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Jelena Perović
University of Belgrade
Faculty of Economics
Department of International
Economic Relations

Ljubica Tomić
TSG Tomic Sindjelic Groza Law Office
Belgrade

DIRECTOR'S LIABILITY FOR DAMAGE HE CAUSES TO THE COMPANY*

Odgovornost direktora za štetu koju prouzrokuje društvu

Abstract

This paper presents the fundamental issues in Serbian law and business practice raised in the context of liability of the director for damage he may cause to the company. The paper thus analyses the rules of the Companies Law establishing specific duties directors owe to the company – duty of care in performing the operations on the one hand and a set of duties that are considered duties of loyalty to the company on the other. In an effort to provide a comprehensive picture of issues which the responsibility of directors may raise, the said rules are analysed both in terms of the specific rules of the Companies Law and in terms of general rules and basic principles of the Law on Obligations and other relevant laws in this area.

Key words: *director, liability, company, damage, indemnification, duty, care*

Sažetak

Predmet rada predstavljaju osnovna pitanja koja se u srpskom pravu i poslovnoj praksi postavljaju u kontekstu odgovornosti direktora za štetu koju prouzrokuje društvu. U tom smislu, u radu su analizirana pravila Zakona o privrednim društvima kojima se utvrđuju posebne dužnosti direktora prema društvu – dužnost pažnje u izvršavanju poslova s jedne strane i skup dužnosti koje se smatraju dužnostima lojalnosti prema društvu s druge strane. U nastojanju pružanja celovite slike o pitanjima koja odgovornost direktora može pokrenuti, pomenuta pravila su analizirana kako sa aspekta konkretnih pravila Zakona o privrednim društvima tako i sa aspekta opštih pravila i osnovnih načela obligacionog prava, kao i drugih zakona relevantnih u ovoj oblasti.

Ključne reči: *direktor, odgovornost, društvo, šteta, naknada štete, dužnost, pažnja*

General introduction

In Serbian law, the general rules governing the liability for damage are contained in the Law on Obligations, which first and foremost proclaims the principle of prohibition of causing damage, and goes on to establish the grounds for liability for damage (liability on the ground of fault, liability for another, liability for loss or injury caused by dangerous objects or dangerous activity, special cases of liability), as well as indemnification, in respect of which it embraces the principle of complete recovery, whereby the injured party is entitled both to compensation for actual damage and to compensation for lost profit.

On the other hand, director's liability for damage he causes to the company is provided separately in the Company Law [2], under the section entitled "Special Duties Owed to Company", comprising three groups of rules relevant to this issue.[1] In the first place, the Law defines the persons owing special duties to the company

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1 Art. 61 – Art. 80, Company Law

[17, p. 141ff.]: partners and general partners; shareholders with a significant holding in the share capital of the company (over 25% of voting rights held either independently or acting in concert with other persons) or controlling shareholders[2]; directors, supervisory board members, representatives and procurators; liquidator, as well as other persons identified in the Memorandum of Association or Articles of Association as persons owing special duties to the company.[3] Furthermore, the Law defines each of the special duties such persons owe to the company – duty of care in carrying out their tasks on the one hand, and on the other, a set of duties considered as duties of loyalty to the company: 1) duty to disclose personal interest; 2) duty to avoid conflict of interest; 3) duty of confidentiality and 4) duty of non-competition. Finally, the Law provides for the rules on filing lawsuits for breach of special duties. The provisions relating to director's liabilities are seen as a strategy towards addressing the so-called *first agency problem, i.e. addressing the conflict between the shareholders and managers* [13, pp. 239-251].

This paper aims to present an analysis of each of the above special duties owed by the director to the company, in terms of their concept, contents and liabilities in case of their breach.

Duty of care

The Law on Obligations adopts the concept of uniform regulation of relations arising from transactions in goods and services, regardless of the status of the parties to such transactions (principle of uniform regulation of obligation relations).[4] This means that the Law provides for the rules that, in principle, apply equally both to the civil-law contracts and to the contracts concluded by business entities engaged in performing business activities – commercial contracts.[5] However, assuming that businessmen are professionals with relevant knowledge and skills in the sphere of business, the Law on Obligations, in certain cases, envisages special rules for commercial contracts, suited to the requirements and specific nature of this type of contractual relations. In comparison with the general rules applicable to civil-law contracts, the rules governing commercial contracts entail greater liability, shorter deadlines and stricter remedies.[6]

As regards the liability for performance, the Law provides that a party to an obligation relation is bound to act with the care which is required in legal transactions in a given type of obligation relations (care of a prudent businessman, or care of *bonus pater familias*).[7] In this way, the Law, whilst defining the general rule of conduct in performance of duties, establishes different standards, depending on the type of the specific obligation relation. These standards imply a lesser or higher level of care as the criterion for liability of the obligor who, in performance of his duties, failed to implement the care required of him in the given type of contractual relation.[8] In each case, the care is evaluated based on the type of person who acts normally with respect to his abilities, knowledge and skills, whilst also taking into account what is typically expected from such person in a specific type of contractual relations. The Law has established *objective* care as the standard, which means that the individual properties of contractual parties are not deemed to be of significance.

