co. v. United States*, 196 U.S. 375 (1905) (identifying the three elements of attempted monopolization); *Spectrum Sports v. McQuillan*, 506 U.S. 447 (1993).

**26** See, e.g., Georgia Draft Competition Law, Article 3 (g) relevant market, (i) dominant position, and (j) significant market share.

**27** EINER ELHAUGE & DAMIEN GERADIN, *GLOBAL ANTITRUST LAW AND ECONOMICS* 258-59 (2007). Marginal cost may be difficult in itself to assess especially in a market that is not competitive, as may be the case if the market is dominated by one or two firms.

**28** EINER ELHAUGE & DAMIEN GERADIN, *GLOBAL ANTITRUST LAW AND ECONOMICS* 258-59 (2007).

**29** EINER ELHAUGE & DAMIEN GERADIN, *GLOBAL ANTITRUST LAW AND ECONOMICS* 258-59 (2007).

**30** EINER ELHAUGE & DAMIEN GERADIN, *GLOBAL ANTITRUST LAW AND ECONOMICS* 258 (2007).

**31** U.S. Dep’t of Justice & Fed. Trade Comm’n, *Horizontal Merger Guidelines* 7 (Aug. 19, 2010); HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* §6.2b (4<sup>th</sup> ed. 2011).

significant economic analysis. The stakes for the parties are high in this analysis because such definition is often outcome determinative for the parties. A broadly defined market will tend to result in smaller market shares for all competitors, whereas a narrowly defined market will tend to favor the government agency or private plaintiff challenging the dominance of a competitor in the market. The relevant market is defined by two coordinates: (1) the relevant product market, and (2) the relevant geographic market.<sup>32</sup>

The relevant product market includes not only the product or service provided by the subject competitor, but also substitutes.<sup>33</sup> The elasticity of demand identifies the degree to which other products will act as substitutes for the product at issue. The elasticity of supply identifies the capability of other production facilities to be converted to produce a substitutable product or service. The timing of any switch in production and the excess capacity of competitors or potential competitors may greatly impact the supply curve. Parties are likely to disagree in assessing suitable substitutes, requiring economic expertise to make a case for substitutes.

The relevant geographic market is the geographic area in which a firm can increase its price without a large number of customers immediately turning to alternative supply sources outside the area, or without producers outside the geographic area quickly flooding the area with substitutes. Economists look to pricing over a period of time in the surrounding areas. If pricing rises and falls quickly in response to changes in the surrounding area, then both are likely part of the same geographic market. Barriers to the movement in or out of the market may increase costs, or delay or prohibit entry, and include geographical barriers such as distance or physical boundaries, and political barriers such as tariffs.

Once the relevant market has been defined through the relevant product market and relevant geographic market, market share is calculated for each competitor that produces or services the relevant market. In Georgia, the Draft Competition Law provides that the “economic agent’s market share on the relevant market is to be determined by the Agency through using market analysis methodical instructions.”<sup>34</sup> In the United States, the 2010 Merger Guidelines recognize “that merger analysis does not consist of uniform application of a single methodology” but it describes relevant considerations in assessing market shares.<sup>35</sup> The US agencies responsible for enforcing the antitrust laws on behalf of the federal government, that is, the US Department of Justice Antitrust Division and the Federal Trade Commission, created the Merger Guidelines. The Merger Guidelines are simply that—guidelines. They are not mandated, and courts are under no obligation to insist on their application in calculating market shares. Instead, the Merger Guidelines reveal the “principal analytical techniques and main types of evidence” used by the Agencies to assess a horizontal merger’s likely impact on substantially lessening competition.<sup>36</sup> Once market shares are calculated, they may be used to guide evaluating whether a firm has market power.

The relevant market and resulting market share is a key consideration in assessing market power, but it may not be the only consideration, because it only reflects the current relative status of firms and cannot account for changing market conditions. Both the Georgia Draft Competition Law and the US courts have recognized that in many cases, other factors may play a significant role in assessing market power. In particular, as identified in the Georgia Draft Competition Law and recognized in US case law and regulatory guidelines, some of these factors to consider are as follows: The financial condition of the economic agent and its competitors, market entry or expansion barriers, buyers’ market power, accessibility to raw materials sources, vertical integration, network effects, level of market development, significant market share, and ownership length.<sup>37</sup> While historical evidence is useful to calculate present market share,

**32** The Georgia Draft Competition Law defines relevant market as follows: The relevant market – goods/services or interchangeable flow of goods in a certain area, the boundaries of which are determined in consideration of economic capability for buying goods and expediency. In determining the relevant market, an unobserved economic activity must be taken into account, if any. Georgia Draft Competition Law, Article 3(g).

