Partner Note

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The law which aims to attract the Foreign Direct Investments provides for the nationalization and confiscation of the investments

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Amid the pandemic-induced economic crisis, a revival of suspended investment projects and the stimulation of foreign direct investments ("**FDI**") have vital importance for the Georgian economy. In this context, we would like to draw attention to the fundamental defect of the respective legal framework that creates an unfavorable investment environment and makes investment projects non-bankable for the financial institutions.

Paradoxically, the law, which is aimed to attract and promote FDI, provides for the nationalization and confiscation of the investment. Legal regulation providing the nationalization was introduced in 2013 and it equally applies to local investors. This is even more ironic as the Constitution of Georgia unequivocally recognizes and guarantees the property rights and does not allow the nationalization.

According to the most common definition, "Nationalization" is the process of transforming private assets into public assets by bringing them under the public ownership of a national government or State; while "confiscation" refers to the seizure of private property by government or other public authority. For reference purposes in this Partner Note we will use the term "Nationalization" for both "nationalization" and "confiscation".

Nationalization Provisions in the Law on State Property

The case concerns the Law of Georgia on State Property dated July 21, 2010 (hereinafter the "**State Property Law**"). The State Property Law is the main legislative act governing the privatization, as well as the transfer of the right to use of the State property (lease, right to build, usufruct, etc.) to private parties. The common form of privatization is the alienation of State property in exchange for payment of its value, in such a case pursuant to respective sales and purchase agreement, the purchaser pays the State (acting as an owner and seller) the sale price for the assets and obtains ownership title over such assets in exchange of the payment of sales price. The purchaser can be selected through auction, tender, competitive selection process, or otherwise.

Another common form of privatization is transferring the State-owned property to private ownership not only for the exchange of payment of purchase price but for the fulfillment of certain privatization obligations as well. Usually, such privatization obligations provide for the development, construction, and operation of various commercial objects covering different industries: hospitality, real estate, healthcare, renewable energy, infrastructure, agriculture, etc. Implementation of such investment projects require multimillion investments and often involves multiple parties (investors, financial institutions/lenders, contractors, operators, etc.). Privatization transactions that involve privatization obligations are done under the complex privatization and investment agreement between the State and the relevant investor(s) pursuant to which the title over the State property is transferred to the investor which in turn undertakes to fulfill certain privatization obligations (hereinafter the "**Privatization Agreement**").

All major investment projects in Georgia involving the transfer of State property into the ownership (or transfer of right to use) is implemented under the Privatization Agreements. The Privatization Agreement usually provides for multiple instruments for securing the investment obligations by investors (bank guarantee, security deposit, default interest payment, etc.).

The new provision of the State Property Law that was introduced in November 2013 sets the consequences of termination of the Privatization Agreement which constitutes the ground for the Nationalization of such investments. In particular, under Article 20, paragraph 6 of the State Property Law, in case of the breach of the privatization obligations by the investor, the State has the right to unilaterally terminate and exit from the Privatization Agreement; as a result of such exit, the privatized property returns back to the State ownership without paying any compensation to the investor for the sums paid and expenses incurred. In other words, in case of the breach of privatization obligations the investor is losing everything and shall walk out with hands in an empty pocket and the State gets everything no matter what the value of such gain is.

The above provisions of the State Property Law contradict the constitutional right to property, the fundamental principles of private (civil) law, and serves as the ground for the Nationalization of the investment (the "Nationalization Provision").[1]

Principle of Restitution

The Privatization Agreement by its nature is a civil law contract – sale and purchase agreement according to which the purchaser fulfills certain obligations in favor of the seller in exchange for the transfer of title.

According to the fundamental principle of civil (private) law enshrined in the Civil Code of Georgia (hereinafter the "**CCG**") the State participates in civil-law relations as a private legal entity;[2] and all parties to the civil law relations enjoy equal rights.[3]

In case of termination of sale and purchase agreement, universally acknowledged fundamental principle, the right to bilateral restitution applies.[4] According to such principle, if the seller (State) renounces the agreement due to the buyer's (the investor) failure to fulfill their obligations (privatization obligations) and for this reason the seller proceeds with the withdrawal (exit) from the agreement, each party is obliged to return to each other everything they gained under the agreement. The said rule is imperative, and the law explicitly states that any agreement derogating from this principle is void (hereinafter the "**Restitution**").[5]

The same principle applies in case any of the exits from the agreement due to breach of the contractual obligations by another party,[6] in which case exiting party is entitled to claim compensation of damages and payment under any agreed instruments of securing the contractual obligations (penalty, bank guarantee, default interest, security deposit, etc.).[7]

In case of application of the above principles and provisions of the CCG, without taking into the consideration the Nationalization Provisions, the breach of the privatization obligations by the investor and exit of the State from the Privatization Agreement would lead to the following consequences:

I. The State is entitled to claim from the investor:
    a) Return of the transferred/alienated property.
    b) Payment under any additional instrument securing the obligations under the Privatization Agreement (bank guarantee, security deposit; default interest payments, etc.).
    c) Compensation of direct and indirect damages faced by the State as a result of investor's breach of the Privatization Agreement, including the lost profit.

II. The investor is entitled to claim from the State everything that the State may gain as a result of the termination of the Privatization Agreement. The State's counterclaims mentioned under items a) b) and c) of Paragraph I above shall be considered, and the meantime can be deducted (offset) from the investor's claims.

The Nationalization Provisions disregard the principle of the Restitution and provide for the Nationalization of the investments. In accordance with the Nationalization Provisions in case of the termination of the Privatization Agreement due to the breach of the privatization obligations by the investor, the later will have no claim against the State, however, the State in addition to the claims under items a), b) and c) of Paragraph I above has right to claim and get entire investment without payment of any compensation to the investor.

