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DIRECTORS' RESPONSIBILITY TO CREDITORS IN COMPANY LAW

This paper deals with the issue of directors' responsibility as one of the main instruments of efficient creditor protection. In continental laws this responsibility can be established in tort law, based on fault. Also, UK law and most developed continen tal laws are also introducing special instruments of directors' liability when a com pany is in the vicinity of insolvency through wrongful trading or similar functional equivalent rules.

Different national law systems of directors' responsibility are compared with the current regime of directors' responsibility in Serbian law. We conclude that in Serbian law there is no direct responsibility of directors to creditors, neither through Company Law rules, nor general rules of Civil Law, particularly tort responsibility. Also, Serbian Insolvency Act does not recognize wrongful trading or similar instru ments by which directors could be directly responsible if the company is near or in insolvency. Although the newly adopted Company Act in Serbia does introduce one particular case of direct responsibility of directors to creditors, it is still very limited and offers neither adequate nor sufficient protection.

This situation, as well as widely existing opinion of case law concerning tort responsibility to third parties only for a company is analyzed and criticised on sev eral particular issues. In this article we urge introduction of wider rules in future legislative amendments, by which directors would be personally responsible to credi tors in exceptional situations. Preferably this could be introduced by general tort responsibility or special company law rules, or through wrongful trading, either al ternatively or cumulatively. This would provide more protection for creditors, which has become even more pertinent after the minimum capital requirement was aban doned and rules concerning distribution of profits relaxed in respect of limited liabil ity companies.

Key words: *Directors' responsibility. Directors' duties. Creditors. Torts.*

"The management liability ...
importance grows while capital is lost."[1]

1. INTRODUCTION

Creditor protection is usually achieved through a range of mechanisms, among which responsibility is considered one of the main tools of *ex post* protection. Other mechanisms usually have the goal to protect creditors *ex ante* – before risk for the realisation of debt has occurred. Such is the example of minimum requirement and maintenance of capital rules or mandatory disclosure. Both of these mechanisms, especially legal capital face important limits in providing efficient creditor protection and have been questioned in recent years.[2] Rules on responsibility have distinctive character of *ex post* protection through introduction of personal responsibility of persons who acted on behalf of the company. Liability serves to align different interests, especially those of directors to other possible interests, such as shareholders, creditors and others.[3]

Although responsibility is limited as a mechanism of creditor protection – it comes too late, it can be difficult to establish etc, it can also be a useful instrument and has important role for certain categories of creditors, such as weak, economically small or involuntary creditors, who are usually unable to negotiate adequate individual protection such as protective contract clauses, covenants or insurance.[4] Responsibility of shareholders, directors or members of the management board is usually considered to be an alternative to mandatory rules, especially legal capital.[5] In addition, responsibility can have important preventive character[6]

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[1] M. Lutter, "Legal capital of public companies in Europe", *Legal Capital in Europe* (ed. M. Lutter), European Company and Financial Law Review, Special Volume 1, De Gruyter Recht, 2006, 12.

[2] See, for example, J. Armour, *Share capital and creditor protection: Efficient rules for a modern company law?,* Working Paper 148, University of Cambridge, Cam bridge December 1999, 16 etc; E. Ferran, *Principles of Corporate Finance Law*, Oxford University Press, Oxford 2008, 18 182 etc.

[3] T. Baums, *Personal Liabilities of Company Directors in German Law*, Speech at the Stratford upon Avon Conference of the British German Jurists' Association, April 21, 1996, 3, *http://www.jura.uni frankfurt.de/ifawz1/baums/Bilder und Daten/Arbeit spapiere/a0696.pdf*, last visited 10 June 2011.

[4] F. Denozza, "Different Policies for Corporate Creditor Protection", *European Business Organization Law Review* 7/2006, 411.

[5] H. Eidenmüller, B. Grunewald, U. Noack, "Minimum capital in the System of Legal Capital", *Legal Capital in Europe* (ed. M. Lutter), European Company and Finan cial Law Review, Special Volume 1, De Gruyter Recht, 2006, 30.

[6] T. Baums, 4.

– directors and shareholders will be discouraged of committing acts that could have as a consequence their personal liability.

Responsibility of shareholders on the one hand and of directors on the other is not equally regulated in different national company laws. In some, there is an obvious advantage in responsibility provisions in company law, while others usually apply to creditors only when a company is near insolvency. Reasons for this distinction can be found in their legal tradition,[7] where a choice is made between preferences over rules versus legal standards.[8]

If we examine the rules on directors' responsibility, apart from special company law rules, there are also general rules on contractual and tort responsibility which can establish responsibility of directors. In addition, a certain act can be determined to be criminal or contravening other public rules (ecology etc.); but this remains outside the scope of this article. Our attention will focus on provisions in Serbian law, where special company law provisions as well as general rules on responsibility have proven inadequate as efficient protection of creditors. Because Serbian law does not recognise specific rules on directors' responsibility to creditors when company is near insolvency, we will briefly deal with these rules in comparative law.

2. WHO CAN BE RESPONSIBLE TO CREDITORS

It is widely considered that members of companies with limited liability and their directors are not personally liable to creditors.[9] Creditors have the right to demand their claims only directly from the company. This is a logical consequence of legal personality of the company. However, this general rule has exceptions, when somebody else can also be personally responsible by his personal property.[10]

In companies where *members* have limited responsibility they can be responsible for subscribed, but not fully paid-up shares, but their responsibility exists only to the company and not to creditors directly.[11] The

[7] E. Ferran, "The Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union", *European Company and Financial Law Review* 2/2006, 199.

[8] *Ibid.*

[9] English law established this principle in the classic case of *Salomon v Salomon and Co Ltd*, see more in A. Keay, *Company Directors' Responsibilities to Creditors,* Routledge Cavendish, London New York 2007, 12.

[10] P. Davies, *Gower and Davies' Principles of Modern Company Law*, Sweet & Maxwell, Thomson Reuters, London 2008[8], 218.

