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EDITORIAL NOTE

The University of Belgrade Faculty of Law hosted an international conference *Contemporary Issues in Company Law* on September 29–30, 2011. A number of legal experts and scholars from ten European countries participated at the Conference, and a selection of their contributions is now published in this volume of the *Annals of the Faculty of Law in Belgrade* (*Belgrade Law Review*). We owe special gratitude to our colleagues Christoph Van der Elst and Rainer Kulms, who kindly accepted to be Guest editors of the publication. The selected contributions deal with the contemporary issues of company laws in various legal systems, so we believe that they will be of interest not only to legal scholars, but to the practitioners and graduate students as well.

The ongoing reform of the rules of company laws, both on the national and transnational levels, happens in a broader context of economic crisis, including the crisis of capital markets and corporate governance, stock market crashes, the new forms of economic protectionism, globalization and the consequential unification of the laws in the affected fields, transnational mergers and transnational takeovers. These circumstances call for re-examination and reconsideration of the existing systems of company law, and the corresponding legal areas of tax and commercial laws, takeovers, bankruptcy, capital markets and competition.

The Editorial board hopes that other contributions in this volume may attract attention of company law lawyers, in the way as some issues of company law would be of ample interest to the readers with differing scholarly profiles.

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CIVIL LAW AND BUSINESS JUDGMENT RULE

The author analyzes the relationship between traditional civil law notions of "care of prudent business person" and "care of prudent expert", "good faith and fairness" and a new "business judgment rule" concept of company law. Although legal tradition standardizes the meanings of these civil law notions, important for legal certainty, the author suggests that all attempts at their substitution or fitting into the concept of business judgment rule, originating from the legal culture of com mon law, have basically failed. The reasons are manifold: first, differences in legal traditions; second, the routine of courts and business of following the usual princi ples of legal thinking and practice; third, legal transplants were not made by replac ing one concept with another rather by fitting one into another and combining their rules which has proved wrong.

The author concludes, after the analysis of all constitutive elements of the new concept of company law "the business judgment rule", that the civil law no tion of "care of prudent business person" or "care of prudent expert" remain the backbone of this new concept and that all other elements thereof may, through care ful analysis be reduced to these notions. In itself, it ruins the credibility of the concept of "business judgment rule" and supports the authority of traditional "due care" notion of civil law.

Key words: *Business judgment rule. Care of prudent business person. Care of prudent expert. Good faith. Loyalty. Director. Liability. Conflict of interest. Fault.*

1. STATING THE PROBLEM

Liability in civil law theory and legal regulation, both contractual and non contractual, is traditionally based on the concept of fault (proven

or assumed, determined *in concreto* or *in abstracto*) – liability based on fault or irrespective of fault – strict liability. Under the influence of case law and the rules based on it in common law legal systems, the continental law adopted the concept of business judgment rule (legal transplant), which questions the concept of fault in civil law as a basis for contractual or non contractual liability defined in traditional terms. Such development is also inherent in Serbian civil law (solutions in the Law on Obligations) and company law (solutions in the Law on Commercial Companies).

"In carrying out his obligation, a party to obligation relations shall be bound to act with the care required in legal transactions of the kind of obligation relations involved (the care of a good businessman, or respectively the care of a good master of the house).

In carrying out obligations relating to his professional activity, a party to obligation relations shall be bound to act, with increased care, according to professional rules and usage (the standard of care of a good expert)".[1]

"Whoever causes injury or loss to another shall be liable to redress it, unless he proves that the damage was caused without his fault".[2]

"Fault shall exist after a tort-feasor has caused injury or loss intentionally or out of negligence".[3]

As far as the concept of fault is concerned, namely "due care" under civil law, the Law on Commercial Companies of Serbia stipulates that the directors, supervisory board members, agents, proxies and administrators ("persons who have special duties towards the company") "shall perform their duties as such in good faith, with due care and in reasonable belief that they act in the best interest of the company".

Care of good businessman in terms of par. 1 of the same Article means the standard of care, which should be exercised by a reasonably careful person, knowledgeable, skillful and experienced to a reasonable extent, in the conduct of his duties on behalf of the company.

If the "persons having special duties towards the company" ... "have some specific knowledge, skills or experience, these will be taken into account when judging the standard of care".

"The persons having special duties towards the company" are also deemed "to be able to act on the information and opinion of professionals in relevant areas, who are reasonably believed to have acted in good faith in the case".

[1] Law on Obligations LOO, *Official Gazette of SFRY*, No. 29/78, *Official Gazette of FRY*, No. 31/93, Article 18 (1 2).

[2] LOO, Article 154 (1).

[3] LOO, Article 158.

"The person having special duties towards the company"... who shall prove to have acted in compliance with that Article shall not be liable for the damage made to the company as a consequence of such an act".[4]

2. CONCEPT OF FAULT IN THE CIVIL LAW

The Serbian civil law makes the concept of fault a core issue of civil law liability ("fault", "care", "intention and negligence") leaving the dilemma of legal interpretation of fault (*in concreto* – subjective notion or *in abstracto* – objective notion). A better grounded definition to this issue, omitted in the text of LOO, is contained in the Sketch of the Law of Obligation and Contracts:

"In judging a person who caused the damage faulty or non faulty, i.e. whether he acted as he should, the court takes into account the normal course of actions and what could have been realistically expected from a reasonable and careful person under the circumstances".[5]

The Pre-Draft of Law of Obligations and Contracts, in the part dealing with the civil law understanding of fault resorted to objective legal standards ("regular course of action", "under the circumstances", "reasonable and careful person", "grounded expectation") and unequivocally departed from criminal law understanding of personalized fault (*in concreto* – subjective notion) and accepted standard objective depersonalized fault (*in abstracto* – objective notion), the fault of the tortfeasor abstractly imagined as "a reasonable and careful person" independently of the individual attributes and characteristics.[6] Moreover, leading Serbian legal theory understands the Law on Obligations in this sense, despite the absence of clear legislative statement to that end; hence fault is objectified and depersonalized.[7] Understanding fault in objective and abstract

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[4] Law on Commercial Companies of Serbia LCCS, *Official Gazette of RS,* No. 36/2011, Article 63 with reference to Article 61. Compare with the Law on Commercial Companies of Serbia, *Official Gazette of RS*, No. 125/2004, Article 32 with reference to Article 31.

[5] M. Konstantinović, *Obligacije i ugovori Skica za Zakonik o obligacijama i ugovorima* [*Obligations and Contracts Pre Draft of Code of Obligations and Con tracts*], Beograd 1969, Article 127.

[6] See V. Kapor, "Komentar člana 18. Zakona o obligacionim odnosima", *Komen tar Zakona o obligacionim odnosima* (red. B. Blagojević, B. Krulj) ["Commentary of Law on Obligations" (eds. by B. Blagojevic, B. Krulj)], Beograd 1980, 88 89; M. Orlić, "Esej o krivici" ["Essay on Fault"], *Pravni život* [*Legal Life*] 1 2/2009, 182 188; M. Karanikić Mirić, *Krivica kao osnov deliktne odgovornosti u građanskom pravu* [*Fault as Basis of Tort Liability in the Civil Law*], Beograd 2009, 326 328.

[7] See M. Konstantinović, "Osnov odgovornosti za prouzrokovanu štetu" ["Grounds of Liability for the Damage Caused"], *Arhiv za pravne i društvene nauke* [*Ar chives for Legal and Social* Sciencies] 3/1952, 90; M. Orlić, 194 197.

terms is a prevailing solution in comparative law, too (French law, English law, German law). An exception is Austrian law, which still considers fault a subjective notion (individualization and personalization).[8]

The question arises whether even in the case where fault is depersonalized and not linked to personal characteristics (judgment *in abstracto*), in civil law, which is undoubtedly the leading comparative legal solution and the position of legislation and legal theory, the personal characteristics do bear some significance. It seems that grading of fault ("intention and negligence") speaks in itself of legal relevance of personal characteristics and capabilities of the tortfeasor also in the case when fault is judged according to the objective standard of "reasonable and careful person" (judgment *in abstracto*). This is particularly so if the highest degree of fault is at stake – intention (and its civil law equivalent of gross negligence – *culpa lata dolus aequiparatur*). It is traditionally upheld that the existence of intention (and thereby gross negligence) could be ascertained only by subjective method that is judgment *in concreto*. Although this view was later abandoned in favor of determining the intention and negligence by means of objective (abstract) criteria, it seems that grading of fault still points to certain legal importance of the subjective element of a given context within which the fault is judged (intimate psychological, mental state under the circumstances). This is independent of the fact that the establishment of subjective liability based on fault supposedly requires no more than the mildest negligence (ordinary negligence). Nevertheless, the Law on Obligations itself and other regulations of contract law make the grading of fault legally relevant, sometimes on the issue of existence of liability (it is impossible to exclude liability for intention and gross negligence in advance from a contract, but for example there is a possibility of exclusion of ordinary negligence), and sometimes on the issue of the level of indemnity (liability for integral damage only for intention and gross negligence, but limited in the case of ordinary negligence – for instance in transportation law) or the burden of proof (assumption of subjective liability and existence of ordinary negligence, and proving the intention or gross negligence, all in transportation law).[9]

[8] A. Lucas, *Code civil*, Paris 2004[23], Article 1382 1383; *BGB,* §276 (2); M. Orlić, 188; M. Karanikić Mirić, 70 74. Vagueness of our LOO provoked some interpreta tions and some authors to judge fault in civil law in a personalized manner according to the individual characteristics and possibilities of the harmful person (no fault and conse quently no liability if the damage is caused by a person who according to its individual attributes could not have behaved otherwise, although according to the standard of "rea sonable and careful person he would be obliged to"). See D. Pop Georgijev, *Obligaciono pravo, Opšti deo* [*Law of Obligations, General*], Skoplje 1976, 154.

[9] Compare M. Karanikić Mirić, 166 183.

3. "PRUDENT BUSINESS PERSON" AND "PRUDENT EXPERT" STANDARDS (DUE CARE)

A legal issue arises when in terms of civil law fault as the ground for subjective liability does or does not exist. The answer is provided in the Law on Obligations, which promotes the legal standard of "prudent business person" and legal standard of "prudent expert" and the Law on Commercial Companies, which promotes the legal standard of "prudent business person". Both cases require fulfillment of a certain degree of "due care" ("care which is expected in legal transactions in a given type of obligation relations"), that is "duty of care". The notion "duty of care" in company law – "persons having duties towards company"– has been developed in American theory and case law to define its substance and limits. The English law analyses the notion, more subtly than the French, and makes the distinction between pure care and the notion of competence – skill. Thus, the two notions *care* and *skill* in English law correspond to the French term *diligance* (diligence).[10] "Duty of care" ("due care") called "the obligation of care" by the civilists implies the obligation of performing to within the maximum of one's own power to achieve a certain result (aleatory). Hence, "persons with obligations towards the company" cannot guarantee the accomplishment of a result (obligation of result), but only undertaking with "due care" and best of effort (the obligation of effort), according to an abstract standard of "reasonable person" or "diligent person".[11] The difficulties of judging "due care" stem from the fact that there are no objective criteria for its evaluation in corporate governance, further complicated by different categories of directors who are generally affected by this rule.

