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DIRECTORS' LIABILITIES IN SERBIAN LEGISLATION

Abstract: This paper examines corporate directors liabilities and the consequences of different types of liability. In the theoretical framework we will discuss the basic principles of modern corporate governance. The rules of conduct are examined and correlated using normative, dogmatic and sociological methods, since positive laws reflect social values. The legislation in this area will be discussed, touching upon all aspects of legal liability. The aim is to give a comprehensive overview of the rights, duties and liabilities of corporate executives in Serbian law, referencing global contemporary trends. Comparative legal analysis will show the advantages and disadvantages of different solutions and the applicability of certain institutes in Serbian legislation

Key words: liabilities, corporate managers/directors, control, corporate management

1. Introductory remarks

Directors, i.e., the board of directors participates in corporate management bodies, which means that they are in charge of managing corporate operations and represent enterprises in relations with third parties. Their rights and obligations are determined by law and corporate acts (primarily the bylaws). When taking legal actions and drafting legislation, they rely on their expertise, experience, and conscience. The legislation contains rules of conduct which are binding so that managers can be called to account in case of non-compliance. The paper

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will discuss consequences of bad management and highlight the potential protection mechanisms for both executives and corporations, with the emphasis on proper legislation as the safeguard against any loss for all interested parties. Primary stakeholders in the business are owners, management, clients, employees, and regulatory bodies. The secondary interest group consists of creditors, various interest groups, the environment, etc. (Peart & Knowles, 2018, p. 89). In modern theory and practice, the notion that there is a multidimensional purpose to a business has become increasingly common. Beyond the members' interests, there are societal interests that must not be neglected (Radović, 2021, p. 2). Since the turn of the 21st century, we have witnessed more and more instances of corporations behaving unethically in relation to social and environmental issues.[2] This gave rise to the need to harmonize corporate governance and socially responsible business. On the other hand, some scholars believe that taking ethical issues into consideration can have adverse effects on business operations (Zaman, Jain, Samara & Jamali, 2020, pp. 3, 10). Milton Friedman, the author of the Friedman doctrine, used the term social responsibility, questioning the notion that executives have social responsibility. If they do, it means that their actions need not always be in the interests of shareholders (Radović, 2021, p. 39). In some legal systems, a corporation has the nature of a contract, which defies the concept of its social responsibility: if a corporation is merely a contract between an agent (the manager) and a principal (the owner), then the only contractual obligation the manager has is to maximize the owner's wealth (Vasiljević, 2021, p. 54).

Adequate legislation should stimulate executives to work in the corporation's best interest, while adhering to the principles of socially responsible business. In order to achieve this, it is necessary to provide incentives to the management and establish effective control mechanisms. One of the best control mechanisms is the open market, which

[2] For instance, the 2010 Gulf of Mexico oil spill or the Volkswagen emissions scandal, when the United States Environmental Protection Agency (EPA) issued a notice of violation of the Clean Air Act to German automaker Volkswagen Group. See Rashid Zaman, Tanusree Jain, Georges Samara, Dima Jamali, Corporate governance meets social responsibility: Mapping the interface, Business & Society, 61(3), 690–752, 2020.

will drive executives to be as productive as possible in order to avoid being replaced (Jovanović Zattila, 2016, p. 190).

2. Status and Office of the Director in a Company

According to the Companies Act[3] ("the Act"), a company or corporation has one or more directors or executives appointed by the company's assembly. The director's term of office is stipulated in the company's bylaws, the term limit being four years. The director's term can end by termination, dismissal or resignation.

Depending on their position and authority, a manager's office can be of an executive or non-executive variety. The CEO is charged with corporate management and representation. The former refers to internal operations, while representation refers to business outside the company, i.e., concluding deals with third parties. The company may also have representatives who are not directors. On the other hand, directors are not concerned exclusively with the representation of the company, but also with its management (Stefanović, 2013, pp. 379 and 380). The company can set aside funds for the use of professional advice from experts in the relevant field, so that the director may have access to accurate, complete and timely information (Corporate Governance Code, Principle 8). Disclosure and transparency are a prerequisite for conducting business according to the OECD Principles of Corporate Governance. The Act states that non-executive directors supervise the work of executive directors and propose the company's business strategy (Article 390). Non-executive directors must not be company employees or members of the supervisory board.

The role of the supervisory board has become especially prominent with the emergence of corporate governance as a new area of law. Modern corporate governance is defined by transparency, duty of loyalty and management accountability (Đurić, 2021, p. 193). Owing to their office, managers often have the opportunity to act in their own interest, while ignoring the company's interests. The conflicting interests of

[3] Official Gazette of the Republic of Serbia, no. 36/2011, 99/2011, 83/2014 – other law, 5/2015, 44/2018, 95/2018, 91/2019. and 109/2021.

the management and the owners or stockholders lead to the so-called agency problem.[4] One of the solutions to this problem is the market for managers, where managers can be rewarded or punished depending on their success (Đorđević, 2004, pp. 191 and 212). Through proper incentives, both the shareholders' and the CEO's interests can be aligned, and managers can thus be motivated to act in the shareholders' best interests (Jones, Harrison & Phelps, 2018, p. 376).