**33** United States v. Grinnell Corp., 384 U.S. 563, 571 (1966).

**34** Georgia Draft Competition Law, Article 5(2).

**35** U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines §1, Overview (2010).

**36** *Id.* at §§1, 5.2.

**37** Georgia Draft Competition Law, Article 5, paragraph 3. *See, e.g.,* United States v. General Dynamics Corp., 415 U.S. 486 (1974) (the Merger Guidelines are not intended to be used to analyze cases other than mergers; however, the description of market participants and the assessment of market shares are illustrative of the approach to assessing the market power of dominant firms). *See also* U.S. Dep’t of Justice & Fed. Trade

changing market conditions may indicate that historical data overstates or understates future competitive significance.<sup>38</sup> Courts assess whether market power, based upon market share and any other pertinent factors, is sufficient to find monopoly power or a dominant position in the relevant market.

### C. Exclusionary Conduct and Abuse of Dominant Position

It is not illegal in Georgia to merely hold sufficient market power to establish a dominant position, nor is it prohibited by US law merely to be a monopoly power in the United States. Central to falling within the restrictions on competition law in Georgia or antitrust law in the United States is a finding that such market power has been abused.

A single economic agent with a “significant market share” of at least forty percent<sup>39</sup> and fitting the definition of dominant position<sup>40</sup> in Georgia is prohibited from engaging in abuse of the dominant position.<sup>41</sup> The Georgia Draft Competition Law identifies specifically several types of prohibited abuses: setting unfair prices or other unfair trading conditions;<sup>42</sup> limiting “production, markets, or technical development to the detriment of consumers;”<sup>43</sup> prohibiting discriminatory transactions with trading partners;<sup>44</sup> and imposing contract preconditions unrelated to the subject of the transaction.<sup>45</sup> The draft law incorporates a catch-all provision for those practices not categorically listed by prohibiting other actions restricting competition or “depriving the legitimate interests of economic agents or consumers.”<sup>46</sup>

Similarly, in the United States, a showing of monopoly position triggers a review of whether exclusionary conduct has occurred. Exclusionary conduct involves improper acts by the firm to acquire or maintain power.<sup>47</sup> Some examples of such improper acts include restrictive agreements (such as long-term leases), limiting secondary markets and aftermarkets, and actions taken by the firm lacking economic justification. On the other hand, actions taken that reflect competition on the merits are considered “honestly industrial” and support a conclusion that unilateral conduct was lawful. US courts have recognized that depending upon the circumstance in the marketplace, instances exist where only a limited number of firms may survive or thrive. Examples of actions considered to be honestly industrial are natural monopolies or limited markets, efforts to take advantage of economies of scale, changes in taste or in cost that shift consumer preferences, innovation or invention, objectively necessary actions, and meeting competition through lower pricing or incentives.

Thus, under both legal regimes, market power alone is insufficient to seek redress.

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Comm’n, Horizontal Merger Guidelines §5.2 (2010).

**38** For example, new technology may cause a shift the purchasing habits that impact a product, see *United States v. Von’s Grocery*, 384 U.S. 270 (1966) (grocery stores in the 1950s US, when suburbs and cars began to dominate; new technology such as refrigeration), or new technology protected by patents in the United States may not be available to all firms in the industry, see *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962) (patents on shoe-making machinery).

**39** Georgia Draft Competition Law, Article 3(j).

**40** Georgia Draft Competition Law, Article 3(i).

**41** Georgia Draft Competition Law, Article 6.

**42** Georgia Draft Competition Law, Article 6(a).

**43** Georgia Draft Competition Law, Article 6(b).

**44** Georgia Draft Competition Law, Article 6(c).

**45** Georgia Draft Competition Law, Article 6(d). This restriction appears comparable to the restrictions on tying an exclusive dealing that are more specifically addressed in the United States by the statutory language in Section 3 of the Clayton Act. The Clayton Act of 1914, 1 U.S.C. §3.