It is an open question (for theory and particularly case law) whether to apply the standard of "due care of prudent business person" or the "care of prudent expert" to the liability of those persons. This is especially relevant in Serbian law where the Law on Obligations recognizes both legal standards, while the Law on Commercial Companies only the standard of "care of prudent business person". In purely formal legal sense the Law on Commercial Companies has the character of special

[10] See E. Scholastique, *Le devoir de diligence des administrateurs de sociétés droit français et anglais*, Paris 1998, 7. *American Revised Model Business Corporation Act RMBCA* (2005), practically rejects the segment of skill in the standard of care, § 8.30 (3).

[11] A. Tunc, "La distinction des obligations de résultat et des obligations de dili gence", *JCP* 1945, I 449. The Corporation Law of Pennsylvania defines this standard as "care expected to be demonstrated by usually diligent person in a similar position, under similar circumstances". Similarly, in: *RMBCA*, § 8.30 (a) (2). See D. Branson, *Corporate Governance,* Washington 1993, 253 254, 262 264; C.A. Riley, "The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard", *The Modern Law Review* 62/1999, 704 706.

law, as far as this form of liability of "persons with duties towards the company" is concerned, hence the only valid legal standard would be "care of prudent business person". The constitutive elements of that standard in terms of this Law are: 1) reasonably careful person, 2) person of knowledge, skill and experience (cumulative of all three attributes) to do a given job, 3) possession, according to grounded expectations, of those three attributes. Constitutive elements of this standard so specified in this Law demonstrate that the "care of prudent business person" is judged *in abstracto*. Nevertheless, the Law goes further and prescribes that if the "persons with certain obligations towards the company have certain specific knowledge, skills and experience the same will be taken into account in judging their degree of care". It seems an exception to the stated rule and standard, because on the one hand the objectification of care by "persons with obligations towards the commercial company" is rendered subjective in certain sense (judgment according to the standard *in concreto*), and on the other tightens the degree of care towards the standard of "due care of prudent expert"[12] (it particularly applies to the directors of financial organizations).[13]

On the other hand, the answer to this question may be traced in the context of the character of the function held by such persons – do such persons pursue professional activity, which has its specific "rules of profession and practice"? In a situation where the market economy is still under development in Serbia and when a profession of a director is yet to be shaped in the new ownership structures, which is the basis for "the rules of the profession", it seems difficult to plead that the abstract degree of the diligence of a director may be understood as the "care of prudent expert". In addition, the responsibilities "of persons with special duties towards a commercial company" can not be qualified by "professional activity" at the general level, like for instance, the activities of the self employed individuals (lawyers, auditors, notaries, designers, medical doctors, brokers, investment advisors, etc),[14] in the pursuit of these activities and liability of these persons standard of prudent expert is applicable, which is rather an exception in the light of Serbian Law on Commercial Companies. Bearing in mind for the time being the main characteristics

[12] See V. Kapor, 89.

[13] Opinion developed in American case law is that directors of corporations with quasi public functions, first of all banks and other financial institutions, should have high er degree of care compared to the directors of other corporations. In present day circum stances such opinions are abandoned in the case law and legislation, alike. The standards of equivalence of standards of care of trustees and directors are abandoned, as their func tions differ (*trustee* is a guardian of assets entrusted, while a director is tasked with profit earning and assets increase for a corporation). See D. Branson, (1993), 252 254.

[14] See A. Lee, "Business Judgment Rule: Should South African Corporate Law Follow the King Report's Recommendation?", *University of Botswana Law Journal* 1/2005, 63 64.

of our market environment, it seems that the right standard of care of a director is "care of prudent business person",[15] in an expectation that the standard of "care of a prudent expert" in the right market ambient will also progressively establish itself, by way of exception to the rule if not otherwise.[16]

4. BUSINESS JUDGMENT RULE

4.1. Persons Involved

One of the major issues in the business judgment rule is who is protected. It is generally upheld that this rule is applicable to both the directors (members of the board of directors) and managers (executive directors, officers). In American case law the application of this rule has been extended to trustees, chief accountants in the capacity of temporary directors and the controlling shareholder, when carrying out managerial functions normally performed by directors or managers. On the other hand, the minority shareholders and employees have not been covered by this rule. Hence, the directors who want to protect employees holding key functions in a corporation may formally nominate them as a sort of manager (officers).[17]

Our Law on Commercial Companies refers to the "persons with duties towards the company"[18] meaning, in terms of application of this rule: the directors, supervisory board members, agents and proxies and liquidation administrators. Thus, all the directors irrespective of their classification, are covered by this rule (directors under the law and *de facto* directors,[19] executive and non executive directors, internal and ex-

[15] In our opinion, The Swiss Civil Code (1911, 2008) shares the same view, be cause it stipulates "due care" of the individuals managing a company, Article 717 (1).

[16] See M. Vasiljević, *Korporativno upravljanje pravni aspekti* [*Corporate gov ernance legal aspects*], Beograd 2007, 155 162; M. Vasiljević, "The Serbian Law on Commercial Companies", *Private Law in Eastern Europe* (eds. Ch. Jessel Holst, R. Kulms, A. Trunk), Tubinghen 2010, 284 285. Contrary, pleading for the standard "care of a prudent expert" in the German law, Croatian law and Macedonian law, See J. Barbić, *Pravo društava društva kapitala* [*The Law of Companies Capital Companies*], Zagreb 2000, 381 383; German Law on Shares *AktG* (2005), § 93 (1); G. Koevski, "Američka poslovna doktrina i njena moguća primena u evropsko kontinentalnom korporativnom kontekstu (*Business Judgment Rule*)" ["American Business Doctrine and its Possible Ap plication in Continental European Corporative Context (Business Judgment Rule)"], *Pravni život* [*Legal Life*] 12/2009, 350.

[17] Quoted according to: D. Branson, (1993), 333. See RMBCA, § 8.30 and § 8.42.

[18] LCCS, Article 61 (1) (4 5) with reference to Article 63. Compare G. Koevski, 353 355.

[19] Directors, under the law, are members of the management board in the conti nental practice or the board of directors in the Anglo Saxon practice (plus executive direc

ternal directors, independent directors and directors who have no interest in a contract, directors and administrative senior staff – officers, administrators, directors attending the board meeting or not, the "so-called directors or dummy directors" and similar).[20]

4.2. Notion and Background of the Rule

The rule of business judgment emerged almost two centuries ago in the precedent practice of American Courts[21] and has been codified

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tors the management, involved in business activities of daily management), either inde pendently (or non executive) or executive. The notion of "*de facto* directors" (continental school) and/or shadow directors Anglo Saxon legal tradition (*les dirigeants occultes, shadow directors*) remains rather vague. In any case, these are not the persons who are directors under the law and who formally hold such positions in the company, based on which they have formal responsibilities, irrespective of their designation (directors, man agers, managing board members, BoD members, officers, trustees, etc.). It is usually up held in the case law and business practice that the persons in this position are directly or through another person exercising a continued influence on how a company is managed and independently, either under the shield of the director under the law or openly instead of him. In such a position, not automatically but at a great risk to be so characterized, is a controlling company and its management vis a vis a subsidiary and its management. A bank may find itself in such a position (or another major creditor), when setting condi tions for credit approval to a company, which may be qualified with such a character of influence. See E. Scholastique, 9 16; R.P. Austin, I.M. Ramsay, *Ford's Principles of Cor porations Law,* Sydney 2007[13], 341 350.

[20] In terms of company law all the directors, irrespective of the category, have the same duty of care while delineations like technical, specialized, part time, absent, semi retired director or the similar, in terms of this duty are not recognized. The directors who want such a status may resign or not accept the designation, but there is also the possibil ity of the existence of technical or advisory board of directors, which is no board of direc tors under the company law nor in terms of the obligation of due care. In the case of *Francis v. United Jersey Bank*, a special status was required for a wife of a deceased di rector founder of the corporation. After her husband's death, she did nothing in her capac ity of director but became drunkard to death. During the time her son systematically looted the corporation. The Supreme Court of New Jersey made it clear that the director may not find remedy in a special status of refugee, even temporarily: "the director is no ornament but a crucial component of corporate governance. Consequently, the director may not protect himself under the veil of a paper under the motto of "*dummy director*". *New Jersey* Corporate Law imposes standards of ordinary care on all the directors, con firming that "*dummy directors*", "figuring directors" and the similar are anachronisms, without a place in the law of New Jersey". See D. Branson, (1993), 279 283.

[21] The Supreme Court of Delaware first formulated this rule (which is often used both in that state and outside USA) in the precedent case *Aronson v. Lewis*: "the presump tion that at the time of taking business decision the directors of the corporation were suf ficiently informed, acted in good faith and in sincere (reasonable) belief that they acted in the best company interest". See D. Branson, (1993), 329. See P. V. Letson, "Implications of Shareholders Diversification on Corporate Law and Organization: the Case of the Busi ness Judgment Rule", *Chicago Kent Law Review* 77/2001 2002, 209 210.

since. Later, it was accepted in Australia (common law)[22] and as of lately in the legislation of continental legal tradition (civil law).[23]

The rule of business judgment emerged because of the need to protect persons owing duties to commercial companies (company, corporation), and in some instances has been treated as a "safe haven" for such persons, provided some requirements are fulfilled. Namely, business decisions taken by these persons requires assumption of serious risk due to impossibility of foreseeing all commercial consequences, which in a legal aspect may result in damages to the company and its shareholders (members), because persons who make decisions can be held liable. In the ultimate instance the commercial risk of business decisions of persons who owe duties to the company are born by the shareholders (owners), who appointed such persons and if dissatisfied with commercial effects on their business decisions may dismiss them. On the other hand, business decisions are also taken ex officio by the persons with duties to the company (directors, members of supervisory boards, agents, proxies). In the case of possible liability actions instituted by the company or minority shareholders for damages caused in connection with business decisions the question arises about the powers of the court to judge merit of such decisions. Legal theory and case law today are almost unanimous in that the "director's office" is the only place to judge merit of business decisions, not the courtroom (*theory of abstention of court from interfering in the convenience of business decisions*),[24] but in formal terms it is (ex-

[22] USA RMBCA, § 8.30 and §8.42; M.J. Staab, "Business Judgment Rule in Kan sas: From Black and White to Gray", *Washburn Law Journal*, 1/2001 2002, 234 235; *Australian Corporation Act* (2005), § 180 (2) See R.P. Austin, I.M. Ramsay, 395 400.

[23] *AktG,* § 93 (1) 2; LCCS, Article 63.

[24] One of the best examples is the case law of the Supreme Court of Delaware in: *Shlensky v. Wringley* (237 N. E. 2d 776, III App. Ct. 1968). The Plaintiff *Shlensky* sued *Wringley's* because the latter refused to install lights on *Chicago's Wringley Field* baseball stadium. At the time, the defendant *Wringley* was the majority owner and president of the corporation which owned Chicago Cubs. *Shlensky* was a minority shareholder of the com pany. *Chicago Cubs* in the period from 1961 1965, the period subject to charges, operated with a loss, due to low visiting rate, and the Plaintiff claimed that the reason was the de nial of the Defendant to install lights at *Wringley Field* where matches took place, but not during the night. The Plaintiff stated that the reasons for denial were dual: *Wringley* felt that baseball was a daylight sport and that it would negatively affect the surroundings, if played by night. The Defendant *Wringley* and other directors (dominated by *Wringley* as a majority owner) invoked the business judgment rule, according to which no court may in terfere in business decisions (theory of abstention), except for fraud, illegality and conflict of interest. The court reasoned that it was the matter of business policy in the competence of the board of directors, not the court. This is an absolute power of the board of directors and the court has no powers to substitute the judgment of the director so it must apply the theory of restraint. The more so, as the plaintiff failed to prove fraud, illegality or conflict of interest. By ruling this, the court did not say that such a business policy was correct, because it is beyond its competence and capability. See S.M. Bainbridge, "The Business Judgment Rule as Abstention Doctrine", *Vanderbilt Law Review* 57/2004, 94 96; G. Ko

amination of legality of the procedure of taking business decisions and legality of the decision itself). In commercial terms the rule bestows economic freedoms and freedom of entrepreneurship to directors guided, in any case, by "the best interest of the company".[25] For the shareholders, who ultimately bear the risk of business decisions, the director's misconception is more acceptable (they always have a possibility to replace them since they appoint them and should bear the risks of their appointment) then that of the court.