[11] For Serbian law, see Law on Commercial companies 2011, *Official Gazette of the Republic of Serbia*, No. 36/2011, Articles 17 and 46, Article 139 for Limited Liability Company and Article 245 for public limited liability company.

same is true in the case of unlawful distributions, when members are liable for payment of all amounts unlawfully paid to them.[12] It is also the case when they are responsible for the damage based on breach of their duties, as well as other situations where their responsibility is established.

Members may be personally liable to creditors directly when all conditions for *piercing the corporate veil* are met.[13] This instrument, which exists both in continental and common law systems (where it is rooted) is an important restriction of limited liability rule. Some authors even consider it as an important alternative to creditor protection, which should be used more frequently and consistently.[14] American experience, where legal capital does not play an important regulatory tool, shows that responsibility of company members is commonly used through piercing of the corporate veil.[15] In addition, members can have certain liability in the case of equitable subordination in insolvency of debt claims of controlling shareholders,[16] a provision especially developed in some national laws.[17]

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[12] Serbian law set up this principle in Articles 185 and 275 of the Law on Com mercial companies 2011. There is a difference between unlawful payments to sharehold ers and members of a limited liability company, based on different regime of distributions, which is very relaxed in the latter case and is established on profits made by the company, and only limited in situation when there is a loss or change of value of the capital from last financial year. In this case, members are responsible for unlawful payments, as well as those who acted in good faith, but only when it is necessary for fulfilment of obliga tions to creditors. Other members who voted for distribution and acted in good faith (known or should have known that distributions were against the law) are jointly and severally responsible to the company for their repayments, as well as other members act ing intentionally or with gross negligence who acted by contributing to payments being made. Responsibility is set up not only for members, but also for directors, which will be discussed later. For companies with share capital, distributions are limited by net assets test and shareholders are liable if they knew that payments were made against this provi sion.

[13] See Article 18 of the Serbian Law on Commercial companies 2011. Generally on this issue see Karen Vandekerckhove, *Piercing the Corporate Veil,* Kluwer Law Inter national, Alphen aan den Rijn 2007.

[14] L. Enriques, J. Macey, "Creditors versus capital formation: The case against the European legal capital rules", *Cornell Law Review* 6/2000 2001, 1185.

[15] It is estimated to be around 4000 disputes annually based on piercing the corpo rate veil principle. See M. Lutter, 12.

[16] See more: J. Armour, 16.

[17] Such is the case of Germany with *eigenkapitalersetzender Gesellschafterkredit,* from Article 39 (1) (5) and 39 (4 5) *Insolvenzordnung.* For theoretical analysis see T. Bachner, *Creditor Protection in Private Companies: Anglo German Perspectives for a European Legal Discourse*, Cambridge University Press, Cambridge 2009, 138 etc. Same rule exists in new Serbian Law on Commercial Companies 2011, in Articles 181 and 276, by which member can put their claims only after other creditors in insolvency have been settled. Still, this instrument is not widely in use in the UK and France. See J. Armour, G.

It is obvious that creditor demands towards company members are exceptional as is exceptional liability of other *creditors or third parties*, especially when a company is approaching insolvency. Preferential position of one creditor compared to others is usually sanctioned through preferential transactions which fall within the scope of *actio Pauliana* of continental European laws, or similar instruments in the U.S. (fraudulent conveyance) and UK (undervalue transactions).[18] [19]

Finally, company *directors* are usually not considered personally liable to creditors.[20] Being a legal person, the company must have a person(s) who acts on its behalf. Although it is a person who is acting on behalf of the company, only the company will be bound by this act and responsible for its obligations.[21] Still, in exceptional cases directors could be personally liable to creditors as well, and usually the main goal of this liability is to sanction misbehaviour of management, especially self-oriented conduct.[22] Some authors suggest that the case of personal liability of directors is also a version of *piercing the corporate veil,* because they are responsible also when somebody else is.[23]

While discussing who can be responsible to creditors it should be underlined that it can be difficult to make a distinction between members or shareholders on the one hand and management (directors) on the other. This is especially problematic in closed types of companies, where sepa-

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Hertig, H. Kanda, "Transactions with Creditors", *The Anatomy of Corporate Law: A Com parative and Functional Approach* (eds. R. Kraakman *et al*.), Oxford University Press, Oxford 2009[2], 139.

[18] See *Ibid.*, 141 142.

[19] For Serbian law see rules on action Pauliana in Articles 280 285 of the Law of Obligations, *Official Gazette of the Republic of SFRY*, No. 29/78, 39/85, 45/89 and 57/89 and *Official Gazette of the Republic of Serbia*, No. 31/93, as well as Articles 119 130 of Insolvency Act, *Official Gazette of the Republic of Serbia*, No. 104/2009, for actio Pauliana during insolvency.

[20] We will use term directors as a general term for persons acting as company's managers (single person or collective organ), irrespective of differences in corporate gov ernance in comparative company law. In Serbian law term *direktori* (directors) is used to determine organs of the limited liability company: general meeting, one or more directors (one tier) or supervisory board and one or more directors (two tier system) (Article 198 of the Serbian Law on Commercial Companies 2011), for companies with share capital: general meeting and either one or more directors (or board of directors) in one tier system, or supervisory board and one or more executive directors (board of executive directors) in two tier system (Article 326 of the Serbian Law on Commercial Companies 2011). There fore, same rules apply to directors as a management organ of the company, but also to some extent members of the supervisory board in a two tier system, because they conduct not only control, but also make most important management decisions.

[21] R. Hamilton, *The Law of Corporations,* West Group, St. Paul, Minn 2000[5], 334.

[22] T. Baums, 4.