**46** Georgia Draft Competition Law, Article 6(2).

**47** See, e.g., *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966); *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 602 (1985).

## D. Remedy for Unlawful Abuse of Market Power

The early stage of competition law in Georgia is best acknowledged in the limited remedy available under the Georgia Draft Competition Law. The “Competition Agency,” an independent legal entity of public law, is solely authorized to redress violations of the law.<sup>48</sup> Violations of Article 6 (addressing abuse of the dominant position) and Article 7 (prohibiting concerted agreements by competitors) are subject to “a fine, which shall not exceed 10 percent of the economic agent [the] (sic) annual turnover for the previous financial year.”<sup>49</sup> In assessing the amount of the fine, the agency must determine the amount of the loss, taking into account both “the duration and severity of the violation.”<sup>50</sup>

US law provides remedies for monopolization or attempted monopolization that vary considerably from Georgia law. The differences arise in identifying who can bring such actions, whether such actions are civil or criminal, and finally, the breadth of penalties available to such parties.

In the United States, a civil case may be initiated by private parties injured by the conduct,<sup>51</sup> or by one of two federal government agencies responsible for oversight, the Federal Trade Commission or the U.S. Department of Justice, typically through its Antitrust Division. Additionally, many states also have antitrust or consumer laws providing for civil actions by private parties or by the Attorney General for that state. In addition to civil authority, the Department of Justice has authority to bring criminal actions for monopolization or attempted monopolization.<sup>52</sup> There is no provision for criminal enforcement in the Georgia Draft Competition Law.

Criminal punishment under the Sherman Act provides for substantial penalties. Corporations are subject to fines of up to \$100 million, and individuals are subject to a term of imprisonment of up to 10 years, and a fine up to \$1 million.<sup>53</sup> An alternative fine provision subjects corporations and individuals to a fine calculated up to twice the gross financial loss or gain resulting from a violation.<sup>54</sup> In civil cases, damages are trebled. The provision of treble damages encourages private civil enforcement of US antitrust laws. The benefits of private enforcement are two-fold: first, injured parties do not need to await action on the part of the government, which may be restricted by limited resources or limited will to pursue certain violators; second, the number of parties available to enforce antitrust law compliance is expanded to the number of parties willing and able to prosecute a civil case. In addition to financial remedies, equitable relief provides a vital avenue to redress harm. Two critical equitable remedies frequently sought in such cases are injunctive relief to enjoin future anticompetitive acts, and divestment to disassemble structures created within the defendant firm that perpetuates abuse of its market power.

The changes to Georgia competition law proposed in the Draft Competition Law are significant in that they improve agency oversight of competition with a view toward strengthening the law for business investment. The changes proposed bring Georgia competition law closer to the legal standards and analysis used to evaluate and regulate competitive practices in the United States. Antitrust law in the United States has developed over 125 years, and Georgia has the benefit of drawing upon US law and EU law as it strives to regulate competition without stifling innovation and good business practices. In practice, establishing the exercise of market power through abuse of a dominant position is complex, costly, and unpredictable. Nevertheless, agency oversight is substantially more predictable in creating a positive competitive environment than the absence of such oversight.

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**48** Georgia Draft Competition Law, Article 4 (establishing the Competition Agency).

**49** Georgia Draft Competition Law, Article 33.

**50** Georgia Draft Competition Law, Article 33.

**51** The US Supreme Court has limited private enforcement of antitrust laws to those parties who can demonstrate antitrust injury caused directly by the anticompetitive acts, as distinguished from tort injuries. *See, e.g.,* Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477 (1977); *see also* United States v. Microsoft Corp., 253 F.3d 34 (D.C. 2001) (the government “must demonstrate that the monopolist’s conduct harmed competition, not just a competitor”).

**52** 15 U.S.C. §2.

**53** 15 U.S.C. §2. Prior to June 2004, the maximum fine for a corporation was \$10 million, and the maximum punishment for an individual was up to 3 years imprisonment, up to a \$350,000 fine, or both. *See* Antitrust Amendments Act of 1990, Pub. L. No. 101-588, § 4, 104 Stat. 2879, 2880.