American Legal Institute (ALI, Corporate Governance Project) was the first (1992) to recommend a codification of the rule, with a definition, which caused much controversy:

"Director or manager (officer) who takes a business decision in *good faith fulfills his duty of care,* provided he is:

(1) No stakeholder in the subject of the business decision,

(2) Informed on the subject of the business decision to the extent he reasonably believes adequate under the circumstances, and

(3) Reasonably believes that the decision is in the best interest of the corporation."[26]

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evski, 342 349. In another case, however, the theory of abstention of the court from inter fering in the business policy of a corporation was not applied (*Dodge v. Ford Motor Co*, 170 N. W. 668 Mich. 1919). In that case the court ordered to the majority owner of *Ford* to change the decision rendered on nonpayment of dividends to the shareholders in favor of investment into development and capital projects, by ordering him to pay the dividends to shareholders, because any corporation is organized primarily in the interest of sharehold ers. The decision was taken further to the action by minority shareholders brothers *Dodge*. The decision was criticized in theory as the corporation knows better than the court what was its interest. In the given case several years prior to this action brothers *Dodge* sus pended the delivery of spare parts to the corporation *Ford* and started construction of their own factory for the same production in competition to *Ford*. At the same time *John Dodge* withdrew from the board of directors of *Ford*, where he had been member for ten years. Hence, *Ford* seriously worried that brothers *Dodge* would use dividend to compete and develop their own corporation, reducing the profit in future for the shareholders of his corporation. That is why, this is the very situation where the theory of abstention by the court from interfering in the convenience of business decisions of a corporation should come to the forefront, because *Ford* was justly concerned about the business plan of the corporation and its future and decided to pay no dividends but to invest in the development. See D.A. Jeremy Telman, "The Business Judgment Rule, Disclosure and Executive Com pensation", *Tulane Law Review* 81/2006 2007, 866 869.

[25] All American commentators agree that courts should be capable of examining the decisions of directors, if they are irrational or taken in bad faith and that this is no enrochment into their merit, but if they were passed in such a way the duty of loyalty to the company is violated (fiduciary duty of good faith or due care for the company) or loyalty due to the company when there is conflict of interest. See D. Rosenberg: "Galactic Stupidity and the Business Judgment Rule", *The Journal of Corporation Law* 25/2006 2007, 313 314.

[26] ALI, Corporate Governance Project (1992), §4.01 (c). See D. Branson, (1993), 328; E. Scholastique, 207 211; R.P. Austin, I.M. Ramsay, 397 398.

The US Revised Model Business Corporation Act (RMBCA) set out the constitutive elements of this rule in a somewhat different manner:

"The director performs his duties as a director, including the duty of a committee member, if he acts:

(1) In good faith,

(2) With care of a normally diligent person in such a position under similar circumstances, and

(3) In the manner which he reasonably believes to be in the best interest of the corporation".[27]

The German *AktG* formulates four assumptions for this rule, which if met on cumulative basis constitute the immunity of the directors (sovereignty), who made the subject decision, which resulted in the damage, and which protect them from liability, provided the board of directors:

(1) Passed the business decision,

(2) Acted in good faith,

(3) Acted on the basis of being adequately informed, and

(4) Acted in the best interest of the corporation.[28]

The Law on Commercial Companies of Serbia, having adopted this concept, also determined its constitutive elements through the "persons having duties to the company" that should perform their tasks:

(1) In good faith,

(2) With due care of prudent business person,

(3) In a reasonable belief of acting in the best interest of the company.

4.3. Constitutive Elements of the Rule

4.3.1. Business Decision

The first constitutive element of this rule is a business decision. "Persons with duties towards the company" (subjects of the rule) according to the rules of corporate governance (legal, self-regulatory, autonomous – hard law and the rules of "soft law" and best corporate practice) make business decisions within the scope of their authority (explicitly proscribed or presumed under these rules). Almost all sources that codify the concept of "business judgment rule" explicitly or otherwise provide for *the principle of business decision* as the first constitutive element,

[27] RMBCA, § 8.30. The same rule applies to managers (§ 8.42).

[28] J.J. du Plessis *et al.*, *German Corporate Governance in International and European Context*, Berlin 2007, 60 61.

which can be contested (causative link with the damage caused to the company directly and indirectly to other stakeholders in the company).

However, the attention of legal theory and case law has been on the issue of whether only action (approval of a business decision) or also non-action (lack of a business decision) may be covered by this rule. Sometimes in business life, and consequently in legal life, non-action may cause even greater damage than action, but the fact that there is no business decision means it is not covered by this rule. Seemingly, in legal terms, both action (business decision approval) and non-action (non approval) must have the same legal consequences,[29] irrespective of whether some sources regulating this rule explicitly say so or not (application of general rules of contract law). This applies only when other constitutive elements of this rule exist.

4.3.2. Due Care and Informed Decision-Maker

The second constitutive element of this rule is: "due (reasonable) care". "Persons with duties towards the company" (subjects of the rule) while making business decisions (decision making process) should apply the proscribed "due (reasonable) care".

Depending on the legislator or court practice[30] in the absence of regulations, the care may be "care of prudent business person" or "care of prudent expert".

Several relevant, separate legal issues exist in the context of corporate liability of subjects of the rule, in addition to general legal issues within the theory of contractual law, discussed here.

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[29] See K.B. Davis, "Once More the Business Judgment Rule", *Wisconsin Law Review* 3/2000, 575 576; R.T. Miller, "Wrongful Omissions by Corporate Directors: Stone v. Ritter and Adapting the Process Model of the Delaware Business Judgment Rule", *Journal of Business and Employment Law* 4/2008, 951 954; J. Barbić, 385.

[30] In the classical English case law it was not necessary to establish the rule of business judgment. Starting from the provisions concerning care of the common law the courts simply declared incompetence to judge convenience of business decisions. In recent times, however under the influence of new bankruptcy regulations and the regulations of the so called disqualification of directors, the court practice necessarily changes in the di rection of recognition of this American doctrine of *business judgment rule* (E. Ferran, *Company Law and Corporate Finance,* Oxford 1999, 206 217). In France, to the contrary, the court has always declared competence in judging the convenience of business decisions literally applying provisions, according to which directors were rendered liable for "mana gerial fault". Still, it does not mean that the court denied the possibility to render directors not responsible ("the right to make mistake the right of erroneous belief"), providing for protection of some conduct, although the failure of the company could not have been ulti mately avoided, since the function of company management does not exclude the right to mistake fallacy and that the obligations of directors are not "result but of effort". See. A. Guengant, P. Troussière, S. de Vendeuil, *Le role des juges dans la vie des sociétés,* Paris 1993; C. Lefeuvre, *Le référe en droit des sociétés*, Paris 2006.

First, the issue of relevant "point of connection" of care. Apparently, the general attitude that "due (reasonable) care" is connected to director being adequately informed about the subject of the decision.[31] Some legislations expressly specify it, either by proscribing as a constitutive element of the rule that subjects of the rule in the process of business decision-making are being adequately informed, in addition to the constitutive element of "due (reasonable) care"; or by joining those two constitutive elements into one, or by interpreting the leading legal theory or court practice. In any case, the component of "due care" which is an integral part of this rule is connected to the element of being informed – business decision (or absence of decision) must be based on being adequately informed (which requires certain care, both in collecting and selecting information and its assessment).

In business decision making process or the decision (explicit or tacit) not to make a decision (action or non-action) the subject to this rule may use different methods, techniques and concepts (being self-informed, being mutually informed, being informed by auxiliary bodies – committees and commissions, decisions proposed by corresponding bodies, information obtained from the chairman of the board of directors, based on his duty to inform other members of the board, opinion of professionals in specific areas – auditors, accountants, legal advisors, investment advisors, financial advisors and others). In any case, the question of how much and what type of information is sufficient for a business decision in terms of application of the business judgment rule is more a matter for the subjects of the rule than for a judgment of the court.[32]

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[31] See E.E. Cassell, "Applying the Business Judgment Rule Fairly: A Clarification for Kansas Courts", *Kansas Law Review* 52/2003 04, 1121 1125.

[32] In the precedent case *Smith v. Van Gorkom* (Delaware) the board of directors of a public corporation approved merger, within two hour meeting, without having the pro posed merger agreement at hand. The Board so decided at the insistence of the CEO, Van Gorkom. Applying the standard of business judgment rule, the Supreme Court of Dela ware found that the "presumption that the directors have to act on an informed basis, fairly and in the belief that the act is in the best interest of the company". The court found, also, that the *concept of gross negligence* is an appropriate standard for determination whether the business decision of directors was approved on the basis of whether they were sufficiently informed. The way of conduct of the board of directors is a key road sign to the court in judging its care. The court could or should not investigate whether reasonable or necessary care had preceded the decision of the board meeting. On the merit of this standard the court found the board of directors liable, as it passed the decision on the basis of being insufficiently informed, thus acting in gross negligence (both in terms of the reasons for urging the merger on the part of *Van Gorkom*, and in terms of the value of corporation). That decision caused numerous commentaries, mostly negative, allowing the possibility that the board of directors acted with ordinary rather than gross negligence. This decision was followed by legislative response, which allowed under certain condi tions, limitation or exclusion from liability of some for material consequences of the vio lation of "duty of care". See D. Branson, (1993), 258 259.

The meaning of the standard of "due (reasonable) care" is questionable regarding different grades of fault (intent, gross negligence, ordinary negligence). Namely, what standard of care (fault) is necessary for it? However it is not disputable, that it does include the intention and gross negligence but the question is whether it covers ordinary neglect. The answer to this question is unanimous neither in legal theory and legislation nor in case law. One part of the legal theory is convinced that the standard of "due (reasonable) care" hence the standard of fault as a basis of subjective liability, presumes ordinary negligence unless explicitly stipulated to the contrary in the law, and since this is not the case with the corporate liability of the subjects of this rule, it means that ordinary negligence suffices for their liability.[33] Thus, the protection under the rule of business judgment does not cover any degree of negligence including ordinary negligence, let alone intention or gross negligence. This is the view taken mainly in civil law tradition, starting from the premise that even if only ordinary negligence exists, there is no "due (reasonable) care".[34] On the other hand, in common law tradition the view that the business judgment rule includes ordinary negligence is more frequent, so that it enjoys its protection, while the scope of this rule does not protect the intent and gross negligence.[35]

The case law, particularly rich in some US states, differs on this issue but the view that the business judgment rule covers ordinary negligence (in the process of making or non-making business decisions) is still predominant; so in any case the intent and gross negligence remain out-

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In the French case law it was ruled that the "decisions of the board of directors were null and void, unless the members were sufficiently informed". Nullity is optional and calls for evidence that the rejection of the company (board chairman) to inform its mem bers prevented them to take the decision in "full knowledge about the matter". In the same vein, the breach of the right of a board member to be informed cannot lead to the nullity of the decision, if in the concrete circumstances of the case were such right not infringed and were such a member correctly informed it would not have impacted the decision since he is in a large minority. See E. Scholastique, 216 222, 259 263.