In this regard, the parties to civil-law contracts are required, in performing their contractual obligations, to act with the care of a *bonus pater familias* (*reasonable person*). The care of a reasonable person implies a person who acts reasonably and with due care in performing his tasks, managing property and fulfilling his obligations towards other persons. On the other hand, when an obligation relation stems from business activities of the parties to legal transactions, they are required to act with the care of a *prudent businessman*, *i.e.* the care required in business transactions. In addition to the standard care of a reasonable person and a prudent businessman, the Law also provides for the care of a *prudent expert*, which implies stricter, expert and professional care in performance of contractual obligations. Under the Law, a party to an

2 Art. 61, Para. 2-3, Company Law

3 Art. 61, Company Law

4 For more details see [10]

5 Art. 25, Para. 2, Law on Obligations

6 For more details see [7, p. 221ff.]

7 Art. 18, Law on Obligations

8 Please note that the standards apply to all obligation relations, not only to the contractual relations.

obligation relation is required to act with greater care in performance of tasks which fall within the domain of his vocation, in accordance with the rules and practices of profession (the care of a prudent expert).[9] This is a special professional care, required of professionals pursuing a certain line of business. The assessment of this type of care is based above all on the rules of a given profession and fair business practices which are employed in a given professional field, and applicable in performance of a given professional activity.[10]

From the standpoint of general rules of the Law on Obligations, the above rules pertaining to due care bear special relevance for deciding the issue of liability for failure to perform a contractual obligation. In this context, it is important to distinguish between the obligations pertaining to results and the obligations pertaining to means.[11]

The obligations pertaining to results (*obligations de résultat*) are the obligations whose fulfilment implies attainment of a specific goal in respect of which the obligation was created. In this type of obligations, the obligor is deemed to have fulfilled his duties only when specific results, on account of which the obligee entered the obligation relation, have been achieved. To the contrary, if the obligor fails to achieve such results in the course of his performance, he is deemed to have failed to fulfil his obligation, which results in implementation, by the obligee, of legal instruments envisaged in case of breach of obligation (in case of contracts – request for contract performance and contract cancellation), as well as the obligation to compensate the obligee for the damage. Most obligations fall within the group of obligations pertaining to results. Unlike the obligations pertaining to results, the obligations pertaining to means (*obligations de moyens*) are the obligations whose fulfilment does not necessarily imply attainment of the end result in respect of which the obligation was created. In this type of obligation, the obligor is deemed to have fulfilled its obligations if he has undertaken the promised action with due care, regardless of whether or not the results implied in the obligation have been achieved, as far as the obligee is concerned (*e.g.* obligation on part of an intermediary to endeavour to find and connect with the principal a person with whom the principal can conclude a contract, obligation on part of a distributor to make his best efforts to improve the sale of goods of a certain manufacturer, etc). In performing his duties, the obligor is bound to act in good faith and with the care required by certain standards, however, he will not be held liable for damage if the action undertaken on behalf of the obligee has not produced the expected results. For these reasons, the contracts in modern business transactions[12] often contain clauses binding a party to make its best efforts, reasonable care, due diligence in order to perform the contractual obligation.[13] The key criterion in assessing whether or not the obligor has met the contractual obligation is precisely the assessment of the standard of due care, made by the court in each individual case in the light of all circumstances relevant to the given case.

The above distinction between different types of obligations is of vast practical importance. In case of obligations pertaining to results, the obligee does not need to prove the obligor's fault in order to be entitled to damages; he has only to demonstrate that the contractual result has not been achieved by the other party. To the contrary, in case of obligations pertaining to means, the obligee must prove the obligor's fault in order to be entitled to damages; *i.e.* he must prove that the obligor, in a given case, failed to act with due care.[14]

The type of care required of parties to an obligation relation is also important for assessing the degree of fault within the context of subjective liability for the damage caused. The subjective liability[15] is the liability for injury or loss based on the tortfeasor's *fault*. Law on Obligations provides that whoever causes injury or loss to another shall be liable to indemnify it, unless he can prove that the

9 Art. 18, Para. 2, Law on Obligations

10 For more details see comments to Art. 18, Law on Obligations in [11, pp. 43-46]

11 For more details on this classification see [8, p. 90ff.]

12 For more details on modern commercial contracts not regulated by the Law on Obligations see [6, pp.149-167].

13 For more details on these clauses in international commercial contracts see [3, pp. 211-252].

14 For more details see [7, p. 1293ff.]

15 See decision of the Commercial Appellate Court, Pz 1253/2010 (2) dated 22 Apr 2010

damage was caused through no fault of his own.[16] In this way, the Law has provided for a refutable assumption of fault in the area of non-contractual liability for damage, which means that the injured party does not have to prove the tortfeasor's fault, rather the burden of proof rests with the tortfeasor, who has to prove that the damage was caused through no fault of his own. Under the Law on Obligations, fault exists when the tortfeasor has caused injury or loss intentionally or through negligence (gross negligence and ordinary negligence).[17]