[23] A. Keay, 75.

ration between ownership and management cannot clearly be made. Even when there is a separate management, they could be under strong influence and control (in decision-making) of the company owners. It is worth noting that agency problems between shareholders and creditors are more pronounced if managers and shareholders have mutual interests, which is usually the case in smaller companies.[24] In the case of companies managed by their owners it can be more common that business decisions are being made with higher incentive for risk taking, while business logic or reasonableness in decision-making is less important. Still, the owners can prove to be more responsible because they bear the risk of bad decision-making. Also, directors acting on behalf of shareholders but detrimental to creditors can be more often present when directors have more responsibility to shareholders, or are personally involved in companies business (holding of shares etc).[2526] Large companies usually have professional management, usually experts, educated and specialised to fulfil their duties objectively and according to professional ethics.[27] In these companies managers have less incentive to benefit shareholders at the expense of creditors.[28]

Differences in the (internal) position of directors in their relation to members are usually considered to be irrelevant and could not be taken into account when setting up the responsibility regime.[29] Therefore, if a member is involved in management of a company, he has all the rights and obligations, as well as the responsibility as any other manager of the company and rules on directors' responsibility can be equally applied to shareholders as well.[30] This is true even when a controlling shareholder is exerting important influence on management. In this and similar cases

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[24] J. Armour, G. Hertig, H. Kanda, 135.

[25] *Ibid.*, 117 8 .

[26] Connection can be made between independent directors and company financing through external sources in the capital markets, as well as between directors acting most ly in the interest of their owners, when they are more prone to finance a company through bank loans. See S. Taboroši, "Priroda odgovornosti menadžmenta prema kreditorima" ["Nature of responsibility of management to creditors"], *Korporativno upravljanje*, drugi deo [*Corporate governance*, second part], (eds. M. Vasiljević, V. Radović), Faculty of Law, University of Belgrade, Belgrade 2009, 393.

[27] See more: A. Daehnert, "The minimum capital requirement an anachronism under conservation: Part 2", *Company Lawyer* 2/2009, 35 etc.

[28] J. Armour, G. Hertig, H. Kanda, 135.

[29] P. Davies, "Directors' Creditor Regarding Duties in Respect of Trading Deci sions Taken in the Vicinity of Insolvency", *European Business Organization Law Review* 7/2006, 309.

[30] Same for Croatian law see J. Barbić, "Odgovornost članova organa dioničkog društva za štetu počinjenu društvu i vjerovnicima društva" ["Liability of the members of joint stock company's organs for the damage caused to company and company's credi tors"], *Pravo u gospodarstvu* 1/2010, 274.

many national laws apply provisions concerning liability of persons who were acting as directors, but who are not formally in this position – shadow directors (such is the case of wrongful trading provision of English law, or Swiss tort liability provision, or French case law for liability of directors and managers of the company).[31]

3. ACTING IN THE CREDITORS' INTEREST

A modern concept of a company considers existence of many different interests, among which is that of creditors. The main question would be whether persons who act on behalf of the company and in its best interest should be also taking into account interest of creditors.

National laws usually have many provisions, aiming to secure that persons acting on behalf of a company behave under limits of representation power, and respect certain provisions and standards. Standard of diligence of a prudent businessperson, together with certain duties in relation to their acts and decision-making is the essence of every company law national provision. While common law standards are based on honesty, good faith and diligence,[32] and determine these acts through directors' duties, in continental law acts of directors are seen through general rules and standards, such as the standard of a prudent businessperson, or duty of diligence, where one aspect of this duty is to act within the limits of law.[33] Although liability can be a useful instrument for protecting different interests (companies, shareholders, creditors), it can also have negative effects, such as low incentives for accepting the job of director, who is avoiding risk taking (especially the one of an independent director).[34] Sometimes it is underlined that "being (outside) director is too risky".[35]

It is commonly accepted that a director of a company has certain duties to the company, and it is the breach of these duties, which will result in his personal liability.[36] It is not usual, either in continental, or in common law systems that a director should be liable on the ground of

[31] Shadow director can also be "insider" or other influential creditor. See further on that issue J. Armour, G. Hertig, H. Kanda, 142.

[32] R. Hamilton, 334.

[33] On this issue, as well as differences of continental and English law see T. Bachner, 148.

[34] B. Black, B. Cheffins, M. Klausner, "The Liability Risk for Outside Directors: A Cross Border Analysis", *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (eds. J. Armour, J. McCahery), Hart publishing, Oxford and Portland Oregon 2006, 344.

[35] *Ibid.*

[36] Serbian law has wide definition of persons who have special duties to company. See Article 61 of Serbian Law on Commercial Companies 2011.

strict liability for the company losses – it is his fault (negligence or intention) necessary to establish his liability.[37]

Persons who have duties must act within them, and the breach results in civil (it can also be statutory or criminal) responsibility *to company, and its members*. In English law it is generally considered that there is no direct responsibility to creditors based on breach of directors' duties.[38] Case law firmly established that tort of negligence based on duty of care (for the economic loss) does not exist to creditors.[39] This is because directors can be liable to creditors on the basis of tort of negligence only if it is considered that they owned a *duty of care to them*, which is not the case.[40] Creditors' interests are protected only indirectly through fiduciary duties, while respecting the interest of a company as long as the company is a going concern.[41] It is, therefore, rather financial distress of the debtor company when *ex post* liability is employed.[42]

Justification for the responsibility of directors to creditors when a company is near insolvency can be found in this financial situation. While the company is a going concern, interest of creditors is best served through the rules of directors' responsibility to shareholders and company itself. However, in the case where company is insolvent or in the vicinity of insolvency, the position of creditors' changes and their interest are especially in danger. In this case, shareholders would be prone to riskier business decisions, while the interest of creditors is the opposite. Creditors, especially those who cannot ensure any individual protection, bear the risk if the company becomes insolvent.[43] Therefore, certain national laws consider that when a company is in the vicinity of insolvency, it is the director's duty to have creditors' interest in mind. UK Companies Act 2006 introduced duty to promote company success and requires directors to consider or act, in certain circumstances, in the interests of company's creditors.[44] Even though English law provisions on directors' duties to consider the interest of creditors were undisputedly established through case law decisions, and introduced in the Companies Act provisions, it is

[37] T. Baums, 5.

[38] A. Keay, 253 etc. This is also true for U.S. law, where fiduciaries act in the interest of corporation as a whole, and only in particular cases in the interest of shareholders (individuals or classes of shareholders), but never of creditors. See R. Hamilton, 445.

[39] T. Bachner, 209.

