

**Interrelation between tort liability and strict liability in cases of compensation  
for damages resulting from economic crime**

**Abstract.** The relevance of the issue of the relationship between the doctrine of tort liability and strict liability is caused by the decisions of the Supreme Court of Georgia in 2015 on two identical criminal cases of tax evasion, whereby the strict liability of the partner was used as the legal basis for compensation of property damage, instead of tortious liability. This article discusses the principles of vicarious liability and tortious liability in determining property liability resulting from economic crime.

**Key words:** strict liability; tort liability.

**Introduction.** In cases of economic crimes, the issue of competition between the doctrine of tortious liability and strict liability has gained relevance since 2015, when the Supreme Court of Georgia made two unprecedented decisions, thereby establishing the partner's strict liability as the legal basis for compensation for property damage in two identical criminal cases of tax evasion, instead of tortious liability, despite the fact that the victim (the state) demanded damages based on the delict norm<sup>1</sup>. In the practice of the Supreme Court of Georgia, until this moment, this was the first and last case when the abuse of the forms of limitation of liability provided for by the Law on Entrepreneurs was used in favor of the creditor as a basis for personal liability. It is natural that this precedent was followed by a great resonance, both in practice and in the legal literature, it received a lot of criticism. It is not surprising that the issue of establishing a legal basis for compensation for property damage is still relevant.

Before discussing the relationship and applicability of these two legal bases, it is appropriate to review the norms establishing strict and tort liabilities.

**I. Norm and legal doctrine of partner's strict liability**

In essence, strict liability refers to the personal liability of the limited liability partner for the social obligations in cases of abuse of the principle of limitation of liability.<sup>2</sup> In legal dogmatics, the doctrine of strict liability has been developed, a defined chain of preconditions and factual circumstances, in the

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1 სჯს, №158-1104-2014; სჯს, №1307-1245-2014.

2 Zubitashvili, Liability of the partner for the obligations of the corporation during the insolvency of an entity - exceptional cases from the principle of limitation of liability, 2016, 130-155.

presence of which we can talk about the imposition of strict liability.<sup>3</sup>

The doctrine of strict liability developed in Anglo-American law with 19th century precedents. One of the first cases in the chronology of doctrine is *Salomon vs. Salomon*.<sup>4</sup> In the said case, the Lords Court upheld the independent legal personality of a duly incorporated company and disregarded the personal liability of a partner for the company's obligations despite the partner misusing the company for unfair property interests. It was this decision that laid the foundation for reasoning that the misuse of the company, as a fraud, to mislead the creditors, should lead to the personal liability of the partner.

At the end of the 20th century, the Anglo-American doctrine of strict liability spread widely in various national systems. The basis of the personal responsibility of the partner was included in the 1994 Law of Georgia on Entrepreneurs, in the conditions when Georgian private law,<sup>5</sup> including corporate law, at the initial stage of its development was a version of German law.<sup>6</sup>

Applying the principle of strict liability of partners in practice requires overcoming the principles of independent legal entity and separation.<sup>7</sup>

The separateness of a legal entity is a well-established legal principle, as early as 1998, the Constitutional Court of Georgia evaluated the nature of an entrepreneurial entity in one of the cases, determining that an entity is not the property of its partner and that the property of the partner does not apply to the property of an entity.<sup>8</sup>

According to the Law on Entrepreneurs of 2021, the basis of strict liability is Article 26, paragraph 2, which establishes two cumulative circumstances of the strict liability of a partner in favor of the creditor of an entity: a) abuse of the legal form of limitation of liability by the partner; b) Inability of an entity to satisfy the creditor's demands.

The second circumstance emphasizes the subsidiary and therefore, exceptional character of strict liability. The subsidized nature of a strict liability also reduces the likelihood of the creditor directly abusing the right against the partner.

Thus, strict liability is an extreme mechanism in the hands of the creditor, which should be used only if the entity itself does not have the resources to satisfy the creditor, and in this case the blame is directed to the partner. The self-interest of the creditor in itself cannot be the personal responsibility of the partner, because it violates the fundamental value of corporate law, the principle of separation of partnership and entity. Accordingly, at a time when entity has its own resources to satisfy the creditor, strict liability should not be on the agenda. It should be noted that this prerequisite, expressed in the Article 26, echoes the approach noted by the Supreme Court of Georgia in its 2015 decision, according

3 Zubitashvili, Liability of the partner for the obligations of the corporation during the insolvency of an entity - exceptional cases from the principle of limitation of liability, 2016, 130-155.

4 *Salomon v A Salomon & Co Ltd* [1896] UKHL 1, [1897] AC 22.

5 also provided for in the Law of Georgia on Entrepreneurs of 2021, Art. 26.2.