Intent (wilfulness), as the most serious degree of fault, exits in cases when the damage was caused intentionally, *i.e.* when the tortfeasor had the intention to cause injury or loss to another and, in general terms, when he acted in a way he was aware would harm another person.[18] In determining the existence of intent, the court applies the subjective criterion, establishing the tortfeasor's individual attributes and circumstances in each given case (*in concreto* assessment). On the other hand, *gross negligence* (*culpa lata*) exists when someone acts with utter negligence and carelessness, disregarding the basic requirements of care and prudence normally expected of a person. In other words, a grossly negligent person is one behaving with wanton recklessness and negligence, dismissing even elementary caution in his acts. In terms of liability for damage, gross negligence equals intent. The liability for intent or gross negligence may not be precluded in advance under a contract.[19] These types of fault are also provided in the Law on Obligations under the section defining the liability of legal entities for the damage caused by their officers or bodies, stipulating that a legal entity is liable for the damage its officers or bodies have caused to a third person in performing or in connection to performing their functions; in which case the legal entity is entitled to recover against the person being at fault for injury or loss inflicted wilfully or through gross negligence.[20] Finally, *common negligence* (*culpa levis*), as a less serious level of negligence, exists with the responsible person, in causing injury or loss, neglected the care of a particularly careful, prudent person. This type of negligence includes behaviour that is not permissible to *bonus pater familias*, prudent businessman or prudent expert. The liability for ordinary negligence may as a rule be excluded under the contract, however, at the request of an interested contracting party, the court may annul the contractual provision on the exemption of this type of liability, where such provision arises from the monopoly position of the obligor or, generally, from unequal positions of the parties.[21]

The general rules of the Law on Obligations concerning the care required of the parties to an obligation relation are also defined in more detail in the area of company law, in the form of rules concerning special duties owed to the company.

Under the Company Law, a director[22] has the duty to carry out his tasks in good faith, with the care of a prudent businessman and in a reasonable belief that he is acting in the best interest of the company. The care of a prudent businessman implies the level of care which a reasonably careful person would use if they had the knowledge, skills and experience that might reasonably be expected of a person performing particular functions in a company. If the director has certain specific knowledge, skills or experience, such knowledge, skills and experience are also taken into account when evaluating the level of care. It is deemed that the director may also base his actions on the information and opinions provided by persons specialised in relevant areas, which he reasonably believes to have been given in good faith in a particular case. A director who proves that he has acted in accordance with these provisions of the Law may not be liable for any damage such conduct may have caused the company.[23]

Several inferences may be drawn from the foregoing rules of the Company Law.

16 Art. 154, Para. 1, Law on Obligations

17 Art. 158, Law on Obligations

18 For more details see comments to Art 158, in [11, p. 368ff.]

19 Art. 265, Para. 1, Law on Obligations

20 Art. 172, Law on Obligations

21 Art. 265, Para. 2, Law on Obligations

22 Although this paper, for reasons of clarity, uses only the term "director", it should be born in mind that reference to a director in this regard also means reference to other persons owing special duties to the company under Art. 61, Para. 1, Items 4 and 5, Company Law – members of supervisory board, representatives, procurators and liquidators.

23 Art. 63, Company Law

In the first place, the provisions defining the duty of care indicate that the Law has adopted the *care of a prudent businessman* as the general standard for assessing the care of a director [19, p. 131]. Also, the Law has further defined this type of care by specifying that this is the care that would be exercised by "a reasonably careful person if they had the knowledge, skills and experience that might reasonably be expected of a person performing particular functions in a company".[24] Inferring from certain aspects of the doctrine, the criterion for assessing this type of care is the manner in which an independent manager of a company would act, aware of his duties, who is not running his own business, but other people's assets and who has been entrusted with care for other people's property interests [1, p. 497]. The least required standard of conduct is that of a normally prudent businessman, and the director who fails to observe this minimum in his work cannot be exculpated [1, p. 497]. The assessment of this type of care is made *in abstracto*, which means that the characteristics and attributes of a particular director are not taken into account, and the applicable standard is that of *objective care, i.e.* what is usually expected of such person in the relevant area of business transactions.[25]

In addition to the care of prudent businessman as the standard for evaluating the care of director, the Law, by way of an exception, also provides for the *care of a prudent expert*. In cases when director has certain specific knowledge, skills or experience, such knowledge, skills and experience are also taken into account in evaluating the level of care.[26] This means that a director who has specific knowledge, skills or experience, is *obligated* to apply them. In this way, the Law has provided for a stricter, greater liability of a director who is at the same time an expert in the relevant field.

On the other hand, when director is not an expert in the field relevant to company operations, *i.e.* when he does not have the required knowledge and experience in the field relevant for taking a particular decision, he may hire appropriate experts, such as auditors, investment advisors, legal consultants, accountants, etc. Under such circumstances, the director is required to "reasonably believe that such persons have acted in good faith in a given case".[27] It is necessary to implement appropriate care in the selection of an expert, because otherwise, the issue of director's liability for the wrong choice could be raised (*culpa in eligendo*). Furthermore, in order to determine that in reaching his decision, a director acted "in good faith, with the care of a prudent businessman and in a reasonable belief that he is acting in the best interest of the company", the following questions need to be answered: 1) what information was required in the given case for reaching the decision; 2) to what extent such information needed to be acquired (elementary information about a certain issue, expert opinion, research, relevant analysis, etc); 3) at what time it needed to be acquired (*e.g.* can director base his decision on an opinion submitted by a consultant one year before the decision is taken[28]). It seems that these and similar questions need to be addressed in the light of relevant circumstances of each particular case, whilst the court would be guided by the general principles of the Law on Obligations, as well as the rules of the Company Law bearing relevance to the issue of director's liability.