[40] See more on general principles of tort liability in UK law compared to continental European laws: K. Zweigert, H. Kötz, *Introduction to Comparative Law*, Clarendon Press, Oxford 1998[3], 610.

[41] P. Davies, (2006), 328.

[42] J. Armour, G. Hertig, H. Kanda, 134.

[43] See in detail: P. Davies, (2006), 305 etc.

[44] Article 172 (3) UK Companies Act 2006.

still problematic to take a firm stand on when directors should start to consider creditors' interests.[45]

If we analyse the most important continental European laws, we could see a different approach in the position of a company director. Usually, continental laws consider a manager not to be fiduciary (such is the position of Anglo-American legal system), but rather an *organ* of the company, with its own competences and position, as well as certain independence in management of the company.[46] As such, a more critical standard of behaviour is expected in continental laws.[47] This is true for both concepts of a director who is responsible to the company on the basis of contract (mandate) and tort (theory of institution).[48]

4. DIRECTORS' RESPONSIBILITY IN VICINITY OF INSOLVENCY

Lowest level of liability to creditors exists in the U.S, where even in the case of insolvent firms it was considered that directors own their duty of loyalty to the company, rather than to its creditors, including very few claims, based on tort for deepening insolvency, which is ruled out in some other jurisdictions, such as Delaware.[49] In Europe, it is usually considered that the interest of creditors is to be especially protected when a company is insolvent and they introduce special responsibility for this situation. Advantages of such instruments argue that directors' responsibility for business decisions only in the vicinity of insolvency has perfect timing – it is introduced only when a company is financially distressed, which is the moment when creditors would need somebody else's liability apart from the company and its assets.[50] On the other hand, these provisions are seriously limited not only because they are applied too late,[51] but also have significant limitations in practice in view to causality and other particular problems in practical application.

[45] See in detail on *West Mercia Case* and these issues: V. Finch, "Directors' duties towards creditors", *Company Lawyer* 1989, 22 etc.

[46] T. Baums, 8.

[47] J. Armour, G. Hertig, H. Kanda, 136.

[48] See on this concepts: P. Le Cannu, B. Dondero, *Droit des sociétés*, Montchres tien 2009[3], 309.

[49] J. Armour, G. Hertig, H. Kanda, 135. More on *deepening insolvency* see in: M. Schillig, "'Deepening insolvency' liability for wrongful trading in the United States?", *Company Lawyer* 10/2009, 298 etc.

[50] Report of the High Level Group of Company Law Experts on a Modern Regu latory Framework for Company Law in Europe, Brussels, 4 November 2002, 68, *http:// ec.europa.eu/internal market/company/modern/index en.htm#background*, last visited 5 December 2011.

[51] More on these arguments see P. Davies, (2006), 320.

Provisions for directors' responsibility in English law are developed through wrongful trading and are considered to be an important instrument of creditor protection.[52] According to them, a person who is or has been a director of a company that has gone into insolvent liquidation shall be liable to make a contribution to the company's assets if he knew or ought to have concluded, as a reasonably diligent person, that there was no reasonable prospect that the company would avoid going into insolvent liquidation.[53] Directors' liability is based on negligence for not taking reasonable care in protecting creditors' interests.[54] A very similar provision exists in French law, by the name of *action en comblement d'insuffisance d'actif*.[55] Functionally equivalent, but with somewhat different contents, there are also provisions of *Insolvenzverschleppungshaftung* in German law, according to which a director or other person involved in company management can be directly liable to creditors for late or delayed filing of insolvency proceedings, in the case of over indebtedness or illiquidity of the company on the basis of tort for which creditor can claim damages.[56]

Apart from special rules of liability, continental laws developed other instruments of creditor protection, such as duty of a director to act when the company has a serious loss of capital, including obligation to petition for insolvency proceedings, or finding other sources of financing,[57] as well as rules on disqualification of directors, especially developed in U.S. and English company law.[58]

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[52] Initiative for the introduction of the wrongful trading provision into Community law was made within the Report of the High level group, as a useful instrument of effi cient creditor protection. Still, there are different opinions on this instrument and its equivalent effect in all Member States of the EU. See Report of the High level group, 9, 68 9.

[53] Sec. 214 UK Insolvency Act 1986.

[54] See in detail: J. Armour, G. Hertig, H. Kanda, 135 136 .

[55] Article L651 2 of the French Code de commerce.

[56] See in detail, including differences between German and English concepts in: T. Bachner, 246 etc. An example of this case related to tort liability based on contravention of the statute under Article 823 (2) BGB see in: K. Zweigert, H. Kötz, 603.

[57] See more: J. Armour, G. Hertig, H. Kanda, 133.

[58] Functioning of this instrument can be an important additional rule in setting up a system of responsibility of directors, apart from civil and criminal law responsibility, and is important in sanctioning breaches of disclosure provisions, as well as misuse of companies limited liability. See in detail: H. Fleischer, "The Responsibility of the Man agement and Its Enforcement", *Reforming Company and Takeover Law in Europe* (eds. G. Ferrarini *et al.*), Oxford University Press, Oxford 2004, 409 etc. Still, in U.S disqualifica tion has a limited scope and is not related to creditor protection. See on this issue and related to creditor protection: J. Armour, G. Hertig, H. Kanda, 137.

5. DIRECTORS' DIRECT LIABILITY TO CREDITORS

The basic rule of company law is that a company itself is responsible for all obligations to third parties. It is the company's separate personality "shielding" persons who acted as its directors.[59] Reasoning behind this rule is simple – there is more protection of third parties from the company than from an individual, even though he acted on behalf of the company, because usually the former will be a more solvent debtor.[60] Nevertheless, a situation can arise whereby a creditor cannot claim his debts from a company, because of its insolvency or similar situation, when somebody else's responsibility could be a useful tool in achieving better protection. This problem can be especially important if a link between the act of a director and company insolvency can be established. Therefore, one can pose a question whether a director can be directly responsible to creditors if all conditions for his personal liability based on tort are met. Serbian law follows the French tort law tradition and requires that there is damage, connection between damage and fault – causal link, and fault as a base for liability based on fault.[61] Reasons against this responsibility, apart from logic of separate personality of a company are bearing in mind protection of decision-makers. Directors should not be liable for every business decision they make, even though certain damage may occur to third interested parties as a result of this decision. This is especially the case for decisions made according to the best of their knowledge and in line with business reasoning. Protection of decision making is especially connected to unpredictability and lack of certainty and is usually connected to business judgment rule.[62] Still, vicinity of insolvency and predictability of damage to creditors could be useful guidelines in reducing decision-making freedom which is given to directors.[63] Although this opinion is widely accepted in many national laws, there are still very limited and exceptional cases when company's directors can be personally liable to creditors.