3. Directors' Liabilities in Serbian Legislation

The director's accountability has two aspects: legal liability and social responsibility (socially responsible business).[5] The aim of this paper is to examine the legal liability of company executives in the Serbian law and view this phenomenon in the context of comparative law. The following sections will discuss different types of legal liability and their consequences.

3.1. Status liability

The board of directors is in a somewhat subordinate position in relation to the company's assembly. Under the governance of a one-tiered board, directors are accountable for strategy, service and control, and are expected to report to the assembly (Article 399). In a two-tiered system, strategy and service are executed by the management board while the control is handled by the supervisory board. Status responsibility can mean that directors can be dismissed by the assembly without

[4] An agency problem is a conflict of interest inherent in any relationship where one party is expected to act in the best interest of another. The manager, acting as the agent for the shareholders, or principals, is supposed to make decisions that will maximize shareholder wealth even though it is in the manager's best interest to maximize their own wealth. Agency problems arise when incentives or motivations present themselves to an agent to not act in the full best interest of a principal.

[5] Corporate Governance Code defines corporate social responsibility as a business model which integrates economic, philantropic, social and environmental topics. Companies make a concerted effort to operate in ways that enhance rather than degrade society and the environment.

giving reasons (Article 395). In case of a lawsuit, if the court decides that there is a violation of the rules on approving business transactions which involve a personal interest of a person or persons (Article 6, paragraph 1, point 4 of the Act), the competent court will impose a temporary one-year ban for the person or persons to hold a director's office. Even though it is a case of damages claim, the imposition of a temporary measure also has status and legal elements.

3.2. Property liability

Given that liabilities arise from duties, we will first discuss the director's duties towards the company. Legal provisions stipulate three universal duties of a director:

a) Duty of care

b) Business judgment

c) Duty of loyalty (Fiduciary duties).

The law explicitly prescribes the duty of care, stating that a good manager is required to use their expertise and experience for the company's benefit. The rule of business judgement assumes that, unless proved otherwise, management is acting in the interests of the corporation and its stakeholders and makes business decisions based on the information and opinions of experts in the relevant field, which they believe are conscientious and competent. The rule assumes that it is unreasonable to expect managers to make optimal decisions all the time. Managers will not be held accountable for losses if they prove that they acted rationally when making decisions and relied on the opinion of experts (Stefanović, 2013, p. 398). The duty of loyalty requires directors to put the interests of the corporation and over their own self-interest or the interests of others (Mihajlović, 2018, p. 2). Personal interests must not be allowed to prevail over the company's interests (International Finance Corporation, 2011, p. 110). Therefore, managers are required to report any real or perceived personal interest in a legal transaction or action[6], to avoid

[6] Article 66 entitled "Approval of a Legal Transaction or Action in Case of Existence of Personal Interest" was ammended in the latest ammendments on the

conflict of interest, to keep business secrets and to respect the rule of non-competition. Content-wise, these provisions are similar to abuse of trust in business transactions (Art. 224a of the Criminal Code). In case of damage, the director is accountable to the company. The statute of limitations for submitting a damages claim is three years from the day the damage occurred.

3.2.1. Claims for damages

A claim for breach of duty to the company can be filed within six months from the day of knowledge of the breach (subjective deadline), and no later than five years from the date of the breach (objective deadline). The plaintiff can be:

- a corporation
- a stakeholder who suffered damage (individual lawsuit)
- a stakeholder or group of stakeholders who file a lawsuit for causing damage on behalf of the corporation (derivative lawsuit).

Lawsuit for damages may be initiated by other entities: employees due to illegal dismissal or other violations of the employment contract; persons outside the company in case of violation of rules in the field of tax law, consumer rights, competition law, etc. In addition to the above, directors may be held accountable in connection with bankruptcy proceedings or takeover proceedings, which fall outside the scope of this paper.

3.3. Criminal liability

The purpose of stipulating criminal offenses in this area is to uphold the fundamental social values by stressing managers' duties towards the corporation and the state. The Criminal Code in Art. 223-245 specifies criminal offences committed against a corporation or other entities. In the Companies Act, the duty of loyalty has a purpose to protect the corporation. In the Criminal Code, it is implicitly present in various

Companies Act.

criminal offences such as abuse of trust, damage to business reputation and creditworthiness, disclosure of business secrets, etc. In the field of business crime, tax evasion and tax frauds present a serious problem. Combatting tax fraud requires consistent use of laws and regulations, as well as institutional reform, including the Tax Administration and the judicial system of Serbia (Dimić & Božić, 2020, p. 6). Examining the commercial and criminal legislation of Serbia, we can conclude that the duties and prohibitions of directors are laid down consistently, even though these regulations protect the interests of various entities.