6 Chanturia, The Law on Entrepreneurs and the Origin of Corporate Law in Georgia, Sergo Zorbenadze 70: Jubilee Collection 32-52.

7 Zubitashvili, Liability of the partner for the obligations of the corporation during the insolvency of an entity - exceptional cases from the principle of limitation of liability, 2016, 59.

8 Decision of the Constitutional Court of Georgia of January 29, 1998 N2/36-7.

to which, before checking the prerequisites of strict liability, the court must establish the insolvency of the debtor (i.e. entity).<sup>9</sup>

It is natural that the law cannot explain what circumstances can be considered as misuse of the legal form of limitation of liability, it is the subject of the said assessment. The doctrine of strict liability and judicial practice are used for evaluation. It should be noted here that judicial practice should be considered as a non-normative source of law.<sup>10</sup>

As mentioned, within the framework of the doctrine of strict liability systematized such actions of the partner that constitute the abuse of legal forms of limitation of liability. Two main theories can be distinguished from the theories of substantiation of strict liability - “alter ego” and “instrumentality”. The “alter ego” theory expresses the nature of the relationship between entity and its partner, according to which the partner represents the embodiment of an entity - the alter ego.<sup>11</sup> The “instrumentality theory” is based on the dominance of the partner, which manifests itself by controlling all important/key aspects of an entity’s activities.<sup>12</sup>

The main thesis of substantiation of strict liability is the specific relationship between the partner and entity, which is expressed by the dominance of the partner, the vulnerability of independent legal subjectivity and separation between the two subjects.

The doctrine of strict liability bridges the gap between contractual and tort creditors. Given that the contractual creditor can investigate and evaluate the company and its ability to fulfill contractual obligations and thereby avoid contractual risks, according to the prevailing position in dogmatics, it is not worthy of protection by strict liability.<sup>13</sup> It is assumed that the voluntary creditor knowingly accepts the possible risks of non-satisfaction of the demand arising from the principle of limitation of liability, which does not justify breaking the corporate veil in his favor.<sup>14</sup> The use of strict liability in favor of contractual creditors can only be considered in such a situation where the party has intentionally misrepresented the counterparty about the company. The situation is completely different with regard to tort creditors. Given that they do not have a choice of litigants, they are more in need of protection than contract creditors under the doctrine of strict liability.<sup>15</sup>

9 სჯს, №სს-1158-1104-2014; სჯს №სს-1307-1245-2014.

10 It should be noted that in some cases, judicial practice has fulfilled the function of a direct source of law.

11 Burduli, Makharoblishvili, Tokhadze, Zubitashvili, Aladashvili, Maghadze, Eganatashvili, Corporate Law, 2021, 226.

12 Burduli, Makharoblishvili, Tokhadze, Zubitashvili, Aladashvili, Maghadze, Eganatashvili, Corporate Law, 2021, 224.

13 Zubitashvili, Liability of the partner for the obligations of the corporation during the insolvency of an entity - exceptional cases from the principle of limitation of liability, 2016, 59.

14 This approach is supported by the fact that in the modern world there are many mechanisms to establish the reliability of the counterparty, starting with company ratings and ending with registers. In Georgia, where many state services are digitized and easily accessible (real estate register, debtor register, etc.). In addition, in modern business relations, large commercial actors use the NYC - “know your client” mechanism, which involves checking the client, and due diligence is conducted before large transactions. These mechanisms allow to assess the reliability of the counterparty. Accordingly, permeating liability does not protect the creditor who, before entering into the contractual relationship, had information about the state of the entity or who had the opportunity to seek information, but did not use the available opportunity and entered into the contractual relationship knowingly, on the basis of free will.

15 Zubitashvili, Liability of the partner for the obligations of the corporation during the insolvency of an entity - exceptional cases from the principle of limitation of liability, 2016, 49

In the doctrine of strict liability, several prerequisites of liability can be distinguished:

#### **a) control**

The intervention of the partner in the activity of an entity, which goes beyond the scope established by the law and the statute, is considered as an abuse of the form of limitation of liability. In other words, abuse is considered to be interference in the activities, which violates the independence of the entity and aims to use it for personal gain.

The issue of control is especially problematic in a one-person entity, where power is completely in the hands of one partner. In such a situation, the personal responsibility of the partner can be discussed when it is proven that the entity is used as an instrument for personal benefit, harming the creditors.