For example, Swiss law has a very clear provision on tort responsibility of directors (and other persons involved in management and liqui-

[59] This rule in Serbian law is based on Law of Obligations, Article 172, where a company is responsible for tort for the acts made by its organs.

[60] See M. Konstantinović, *Obligaciono pravo: beleške sa predavanja* [*Law of Ob ligations: notes taken from lectures*], Belgrade 1962, 109.

[61] More on different systems of tort liability in European laws see K. Zweigert, H. Kötz, 596 etc.

Usually, it is underlined that practical problems can arise in causal connection of director's acts and damage caused to creditors.

[62] R. Dotevall, "Liability of Members of the Board of Directors and the Managing Directors A Scandinavian Perspective", *The International Lawyer* 7/2003, 11.

[63] *Ibid.*

dation) for the damage to a company, shareholders and creditors, if this damage was caused *intentionally or negligently*.[64] Extremely limited cases of this responsibility are in practice established in French law. Base for this liability is tort of a director when his decision was made against the law or statutory provision, or erroneously in performing his duties.[65] It is specifically underlined that every director is responsible to the company, as well as to *third parties*, including creditors. Still, a widely spread opinion taken by courts specifies that the responsibility of a director is established only for the acting which can be separated from usual director functions which can be attributed to him personally.[66] It can be said that errors in conducting business can be separated from directors functions, if "... it is not compatible with normal performance of duties; whereby incompatibility is defined through deliberate mistake and its seriousness", even though director acted within his limits or through an execution of a decision of general meeting of shareholders.[67] Base for responsibility to creditors in some other national laws is also found in inability to preserve company's property.[68]

A similar provision of exceptional liability also exists in German Law, where Public Companies Act introduced *duty of care of a diligent and conscientious manager.* For the breach of this duty directors can be jointly and severally responsible for the damage caused to the company.[69] Duty to act as a diligent and conscientious manager is considered to represent an objective standard of directors' conduct.[70] Therefore, the key issue for his liability based on breach of duty of diligence would be whether his acting "...has fallen below the requisite standard of diligence".[71]

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[64] See Article 754 of Swiss Code of Obligations.

[65] Article 1850 Code civil sets up a general rule, also prescribed for limited liabil ity company in Article L. 223 22, and for public limited liability company by Article L. 225 251 Code de commerce. Similar provisions exist in Spanish law for legal and de facto directors who are responsible to company, members and creditors for damage made by acting or non acting contrary to legal and statutory provisions, or for acts made while performing their duties. See Articles 236, 240 and 241 of the Spanish Act on Commercial Companies 2010, Real Decreto Legislativo 1/2010, de 2 de julio, por el que se aprueba el texto refundido de la Ley de Sociedades de Capital, *http://noticias.juridicas.com/base da tos/Privado/rdleg1 2010.t1.html#*, last visited 30 November 2011.

[66] More on this conduct (*la faute séparable de ses fonctions qui lui sont imputable personnellement)* see M. Cozian, A. Viander, F. Deboissy, *Droit des sociétés,* Litec, Paris 2009, 141 etc; D. Vidal, *Droit des sociétés*, L.G.D.J, Paris 2008[6], 216 etc.

[67] See case law in: M. Cozian, A. Viander, F. Deboissy, 142.

[68] Such is the case of Italian law. See Article 2394 of the Italian Civil Code.

[69] See Article 93 (1 2) of German Public Companies Act (*Aktiengesetz*); Article 84 (1 2) of Austrian Public Companies Act; Article 252 (1 2) of Croatian Law on Com mercial Companies; Article 263 (1 2) of Slovene Law on Commercial Companies. Simi lar provision exists in Swiss law. See Article 754 of the Code of Obligations.

[70] T. Baums, 6.

[71] T. Bachner, 157.

Duty of care director has only to the company, but it is the creditors' right to enforce it directly from directors if they were unable to obtain satisfaction from the company itself.[72] Liability for the breach of duty of care is established only if a director *manifestly* violated his duties, but in special cases, which include repayment of contributions, unlawful distributions, purchase of own shares and other similar cases, this liability can be established for every breach of duty of care (comprising breach of legal and statutory provisions).[73] Scope of duty of care is extremely wide, compared to other national (especially English) provisions. It does not specifically involve only acts within limits of law, statutes and other provisions, but also acting according to internal organization of the company, rules on representation, loyalty to company as well as other shareholders and acting within limits of business judgement rule.[74] German law, as well as others who follow this legal tradition consider that damage was caused to the company (not to creditors). Being entitled to claim damages directly in front of a court strengthens and improves creditors' position.[75] Although creditors do have a right to claim damages directly, this claim does not have independent origin, and is accessory to a claim from the company.[76] This concept is problematic when a director acted on the base of a general meeting decision, when he cannot be responsible to the company, but still can be responsible to creditors of the company.[77] When a director pays damages directly to the company, creditors are not entitled to demand further satisfaction from the director, but only from the company itself.[78] Responsibility of directors is established only to the company and is ba-

[72] See Article 93 (5) of German Public Companies Act; Article 84 (5) of Austrian Public Companies Act; Article 252 (5) of Croatian Law on Commercial Companies; Arti cle 263 (4) of Slovene Law on Commercial Companies.

[73] For a detailed list of special cases see par. 3 in previously numbered articles, except in Slovenian law, which does not recognise special cases of responsibility. Mace donian law has similar provisions, but introduces responsibility to creditors only when the director manifestly breached duty of diligent and conscientious manager. See Article 362 (4) of the Macedonian Law on Commercial Companies.