[33] *In lege aquilia et levissima culpa venit*, Ulpianus, 42 ad sab., *Digestae* 9.2.44 (M. Karanikić Mirić, 174).

[34] See V. Breskovski, "Duty of Care in Eastern Europe", *The International Law yer,* 1995, 80 90.

[35] R.S. Sergent, "The Corporate Director' s Duty of Care in Maryland: Section 2 405.1 and the Business Judgment Rule", *Howard Law Journal* 2/2000 2001, 192 193, 243 244; D. Branson, "The Indiana Supreme Court Lecture: The Rule That isn't a Rule The Business Judgment Rule", *Valparaiso University Law Review* 36/2002, 639 640; M.J. Staab, 244; W.O. Hanawicz, "When Silence is Golden: Why the Business Judgment Rule Should Apply to No Shops in Stock for Stock Merger Agreements", *The Journal of Corporations Law* 28/2002 03, 217 218; E.S. Miller, Th.E. Rutlendge, "The Duty of Fin est Loyalty and Reasonable Decisions The Business Judgment Rule in Unincorporated Business Organizations?", *Delaware Journal of Corporate Law* 30/2005, 347, 352 353.

side the protection of this rule.[36] Therefore, the standard of "due care" is more strict in continental Western Europe (includes ordinary negligence and the rule of business judgment is not applied to any degree of negligence), than in USA (includes no ordinary negligence in the corporate liability, which is covered by the business judgment rule).[37] Finally, discussing the countries of Eastern Europe, instability of legal provisions and a high degree of uncertainty render a clear answer about the legal regime of ordinary negligence impossible in terms of corporate liability (coverage by the business judgment rule and non liability or non-coverage and liability). Some feel that by stricter standard of care (non-coverage by the business judgment rule and liability on the grounds of ordinary negligence) would perhaps encourage foreign investment in those countries.[38]

The answer to the coverage of ordinary negligence (in the process of making or non-making business decisions) by the business judgment rule, and nonexistence of liability of the subject of this rule in this case seemingly should depend on the legislature's view about the nature of applicable standards to corporate decisions of the subject of this rule – be it the standard of "duty of care of prudent business person" or the standard of the "duty of care of prudent expert". If however, this is a higher "care of prudent expert" standard of professional liability (exception in Serbian company law) there is no room to exculpate the subject of this rule on the grounds of ordinary negligence.[39] On the other hand, if we think of the standard of "due care of prudent business person" (the rule of Serbian company law), than it seems that due to the nature of business of the subject of the rule, which involves the principle of impossibility to foresee all business risks when (non) making business decisions, as well as out of the need to spur up the entrepreneurship of the subjects of the rule (taking the risk with "due – reasonable care"), it is possible to defend the view that ordinary negligence exculpates the liability (except in the

[36] In principle, the US courts express this principle in the formula "regularly either directors or other corporate managers are accountable for ordinary mistakes or beliefs when they assess (business decision making), be it legal or factual mistake". As a declara tion of business decision making policies, these courts often use the formula that the "di rectors of commercial undertakings may take commitments of the same kind as one may take in own business". In the case *Smith v. Van Gorkom* The Supreme Court of Delaware stated "we are of the view that the concept of gross negligence is appropriate standard for judging whether the standard of directors being informed in terms of applicability of the business judgment rule has been achieved." See. D. Branson, (1993), 344.

[37] See D. Ping Lee, "The Business Judgment Rule: Shoud it Protect Nonprofit Directors?", *Columbia Law Review* 103/2003, 926 928.

[38] See V. Breskovski, 95 96.

[39] Subjectivisation of due care through relevance of knowledge and skills of direc tors who have them is the standard also in the English law and theory. See. J. Charles worth and G. Morse, *Company Law,* London 1999, 277.

case of conflict of interest)[40], and that it is covered by the protection of business judgment rule,[41] while it can under no circumstances be considered the regime for intention and ultimate-gross negligence. This is irrespective of the fact that according to an otherwise acceptable dominant view of legal theory, the standard of "due – reasonable" care includes ordinary negligence (the need and grounds for exception from corporate liability). This is in accordance with case law of Delaware, although this is not entirely clear from their legislation.[42]

4.3.3. Good Faith

Third constitutive element of this rule is the principle of good faith,[43] recognized by company laws and civil laws of contracts.[44] The rule of "good faith" is a sort of umbrella for the application of business judgment rule,[45] as well as the rule of "due care", which poses the question of their relationship. American legal theory argues that the standard of "due care" applies to this rule in the case when directors are in no conflict of interest (individually or in connection to related persons) with the interest of the company to asses whether the standard is violated. In the case of a conflict of interest which binds the director to loyalty to the company, when the presumption of directors' good faith under the business judgment rule is eliminated, the standard of good faith is applied to determine if the director violated the duty of loyalty to his company (the

[40] Thus E.E. Cassell, 1131 1135.

[41] The view of the authors who argue that the standard of conduct of the corpora tion directors must be less burdensome than the standard for a corporation in general seems acceptable whatever the reality might be. Thus, one court ruling of US courts states: "It has been often alleged that the corporation directors and managers are liable for negli gence in carrying out corporate duties, but apparently all agree that such allegation is wrong. While a car driver who makes a wrong assessment of speed and distance and in jures a pedestrian will be called to compensate the damage, a corporate manager who makes wrong judgment about economic conditions, consumers; taste or efficiency of a production line will be rarely if ever liable for the damage to the corporation. Any termi nology, any fact that the liability of corporate directors or managers has been rarely im posed on the grounds of wrong judgment, only.....". See D. Branson, (1993), 372 373.

[42] See D. Branson, (1993), 256.

[43] For this principle more in: J. Beatson, D. Friedmann (eds.), *Good Faith and Fault in Contract Law*, Oxford 1995.

[44] The Uniform Commercial Code of USA (1962) provides (Articles 1 203) that "each contract or obligation in terms of this Law requires applying or performing in good faith". The Serbian Law on Obligations (Article 12) postulates "good faith and fairness" as general principles of law of contracts and torts.

[45] The American legal authors are of the view that "the requirement of good faith is something encompassing everything" but that this "umbrella" is especially important in the case when illicit motives underlie the business decision, and in the case of ratification of forbidden conduct of the subject of the Rule. See D. Branson, (2002), 643 645.

duty to act in its interest).[46] In the same vein, the standard of good faith is relevant when there is a conflict of interest between the director and the company, and there is a likelihood of the breach of the principle of loyalty to the company (work in the best interest of the company), that the director can prove a given legal transaction is fair (honest) for the company (corporation) despite possible absence of a proscribed approval for such a transaction.[47]

The rule of "good faith" is one of the most controversial elements of the business judgment rule due to more reasons than one. First, is it an independent element of this rule, irrespective of others? There is tacit understanding of good faith is not a duty which could be defined separately without reference to other duties. Namely, the duty of good faith requires the directors to make a serious effort to fulfill their duty of "reasonable care" and the duty of loyalty towards the company (act in the best interest of a corporation).[48] Second, is this standard specifically, as it seems to be, in the function of presumption of "reasonable belief of acting in the (best) interest of the company", and therefore has no specific *ratio* of its own in terms of the business judgment rule?[49] The answer to both questions leads to the conclusion that duty of good faith is no specific duty as regards the rule of business judgment, but covers other obligations (duties) of directors in the same way as contracting parties have duty of good faith (and honesty).[50] In case law and American legal theory the principle of good faith is replaced with the principle of rationality or reasoning.[51] According to them, "irrationality" or "lack of reason" of a

[46] E.E. Cassell, 1121.

[47] Thus E.E. Cassell, 1136 1137.

[48] Some look at this duty of good faith as a bridge between duty of care and duty of loyalty. In any case, be it taken as an independent duty or as subsidiary duty of duty of loyalty to the company (*it is not possible to act in bad faith and be loyal to the company)*, the duty of good faith is considered as an amorphous concept. See A.S. Gold, "A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith and Judicial Uncertainty", *Maryland Law Review* 66/2006 2007, 404 408, 417.

[49] Thus E.E. Cassell, 1131 1135; D. Rosenberg, 304 306; R.P. Austin, I.M. Ram say, 351 354.

[50] D. Rosenberg, 307.

[51] The American Legal Institute in the *Principles of Corporate Governance* sug gests at the same time a ridiculous example of irrational decision: company A needs a big quantity of ball bearings for its production; it has a possibility of procuring them and of the same quality from two companies B and C, where those from C cost 30% more. Com pany C is the company of the university colleagues of the most members of the BoD of company A, which nevertheless decides to buy those bearings and for three years in run, wishing to favor it, expecting no reciprocity. Whoever wants to question the liability of director of company A in the given case, must prove that their decision is not rationally (reasonably) grounded. See E. Scholastique, 209; M.A. Eisenberg, "The Duty of Care of Corporate Directors and Officers", *University of Pittsburgh Law Review* 50/1990, 970 972.

business decision shows that the decision is not taken in good faith and not based in the best interest of the corporation. In any case, it is pointed out that applying the test based on rationality, as a test of court examination of lack of good faith, helps avoid *Van Gorkom* style of liability[52].

Historically, most case law dealing with the issue of good faith with reference to the business judgment rule were about financial or other conflict of interest (duty of loyalty to the company). It is upheld today that "the majority of independent directors have proven that the board of directors acted in good faith", which as the Supreme Court of Delaware put it, "substantively reinforced it".[53]

4.3.4. Company Interest (Duty to Act in the "Best Interest of Company")

Fourth element of this rule is "reasonable belief of having acted in the best interest of the company". Legal position of the "persons with duties to the company" (directors) although originally tied to the legal form of a trust is still not fully analogous to it.[54] Duties of company directors are not identical to duties of trustees or other agents (that have a heightened obligation of preserving the entrusted assets, while the position of the director is to run an entrepreneur's risk to increase the assets and maximize profit for development and for shareholders' benefit). The legal position of the director is therefore specific, although based in a sort of *fiducia* (trust).[55] Consequently, the directors are required to act in "the best interest of the company" (identified by some as shareholders' interest).[56] Moreover, the directors must not in exercising their duties put themselves in a position of conflict of interest between themselves (direct

"Sincere mistake (fallacy) of judgment is permitted. But a judgment which cannot be viable on the rational basis is beyond protection of business judgment rule". Some court decisions of the American courts argue in favor of application of the business judg ment rule that the decisions of directors must be "reasonable" or grounded on "rational grounds" or "legitimate business ends" not to represent "big abuse of discretionary pow ers". See D. Branson, (1993), 358 361.

[52] See A.S. Gold, 428 431. Some American legal authors suggest that the direc tors are acting in good faith when they: 1) take the decision rationally, and 2) if their deci sion is reasonable, even if they did not reach the decision in a rational manner See B.S. Sharman, "Understanding Maryland's Business Judgment Rule", *Duquesne Business Law Journal* 8/2006, 320 322.

[53] See D. Branson, (1993), 364.

[54] See R.P. Austin, I.M. Ramsay, 349 350.

[55] *Ibid*., 338 339.