**54** 18 U.S.C. § 3571(d).

## IV. CREDIBLE, EFFICIENT ENFORCEMENT: COOPERATION PROGRAM & US DEPARTMENT OF JUSTICE ANTITRUST LENIENCY POLICY

The Georgia Draft Competition Law and US Sherman Act both prohibit concerted agreements to restrict trade among competitors under certain circumstances. The Georgia Competition Agency may impose fines for violating the prohibition, whereas the US Department of Justice may seek civil or criminal sanctions. The difficulty in detecting such violations arises from the secret nature of the agreements. The US Department of Justice has created an Antitrust Leniency Policy<sup>55</sup> designed to promote voluntary cooperation with the government; the policy encourages antitrust violators to step forward to admit misconduct and cooperate with the investigation of its competitors in exchange for the opportunity to avoid sanctions. The Georgia Draft Competition Law offers a limited version of this policy, known as the Cooperation Program.<sup>56</sup> Offering leniency for cooperation aids the government in gathering information and pursuing offenders, thereby requiring fewer resources for more certain outcomes. For offenders, the policies present a means of escaping an unlawful agreement and clearing its risk of liability.

### A. Prohibiting Concerted Agreements

Fostering competition among competitors promotes efficiencies in production and distribution, invention and innovation, and promotes consumer savings and consumer choices. While the government may have the consumers' interests at the forefront of regulatory purpose, certain conditions are favorable to fostering agreements or cartels by otherwise would-be competitors.<sup>57</sup> Where competitors are few in number, the level of market concentration is ripe for cartel agreements because agreements are more easily reached among fewer competitors and more easily policed among the cartel members. High barriers to entry into the industry or product homogeneity also serve to promote cartel behavior because barriers restrict the number of competitors, and homogeneity diminishes the likelihood of reliance upon distinguishing factors to set apart products or services. Finally, facilitating devices (such as trade groups) and some sales methods (such as auctions) present opportunities to form cartels.<sup>58</sup> By aggregating market share through cartel agreements, groups of firms who should be competitors may behave as a dominant firm, collectively, resulting in less innovation and lower satisfaction of consumer needs.

Article 7 of the Georgia Draft Competition Law prohibits agreement between economic agents designed to restrict or prohibit competition through setting prices or other trading conditions<sup>59</sup>; restrict production, markets, technical development, or investment<sup>60</sup>; allocate markets, customers, or territories<sup>61</sup>; and prohibit bid rigging in state procurements.<sup>62</sup> Article 8 of the Georgia Draft Competition Law exempts application of Article 7 depending upon the relationship between the economic agents. Thus horizontal agreements are exempt if the "common market share does not exceed 10 percent,"<sup>63</sup> vertical agreements are exempt if the "common market shares does not exceed 15 percent,"<sup>64</sup> and mixed agreements with horizontal and vertical elements are exempt if each party to the agreement has a "relevant

**55** US Dep't of Justice, Corporate Leniency Policy, *available at* <http://www.justice.gov/atr/public/guidelines/0091.htm>.

**56** Georgia Draft Competition Law, Article 33.

**57** *See, e.g.*, U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines §7.2, Evidence a Market is Vulnerable to Coordinated Conduct (2010).

**58** *See, e.g.*, Adam Smith, *The Wealth of Nations* 128 (Canaan ed. 1937) (1st ed. 1776) ("People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.").

**59** Georgia Draft Competition Law, Article 7(a).

**60** Georgia Draft Competition Law, Article 7(b).

**61** Georgia Draft Competition Law, Article 7(c).

**62** Georgia Draft Competition Law, Article 7(f).

**63** Georgia Draft Competition Law, Article 8(1)(a).

**64** Georgia Draft Competition Law, Article 8(1)(b).

market share that does not exceed 10 percent.”<sup>65</sup> Realistically, agreements that implicate only a narrow share of the market are unlikely to have significant anticompetitive effects on the market.

The US antitrust laws restrict cartels and horizontal agreements by applying two distinct analytical frameworks referred to the “*per se* approach” and the “rule of reason.”<sup>66</sup> The choice of which framework applies impacts the anticipated cost of litigation and the predictability of such litigation. Indeed, the decision will often have an outcome determinative impact on the litigation.