This provision shows an important difference between concept of directors' duties in English and continental European laws. For example in English law, directors' liability to unlawful distributions is not represented in specific duty, developed through Companies Act, but is considered to fall within general duty to exercise powers only for the purposes of which they were conferred. Still, a director can address the Court in order to be relieved of liability on the ground of having acted honestly and reasonably, having regard to all circumstances of the case. E. Ferran, (2008), 255. Besides, acting beyond provisions of the law or other provisions is usually considered to represent a breach of fiduciary duties, and not duty of care. See more: T. Bachner, 158 etc.

[74] J. Barbić, 277.

[75] *Ibid*., 300.

[76] *Ibid.*

[77] See *Ibid*., 289.

[78] See in detail in Croatian law: *Ibid*., 300 301.

sed on non compliance with the standard of behaviour. It is emphasised that the origin of this responsibility is not in the contract, but position as the *organ of the company*.[79] It is also established in case of *de facto* directors.[80]Apart from this entitlement which belongs to creditors only in the case of manifest violation of duty of care, German law also recognises special case of tort liability for the breach of protective norm, based on art. 823 (2) German Civil Code, which usually include directors' liability to creditors for late filing of insolvency proceedings, mentioned before.[81]

6. DIRECTORS' RESPONSIBILITY TO CREDITORS IN SERBIAN LAW

Provisions on directors' duties in Serbian law are mostly a legal transplant from the Anglo-American legal system, disregarding provisions of continental laws on this issue, which will be discussed in detail further.

In Serbian law there are only provisions for civil responsibility of members of company organs (management or supervision) *to a company and its members* (but not creditors with whom they do not stand in direct relationship) for all damages made by their decision-making in contravention of legal and statutory provisions or general assembly decisions.[82] General limits concerning the conduct of a director define several duties, among which most important one is duty of care. This duty implies acting within limits of law and other provisions according to a certain standard of conduct. Duty of care requires a person to perform activities in good faith, with care of a diligent manager, which means behaviour of a diligent and conscientious person with knowledge, experience and skills which can be expected of a person performing these kinds of activities and including his personal abilities, knowledge and experience; and believing to act in the best interest of the company.[83]

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[79] *Ibid*., 276, 290.

[80] See on responsibility of de facto directors in Croatian law: *Ibid*., 287.

[81] See in detail on this case of tort liability: W.Müller, T. Rödder (Hrsg.), *Beck'sches Handbuch der AG: Gesellschaftsrecht, Steuerrecht, Börsengang,* 2. vollständig überarbe itete und ergänzte Auflage, Verlag C.H.Bech, München 2009, 552 etc; T. Bachner, 183 etc.

[82] See Article 415 of Serbian Law on Commercial Companies 2011. Same rule is applicable to management body (Aticle 430) as well as to the supervisory body (Article 447), depending on the model of corporate governance of the public company introduced. Previous Act contained detailed rules on responsibility, among which special cases of re sponsibility, including unlawful payments, distribution of dividends, purchase of compa ny's own shares etc. See Article 328 of previous Serbian Law on Commercial Companies 2004, *Official Gazette of the Republic of Serbia*, No. 125/2004.

[83] Article 63 of Serbian Law on Commercial Companies 2011.

Previous Act had special provisions on civil responsibility of members of the management board, such as payment of dividends to shareholders, companies' purchase of its own shares, approval of loans or other borrowing, breach of duties implied to them etc, but newly adopted Law on Commercial Companies does not define special provisions concerning responsibility for any type of company.[84] Only the case of special responsibility to the company is introduced in the case of unlawful payments but only for limited liability company (*društvo sa ograničenom odgovornošću*), when directors and other persons involved in these payments are jointly and severally liable to payments of such distributions.[85] Civil responsibility is generally introduced in other provisions, but always related to the company (such is the case of directors' duties) and members (provisions concerning individual and derivative suit).[86]

Serbian law has only one provision in which directors' responsibility to creditors is established.[87] Namely, a director of a limited liability company (and members of a supervisory board in a two-tier system) is liable to *members and creditors* for the damage caused by distribution of profits, in the case of breach of his duty to inform the general meeting of losses or serious change in the value of subscribed capital.[88] Still, this rule is not applicable to public companies. Reasoning behind this is a different regime for limited liability companies compared to public companies concerning conditions for distributions. In the case of a limited liability company, there is no such limitation, except that profit was made, and that since this was confirmed in annual accounts, no change which would mean loss or serious reduction in the value of subscribed capital occurred. On the contrary, companies with share capital can make distri-

[84] For the provisions of previous Serbian Law on Commercial Companies 2004, see Article 328 (2).

[85] See Article 185 of Serbian Law on Commercial Companies 2011.

[86] See, for example provisions in Articles 61, 64, 78 and 79 of Serbian Law on Commercial Companies 2011. It is the position of newly adopted Law on Commercial Companies. See, for example Article 415.

[87] In the old Serbian Law on Enterprises 1996, *Official Gazette of the Republic of Serbia*, No. 29/1996, 33/1996, 29/1997, 59/1998, 74/1999 and 36/2002, there used to be provisions of directors' responsibility for the damage caused by its decision making to wards company, owners and creditors in the case when decision was taken by gross neg ligence or intentionally. See Articles 72 73 of the Law of Enterprises 1996 for action by creditors with debts representing 10% of the capital of the company, if company had not already initiated compensation proceedings for damages against director.

[88] Article 184 is setting up a duty for directors and members of the supervisory board in a two tier system, who know that from the end of financial year and general meeting's decision on approval of annual accounts company financial situation worsened seriously and permanently (loss or serious change of value of the subscribed capital) to inform the general meeting, after which general meeting cannot distribute profits which are of the equivalent value of reduction of the company's assets. See particularly Article 184 (2 3).

butions according to the net assets test, which is further limited by certain restrictions.[89] Therefore, this single rule on responsibility is basically only protection for distributions in the case of limited liability companies, which is not the case for companies limited by shares.