[56] About the company interest, see: D. Schmidt, *Les conflits d' intérets dans la société anonyme,* Paris 1999, 7 25; M. Vasiljević "Korporativno upravljanje i agencijski problemi", II deo ["Corporate Governance and Agency Problems", Part II], *Anali Pravnog fakulteta Univerziteta u Beogradu* [*Annals of the Faculty of Law in Belgrade*] 2/2009, 5 28.

or indirect) and the company – the duty that stems from the conflict of interest clause *(duty of loyalty to the company when such a conflict exists)*. According to long standing tradition, fiduciary duty is owed to the company[57] and not to individual shareholders, although some recent case law and theory question this view.[58]

In USA the fiduciary duty rule, although originally created on equity principles, continued to evolve in the corporate context, where it was particularly perfected in the most famous court for corporations – Delaware's Court of Chancery. As a general rule, fiduciary duty extends further than honesty and good faith. The courts and legal authors agree that the directors have to subject their individual interest to the duties they owe to the corporation.[59] In English case law it is deemed that a member of the board of directors is in fiduciary duty to the company only when he decides and acts in such a capacity, but not when he votes in the general meeting in his capacity of shareholder.[60]

Fiduciary duty of a director has been taken from common law by way of "legal transplants" into continental law, both in general terms of fiduciary duty (*work in the company interest*),[61] and in a special terms in the clause of conflict of interest of directors (directly or via connected persons) and the company, where again there is a duty to act in the interest of the company (*duty of loyalty to the company*). Thus, in France,

[57] Directors have duties towards the company, particularly to act in good faith in the company interest thus A. Hicks, S.H. Goo, *Company Law*, Oxford 2004, 310 325; E. Ferran, 154 170.

[58] H. Fleischer, "The Responsibility of the Management and of the Board and Its Enforcement", *Reforming Company and Takeover Law in Europe* (eds. G. Ferrarini *et al.*), Oxford 2004, 373 375.

[59] The direct cases of breach of fiduciary duty encompass: own usage of corporate chances (possibilities), appropriation of the company assets (theory of assets), and bene fits from third parties related to the company, competition to the company, prohibition of ungrounded enrichment. The indirect cases of the breach of fiduciary duty in the case of conflict of interest with the company (direct or indirect though related persons) are: the contract with itself, the existence of conflict of interest (direct or indirect), as well as the existence of certain post contractual duty (no competition with the company for a contrac tual period). See K.J. Hopt, "Trusteeship and Conflicts of Interest in Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service Oriented Society", *Reforming Company and Takeover Law in Europe* (eds. G. Ferrarini *et al.*), Oxford, 2004, 57 62; *Corporate Director's Guidebook*, (Committee on Corporate Laws and Corporate Governance, Section of Business Law, ABA Annual Meet ing), 2003[4], 16 18; B. Kasolowsky, *Fiduciary Duties in Company Law,* Hamburg 2002, 94 103, 139 151; A. Bohrer, *Corporate Governance and Capital Market Transactions in Switzerland*, Schulthess 2005, 173 181; M. Vasiljević, *Company Law,* Belgrade 2006, 409 412; M. Vasiljević, (2007), 145 150;

[60] *Case*: *Northern Countries Securities Ltd. v. Jackson & Steeple Ltd Chancery division*, in L. S. Sealy, *Cases and Materials in Company Law*, London 1992, 174 176.

[61] See R.P. Austin, I. M. Ramsay, 355 368.

Court de cassation explicitly recognized *devoir de loyauté* (duty of loyalty) of directors.[62] Legal authors characterize almost unanimously the position of director as fiduciary, provided that "duty of loyalty" requires, they point out, stronger application standards than the general obligation which stems from the principles of good faith and honesty.[63]

4.3.5. Absence of Conflict of Personal Interest and Company Interest

The American Legal Institute (ALI) in its definition of the business judgment rule includes as a constitutive element also absence of conflict of interest (direct or indirect) of persons concerned (with the company). Namely, the business judgment rule presumes that directors are not in conflict of interest, or if they are, that they are loyal to the company.[64] Some case law in America suggests that directors who approve a transaction out of conflict of interest must be both independent and informed in order to invoke the application of some rules of business judgment (good faith, loyalty)[65] by their decision to approve the transaction out of conflict of interest.

Certain links exist between the rule of business judgment and the rule of loyalty to company. In broad terms, if directors being sued invoke the application of business judgment, and the court finds a presence of conflict of interest which invalidates its application, loyalty and inherent honesty will be assessed. Practically, in all cases of conflict of interest with a company (and related persons) loyalty to the company shall be examined (eliminating the application of the rule of business judgment and its presumption) applying the most stringent criteria (even ordinary negligence alone is sufficient). Even if directors who have no interest in a given transaction (or only independent directors) do not approve a transaction, director who is in conflict of interest can "prove that at the time of contract signing or its performance it was in the interest of the company" or "fair for the corporation" (interest of the company) and the transaction would be legally valid.

The inclusion of conflict of interest into constitutive elements of business judgment rule is legally wrong, because these are two different

[62] In one case the director resigned in the previous company and established a new one. However, he persuaded the key employees of the former company to join the new one. Unlike the Appellation court, the Cassation court granted compensation for damages to the previous company, the plaintiff, founding that director violated the duty of loyalty to the previous company. See H. Fleischer, 377.

[63] *Ibid*., 378 379.

[64] Some case law defines the "director having the conflict of interest": 1) when he appears on both sides of a transaction or 2) if he has or expects material benefit which is not equal to the one which shareholders have from the transaction. See D. Branson, (1993), 348 350.

[65] D. Branson, (1993), 352.

concepts (business judgment rule is applied only in absence of conflict of interest between the director and the company, direct or indirect). Hence, no legal sources governing those concepts act in this manner. Still, whether conflict of interest exists or not, it is the duty of directors to act in rational (reasonable) belief in "the best interest of the company" (company loyalty, fiduciary duty of loyalty to the company).

The legal regime of the clause of conflict of interest of directors (personal interest with company interest) and redress (disclosure – prevention of the consequences of conflict of interest, approval by persons without voting rights in the given transaction, proof that the legal transaction is in the interest of the company)[66] is one of the paradigms of corporate governance. Nevertheless, it defies conventional logic: interest of the company must prevail under the duty of loyalty in the case of conflict of personal interest of a director. Is it normal to expect of a director to put the (general) interest of the company before his personal interest unless he is personally interested to put another interest (in this case the interest of the company) before his interest (or that of related persons)?! Without diminishing positive achievements of contemporary company law in redressing this issue,[67] it seems that a solution rests in the instruments of personal interest (or that of related persons) of directors to promote the company interest above his interest (or the interest of related persons). That instrument of harmonization of both interests, so that the "another's" interest (company interest) would have primacy over the private (personal) interest of the director (or the interest of related persons) is found primarily in the (variable and fixed) remuneration regime for directors. Only then the law should serve the needs of economy and vice versa, the economy would help the law justify its mission.

5. BURDEN OF PROOF PROCEDURAL AND/OR SUBSTANTIVE RULE

The nature of the rule of business judgment can be either procedural and/or substantive. A part of American legal theory as its origin, argues that this is just a legal procedural rule (refutable legal procedural presumption[68] of good faith and /or "due care" on the side of the subjects affected by the rule),[69] while the other part of legal theory suggests that

[66] See D. Schmidt, 29 86.

[67] *Ibid*., 87 180.

[68] This presumption at the side of directors (good faith, due care, conduct on the informed basis) is practically difficult to refute, except in the case of conflict of interest, so that in Delaware all business decisions of directors where no conflict of interest existed practically remained in force, while in other USA states the protection of directors was not so strong. See P.V. Letson, 179 180.

[69] See L. Stout (suggests that "courts, unequipped to judge the substance remain in the secondary solution to rule the procedural issues" and finds that "from the angle of

this is both a legal procedural rule and substantive legal rule (constitutive elements of this rule, the proof of existence of which activates its application, which is already a substantive legal rule).[70] Exceptionally, if there is a conflict of interest between a director and the corporation (direct or indirect) then there is no presumption (refutable) on the side of the director but it is deemed to be refuted and it is up to directors to prove that they did not violate the duty of loyalty to the corporation acting in good faith and with "due care".[71]

One of the most frequently quoted cases concerning this aspect of the rule in the Supreme Court of Delaware is *Warshaw v. Calhoun*: "In the absence of proof of bad faith on the part of directors or gross misuse of powers in business judgment the directors shall not be involved in the court procedure. The burden of proof of bad faith or abuse of powers remains on the Plaintiff. The acts of directors are deemed presumably faithful and motivated by the best corporate interest and the minority shareholders disputing their good faith should shoulder the burden of proof."[72]

Many court cases in the USA suggest that business judgment rule means "presumption that in making business decision, corporate directors acted on the basis of being sufficiently informed, in good faith and sincere belief that the action had been taken in the best of its interest." Thus, this is the presumption of regularity linked to all actions taken by the elected corporate directors. This is a refutable presumption[73] standing "above routine presumption of regularity"[74], with the effect of shifting the burden of proof onto the Plaintiff for violation of duty by a director.

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rationality, it seems counter productive to focus on the of being informed procedure and of being informed as the basis for responsibility"), "In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and The Business Judgment Rule", *Northwestern University Law Review* 2/2001 2002, 691 694; B.C. Brantley, "Deal Pro tection or Deal Preclusion? A Business Judgment Rule Approach to M&A Lockups", *Texas Law Review* 81/2002 2003, 371 372, 374 380; W.O. Hanawicz, 217 218.

[70] See S.M. Bainbridge (writing that it is not the point that under the theory of restraint, the court can not even ask whether the accused directors violated the rule of due care, good faith or loyalty, as substantive constitutive elements of the *business judgment rule*, rather that when those presumptions were not refuted by the Plaintiff, and the Defen dant failed to prove to the contrary, hence when all those presumptions for the application of this rule are present, then the court has no room to enter the merit substantive legal aspect of business judgment of the directors), 93 99; F. Shu Acquaye, "The Taxonomy of the Director's Fiduciary Duty of Care: United States and Cameroon", *New York Law School Journal of International and Comparative Law* 22/2003, 591 593.

[71] See E.E. Cassell, 1121, 1134 1135.

[72] Quotation according to: D. Branson, (1993), 330; E. Scholastique, 212 225.

[73] See S. Graić Stepanović, "Pravilo (adekvatne) poslovne procene" ["The Rule of (adequate) Business Judgment"], *Pravo i privreda* [*Law and Economy*] 5 8/2008, 306 309; G. Koevski, 338 340.

[74] D. Branson, (1993), 365.

Still, to attract the presumption of this rule and shift the burden of proof on the Plaintiff, a certain quantum of evidence of the presence of preconditions necessary for the business judgment rule (its elements) must be provided to "move from presumption to preconditions" (each presumption has preconditions). Hence, to apply the presumption of this rule, its elements must be proven ("the stronger the proof the stronger the effect"). The effect could be only the presumption of presence of the elements or so convincing a proof of existence of all elements of the rule that the rule may appear as an irrefutable presumption, "safe haven" for corporate decisions and their makers. If not, the less proof the more questionable the presumption is, instead of being the "safe haven".[75]

General substantive rule of the laws of contract on subjective liability (as a rule and strict liability as an exception) with presumed fault is that "whoever causes damage to another shall be liable for its compensation, unless he proves that the damage was caused without his fault"[76] hence, liability is presumed pending proof to the contrary by the tortfeasor. The Law on Commercial Companies of Serbia, however, constitutes the opposite rule that person with duties to the company "who prove to have acted in compliance with this rule ... is not liable for the damage inflicted on the company due to such act"[77] (substantive legal presumption of liability, that is the presumption of bad faith and action without "due care" in the interest of the commercial company), pending the proof of the tortfeasor to the contrary[78] (in practical legal terms the proof of presence of constitutive elements of this rule and action in compliance with them). Thereby the substantive legal presumption does not coincide with the traditional legal procedural presumption further to which the Plaintiff (the presumed injured person: company, shareholders and possibly creditors) proves the harmful conduct of the defendant[79] (loss, fault and causative link between the fault of the tortfeasor and the damage inflicted). Although new Serbian procedural laws have changed this traditional procedural rule in terms of a more equitable distribution of the burden of proof to both litigation parties (each party, the Plaintiff and Defendant, present their evidence in the process, and it is up to the court to judge their relevance from the view point of existence or nonexistence of liability),[80] the gap in Serbian law still remains between substantive

[75] *Ibid.*, 368 370.