In circumstances where the type of agreement or practice is almost always economically malign, such horizontal agreements are treated as *per se* illegal, and no proof of a minimum of market power is required.<sup>67</sup> The plaintiff or prosecutor need only prove the agreement to restrain trade. The court will not accept a defense that such an agreement was reasonable. In criminal cases applying the *per se* approach, the prosecutor does not need to prove harm. The *per se* approach is disfavored except in simple cases where there are “naked restraints” on competition. Typically, such restraints arise in three categories of horizontal restraints: (1) agreements to increase prices or restrict production output;<sup>68</sup> (2) market, customer, or territory allocations;<sup>69</sup> and (3) unlawful refusals among competitors to deal with a supplier or buyer aimed at limiting a competitor.<sup>70</sup> Such naked restraints on competition alone are sometimes not sufficient to retain the *per se* approach, and courts will take a quick look at the complaint to assess whether the agreements must be more closely scrutinized to allow the defendants to rebut the presumption that the alleged conduct is illegal and to discern whether it is truly anticompetitive.<sup>71</sup> Limited circumstances such as, for example, agreements involving professional organizations,<sup>72</sup> unfamiliar industries,<sup>73</sup> ancillary agreements,<sup>74</sup> or vertical restraints,<sup>75</sup> likewise may shift the analysis from the *per se* approach to evaluating the agreements under the rule of reason approach.

The US Supreme Court has shifted the primary thrust of antitrust analysis of competitor agreements to the rule of reason approach: “Every agreement restrains trade. The true test is whether it merely regulates and thus perhaps promotes competition, or whether it suppresses or even destroys competition.”<sup>76</sup> The rule of reason approach applies a weighing of the agreement’s anticompetitive effects against its procompetitive benefits.<sup>77</sup> The plaintiff must first establish market power sufficient to demonstrate that the agreement has or will have an anticompetitive effect on the market. Establishing market power requires the relevant market analysis discussed above, and the accompanying expert economic analysis to establish the relevant market and considerations impacting market power assessment. Once the plaintiff has satisfied this burden, the defendant may demonstrate a procompetitive purpose for the agreement, which the plaintiff may dispute. Often the contested activity may extend beyond simple overt agreements, and includes

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**65** Georgia Draft Competition Law, Article 8(1)(c).

**66** For cases applying the *per se* approach, see, e.g., *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940) (explaining the *per se* approach); *Arizona v. Maricopa County Med. Soc’y*, 457 U.S. 332 (1982) (applying *per se* approach to price-fixing conspiracy); *FTC v. Sup. Ct. Trial Lawyers Ass’n*, 493 U.S. 411 (1990) (applying *per se* approach to conspiracy to a refusal to deal, also known as a “boycott”); *Palmer v. BRG of Georgia, Inc.*, 498 U.S. 46 (1990) (applying *per se* approach to territorial allocation conspiracy). For cases applying the rule of reason approach, see, e.g., *Broadcast Music v. Columbia Broadcasting System*, 441 U.S. 1 (1979) (applying rule of reason approach to price-fixing conspiracy); *Northwest Wholesale Stationers v. Pacific Stationery*, 472 U.S. 284 (1980) (applying rule of reason approach to boycott conspiracy).

**67** See, e.g., *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940).

**68** See, e.g., *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940).

**69** See, e.g., *Addyston Pipe & Steel Co. v. United States*, 175 U.S. 211(1899); *United States v. Topco*, 405 U.S. 596 (1972); *Palmer v. BRG of Georgia, Inc.*, 498 U.S. 46 (1990) (upholding *per se* approach despite broad criticism of its application to territorial agreements, subsequent to the *Topco* decision).

**70** See, e.g., *Fashion Originators’ Guild of America v. FTC*, 312 U.S. 457 (1941).

**71** See, e.g., *NCAA v. Board of Regents of the Univ. of Oklahoma*, 468 U.S. 84 (1984).

**72** See, e.g., *Nat’l Soc’y of Professional Engineers v. United States*, 435 U.S. 679 (1978).

**73** See, e.g., *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1 (1979).

**74** See, e.g., *Cement Mfrs. Protective Assn. v. United States*, 268 U.S. 588 (1925).

**75** See, e.g., *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007) (rejecting application of the *per se* approach in favor of the rule of reason to vertical agreements to fix minimum resale prices).