A director who has breached the duty of due care is liable for damages. It is a subjective liability, based on the assumption of fault under the above discussed general rules of the Law on Obligations. In terms of classification of obligations into the obligations pertaining to results and

24 Art. 63, Para. 1 and 2, Company Law

25 The general rule about the implementation of standards of objective care, in the context of rules pertaining to the duties of a company director, may seem somewhat relativised, given that in some cases, the assessment of care requires taking his personal attributes and qualifications into account. This derives from the very provisions of the Law concerning the duty of care, which draw a distinction between a case where the director is an expert (Art 63 Para 3) and the case where he does not have the required knowledge of the relevant field of business, (Art 63, Para 4). Furthermore, personal attributes must be taken into account within the context of general rules of the Law on Obligations concerning the grading of fault from intent, gross negligence to ordinary negligence, given that the tortfeasor's individual attributes and circumstances are, as a rule, determined in each particular case when the existence of intent and gross negligence is evaluated [18, p.10].

26 Art. 63, Para 3, Company Law

27 Art. 63, Para 4, Company Law

28 See Decision of the Higher Court of the Republic of Slovenia: VSL Judgement I Cpg 510/2010 dated 16 Sep 2010, whereby director is bound to pay damages to the company (bank) in the amount of EUR 2,519,224.00 because he had granted a loan to an insolvent company. The court took the position that "by invoking the opinion of M.P. /the expert/... the accused may not be released of its liability also because such opinion was compiled more than two years prior to conclusion of the first draft loan agreement..."

those pertaining to means, director's duty of care may be qualified as the obligation pertaining to means [16, p. 131]. In other words, the director, in the very nature of things, cannot *guarantee* achievement of success in the work he is undertaking; he is required, whilst acting on behalf of the company, to use his *best efforts* to achieve particular result, which in this case means that he has to act with the care of a prudent businessman, in good faith and in a reasonable belief that he is acting with the company's best interest in mind. Under the Company Law, the burden of proof rests with the director, and not with the company which has suffered damage. The director who proves that he has acted in compliance with Article 63 of this Law is released from the liability for damage.[29]

Once requirements for the existence of liability for damage are met, the injured party becomes entitled to damages. In general terms, damages consist of certain payment or actions which seek to remove the consequences of the loss the injured party has suffered, made at the expense of the person who had caused the loss. The purpose of such compensation is to restore the injured party to that position in which he or she would have been had the harmful event not occurred.[30] This means that damages must be equivalent to the loss suffered [14, p. 269]. The damages available to a company for the loss caused through operations of the director are generally governed by the rules of the Law on Obligations concerning the indemnity for damage to property,[31] with the exception of those issues that are specifically provided in the Company Law.

With regard to the manner of indemnification of damage to property, the Law on Obligations provides for restitution to the previous condition and pecuniary compensation. Under the basic rules of the Law, the responsible person must restore the conditions existing prior to occurrence of damage. This allows for the principle of restoration in kind, which entails individual restitution (*e.g.* return of items unlawfully seized from the inured party), repair of the damaged item, as well as generic restitution performed by giving items of the same kind, quality and quantity as the items to be compensated. The choice of the method of indemnification will depend on the circumstances of each particular case, claims by the injured party and assessment of the court. However, compensation in kind is neither the only nor the primary method of indemnification; compensation will always be in cash when the injured party so demands, except where the circumstances of the particular case should justify restoration to the previous condition. Finally, a combination of the compensation in kind and pecuniary compensation is also possible, in cases where restoration to the previous condition does not remove the damage in full [7, p. 330ff.]. When the injured party is a company, the damage often consists of the loss of a certain pecuniary amount, and recovery of such amount is, as a rule, requested by way of indemnification. Exceptionally, where the damage consists of seizing, destroying or damaging an item, the company may claim individual or generic restitution, depending on the circumstances of the particular case.[32]

As regards the scope of damages, the Law on Obligations provides that the injured party is entitled both to indemnity for actual damage and compensation for lost profit. The Law thus adopts the principle of full (integral) recovery, whereby recovery should equal the total damage caused. This principle is explicitly provided in the clause of the Law stipulating that the court, whilst also taking into account the circumstances after the occurrence of damage, shall determine damages in the amount necessary to restore the material state of the injured party into the condition it would have been had not the damaging act or omission occurred. The Law does not draw a distinction between the actual damage and lost profit depending on whether the tortfeasor caused the damage intentionally or through negligence.[33] By adopting the principle of integral recovery, the Law lays down the rule that the

29 Art. 63, Para. 5, Company Law

30 This is non-contractual liability for damage. To the contrary, the purpose of damages available for breach of contract is to place the claimant in the same position as if the contract had been fully performed. For more details about the differences between contractual and tortious liability, see [7, p. 330ff.]

31 Indemnity for damage to property is governed under Articles 185-198 of the Law on Obligations

32 For more details on indemnification of a company see [20, p. 121ff.]

33 In this regard, the position suggesting that so long as damage did not occur as a consequence of director's personal gain, the company is in principle entitled only to compensation of actual damage, however not lost profit, is contrary to the general principles of the Law on Obligations. This position is held by a number of international theoreticians, and is present in one decision rendered by domestic courts. For more details see [20, p. 55ff.]

injured party should be awarded full, complete recovery, regardless of the level of fault. In that regard, the level of fault involved in the tortfeasor's causing damage is quite irrelevant to the injured party; what matters to him is that the indemnification should fully cover the loss suffered as a result of the damage, *i.e.* that indemnification should equal the value of the damage caused [9].