Apart from direct liability to creditors, special rules on directors' responsibility to the company are also introduced for the limited liability company. For example, there is directors' (or supervisory board member) responsibility to the company for the repayment of all other distributions (not only but including dividend payments), if he approved any kind of distribution and known or should have known that distributions were against the law.[90] Furthermore, directors who acted intentionally or with gross negligence and contributed to these payments being made are also jointly and severally responsible.

Unlike these provisions, rules on directors' (and supervisory board members' in two-tier system) responsibility differ importantly in companies with share capital. For these directors there is no provision on special responsibility for unlawful payments, as well as no particular provision for responsibility to creditors in case of breach of duty of information of the general meeting that made a decision on distribution of profits. The only rule, establishing general responsibility of directors, as well as executive directors and supervisory board members is based on breach of law, statute or decisions of the general meeting. Nevertheless, this responsibility will not be established if the director acted according to a general meeting decision.[91] Rules on unlawful distributions establish only shareholders responsibility, but not that of directors. Of course, if directors acted in breach of the law in order to make any distribution, it would be under the rule of their general responsibility for the breach of the law.

Therefore, from the existing regime of responsibility, creditors can only ask the company to pay their debts, and are protected indirectly through rules on responsibility of directors to the company (general or particular concerning unlawful distributions).[92] But, if a company fails to ask for compensation from director, and is not able to meet its obligations creditors can only initiate an insolvency procedure, if other conditions are met. So, there is no possibility for a creditor to address the director directly even if he acted against the law, or if his decision-making was made

[89] It is the same rule as the one adopted in the Second Company Law Directive, where only shareholder responsibility is introduced. See Articles 15 16.

[90] See Article 185 of the Serbian Law on Commercial Companies 2011.

[91] Articles 415, 430 and 447 of the Serbian Law on Commercial Companies 2011.

[92] See in detail in Serbian literature on this issue: M. Vasiljević, *Korporativno upravljanje: Pravni aspekti* [*Corporate Governance: Legal aspects*], Pravni fakultet Univerziteta u Beogradu, Beograd 2007, 151 etc.

with intention to damage creditors. The same is true even if a company itself cannot fulfil its obligations.

Such a situation raises a question of whether it could be possible to use general rules on tort responsibility in order to protect creditors. Law of Obligations introduces a general rule for tort responsibility of all legal persons.[93] In this provision company (legal person) is responsible to a third party in the case of damage caused when its organ made a decision in performing its functions and duties.[94] Second paragraph of the same rule concerns only the internal relationship between organ and company, when the latter can demand refund for the sum paid from the person who acted intentionally or with gross negligence.[95]

Analyzing this provision we could say that there is nothing to prevent a creditor to ask the director (or directors and other persons being the company's organs, such as supervisory board) directly for the damage caused by their decision making. But, it would be necessary to take into account a similar provision from the Law of Obligations concerning company's responsibility for the damage to third parties caused by an employee performing or connected to performance of his work duties. In this case, apart from company's liability, the employee is also directly responsible to the third party if he acted intentionally (certain level of his fault).[96] Therefore, it is unquestionable that a company employee can be directly responsible to the claimant in certain circumstances. But, for the responsibility of the organ we could say that either director can always (whatever the case of his responsibility for the damage – intention or negligence) be considered directly responsible to a creditor, as well as the company itself, because there is nothing to say that he is not responsible. Or, we could say that responsibility of the organ is not expressly regulated, and therefore, does not exist.

A widely spread opinion in case law is that provisions for company's responsibility completely exclude direct responsibility of an organ to third parties. According to common position of Serbian courts *only* the company can be responsible to third persons.[97] Reasoning behind this opinion

[93] See Article 172 of the Serbian Law of Obligations. Same provision is in the Croatian Law of Obligations (2005) in Article 1062, but this general regime of tort re sponsibility is under special provisions of the mentioned creditors' rights introduced by company law provisions.

[94] Thus, similarly to French case law, it can be argued that personal liability exists if organ acted beyond his functions or duties.

[95] See Article 172 (2) of the Serbian Law of Obligations.

[96] Article 170 (1 2). In the Article 171 internal relations are regulated in the same way as for the company and its organs. Therefore, company can ask for the sums paid from employee if he acted intentionally or with gross negligence.

[97] See, for example recent Judgement of the Valjevo High Court, Gž. 731/2008 from 21.11.2008. or Judgement of the Supreme court of Serbia, Rev. II 728/2003 from

is obviously that the organ *is the company* itself, and that a person performing his activities as an organ is acting on behalf and in the name of the company, and therefore shouldn't be personally responsible. An organ of the company cannot be acting as an agent (alter ego) of the company, but it is *the company* (ego), and therefore acts of the organ are acts of the company itself.[98] In this case, a company completely shields the director or other persons acting as its organs. This is even the case when the director is an employee of the company, when it is considered that rules on employee's responsibility cannot be applied, based on fact that damage to a third person is caused through performance of the functions and duties of the organ, and not of the employee.[99]

The opinion that the director (person acting as an organ) is not directly responsible to third parties for tort is also widely spread in literature,[100] although few contrary opinions exist. Still, their only explanation is that analogy with the provision on employee responsibility should be applied,[101] which does not sound particularly convincing – provision on the organ responsibility is lacking any mention of direct responsibility, and therefore it is logical to assume that it does not exist. Apart from that, a solitary opinion on Djordjević/Stanković is that a creditor can use the provision of the company's responsibility, but also general provisions of tort liability, whereby an organ of the company could be directly personally liable for all damages caused if other conditions for his liability are met.[102]

If we return to the original intention to find whether creditors could be efficiently protected through responsibility rules, we come to a surprising result. From the strict application of the mentioned provisions there

18.6.2003, published in *Bilten sudske prakse Vrhovnog suda Srbije,* 1/2004, 90. Both accessible through *ParagrafLex* database, last visited 8 June 2011.

[98] S. Cigoj, "Građanska odgovornost" ["*Civil responsibility*"], in: *Enciklopedija imovinskog prava i prava udruženog rada*, Tome 1, Službeni list SFRJ, Beograd 1978, 424.