**76** *Chicago Board of Trade v. United States*, 246 U.S. 231, 238 (1918).

**77** See, e.g., HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* §5.6, at 253-59 (3d ed. 2005) (describing the rule of reason approach and its distinction from the *per se* approach).

legally and economically ambiguous practices that raise the risk of anticompetitive misconduct, but also could have genuine business benefits. Agreements to exchange some industry information may be lawful and beneficial to enhance competition, but such contact may also risk facilitating illegal exchanges of information. Likewise, tactics such as conscious parallelism in pricing or trade practices may be smart business practices that occur outside of illegal agreements among competitors, or they could be evidence of tacit illegal agreements. The court is tasked with weighing the harm or risk of harm against the benefit or anticipated benefit to arrive at its conclusion regarding whether the challenged agreement violates the antitrust laws. The increased cost of presenting the market power analysis and the unpredictability of the court's assessment in weighing the parties arguments results in a more costly and less predictable outcome than utilizing the *per se* approach. The increased litigation cost and lack of predictive outcomes is justified because the rule of reason approach is less likely to stifle innovative or efficient business practices.<sup>78</sup>

An alternative to the full rule of reason analysis described above is available in certain cases. A court may determine that the case falls within the circumstances that remove it from *per se* analysis, but after a brief examination of the circumstances, still assess that the anticompetitive harm is obvious and a procompetitive explanation is lacking.<sup>79</sup> In these cases, the parties may avoid the cost of protracted litigation, including the need to establish market power. This alternative does not fully evade the lack of predictability accompanying the rule of reason approach because the parties face the difficulty of not knowing whether the court will choose this limited approach in evaluating the case, or will expect the parties to prepare their case with a full rule of reason analysis.<sup>80</sup>

## B. Trading Leniency for Cooperation

Twenty years ago, in 1993, the US Department of Justice Antitrust Division implemented a Corporate Leniency Program.<sup>81</sup> The leniency program is instrumental currently in 90% of the government's antitrust criminal cases.<sup>82</sup> The program has increased the number of large fines, with over 100 fines of at least \$10 million dollars from criminal antitrust investigations, and more than \$1.1 billion dollars in fines in 2012.<sup>83</sup> Average prison sentences for individuals convicted of antitrust crimes in 2010 and 2011 were 2 years.<sup>84</sup> Leniency is only available to a single eligible party to a cartel, and preference is given to the first eligible party to apply.<sup>85</sup> Consequently, the DOJ has had several officers of a corporation contact the government offering cooperation for leniency within two to three hours after a government raid on a corporation.<sup>86</sup> The effectiveness of this program has gained attention not only within the United States, but also by the European Competition Network which adopted a Model Leniency Program in 2006 and revised the MLP in 2012.<sup>87</sup> The Georgia Draft Competition Law includes a Cooperation Program,<sup>88</sup> although it is limited to relief for civil liability given that the draft law does not apply criminal punishment. The discussion below describes the US Leniency Program and then compares that program to the Georgia Draft Cooperation Program.

**78** See, e.g., *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1, 20 (1979).

**79** See, e.g., *FTC v. Indiana Federation of Dentists*, 476 U.S. 447 (1986).

**80** See, e.g., *California Dental Ass'n v. FTC*, 526 U.S. 756, 770 (1999).

**81** The Antitrust Leniency Program has been modified over time. See Antitrust Criminal Penalty Enhancement and Reform Act of 2004, Pub. L. No. 89-670, tit. II § 213(a), 118 Stat. 666 (2004).

**82** Jerry Crimmins, *Cooperation in Antitrust Cases is "Red Hot," DOJ Attorney Says*, Chicago Daily Law Bulletin, Vol. 159, No. 55 (Mar. 20, 2013).

**83** *Id.*

**84** *Id.*

**85** US Dep't of Justice, Corporate Leniency Policy, Parts A.1, and B.1. Additional eligibility conditions are further described in parts A and B of the Corporate Leniency Policy.

**86** Jerry Crimmins, *Cooperation in Antitrust Cases is "Red Hot," DOJ Attorney Says*, Chicago Daily Law Bulletin, vol. 159, No. 55 (Mar. 20, 2013).