[76] LOO, Article 154 (1).

[77] LCCS, Article 63 (5).

[78] Thus the Croatian law ("members of the management shall be liable for any fault. It is presumed, and the burden of proof is on them that there is no fault for the dam age incurred"). See J. Barbić, 381.

[79] Compare M. Orlić, 198.

[80] Law on Litigation Procedure, *Official Gazette of the Republic of Serbia*, No. 125/04 and 111/09, Article 220.

and procedural burden of proof. In the context of the rule of business judgment presumed subjective liability of directors in company law, as a substantive legal rule, cannot be taken as an improvement for the need of entrepreneurs risk and initiative of directors, which shall slow down business decision-making and render it more cautious and noncompetitive.

6. RATIFICATION IN THE CASE OF BREACH OF BUSINESS JUDGMENT RULE

The question is whether the company general meeting or board of directors or supervisory board may ratify a breach of fiduciary duty of directors, including the violation of the duty of care. As a rule, the courts and legal theory point out that the company's general meeting may not ratify acts of directors which constitute fraud that are contrary to law or lead to a company property loss, that affords them immunity from liability, while other acts may be ratified under the general principles of contract law on the relationship of the principal and the client (the contract of the order-mandate) and special rules of the company law.[81] American and Australian courts distinguish between transactions, which are not made null and void by ratification by a majority vote, transactions which are null and void by law (which cannot be subject to ratification) and the transaction which constitutes a loss or gift of corporate property (which are also null and void and may not be ratified).[82] The transactions in violation of duty of loyalty, which are contained in the clause on conflict of interest or the clause on ban on competition, could be ratified by the board of directors (if the majority has no interest in the given transaction) or the company general meeting. In principle, ratification is taken as one of the internal corporate remedies, another mean of alternative dispute resolution.[83]

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[81] LOO, Article 752. "Director shall be liable to the company for the damage caused to it in breach of the provisions of this law, statutes or general meeting decision. Exceptionally, the director shall not be liable for the damage caused if he acted in compli ance with the general meeting's decision" LCCS, Article 415 (1 2).

"Liability of the managing board is excluded if the action is taken on the merit of a valid decision of the general meeting. This excludes the liability for damage to the com pany, but not to the company creditors. The decision must not be annulled or refuted." Thus J. Barbić, 386.

[82] See R.P. Austin, I.M. Ramsay, 816 831.

[83] D. Branson, (1993), 298 301.

7. LEGAL REGIME OF THE RULE (POSSIBILITY OF LIMITATION OR EXCLUSION)

An open question is the legal nature of regulation of business judgment. Is it a question about *ius cogens* concept or of dispositive norms? Common law accepts the view that it is possible, in whole or in part, to exculpate the director from liability if he acted "honestly and reasonably and who, under the circumstances, deserves fair acquittal". These three conditions are cumulative and are judged subjectively by the court. However, all provisions of the articles of association or other agreements or contracts aimed at exculpating or compensating directors for any judgment for negligence or violation of duty are null and void.[84] Force major, a bylaw of the company (ratification of decision of the board of directors by the company general meeting, except in case of fraud and violation of law), as well as when there is proof of absence of fault, namely proof that they acted with due care[85] can also be cause for acquittal of directors.

Corporate Law of Delaware enables also limitation or exclusion of directors liability on an autonomous basis (it is deemed that the market – loss of reputation of directors, is more efficient in terms of directors' liability than sanctions of the court) for a loss (except: 1) in the case of any breach of the duty of loyalty to the company or its shareholders, 2) for action in bad faith, non action, willful mismanagement or deliberate violation of law, or 3) for any transactions inappropriately benefiting the director – conflict of interest), which is considered more acceptable than codification of different standards of due care.[86] The other states in USA followed suit in their corporate legislation, allowing the corporations to limit or eliminate the liability of directors also in the case of minor and often gross negligence.[87] Also RMBCA in USA enables exculpation of directors from liability for violation of duty of loyalty also for actions that are not taken in good faith and which do not include the financial benefit of directors (conflict of interest) or intentional impairment to the corporation.[88]

Unlike USA in Germany "due care" of directors cannot be diminished by company's articles of association. Additionally the directors can-

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[84] Company Act (1985), § 310.

[85] Unlike *duty of care* the only aim of which is prevention of making damage to the company, *the violation of duty of loyalty* and thus the liability of directors exists even if the company did not incur damage by the doings of the directors, but suffices that they earned the profit by making such a violation (e.g. breach of the clause of conflict of inter est). See D. Branson, (1993), 293.

[86] Delaware General Corporation Law (1953, 1973, 1974), § 102 (b) (7), *Dela ware Laws*, 2000; A.S. Gold, 413 414.

[87] D. Branson, (1993), 257 260; D.A.J. Telman, 844 847.

[88] RMBCA, § 2.02 (b) (4).

not be exculpated from liability by ratification of their decisions by a general meeting of the company or the supervisory board.[89] Serbian contract law allows exclusion (or limitation) of contract (in company law in terms of corporate liability of directors the same could be analogous under the articles of association or another company bylaw) liability of the debtor for ordinary negligence (unless there is equality of the contractual parties) in advance, but not for intention and gross negligence.[90]

8. APPLICATION OF MODIFIED RULE OF BUSINESS JUDGMENT INSTEAD OF THE CONFLICT OF INTEREST RULE

8.1. Duty of Care or Conflict of Interest of Directors (Loyalty to Company) and Takeovers

In the case of takeover of joint-stock companies under takeover bid, the directors are as a rule reproached for being in the conflict of interest if they take any measures of defense (they are interested that the target company in which they hold a position, is not taken over by a hostile party, to avoid being replaced after takeover – action in own interest, while not protecting the interest of company and its shareholders – bound by law). In such cases, American courts, generally do not automatically apply concept of loyalty to the company (conflict of interest), rather duty of care of directors (business judgment). As a result *business judgment rule* is not applied, since *duty of care is used instead of duty of loyalty*. Application of the principle of due loyalty in the case of takeover could lead to quite another result (the rules of conflict of interest) than the application of the principle of duty of care (duty of decision making on the basis of being fully informed, duty of investigation, when appropriate etc.).

The Supreme Court of Delaware first adopted duty of care, giving it primacy over the test of loyalty to the company in the cases of defense measures against takeover. In the case of *Cheff v. Mathes*, when the material interest of each director was found to be minimal or non existent, the court applied the principle of due care to the acquisition of a significant block of shares in the target company. The court found, after an investigation, professional advice and personal observations that the directors acting with due care and in good faith came to believe that the takeover was a threat to the going concern of the company. Many commentators of that decision found that it can be shocking and unfair for the shareholders of the target company. Other commentators found that the application of due

[89] See V. Breskovski, 90 91.

[90] LOO, Article 265.

care in such cases leads to the collapse of the concept of conflict of interest and it's folding into the business judgment rule.[91]

In the context of takeover of joint stock companies, both hostile (without management consent) and non hostile (with management consent), application of the business judgment rule concerning defense measures is contentious. In this case the court has two options: first to apply the usual rule of business judgment (shortened inquiry), which practically means allowing management to take all defense measures under the guidance of this rule – *the first generation of the rule of business judgment* in the context of takeover; and second, to apply the *modified rule of business judgment* applicable as a reply to the takeover bid (examination of full due care, analysis of due loyalty or analysis of modified duty of loyalty under the national law for the needs of a takeover)[92].

The Supreme Court of Delaware specified, in more than one case, some modifications of the usual rule of business judgment – *the second generation of the business judgment* rule in the takeover context. Thus, in the case of *Unocal Corp. v. Mesa Petroleum Co*, guided by the fact that the board of directors may primarily act in own interest in takeover before consideration of the application of the rule of *business judgment*, that the court should separately review two issues: first, whether the conduct of directors is only or primarily motivated by the wish to ensure their survival on the positions held, and second, whether the defense measures are proportionate to the threat of acquisition (reasonable proportionality of the measures of defense is at the very heart of the modified business judgment rule in the context of takeover).[93]

Finally, the Supreme Court of Delaware developed in the case *Revlon, Inc. v. MacAndrew & Forbes Holdings*, the *third generation of the rule of business judgment* in the context of a takeover (so called bidding phase). Namely, when it becomes clear that a bid is imminent the role of directors changes from defenders of the corporate bastion into auctioneers tasked with getting the best price for shareholders – the rule *just say no defense*. In the bidding phase, any defense measure which target company management takes must be "rationally connected with the interest (benefit) of shareholders". Interestingly, Serbian Law on Takeover of Joint Stock Companies generally (applied in all takeover cases) changes the general rule of duty of management (which is rather debatable in legal

[91] See D. Branson, (1993), 301 303.

[92] In the state of Ohio Corporation law provided that the director must keep in mind the interest of "employees, creditors and consumers, economy, state and nation" and "the long term like short term interest of corporation, including the possibility that those interests may be best protected by ongoing independence of the corporation". See D. Branson, (1993), 383; R. Hamilton, *The Law of Corporations,* Minnesota 1991, 317 318.

[93] See D. Branson, (1993), 384.

theory) of loyalty to the company (and its multi interested constituents),[94] which in the context of takeover (from the moment management is unable to take defense measures) must be loyal to shareholders only, ("the management of target company is bound to act, during the period of takeover in the best interest of the shareholders of target company").[95] The Supreme Court of Delaware, however, in some subsequent cases partly revised its approach. Thus, in the case of *Paramount, Inc. v. Time, Inc*., *inter alia* concluded: "...we have said that directors must consider inadequacy of the price offer, the nature and the time of offer, the question of illegality, the range of other interest constituents in addition to the shareholders and other factors...".[96] It all shows that the development of the rule of business judgment in the context of takeover of joint stock companies is not linearly progressing, but modifications to the general business judgment rule in the context of takeover are necessary to cast more light on this general rule.

8.2. Due Care or Conflict of Interest (Loyalty to Company) and Derivative Suit

In the case of derivative suits instituted on behalf of a joint-stock company (*actio pro socio*) against one or more directors who should represent the company as plaintiff, the directors are in a specific conflict of interest and cannot practically represent the company in such litigations. Therefore, American practice is to form a special *Directors Disputes Committee* (which is not beyond criticism),[97] composed of persons who are in no conflict of interest and who may participate in the dispute. In this way conflict of interest is eliminated and the rule of *business judgment* may be applied in compliance with recommendations of the Disputes Committee, which most frequently recommends to dismiss the dispute, because "it is not in the best corporate interest". Whether Disputes Committee acts with certain care or due care is usually determined via an independent board through establishment of facts by interviews or questionnaires and other reports analyzing the support of the Disputes Committee to dismiss the proceedings before the court, because the require-

[94] The rule that the company management must perform its duties "in the best interest of the company" bearing in mind the interests of the shareholders, investors, em ployees, creditors, consumers and public interests, is generally a sort of universal (with specific and dominant single interest in some cases of takeover like the interest of share holders, for instance) and accepted both as a general principle of the EU Thirteenth Direc tive, Article 3 (1) (c). It is accepted by LCCS (Article 63) and Code of Corporate Gover nance of Serbia, *Official Gazette of the Republic of Serbia*, No. 1/06, Article 113.