However, the level of fault is not entirely irrelevant in this matter. Thus, the Law provides that the court may, whilst taking into account the material situation of the injured party, order the responsible person to pay an indemnity which is lower than the amount of the damage, provided that such damage was caused neither wilfully nor through gross negligence, where the responsible person is in straightened circumstances, so that the payment of full indemnity would reduce him to poverty. Furthermore, if the tortfeasor has caused damage whilst acting in the interest of the injured party, the court may order a lower indemnity, taking into account the degree of care the tortfeasor applies in his own affairs. Finally, in certain cases, the amount of indemnity may be affected by the injured party's conduct. In such cases, the liability is divided between the injured party and the tortfeasor. Under the Law, the injured party who has contributed to the occurrence of loss, or to loss being heavier than otherwise, is entitled only to a proportionally reduced indemnity. Where it is impossible to establish which part of loss arises from actions of the injured party, the court awards the indemnity taking into account the circumstances of the case.[34]

Compensation for damage becomes due from the moment the damage takes place, and the amount of compensation is determined according to the prices applicable at the time of the court decision. This rule applies both to indemnity for actual damage and compensation for lost profit. In assessing the lost profit, account is taken of the profit that was reasonably to be expected, based on the normal course of things or particular circumstances, but failed to be generated through the tortfeasor's acts or omissions. In determining the amount of damages based on the prices applicable at the time of the court decision, it is irrelevant whether such prices are higher or lower than those applicable at the time of the damage, and the reference to prices implies the current, everyday prices.[35] The arguments in favour of setting the time of court decision as one relevant for determining the amount of damages, underline that it offers the greatest guarantees for full compensation of damage, in view of frequent monetary changes resulting in reductions or increases of prices in the market [10, p. 52].

Finally, it is necessary to bear in mind that the Company Law provides for special deadlines for filing claims for damages on part of a company against the director who has breached the duty of care. In that regard, the provisions of the Company Law differ significantly from the general rules of the Law on Obligations on the statute of limitations for claiming damages.[36] Under the Company Law, such claim may be filed within six months of becoming aware of the breach, however not later than five years upon the actual occurrence of such breach.[37]

Duty to disclose personal interest

Legal actions and transactions where the company and its director appear concurrently as parties constitute business situations which require a set of legal rules of conduct for directors, to ensure that directors act in the interest of the company, rather than in their own personal interest.

The Company Law provides a broad definition of (direct and indirect) personal interest of the director, *i.e.* defines situations which involve the legal assumption of existence of director's personal interest.[38] The Law recognises *direct* personal interest of the director in cases of: 1. transactions between the company and the director; 2. transactions between the company and a person affiliated with the director[39]; 3. actions taken by the company in relation to the

34 For more details on these rules from the standpoint of a company as the injured party see [20, pp. 122-124]

35 See comments to Art. 189 in [11, p. 438]

36 Art. 376, Law on Obligations

37 Art. 77, Company Law

38 Art. 65, Para. 3, Company Law

39 Persons affiliated with the director include: blood relatives in direct line and in lateral line up to the third degree of kinship; spouse or *de facto* partner of such persons; director's spouse or *de facto* partner and their blood relatives up to the first degree of kinship; adoptive parents or children of the director, as well as descendants of adoptive children; all persons sharing the household with the director; legal entity in which the director holds material interest or is a controlling member; legal entity in which the director is a member of a management or supervisory body, Art 62.1.2 of the Company Law.

director or a person affiliated with the director (*e.g.* filing or withdrawing a lawsuit against the director, waiver of a right enjoyed by the company, etc). The director's *indirect* personal interest is deemed to exist in cases when the company enters into a transaction or takes action (a) in relation to a third party who has a financial relationship with the director (or a person affiliated with the director) and such relationship can reasonably be expected to affect the director's actions, or (b) which would bring financial gain to a third party, if such third party has a financial relationship with the director (or a person affiliated with the director), which can reasonably be expected to affect the director's actions.

In case of existence of (direct or indirect) personal interest, the director has the duty to notify such interest to the competent body of the company[40]. In compiling this notification, the director has to include a detailed description of the transaction (or action) undertaken and state the nature and extent of personal interest.[41] It is based on this notification that an approval of the transaction or action is granted. In limited liability companies, such decision is taken by the General Meeting by a simple majority of all shareholders, or by the Supervisory Board (in two-tier management systems). In joint-stock companies, if the director has a personal interest, the authorisation is granted by a majority of votes of all disinterested (non-executive) directors[42] or by the Supervisory Board (in two-tier management systems). When the authorisation is not granted by the General Meeting, it needs to be notified thereof and provided with a detailed description of the transaction (or action) and the nature of personal interest, at the first succeeding session.[43]

If transaction/action involving director's personal interest is not authorised, or if the authorisation was granted based on false or incomplete information, the company may file a lawsuit for annulment of such transaction[44] and indemnification against the director. Such action may be brought within six months of becoming aware of the breach, however not later than five years upon the actual occurrence of such breach. One or more shareholders may bring derivative action on behalf of the company, if at the time of filing such action they held shares representing minimum 5% of the company's share capital.[45] On the other hand, if the director can demonstrate that the transaction/action was in the interest of the company, or that no personal interest existed, no breach of rules regarding authorisation of transactions involving personal interest shall be deemed to have occurred[46]. If a third party (who was party to a transaction indirectly involving director's personal interest) was not aware and did not have to be aware of the existence of personal interest at the time of entering into the transaction, such transactions or actions are not annulled, which serves to protect the third parties acting in good faith.[47]

A director who breaches the above rules with the *intent* of causing damage to the company lays himself open to criminal liability.[48]

There are no special provisions in Serbian law governing this matter in respect of public companies,[49] although the Corporate Governance Code [5] explicitly provides for the principle of loyalty in this context, which lays down that members of the Board of Directors appointed by the state

40 Competent bodies are: (i) the Board of Directors or the General Meeting (in case of a company with a sole director) if a company has a one-tier management system, or (ii) the Supervisory Board, in two-tier management systems, Art. 65.1, 65.2 of the Company Law.