**87** European Commission – MEMO/12/887, 22/11/2012, *Competition: European Competition Network Refines its Model Leniency Programme*, [http://europa.eu/rapid/press-release\\_MEMO-12-887\\_en.htm](http://europa.eu/rapid/press-release_MEMO-12-887_en.htm) (reporting that 26 European Union countries now have a competition leniency program); see <http://ec.europa.eu/competition/cartels/leniency/leniency.html> (describing the Model Leniency Program).

**88** Georgia Draft Competition Law, Article 33.

The US Corporate Leniency Policy provides that an award of leniency releases a corporation from criminal antitrust liability for a single corporation that is a member of an illegal cartel in one of two circumstances, and these two circumstances are referred to as Type A and Type B.<sup>89</sup> Type A applies when a corporation comes forward to report illegal activity prior to the Antitrust Division receiving information about the illegal activity; in contrast, Type B applies after the Antitrust Division has knowledge of illegal activity, but prior to acquiring “sustainable proof” of the offense as against the company seeking leniency.<sup>90</sup> To qualify as eligible, the corporation must be the first one to come forward with respect to the illegal activity and to (1) have promptly and effectively terminated criminal activity upon its discovery<sup>91</sup>; (2) report with “candor and completeness and provide[] full, continuing and complete cooperation” that advances the investigation<sup>92</sup>; (3) demonstrate that the “confession of wrongdoing is truly a corporate act”<sup>93</sup>; and (4) provide restitution to its victims, where possible.<sup>94</sup> Moreover, the Antitrust Division must also determine “that granting leniency would not be unfair to others, considering the nature of the illegal activity, the confessing corporation’s role in it, and when the corporation [came] forward.”<sup>95</sup> As an added incentive to corporations, in 2004, Congress eliminated treble damages in private civil actions against successful leniency applicants.<sup>96</sup>

A corporation may only act through its individual agents and employees. Leniency for a corporation requires that those employees cooperate with the government. Consequently, if a corporation qualifies for Type A leniency, then all of its directors, officers and employees who candidly admit their involvement and continue to assist the investigation will also qualify for leniency protection.<sup>97</sup> If the corporation qualifies for Type B leniency, the policy states that leniency for such individuals will be assessed under the Antitrust Division’s Leniency Policy for Individuals. Nevertheless, in practice, the Antitrust Division has applied the same protections to Type B corporate leniency employees and agents as it applies to Type A corporate leniency cases.<sup>98</sup>

The Antitrust Leniency Policy includes provisions applicable to individuals separate and apart from those for corporations. Significantly, the corporate leniency policy may not be available either because the individual does not work for a corporation or other organization covered by the policy, or the individual wishes to cooperate while the corporation does not. Leniency will be granted to an individual reporting illegal antitrust activity before an investigation has begun if (1) “the Division has not received information about the illegal activity from any other source; (2) the individual reports with candor and completeness and provides full, continuing and complete cooperation to the Division throughout the investigation; and (3) the individual did not coerce another party to participate in the illegal activity and clearly was not the leader in, or originator of, the activity.”<sup>99</sup> As with the corporate leniency policy, in the interest of fairness, the Antitrust Division does not want to reward the most culpable party to the conspiracy with leniency to the exclusion of less culpable cartel participants.

The Georgia Draft Competition Law also includes a Cooperation Program that also excludes leniency to an individual who is the sole organizer and/or initiator of the illegal agreement, or to a person who forcedly made other

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**89** US Dep’t of Justice, Corporate Leniency Policy, Parts A.1, and B.1.

**90** US Dep’t of Justice, Corporate Leniency Policy, Parts A.1, and B.1.

**91** The Antitrust Division revoked leniency granted to a corporation in one reported case for failing to promptly withdraw from the antitrust conspiracy. *Stolt-Nielsen S.A. v. United States*, 352 F. Supp. 2d 553 (E.D. Pa. 2005), *rev’d* 442 F.3d 177 (3d Cir. 2005), *cert. denied* 127 S. Ct. 494 (2006). The district court dismissed the indictment of the company after leniency was revoked, finding that the government had received the benefit of its bargain and that it had not proven satisfactorily that the defendant materially breached the agreement by failing to withdraw promptly from the conspiracy. *Stolt-Nielsen S.A. v. United States*, 524 F. Supp. 609, 616 (E.D. Pa. 2007). The government did not appeal. Press Release, U.S. Dep’t of Justice, Justice Department will not Appeal *Stolt-Nielsen* Decision Dec. 21, 2007, available at [http://www.usdoj.gov/atr/public/press\\_releases/2007/228788.pdf](http://www.usdoj.gov/atr/public/press_releases/2007/228788.pdf).