[95] Law on Takeover of Joint Stock Companies LTJSC, *Official Gazette of the Republic of Serbia,* No. 46/06, Article 3 (1) (4) with reference to: LCCS, Article 63 and Article 61.

[96] See D. Branson, (1993), 387.

[97] *Ibid*., 303 305, 378 379.

ments are met for the application of the rule of business judgment (Disputes Committee acting rationally in issuing its recommendation).

Unlike earlier practice that accepted Disputes Committees, which according to some was a unilateral application of the rule of business judgment, as of recently the case law particularly of the Supreme Court of Delaware started modifying the application of the rule of business judgment in the context of disputes in derivative suits.[98] Thus, it promotes a practice that the court may in its own discretion, consider Disputes Committee recommendations also from the view point of merit, along with the application of own independent assessments in some cases.

9. (UN) JUSTIFIABILITY OF BUSINESS JUDGMENT RULE?!

A question remains about real justifiability of business judgment in civil law countries, in legal cultures which do not practice common law. Namely, civil law countries have always used the legal standard of "due care" ("care of prudent business person" or "care of prudent expert"), and the legal standard of "good faith and fairness" and "loyalty to company". Three unavoidable elements of business judgment are these three standards in all legislations which codify it (either continental or common law legal tradition). Still, the promotion of those three standards (*due care, good faith, loyalty to the company*) leaves a dilemma about the sort of conduct which may constitute a breach of good faith, but not a violation of "due care" or loyalty. It seems acceptable that good faith cannot be viewed as a separate legal standard, which may be defined without reference to other duties, because the "duty of good faith" requires the director to make a sincere (fair) effort to act "with due care" and "due loyalty". It has been rightly concluded that duty of good faith is not a separate duty but covers other obligations of directors in the same way contractual parties are bound to good faith.[99] Legally and logically it is not possible that the director as a fiduciary acts (loyalty – fiduciary duty of acting in the interest of the company) simultaneously in bad faith and loyally to the company and shareholders, thus the duty of good faith cannot be an independent duty but accessory to the duty of loyalty. Analogously, the duty

[98] Modified is the regular rule, the rule of *business judgment* by presumption of good faith in derivative suit; the possibility of forming the Dispute Committee of corpora tions when majority of directors are sued is being denied; court review of the findings of the Corporate Disputes Committee is requested. See D. Branson, (1993), 380; R. Hamil ton, 319 321.

[99] "Duty of good faith could be best apprehended from the reply to the question 'whether the directors do their best when working for someone else'? This includes the conduct which breaches either the duty of loyalty or the duty of care or perhaps another behavior". See B.S. Sharman, 307 309.

of good faith is an indirect way to impose responsibility on the grounds of due loyalty.[100]

The rule of "due care" ("care of prudent business person" or "care of prudent expert") is therefore the most important segment of the rule of business judgment.[101] The rule of business judgment, in itself is not a separate legal standard and is inseparably linked to the rule of due care. Factually and legally, the rule of business judgment as a standard of corporate director's conduct presupposes some care on the part of director as a rational basis for taking business decisions. Basically, special doctrine of business judgment is unnecessary and provides no special protection to the directors not already accorded by the standard of "duty of care".[102] This is because the rule has never been a "safe haven" for directors when acting in gross negligence in making business decisions. If the rule of business judgment constitutes a refutable presumption (principle of common law) of existence of its constitutive elements at the side of the directors pending the plaintiff's proof to the opposite (in common law regime), then the question arises what this presumption means provided the evidence is secured or provided that the director obviously violated duty of care? Hence, it should be concluded that the rule of business judgment is unnecessary and constitutes no independent legal standard but is practically inherent part of "due care".[103]

Practically the rule of business judgment is a standard of directors' behavior, which is applied when there is no conflict of interest between the interest of directors and company and includes, measured by the standard of "due care" an assessment of performance of their duty to supervise, duty to investigate, duty to make a reasonable decision and duty to reasonable procedure in business decision making. Hence, the rule of business judgment and the standard of court deliberation in ruling whether the directors violated the standard of behavior is dictated by due care.[104]

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[100] See A.S. Gold, 407 409 and 426 427. In the American theory there are argu ments in favor of the standards of good faith, in an honest belief that it is in the best inter est of the corporation, be replaced with the standard of rationality, which offers more maneuvering to the directors. See M.A. Eisenberg, 969 971.

[101] See D. Branson, (1993), 334 337.

[102] R.S. Sergent, 194 195.

[103] *Ibid*., 247 248.

[104] See E.E. Cassell, 1126 1127. "It is not the point that the court under the theory of restraint may not even ask: has BoD violated the duty of care?" See S.M. Bainbridge, 93 94. American legal theory argues "if the judges are not qualified to judge whether the conduct of directors violated duty of care then they are not qualified to judge if their con duct crossed the line of ordinary negligence and entered the zone of gross negligence or another such standard." See D.A.J. Telman, 864 865.

The standard of "due care" (according to the rule "care of prudent business person", and exceptionally "care of prudent expert"), as an intention and gross negligence (exceptionally in application of the standard of "care of prudent expert" and when conflict of interest exists, direct or indirect, between directors and companies, and ordinary negligence), determined, as a rule, on the standard of objectification – *in abstracto* (with the elements of subjectivization – *in concreto*, in professional care or existence of special skills of some directors – *skills*, in common law terms), with a refutable presumption of its existence on the side of directors pending opposite proof by the plaintiff (except when conflict of interest exists when this presumption should not exist on the side of directors, unless the directors then prove the existence of "good faith and loyalty to the company"), as a classical concept of civil law, with standardized meaning in the court and business practice, is the only and acceptable concept of liability (contractual and non contractual) of directors in company (corporate) law.

The attempt at partial substitution of "due care" for the liability of directors under the company (corporate) law by non critical "legal transplants" of a common law business judgment rule into the civil law culture, failed in our view, as completely artificial, contrary to continental legal tradition, and unnecessary. Legal certainty has not increased. On the contrary, it caused complete legal confusion in courts and in business practice in the domain of liability of the company. The replacement of a proven and standardized legal concept of "due care" failed, but contrary to the saying that the operation was successful however the patient died, here the patient itself (legal system) survived, although in reality it is about to die.

Legal practice, both court and business practice, is still, according to our knowledge in civil law tradition true to its good old standard of "care of prudent business person" as the rule and standard of the "care of prudent expert" as an exception (with dilemmas whether in the circumstances of corporate scandals it is to accept the need of being more stringent as to corporate liability of directors by replacing the rule with the exception or at least by non exculpating the directors from liability when applying the standard of "care of prudent business person" for ordinary negligence[105]). Finally, objectification of the standard of "due care"[106] (which should in return affect better selection of more successful directors), with small ingredients of subjectivism, is in itself a hint of possibility of embarking along this path. Sooner or later it will come. There is a

[105] About the advancement of the Macedonian law (in our view too early) to that end, see G. Koevski, 349 352.

[106] Thus the Australian law. See R.P. Austin, I.M. Ramsay, 387 395 and 406 410; for Croatian law see J. Barbić, 382.

need for wisdom rather than haste (before the existence of general awareness that being a director is a profession), or delay (that the risk of their erroneous beliefs shifts to the shareholders, which are still less risky than those of court misleading notions). Until then, let us hope courts are wise (restraint in interfering with the convenience of business decisions of directors), along with legislators, directors and lawyers.

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SHAREHOLDER RIGHTS AND SHAREHOLDER ACTIVISM: THE ROLE OF THE GENERAL MEETING OF SHAREHOLDERS

An appropriate division of power between the board of directors and share holders of the company is quintessential for the success of the company. However, for a long period of time the monitoring powers of the shareholders were limited. Re cently, both the European and the national member states' legislators refined corpo rate law and allocated more (monitoring) powers in the hands of the (general meet ing of) shareholders. This paper addresses in a comparative perspective the powers of the general meeting in five countries. First, the power of the shareholders that is provided through the European company law directives is briefly described. Next the "national" powers of (1) ordinary general meetings and (2) extra ordinary meetings are addressed and compared. Third, the law in action is used to analyse the develop ments of shareholder rights and shareholder activism and to discuss whether the law and regulations provide in the appropriate shareholders rights.

Key words: *General meeting. Shareholder rights. Voting. Attendance.*

1. INTRODUCTION

Shareholder monitoring and shareholder activism is at the heart of the corporate governance debate. It is considered as a fundamental component balancing the powers of the board and of the shareholders. The issue is not very new. Ever since corporate law was developed, questions were raised as to how to divide the power between boards and shareholders, quintessential for the corporation that exists in part to facilitate delegated decision-making.[1]

[1] R. Kraakman *et al., Anatomy of Corporate Law*, Oxford University Press, Ox ford 2009, 72.

Shareholders generally occupy a central position in company law all over Europe. Investors put money at risk in a venture and use the corporate form to legally structure the business. As consideration for their investment, the investors receive shares, which make them shareholders. These shares provide the shareholder a bundle of shareholder rights. Shareholders will make use of these rights to protect their investment. Easterbrook and Fischel note:

> "Shareholders are the residual claimants to the firm's income. Creditors have fixed claims, and employees generally negotiate compensation schedules in advance of performance. The gains and losses from abnormally good or bad performance are the lot of shareholders, whose claims stand last in line. As the residual claimants, shareholders have the appropriate incentives (collective choice problems notwithstanding) to make discretionary decisions...The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion. And although the collective choice problem prevents dispersed shareholders from making the decisions day by day, managers' knowledge that they are being monitored by those who have the right incentives, and the further knowledge that the claims could be aggregated and votes exercised at any time, leads managers to act in shareholders' interests in order to advance their own careers and to avoid being ousted".[2]

This theory still stands today notwithstanding some scholars have criticized its incompleteness. Black provides an overview of the interests of other corporate constituents, explaining why these constituents have no voting rights.[3]

For a long period of time the shareholders – acting together in the general meeting of shareholders – were considered the supreme and final decision makers of the company. The shareholders controlled all powers which were not vested in other bodies of the company. The shareholders were – and still are today – presented at the top of the diagram representing the company.[4] Shareholders are seen as "owners" of the company. However shareholders own the shares, not the company. When shareholders become numerous and the ownership of the shares is constantly changing, the allocation of all powers in the hands of shareholders and general meeting becomes inefficient. Today the residual powers shifted to the board of directors and the general meeting of shareholders can only vote

[2] F. Easterbrook, D. Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, Cambridge 1996, 67 68.

[3] Black refers to the wide distribution of the residual interests, the costs and na ture of the residuals claimant. Other distributions of formal control rights will be less ef ficient (B. Black, *Corporate Law and Residual Claimants*, Working Paper, *http://eschol arship.org/uc/item/5746q7pj#page 1*, last visited 1 December 2011).

[4] Until 1973 the Belgian Companies Act stated explicitly that the general meeting had all the residual powers which were not vested in the board of directors.

on the issues that the law or the articles of association are willing to allocate to the decision making power of the general meeting. As long as corporate issues cannot or are not subject to a vote, the right to vote is of limited value.