[99] See, Judgement of the Supreme court of Serbia, Rev. II 728/2003 from 18.6.2003, published in *Bilten sudske prakse Vrhovnog suda Srbije,* 1/2004, 90. Accessible through *ParagrafLex* database, last visited 8 June 2011. In Scandinavian law, member of the board of directors can be responsible either under Company Act, or as an employee under general rules on tort responsibility, depending on the capacity in which he caused damage. See R. Dotevall, 10.

[100] See, for example, also S. Perović, D. Stojanović (eds.), *Komentar Zakona o obligacionim odnosima* [*Commentary on the Law of Obligations*], Tome 1, Kulturni centar, Gornji Milanovac, Pravni fakultet, Kragujevac 1980, 522. See also in the company law literature M. Vasiljević, 228 229.

[101] J. Radišić, *Obligaciono pravo Opšti deo* [*Law of Obligations General part*], Nolit, Beograd 1979, 205.

[102] Ž. Đorđević, V. Stanković, *Obligaciono pravo Opšti deo* [*Law of Obligations General part*], Naučna knjiga, Beograd 1986[4], 392.

is a complete lack of any kind of protection for creditors, which is of *ex post* character, and is based on responsibility, apart from the insolvency proceedings. Not only is Serbian law missing any company or tort provision establishing this responsibility, but has no similar instrument which can be used by a creditor in order to protect him in the case of corporate opportunism when a company is near insolvency, such as wrongful trading in English law or some other functional equivalent. It can only be concluded that a creditor is left to insolvency law protection, which undoubtedly comes too late and is not adequate.

Lack of *ex post* protection through directors' responsibility is even more problematic if it is to be placed in the general system of creditors' protection in Serbian law. Apart from mandatory rules on disclosure of certain information, there seems to be little to protect creditors further. This is especially true of the minimum capital requirement, which is set at a very low level,[103] and rules on maintenance of capital, with a relaxed regime on profit distributions in closed companies and also including lack of explicit directors' responsibility in public companies for unlawful distributions.[104] Therefore, apart from insolvency, the only real protection of creditors currently can be achieved through contractual provisions and individual protection.[105]

Therefore, we should consider on what basis creditors could be protected *ex post* before insolvency proceedings have started, and whether this protection should be also necessary in a domestic environment. We suggest as the easiest solution amendments to the existing tort law regime, which would serve as a general system of responsibility. This line of thinking is also adopted in the recently presented Proposal for a Serbian Civil Code, where it is suggested that existing regime of company's responsibility for the acts of its organs could be amended by an additional paragraph, where direct liability of an organ of the legal person (including company) is established for the damages to third parties by unlawful acts and during or connected to performance of his duties.[106] Here we

[103] Minimum capital requirement for limited liability company is symbolic 100 RSD (approximately equivalent of 1 Euro), and for the public limited liability company 3.000.000 RSD (approx. 30 000 Euros).

[104] This responsibility is introduced for limited liability companies in Article 185, while for the public companies exists only through general provision on their responsibil ity for breach of law, although even then it can be excluded if a director acted in accord ance with a general meetings' decision. See Article 415 (1 2) of the Serbian Law on Commercial Companies 2011.

[105] Literature on creditors' protection is abundant. To see more on general rules of creditor protection, as well as its limits in serbian literature T. Jevremović Petrović, "Pov erioci u kompanijskom pravu i instrumenti njihove zaštite" ["Creditor protection in com pany law"], *Anali Pravnog fakulteta Univerziteta u Beogradu* 1/2011, 223 etc.

[106] See *Prednacrt Građanski zakonik Republike Srbije, druga knjiga: Obligacioni odnosi* [*Pre draft of Serbian Civil Code: Law of Obligations*], Vlada Republike Srbije, Komisija za izradu građanskog zakonika, Beograd 2009, 69.

should note a connection between unlawful acting and understanding of decision making made according to provisions of duty of care and business judgment rule, but it would be rather a standard of conduct. Care should be taken in particular of the freedom of business decision making and reasonable care of a prudent business person. The issue of personal liability of director usually can pose a problem concerning causal link between conduct of that person and damage made to creditors, but this connection should be easier to establish if the company is insolvent. Although this connection can be very problematic this issue is outside the scope of the research presented here.

7. CONCLUSION

In the presented analysis we have taken into account various provisions of Serbian law concerning creditors' protection through responsibility rules. We can conclude that Serbian law does not provide adequate and efficient protection to creditors.

Apart from insolvency proceedings, the only substantial protection for creditors in Serbian law currently can be achieved through contractual provisions and individual protection. Mandatory rules on disclosure of certain information were mainly taken from the existing regime of disclosure of information, especially developed through European Company Law and Law on Financial Markets. Still, this tool has limited use in creditors' protection. Apart from disclosure, there seems to be little to protect creditors further in Serbian law. This is especially true for the minimum capital requirement, which is set at a very low level,[107] and rules on maintenance of capital seem to be inadequate to protect creditors, especially bearing in mind relaxed regime on profit distributions in closed companies and also including lack of explicit directors' responsibility in public companies for unlawful distributions.

Modern commentators urge for a wider application of *ex post* protection of creditors through responsibility provisions. Among these, directors' responsibility seems to be very important, especially in the case when the company is near insolvency. Reason for introducing this liability is a situation in which a person who is in the best position to foresee the future financial situation of the company can react appropriately, especially taking concern of the creditors, and therefore, this instrument should be introduced by national laws as a standard of conduct for directors.

[107] Minimum capital requirement for limited liability company is symbolic 100 RSD (approximately equivalent of 1 Euro), and for the public limited liability company 3.000.000 RSD (approx. 30 000 Euros).

Unfortunately, Serbian law in its existing regime of responsibility does not recognise any case of directors' responsibility to creditors. Furthermore, Serbian law is missing any company or tort provision establishing direct responsibility of directors to creditors, but has no similar instrument, which can be used by a creditor in order to protect him in the case of corporate opportunism when the company is near insolvency. It can only be concluded that a creditor is left to insolvency law *ex post* protection, which undoubtedly comes too late and is not adequate.