4. Directors' Liabilities and Corporate Governance: Recent Developments

In recent decades, establishing good corporate governance practices has become a priority. Good corporate governance largely depends on the board of directors who manage the corporation. Corporate governance enables the company to conduct business efficiently and protect owners and other parties that have legitimate interests in the company (the Stakeholders Model). Making wrong decisions can result in all sorts of costs for the company (Carberry, Engelen, & Essen, 2018, p. 123). Directors and officers (D&O) liability insurance is insurance coverage intended to cover damages incurred by the actions of a director acting in good faith, but only in the case of negligence. The purpose of liability insurance is linked to the purpose of the liability regime (Vasiljević & Tomić, 2020, p. 31). Liability insurance can also cover the legal fees and other costs the organization may incur as a result of a lawsuit if the director acted in good faith, in accordance with the law and in the best interest of the company (International Finance Corporation, 2011, p. 115). Liability insurance protects directors and officers acting in good faith; however, this protection must be applied rationally, so that the problem of moral hazard does not arise (Parchomovsky & Siegelman, 2021, p.5).

Contemporary legislation related to corporate governance tends to expand the scope of duties of directors and officers. In the 2020 Resolution on Sustainable Development, the European Parliament stresses the importance of strengthening the role of directors in achieving long-

term interests and the need to establish a balance between short-term and long-term goals, taking into account the principles of sustainable corporate governance. In 2020, the European Commission announced the intention to impose a general duty on the business community to address adverse human rights and environmental impacts, rather than providing general governance rules (Allen & Overy LLP, 2022). The European Commission states that the absence of uniform national rules on directors' duty of care slows down the adoption of good practice. Upon ratifying the Proposed Directive (Proposed Directive on Corporate Sustainability Due Diligence and Annex) issued on February 23, 2022, the member states will introduce new rules within two years and report to the Commission. (European Commission, Publication Office, 2020). The increase in litigation against companies for their activities that violate human rights is of relevance to directors' duties. There have been cases brought in France, Germany, the Netherlands and the UK against companies, often for actions where there have been human rights or environmental impacts (McCorquodale & Neely, 2021, p. 22). Breach of due diligence by directors can lead to derivative claims, on the grounds that the company has suffered damage due to their negligence. In the US, an action was brought against a company's directors for breach of director's duty to create an environment which respects human rights. This lawsuit ultimately led to reforms in the field of corporate governance (McCorquodale & Neely, 2021, p. 22). Lawsuits against directors for human rights abuses can include criminal charges. For example, in France, the directors of a corporation have been charged with complicity in war crimes and crimes against humanity due to their actions in signing commercial agreements with the Islamic armed group (ISIS) in Syria (Trial International, Geneva, 2022). A trial has commenced in Italy against a CEO for international corruption allegedly committed in Nigeria. We can conclude that these situations of liability are not recognised by the EU regulations at the moment, although judicial practice indicaters that directors should be aware of the potential adverse consequences of ignoring human rights risks when considering the best interests of the company (McCorquodale & Neely, 2021, p. 22).

Recent changes in corporate governance regulations are to some extent the result of the globalization process, which includes harmo-

nisation and unification across jurisdictions. However, the purpose of these changes remains questionable. Any legislation by necessity reflects social values and the degree of development of corporate culture. Consequently, the selective implementation of international legislation may lead to inconsistencies in the regulation of the director's duties and liabilities. The provisions on the liability of directors in company law must be in accordance with the legal system as a whole so that legal certainty is preserved. For example, a derivative claim is a legal transplant which has not been adequately implemented yet. The effectiveness of a derivative action is evaluated based on two criteria: (1) practical application and (2) results or outcomes of such actions. Research has shown that the derivative action is ineffective on both accounts (Mihailović, 2020, pp. 298–299). However, sometimes combining management models is inevitable, as in the case of affiliated and transnational companies where the issues of control and liability become even more complex. Company law and legislation must be seen in a broader international and social context, not from the viewpoint of only one jurisdiction or national legislation. The general harmonization of regulations between states boosts international trade and prevents conflict of jurisdictions (Ljutić, 2013, p. 21).

5. Conclusion

Due to the changes in corporate governance on the global level, the position of the company's director or board of directors is also changing. Newly introduced provisions, especially if they are taken from comparative law, must be precise and applicable. Both directors' behaviour and company's success are largely the outcomes of (in)adequate legislation.

In recent years, there has been a tendency of expanding the scope of directors' duties. Their duties towards the company and other entities must be compliant with the law, the company bylaws, and the corporate governance code (although it has the force of recommendations). The EU accession process includes the harmonization with the EU law, so the developments in the EU jurisdiction and legislation must be taken into consideration.

The 2021 Amendments to the Companies Act revised the concept of directors' liability, specifically the director's duty to report affairs and actions in which there is a personal interest. This duty, apart from specifying certain provisions (e.g., prescribing the content of the notification), essentially remains unchanged. In the end, we can conclude that there is room in Serbian legislation would benefit from adopting new acts and correcting inconsistencies in this area.

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