41 Art. 66.5, Company Law

42 Recommendation of the European Commission from 2005 about the role of non-executive directors and members of the Supervisory Board indicates that this authorisation ought to be given by independent directors, see [18]

43 Art. 66.4, Company Law

44 In this context see Decision of the High Commercial Court, Pz 2664/2007 dated 2 Apr 2008 – Court Practice of Commercial Courts – Bulletin No. 2/2008

45 Art. 77 and 79, Company Law

46 Art. 68, Company Law

47 Art. 67.3, Company Law

48 The penalties provided by the law include a fine or a prison sentence of up to 1 year, and if the damage incurred by the company exceeds RSD 10 million (ca. EUR 87,000), the breach is punishable by a term of imprisonment of between 6 months and 5 years, and a fine. The court may also impose an injunction barring the offender from holding an office or pursuing a vocation in accordance with the Criminal Code (Art. 582, Company Law).

49 Germany has rich court practice with regard to public companies. Thus, for example, a director of a public utilities company in Germany was held liable for damages and was fired because he had paid training for his employees at a catering company, in case where (i) it was not clear that the training was expedient for the public utility company and (ii) director's *de facto* spouse enjoyed the free use of the pool given to her by that catering company at that time. (Oberlandesgericht Koblenz Urt. v. 11.07.2013, Az.: 6 U 1359/12)

owe their loyalty to all shareholders and the *company*[50], rather than to the state as the shareholder. Thus, several important issues remain open in Serbian law when it comes to public companies such as which body should grant authorisation in case of personal interest of the director of public company (in the light of the aforementioned Corporate Governance Code, it seems that this should be the Supervisory Board, subject to mandatory consent of the independent member of the Supervisory Board[51], but the regulation is not clear).[52] These and other issues of corporate governance in public companies need to be provided in the law in more details, as confirmed by the European Commission's Serbia Progress Report which calls for "improving corporate governance of public companies".[53]

Duty to avoid conflict of interest

The duty of loyalty to the company, in terms of conflict of interest between the director and the company, implies a duty on part of the director to avoid any cases that may involve a conflict between his own interests and those of the company [16, p. 133]. Under the broadly accepted principles of comparative legislation and business practice, direct breaches of the duty to avoid conflict of interest include [16, pp. 135-136]: 1) personal use of corporate opportunities; 2) appropriation of company assets in broad sense of the word; 3) obtaining benefits from third persons from company related transactions; 4) breach of prohibition of unjust enrichment; 5) use of privileged information; 6) abuse of position in the company.

With this in mind, the Company Law provides explicit rules concerning the duty to avoid conflict of interest, envisaging that the director may not in his own interest or in the interest of persons affiliated to him[54]: (i) use company's assets; (ii) use any information he may have obtained in the capacity of the director, insofar as such information is not otherwise publicly available; (iii) abuse his position within the company; (iv) personally use opportunities for entering into transactions that arise for the company.[55]

In case of a breach of this duty, the director is liable for damages, and the company may claim transfer of benefits gained by the director.[56] Furthermore, it is irrelevant whether or not the company actually had the opportunity to use the assets or information or to enter into the transactions used by the director to his personal benefit. The claim for indemnification and transfer of benefits may be filed within six months of becoming aware of the breach, however not later than five years upon the actual occurrence of such breach.[57] One or more shareholders may bring derivative action on behalf of the company, if at the time of filing such action they held shares representing minimum 5% of the company's share capital. However, the director may be released of his liability if he can obtain prior or subsequent approval[58] from the competent body[59].

A director who breaches the duty to avoid conflict of interest with the intent of obtaining financial gain for himself or another person is subject to criminal liability.[60]

The Serbian law offers no special provisions governing this matter in respect of public companies, thus it remains an open issue how the above rules concerning the approvals related to the conflict of interest issues may apply to the directors of public companies.

50 Principle 4, Recommendation 2 of *Kodeks korporativnog upravljanja* [5]

51 Law on Public Companies provides that there has to be an independent member on the Supervisory Board of a public company (Art. 13)

52 A number of other legal systems have special codices related to corporate governance in public companies (Austria, Switzerland, Germany)

53 European Commission Serbia Progress Report, October 2014, p. 4

54 See definition of *affiliated persons* in [7, p. 221ff.]

55 Art. 69, Company Law

56 For more details on this solution in Serbian law see reference [18] and [16, pp. 133-136]

57 Art. 77, Company Law

58 Art 70, Company Law

59 This is the same competent body which grants the approvals related to personal interest, see footnote 39 and footnote 40

60 The penalties provided by the law include a fine or a prison sentence of up to 1 year, and if the damage incurred by the company exceeds 10 million RSD (ca. EUR 87,000), the breach is punishable by a term of imprisonment of between 6 months and 5 years, and a fine. The court may also impose an injunction barring the offender from holding an office or pursuing a vocation in accordance with the Criminal Code (Art. 583, Company Law)

Duty of confidentiality

In business practice, the duty of confidentiality is usually provided under a_contract, in confidentiality clause, whereby one or both parties to the contract undertake to keep confidential the information and data they have acquired through conclusion and execution of the contract, as well as in connection with the contract. Confidentiality clause has become not only common, but also a standard clause in contracts in business transactions. However, several issues are raised in the context of this clause, the most significant of which relate to: 1) defining the scope of the duty of confidentiality, 2) defining the duration of the duty of confidentiality, and 3) defining the sanctions in case of breach of the duty of confidentiality.