It should be noted that such a manifestation of control, which did not result in harm, cannot be considered as a sufficient prerequisite for strict liability. Control taken separately does not constitute a criminal offense, nor is it a basis for private liability (unless it results in property damage to the creditor). Thus, the fact of control is the so-called primary Prerequisite<sup>16</sup> to all cases of abuse, but taken separately do not give rise to liability. Along with the control, it is necessary to confirm the following facts:

#### **b) Mixing of property**

The separation of the company and the partner is expressed in the property demarcation, ie when the property of an entity is separated from the property of the partner and vice versa, the property of the partner is separated from the property of the entity. The insecurity of property demarcation, expressed in mixing of property, deprives the creditor of the opportunity to determine with whom he/she has a relationship - the entity. Mixing of property can also constitute a criminal offense.<sup>17</sup>

#### **c) reduction of property**

The case when a partner disposes of entity's property as well as personal property should be mentioned separately. This circumstance may lead to wasting/reduction of entity property by the partner. Peculation may also constitute a criminal offense.<sup>18</sup>

#### **d) improper capitalization**

When we talk about social capital, first of all, we should distinguish between nominal and material capitalization.

Nominal capitalization occurs when the minimum amount of initial capital stipulated by law is present. Material capitalization is present when the financial leverage of the corporation is adequate in relation to specific activities.<sup>19</sup> At the same time, the amount of adequate capital, in terms of fulfilling the function/purpose of capital, cannot be common to all. The amount of adequate capital can be calculated directly taking into account the type and nature of the activity of a specific entity.

16 Burduli, Makharoblishvili, Tokhadze, Zubitashili, Aladashvili, Maghadze, Eganatashvili, Corporate Law, 2021, 226.

17 Criminal Law Code of Georgia, Art. 204.<sup>1</sup>.

18 Criminal Law Code of Georgia, Art. 182.

19 Zubitashvili, Liability of the partner for the obligations of the corporation during the insolvency of an entity - exceptional

**Breaching of corporate formalities.** Business name, legal address, independent bank accounts and accounting books, holding of general meetings, drawing up meeting minutes, properly signing the agreement between the partner and an entity, etc. are considered as corporate formalities.<sup>20</sup>

Ignorance of corporate formalities is the weakest prerequisite for strict liability. Entities cannot be required to observe all formalities, especially in the mode of dispositional regulation. What is important for strict liability is not the failure of the corporate formalities themselves, but whether the motive for misleading the creditor was to avoid the obligation. For example, parent-subsidiary companies use one address, one brand name, have a common director. Due to the manipulation of these formalities by the parent company, the counterparty, in turn, thinks that it is involved in litigation with the parent company, but in the end, it ends up in relation with the subsidiary that is insolvent. Thus, the violation of corporate formalities should be considered as a prerequisite for strict liability, when as a result of this violation, the creditor was misrepresented, failed to identify the counterparty and suffered damages. Such a breach of corporate formalities, taken separately, which did not lead to a negative result for the creditor, does not constitute a prerequisite for strict liability.

## II. Tort liability

The legal basis of tort liability is Article 992 of the Civil Code of Georgia, according to which a person who causes damage to another person by an illegal, intentional or careless act is obliged to compensate him/her for the damage. Thus, the damage resulting from a criminal offense was classically compensated under Article 992, the only exception being 2 precedents of the Supreme Court of Georgia in 2015, according to which the delict was compensated not by the tort norm, but by the corporate legal norm. According to the court's assessment, tax evasion in the disputed litigation was an abuse of the principle of limitation of liability by the controlling partner. It should be noted that in Georgian judicial practice, there has never been a precedent of strict liability in favor of contractual creditors.<sup>21</sup>

Unified practice could not be achieved with the above-mentioned 2015 decisions. As a result of observing the practice of the Supreme Court in recent years, it is clear that in the case of an economic crime, the basis of the partner's private legal responsibility is the use of the delict norm.<sup>22</sup>

On the issue of the relationship between strict and tort liabilities, it should be said that the use of strict liability is justified only in such a situation, when there is no other legal mechanism for the protection of the creditor. Accordingly, when there is a legal basis for compensation of damages to a creditor known to be a victim of a criminal offense in the form of a tort norm, the use of strict liability is unreasonable. The legal basis for the plaintiff does not change the result - the material liability of the partner still arises. Upon proving the proper preconditions for damages, the creditor will recover on a tortious basis in the same way as it would under strict liability. Unlike strict liability, tort liability is much easier to prove for an injured creditor in a criminal case in terms of the burden of proof.

**Conclusion.** We discussed the legal bases of strict and tort liabilities. It is clear that due to the complexity of the burden of proving the legal mechanism of strict liability, tortious liability is a reasonable mechanism for the creditor to compensate for damages resulting from economic crime. At the same time, the exceptional character of strict liability indicates its use only in conditions where no other legal mechanism exists. Accordingly, in cases where it is possible to compensate the creditor's damages by the norm determining tort liability, the principle of strict liability should not be employed.