Hypothetical Case

For clarity we refer to the hypothetical example, which is similar to many investment projects in Georgia involving privatization of State property.
The State and an investor entered into the Privatization Agreement under which:

- The State has transferred the ownership title over the land plot to the investor in exchange for:
  (i) immediate payment of sales price USD 1 million that is much lower than market price (being USD 3 million); and
  (ii) fulfillment of privatization obligations: construction and operation of 150 rooms hotel in 3 years for which USD 30 million investment shall be made.
- The investor has paid the purchase price (USD 1 million) and started the implementation of the project. In 2 years' time the investor completed around 80% of the obligations (construction of the hotel building is completed) for which USD 25 million was invested. However, due to financial difficulties the investor failed to complete the project (finishing works and opening the hotel) as a result, the investor is in breach of the obligations under the Privatization Agreement.

- The Privatization Agreement provides for the following, additional instruments of securing the investor's privatization obligations:
  (i) bank guarantee of 10% of the value of the investment obligations i.e. USD 3 million;
  (ii) default interests to be calculated daily for the overdue obligation (at the moment of the termination of the Privatization Agreement by the State amount of such interest accrued is USD 500,000).
- The State has requested unilateral termination of the Privatization Agreement.

Scenario in case CCG applies

Without the application of the Nationalization Provisions and based on the CCG principles the consequences of the termination of the Privatization Agreement would be as follows:

The State would be entitled to claim from the investor:

(i) Return of the land plot back into the State's ownership that also would result in the transfer of title on the unfinished hotel building to the State (with a value of USD 25 million);
(ii) Payment of USD 3 million under the bank guarantee;
(iii) Payment of accrued default interests of USD 500,000;
(iv) Compensation of damages in case the State evidences that such damages are the result of the breach of the Privatization Agreement. Let's assume hypothetically, the damages the State has suffered (including the lost profit) is the market value of the land plot in the amount of USD 3 million that is the amount the State would receive in case the land plot was sold on the auction.

In accordance with the CCG, the State may claim from the investor the title over the land plot and payment of USD 6,500,000 (3 million under the bank guarantee; 0,5 million accrued interests and USD 3 million for damages).

The Investor may claim against the State:

(i) Reimbursement of USD 1 million, paid as a purchase price.
(ii) Compensation for the value of unfinished hotel building of USD 25 million (the counterclaims of the State's above under items (i)- (iv) can be deducted from such compensation claim).

Scenario in case Nationalization Provisions apply

In case of the application of the Nationalization Provisions to the above case, the investor will have no claim against the State and the State in addition to claims described under items (i) – (iv) above is entitled to claim entire investments including ownership title on the unfinished hotel building without payment of any compensation. As a result, the State will be entitled to claim and receive:

(i) title on the land plot (worth of USD 3 million) without returning paid sales price of USD 1 million (i.e. the State will gain one more million of USD);
(ii) USD 6,5 million as described under items (i), (ii) and (iii) above;
(iii) unfinished hotel building worth of USD 25 million.

To summarize the above example, pursuant to the Nationalization Provisions, as a result of the termination of the Privatization Agreement, the State will be entitled to claim and receive in aggregate USD 32,5 million and investors will have to walk out of the country with nothing.

To the best of our knowledge and based on our experience unfortunately, the State is actively stressing on the Nationalization Provisions when negotiating the Privatization Agreements with the investors and insists on the incorporation of contractual provisions similar to Nationalization Provisions in the Privatization Agreements. Such an attitude of the State puts the investors even at a greater risk. In particular, if the Nationalization Provisions are annulled/canceled by the Parliament of Georgia in the future (which we hope will be the case) provisions similar to the Nationalization Provisions will remain in the Privatization Agreements as contractual provisions that will cause the additional difficulties for the investors.[8] Furthermore, to the best of our knowledge and based on our experience, in the court cases related to the Privatization Agreements and examined by Georgian courts, the State actively deploys the Nationalization Provisions and thus claims the Nationalization of the investments.

The Nationalization Provisions were introduced only in November 2013 and based on my knowledge and experience I came to my personal version of its prehistory. In particular, before the adoption of the Nationalization Provisions by the Parliament of Georgia, while negotiating the terms of the Privatization Agreement, the State always insisted on the incorporation of contractual provisions similar to the Nationalization Provisions in the Privatization Agreement. Such a position of the State usually met strong and fair opposition by investors, and this has always been the subject of tough negotiations and discussions. Therefore, I assume, one day the State got tired of intense opposition/discussions with investors and found a "simple" solution – Nationalization Provisions was introduced in the State Property Law.

An antonym for the "Nationalization" is the term "Privatization". Ironically, the law that aims to attract and promote the investments follows the paths of the Nationalization of such investments. We hope that ways will be found to change this reality, for which, in my opinion, the active involvement of professional-business organizations is necessary.

1. The Nationalization Provisions provide for another fundamental issue - termination of hypothecation/mortgage agreement that makes investment projects involving the privatization less attractive and non-bankable for the financial institutions that is not subject matter of this Note.
2. CCG, Article 24, paragraph 4
3. CCG, Article 1
4. CCG, Article 508
5. CGG Article 508
6. CCG, Article 352
7. CCG, Articles 394, 407, 417
8. Meantime the issue of having contractual provisions similar to the Nationalization Provisions just in the Privatization Agreement can be addressed based on the Article 508 of CCG that declares any such contractual agreement as null and void.

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