As regards the scope of the duty of confidentiality, the parties usually opt for a system defining in general terms the information deemed as confidential (*e.g.* "all commercial and technical information in relation to this Contract or in relation to the clients, business or affairs of the other Party"), whilst identifying the information which is *not subject* to confidentiality ("this restriction shall not apply to any information that is publicly available or required to be disclosed according to any law or regulation or binding regulation or judgement, order or requirement of any court or other competent authority") [4].

The period of observing the duty of confidentiality is usually determined in the contract, in accordance with specific needs and interests of the parties. It may be limited in time ("until five years after X shall have completed the work provided for in article 9 of this Contract", "until four years after the start of commercial use of the Project", etc) or provisions can be made for the duty of confidentiality to apply indefinitely ("I shall not disclose any Confidential Information, both during my employment with the Company and at any time thereafter", "X shall, at all times during and after expiry or termination of this Agreement, keep secret and confidential...").[61]

In view of the general rules of the law on obligations concerning indemnification, the parties rarely make specific contractual provisions for sanctions in case of breach of the duty of confidentiality. Thus, some confidentiality clauses do not provide for any sanctions, some contain only a general definition of the existence of liability in case of breach of the confidentiality duty ("it is understood that you shall be responsible for any breach of these obligations by any of your officers, directors, employees or professional advisors"), while some clauses contain a precise definition of the duty of indemnification ("In the event of any breach of the secrecy provisions of this Contract, the party in breach shall indemnify the other party for any loss or damages..."). In this context, it is necessary to bear in mind that it is extremely difficult in practice to identify and prove the amount of damage suffered due to a breach of the confidentiality duty, which is why a lump sum to be paid out in damages may be anticipated under these clauses ("In the event that a party should commit a breach of his undertaking under this Article, he shall be liable to pay to the other party for each breach a penalty of _____USD ").[62]

As regards the *legislation* governing the duty of confidentiality in Serbia, the Law of Obligations does not contain specific rules on this duty, but it derives from the very principle of good faith and fairness, as one of the basic principles on which this Law is based. On the other hand, the Companies Law expressly provides for the duty of confidentiality within the rules governing special duties owed to the company.

Under the Companies Act, the duty of confidentiality applies to director, other persons with special duties, as well as company's employees. The law stipulates that these persons should owe the duty of confidentiality until two years upon expiry of their terms, whilst allowing for a longer term if so provided under the Memorandum of Association, Articles of Association, the decision of the company, or employment contract. However, the Law does not allow such term to exceed 5 years[63], which means that any contractual clause providing for a longer or unlimited duration of this duty would be subject to the sanction of nullity.

The Law defines the trade secret as "any information whose disclosure to a third party could cause damage to the company, as well as any information which may

61 For more details see [3, p. 304ff.]

62 Examples of clauses in [3, pp. 308-311ff.]

63 Art. 72, Company Law

have economic value because it is not generally known and is not readily available to third parties who could gain economic benefit from its use or disclosure, and which is protected by the company with appropriate safeguards aimed at protecting the confidentiality. Information which is considered a trade secret can be production-related, technical, technological, financial or commercial information, a study, a research result, as well as a document, drawing, formula, object, method, procedure, notice or instruction of internal nature, etc. A trade secret is also any information defined as such under the law, other regulation or a company by-law. A company by-law may identify as trade secret only such information that complies with the requirements of the trade secret as provided in the Law. Furthermore, a company by-law may not define all information relating to the company's operations as trade secret.[64]

On the other hand, it is worth noting that disclosure of privileged information shall not be deemed as a breach of duty of confidentiality if such disclosure is: obligatory under the law; necessary to perform business operations or to protect the company interests; made to the competent authorities or general public with the sole purpose of calling attention to an offence punishable under the law.[65]

The sanctions provided by the Law for a breach of the duty of confidentiality are: indemnification, expulsion from company, in case of a company member, termination of employment relation, in case of a company employee.[66] This action may be filed within six months of becoming aware of the breach of duty, however not later than five years upon the actual occurrence of such breach.[67] One or more shareholders may bring derivative action on behalf of the company, if at the time of filing such action they held shares representing minimum 5% of the company's share capital.[68]

64 Art. 72, Company Law
65 Art. 73, Company Law
66 Art. 74, Company Law
67 Art. 77, Company Law
68 Art. 79, Company Law

Non-compete duty

Director's duty of loyalty to the company encompasses the area of director's unlawful competition with the company in which he holds the office of director [17, p. 148].

The rules governing unlawful competition are provided in the Company Law[69], but they may be extended under (a) the company by-law, *i.e.* Memorandum of Association or Articles of Association or (b) agreement between director and the company *i.e.* employment contract or director contract under the non-compete clause. The Company Law provides for the scope of prohibitions concerning director's engagement. Thus, without the approval of the competent body[70], the director may not: (i) act as a director, supervisory board member, representative, procurator, partner, general partner, controlling[71] shareholder or shareholder with a material interest[72] in another company with the same or similar scope of business activities (hereinafter: "Competitor"); (ii) be a sole proprietor with the same or similar scope of business activities; (iii) be employed with or otherwise hired by a Competitor; (iv) be a member or a founder of a Competitor.