**92** US Dep’t of Justice, Corporate Leniency Policy, Parts A.2, and B.2.

**93** US Dep’t of Justice, Corporate Leniency Policy, Parts A.3, and B.3.

**94** US Dep’t of Justice, Corporate Leniency Policy, Parts A.4 and B.4.

**95** US Dep’t of Justice, Corporate Leniency Policy, Parts A.5 and B.5.

**96** Antitrust Criminal Penalty Enhancement and Reform Act of 2004, Pub. L. No. 89-670, tit. II § 213(a), 118 Stat. 666 (2004).

**97** US Dep’t of Justice, Corporate Leniency Policy, Part C.

**98** US Dep’t of Justice Antitrust Division, Antitrust Division Manual III-98 (5<sup>th</sup> ed. Nov. 2012).

**99** US Dep’t of Justice, Leniency Policy for Individuals, Part A.



parties participate in the agreement.<sup>100</sup> In language quite similar to the US Leniency Policy, the Cooperation Program promises to release a person from liability under the Competition Law provided the person (1) admits to participating in an agreement to fix prices, allocate markets, customers or territories, or rigs procurement bids in violation of Article 7(a), (c), and (f); provides the agency with all information known and if possible, evidence about the agreement before the agency is aware of the agreement from other sources; and finally (3) cooperates with the Agency in the investigation process without interruption or limitation.<sup>101</sup> The Georgia Cooperation Program appears limited to individuals only and does not include a corporate counterpart.

The benefits of a leniency program extend beyond the ability to collect fines, or in the case of the US Antitrust Leniency Policy, to imprison non-leniency violators. Much more significant is the opportunity for earlier detection of violations that arises from the requirement that cooperators approach the government agency before the agency is aware of the illegal conduct from other sources.<sup>102</sup> Early detection minimizes or stops the harm to consumers from the illegal conduct. Cooperation also spurs efficient enforcement of competition laws. Given that cartels operate as secret agreements, the ability for government agencies to access key information about such cartel agreements is limited without cooperation or is at least substantially more difficult to prove. With the aid and guidance of a cooperating conspirator, the agency is able to locate or develop relevant evidence more quickly, and prove its case more readily with the testimony of the cooperator. Limiting the reward of leniency to the first eligible cooperator disrupts illegal agreements and participants by pitting competitors against each other for the benefit of leniency. Finally, the leniency program promotes lawful conduct by offering firms and individuals the opportunity to admit wrongdoing, resolve legal claims, and move to a lawful business model.

## V. CONCLUSION

Georgia's proposed changes to evaluating unilateral practices and horizontal agreements will more closely align its competition policy with US law and EU practices. Drawing upon the experiences of other nations should enhance confidence in Georgia's markets and thereby promote competition. Oversight to detect abuse of market power and exclusionary practices of dominant firms is necessarily subject to variable economic analysis, but nevertheless strengthens the overall competitive environment.

The US Antitrust Leniency Policy has proven to be an outstanding means of efficiently encouraging identification and resolution of antitrust violations. By adopting similar measures, Georgia's Draft Competition Law and its Competition Program is a promising offer to provide credibility to the new legislation through efficient enforcement of laws prohibiting concerted agreements. Georgia's proposed Cooperation Program will encourage a flourishing commercial environment that rewards competition on its merits.

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**100** Georgia Draft Competition Law, Article 33.

**101** Georgia Draft Competition Law, Article 33.

**102** Gary R. Spratling, *Detection and Deterrence: Rewarding Informants for Reporting Violations*, 69 GEO. WASH. L. REV. 798, 799 (2001).

The project is enabled through the generous support of the American people through the United States Agency for International Development (USAID). The author's views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.



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