Prohibition of competition should seeks to preserve company's legitimate interests in terms of protection from director's unlawful conduct (positive interest), but should also seek to preserve director's economic freedom (negative interest) [16, p. 150]. Thus, the Memorandum of Association or Articles of Association may provide for an extension of non-compete duty even beyond the term in office as the director, however not longer than 2 years. Furthermore, the said company by-laws may also identify transactions, and the manner and place of their performance, which are not deemed to be a breach of the non-compete duty.[73]

69 Art. 75, Company Law
70 See footnote 38.
71 Control implies a right or a possibility a certain individual has, independently or with other persons acting with him, to exert controlling influence on the company's business operations by means of participation in the original share capital, contract or a right to name the majority of directors or members of the supervisory board.
72 Material interest in a company exists if a single person holds more than 25% of the voting rights in the company, independently or with other persons acting in concert with him
73 Art. 75.2.2-3, Company Law

If director is in employment relation with the company, the company is obliged to pay to the director certain pecuniary compensation for such extended period of non-compete duty[74]. This rule on payment of compensation to the director should be interpreted so as to apply also to director contracts not involving employment relation, in cases where a company by-law or director contract provide for an extension of non-compete duty for the director beyond expiry of the director's term in office. If a director breaches the non-compete duty, he shall be liable for damages, whilst the company may claim transfer of benefits gained by the director or the Competitor. The director may also be barred from pursuing a vocation and his employment relation (if any) may be terminated.[75]

This action may be filed within six months of becoming aware of the breach, however not later than five years upon the actual occurrence of such breach.[76] One or more shareholders may bring derivative action on behalf of the company, if at the time of filing such action they held shares representing minimum 5% of the company's share capital.[77]

Serbian laws do not provide special regulations for this area in so far as public companies are concerned, thus, what has already been said in respect of the rules concerning public companies, applies, *mutatis mutandis*, to this area as well.

Conclusion

An examination of the rules provided in the Serbian law with regard to director's liability for damage caused to the company leads to the conclusion that the rules of the Companies Law governing this area cannot be viewed in isolation; their proper understanding and successful implementation require sound knowledge of all other relevant laws in this field, particularly the rules of the Law on Obligations and general principles of the obligations law. The general rules of the Law on Obligations are particularly relevant to the issue of assessment of director's duty of care, duty of confidentiality, as well as the issues raised in the context of indemnification in case of breach of special duties owed to the company.

With regard to public companies, the Serbian law does not provide specific rules on the liability of directors, but only general reference to appropriate application of the Companies Law. Given the differences in company bodies envisaged respectively by the Companies Law and the Law on Public Companies, this begs the question, left to the practice to address, of the body and the procedure that should grant approval to the director for certain legal transactions involving personal interest or conflict of interest between director and the public company, or in cases of prohibition of competition.

In view of the fact that Serbia has not yet developed significant court practice regarding the application of the rules on directors' liability for damage caused to the company, it is essential that legal solutions in this area should be carefully analysed from the aspect of legal doctrine, both in terms of domestic law and requirements of business practice and in terms of their comparison with the corresponding solutions of the comparative law. Given that the duties of care and loyalty should be seen as foremost strategies towards addressing the so-called first agency problem, i.e. the conflict between the shareholders and managers, a consistent interpretation of the rules related to these issues and a harmonised court practice whereby these rules are brought to life are key factors in achieving a higher degree of legal security in this area.

74 Art. 162.2, Labour Law (Official Gazette 24/2005, 61/2005, 54/2009, 32/2013 & 75/2014)

75 Art. 76, Company Law

76 Art. 77, Company Law

77 Art. 79, Company Law

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Jelena Perović

is a Full Professor at the Faculty of Economics, University of Belgrade. Lecturing: International Commercial Law (undergraduate course), International Business Contracts (master's degree course), EU Private Law (master's degree course). She is the president of the Commission for the International Sale of Goods of International Association of Lawyers (UIA), Paris and a member of International Academy of Comparative Law, Paris. As an expert of the ITC Committee on International Commercial Model Contracts of UN/WTO/ITC in Geneva, professor Perović is the author of the ITC Model-contract for the International Commercial Sale of Goods. She is scientific collaborator for the *Revue de droit international et de droit comparé*, Bruylant, Brussels. Professor Perović is specialized in international business law, particularly international sales and related transactions. She has also acted for many years as arbitrator in international arbitration proceedings. Ms. Perović is vice president of the Jurists Association of Serbia.

Ljubica Tomić

is a Co-founder and Managing Partner of TSG Tomic Sindjelic Groza Law Office in Belgrade, Serbia. She is head of the firm's corporate law team and corporate governance practice. She has completed the Corporate Governance Specialization at the Law Faculty in Belgrade (specialization established in Belgrade within the IFC –World Bank program). Her 15 years practice is devoted largely to complex transactions, regulatory and corporate governance matters in Serbia. Ms. Tomić and her team were awarded the Corporate INTL annual legal award as the Corporate Governance Law Firm of the year in Serbia for 2015. She is the German and English speaking member of the firm.