The shareholders' meeting is not deprived of all powers. In most countries the (general meeting of) shareholders are in charge of the election of the board of directors, a number of other recurrent corporate items and the "fundamental decisions" of the corporation. In one textbook it sounds: "In any case, however, it is the general meeting that decides on fundamental matters, such as the alteration of the articles, including the objects of the company, the transformation of the company into another legal person and its winding up."[5]

The objective of this paper is to comparatively examine the role of the general meeting of shareholders and relate this role to the attendance and voting turnout of shareholders and identify the drivers for shareholder attendance. That is, we examine whether the AGM can play the role it is given in the new corporate governance framework.

2. THE POWERS OF THE GENERAL MEETING OF SHAREHOLDERS

2.1. The European Harmonisation Efforts

In many corporate law textbooks the position of the general meeting is addressed in a strictly formal way. In a large comparative research project on the efficiency of voting systems, Eckbo, Paone and Urheim started the analysis of the general meeting with the time and power to convene the meeting, the notification date, the techniques to provide the notice, and the content of the notice and the agenda. The paper continued with the right to put items on the agenda, the distribution of information, the criteria for participating and voting at the general meeting, how shareholder can vote at the general meeting. Finally the work ends with the quorum and majority requirements, the functioning of the meeting and the distribution of information after the general meeting.[6] The analysis does not come as a surprise in light of the legal developments of shareholder rights for which the European Shareholder's Directive 2007/36/EC

[5] A. Dorresteijn *et al., European Corporate Law*, Kluwer Law International, Al phen aan de Rijn 2009, 193.

[6] B. Eckbo, G. Paone, R. Urheim, *Efficiency of Share Voting Systems Report on Italy*, Tuck School of Business Working Paper No. 2009 64, July 2009, 183; B. Eckbo, G. Paone, R. Urheim, *Efficiency of Share Voting Systems Report on Sweden*, Tuck School of Business Working Paper No. 2010 79, August 2010, 226.

serves as an illustration.[7] The directive aims "to allow shareholders effectively to make use of their rights throughout the Community".[8] The Directive requires that companies provide in a timely manner information on the time and the place of the meeting, that shareholders have a right to put items on the agenda, that shareholders do not have to deposit their shares prior to the meeting, that shareholders have a right to ask questions and vote by proxy and that companies disclose the voting results. How major the step forwards towards more shareholder democracy was, the shareholder directive does not empower shareholders with more control rights.

The agenda items upon which the shareholders are empowered to vote are not identical in the different countries. To assess the monitoring behavior of shareholders it is necessary to study which items the general meeting of shareholders are according to the law subject to a vote, when these matters come up to a vote, how these matters come up to a vote and how the topics are approved or rejected. We address the first two questions.

First it is necessary to identify the rights of the general meeting of shareholders. The European harmonization efforts of company law failed to focus on the internal organization of the company. In the nineteen seventies the European Commission started a debate to harmonize the internal structure of the company through the proposal of the fifth company law directive. It was considered that the two-tier system was superior but the Commission recognized that one-tier systems provide characteristics that in certain situations can be tolerated. The proposals were modified during the discussions over the next years but finally, as it became obvious that both systems had their merits and shortcomings, the European Commission withdraw its proposal.[9] Many of the discussion topics had been picked up in other developments like corporate governance and freedom to (re)incorporate. As a result the harmonization efforts vis-à-vis the position and power of the general meeting of shareholders ended with the provision of mandatory approval rights of a limited number of reorganizations of the company.

Table 1 provides an overview of the rights of the general meeting of shareholders in the different company law directives. It is of importance to note that the field of application of the directives can differ. The

[7] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, *PBL* No. 184, 14 July 2007, 17.

[8] Considerans 14 of the Directive 2007/36/EC.

[9] The developments regarding the proposal of the fifth but also of all other direc tives are recently and orderly provided in A. Dorresteijn *et al., European Corporate Law*, Kluwer Law International, Alphen aan de Rijn 2009, 39 93.

second, third and sixth company law directive as well as Directive 2005/56/EC is applicable to all public limited liability companies while the takeover directive, the transparency directive and the shareholder rights directive is only applicable to companies which have their shares traded on a regulated market and in Directive 2006/43/EC the articles differ from one another in the field of application.

The second company law directive which emphasizes the protection of creditors of the company via the minimum capital rule and the maintenance of capital provides in the intervention of the general meeting when the capital is modified. First, when the company acquires assets of the founders of the company outside the normal course of business shortly after incorporation, the acquisition must be submitted for the approval of the general meeting.[10] The rule was promulgated to avoid founders to first establish the company and subsequently circumvent the procedures for considerations in kind. In 2006, the requirement was further softened when transferable securities are contributed as consideration. The protection of capital is further strengthened via the intervention of the general meeting of shareholders when the company decides to undertake any kind of the reduction in the subscribed capital,[11] as well as for distributions to shareholders through the acquisition of its own shares.[12] Both can be used as tunneling techniques that the European Commission wanted to prohibit.

Next, the position of the incumbent shareholders can be significantly influenced if the company issues new shares.[13] Incumbent shareholders will have to vote on the decision to increase the capital or to empower another company organ to take the decision to increase the capital. The general meeting will also have to decide if the preemptive rights of the incumbent shareholders can be waived. The European Commission considered these shareholder rights as very important and requires the general meeting of shareholders to take these decisions with a majority of not less than two thirds of the votes attached to the securities or the subscribed capital. The supermajority rule can be waived when at least half of the subscribed capital is represented. It is obvious that this procedure makes calls for capital in the European Union more complicated.

The second company law directive also requires the approval of the general meeting to wind up the company in case of serious losses or to decide whether any other measure should be taken in place thereof.[14]

[10] Article 11.

[11] Article 30.

[12] Article 19.

[13] Article 25.

[14] Article 17.

The election of the auditor is a current item of the agenda of the general meeting in all European countries in this study in line with article 37 of Directive 2006/43/EC. However, this directive allows countries to provide in alternative systems if this system does not impair the auditor's independence from the executive members of the board or management board. Next, it should be noted that although the shareholders elect the auditor, it is the board that governs or monitors the selection procedure. Finally, the right to dismiss the auditor is not explicitly granted to the general meeting of shareholders. The Directive only requires that the dismissal is based on proper grounds and excludes the divergence of opinions on accounting treatments or audit procedures as proper grounds.

Mergers and divisions of companies require the *fiat* of the general meeting of shareholders. The regulatory requirements can be found in the third directive for (national) mergers, in the sixth directive for divisions and in Directive 2005/56/EC for international mergers. As for the capital requirements, the European Commission provided for specific majorities approving these types of restructuring. In many countries several types of mergers and acquisitions are distinguished and the involvement of shareholders is also required in case all the assets of the company are transferred.[15]

The European Union empowered the general meeting of shareholders to frustrate a takeover bid. If the board of directors considers the bid to be inappropriate it requires prior authority of the general meeting of shareholders before taking any action resulting in the frustration of the bid. However, in order to pass the takeover directive the European Commission compromised that the Member States can authorize the board of directors not to apply the condition that the general meeting must approve the defensive mechanism. The opting out of the Member States had to be combined with an opting-in system for the individual companies.

The Transparency directive protects the investors' community by regulating the information that companies listed on a regulated market must disclose. The use of electronic means to distribute information is allowed if it is approved by the general meeting. The transparency directive also refers to the general meeting in case of the amendment of the articles of association. Article 19 of the Directive states:

> "Where an issuer proposes to amend its instrument of incorporation or statutes, it shall communicate the draft amendment to the competent authority of the home Member State and to the regulated market to which its securities have been admitted to trading. Such communication shall be effected without delay, but at the latest on the date of calling the general meeting which is to vote on, or be informed of, the amendment".

[15] See for example in the German *Umwandlungsgesetz* and the Dutch Book 2:107a. In the latter case the transfer of the company or the transfer of "as good as" the whole company requires shareholder approval.

It considers that the changes of the statutes requires at least the general meeting of shareholders to be informed about all amendments, but more in general, that the general meeting is to vote on any amendments. The vagueness of the article suggests that many other issues regarding corporate life and the position of the general meeting of shareholders have not been harmonized at the European level. We will discuss next how national corporate law empowers the shareholders of listed entities.

Table 1: Rights of the general meeting of shareholders according to the European company law related directives.

Directive	article	power of general meeting
second company law directive	article 11	approve acquisition of non-cash assets from founders
second company law directive	article 17	decide winding up in case of serious loss
second company law directive*	article 19	acquire own shares (exception for serious and imminent harm)
second company law directive	article 25 (1)	decide an increase of capital
second company law directive	article 25 (2)	authorize other body to decide on capital increase
second company law directive	article 25 (3)	waive pre-emption rights
second company law directive	article 30	decide on reduction in the subscribed capital
third company law directive (codified in directive 2011/35/EC)	article 6–7	decide on merger
directive 2005/56/EC	article 6	decide on cross-border merger
sixth company law directive	article 4–5	decide on division
directive 2006/43/EC	article 37	appointing auditor
take over directive	article 9	empower board to frustrate a bid (but MS can waive)
transparency directive	article 17–18	techniques of conveying information
transparency directive	Article 19	Indirectly: change of instrument of incorporation or statute
* as amended by directive 2006/68/EC		

2.2. The Position of the General Meeting of Shareholders in National Member States

The general meeting of shareholders (AGM) serves as a corporate body to obtain the consent of the shareholders for decisions that do not lie within the managerial discretion of the board of directors. Aforementioned we briefly discussed which issues the European Union considers as outside the discretion of the board of directors. For the remainder, it is up to the national legislators to consider these issues which should be inside and outside this discretion. We studied the national company legislation of five European member states and identified the powers of the general meeting of shareholders. Table 2 indicates the powers of the general meeting of shareholders according to the Companies Code of Belgium, the Code de Commerce for France, Book 2 Civil Code for the Netherlands, the German *Aktiengesetz* and the Companies Act of 2006 for the UK. We identified and classified other powers than the "European" powers referred to in table 1. We have separated the issues we considered as current items (table 2) and non-current items (table 3). This classification is somewhat arbitrary as some current items are only scheduled for approval by the AGM biennial, triennial or multiannual while some non-current items are *de facto* scheduled annually. The division is based on the legal requirement that the general meeting recurrently have to approve the item or not. As an example, we can refer to the French case of approving contracts between board members and the election of auditors. The latter decision is recurrent but the articles of association of the company can provide for a term of up to six years. The former item only requires a decision of the AGM if a contract between the board member and the company is entered into, but in practice almost all AGMs of large listed entities must approve some of this kind of contracts every year.

A first look at table two already illustrates that common agenda items are rare. The approval of the annual financial statements serves as a good example. In Belgium and France the general meeting must approve the financial statements. In the UK the accounts and reports are approved by the board and signed by a director after which both the accounts and reports are "laid before" the general meeting.[16] The German management board must submit the accounts and the report to the supervisory board that reviews both the accounts and the report. This procedure results in the "adoption" of the accounts.[17] The management and the supervisory board are allowed to take the decision that the "adoption" of the accounts is left to the AGM.[18] The Dutch board must sign the ac-

[16] Section 414 and 437 UK Companies Act 2006.

[17] Section 171 172 UK Companies Act.

[18] Section 173 UK Companies Act.

counts while it is the power of the AGM to "adopt" the accounts.[19] The report is only provided to the shareholders. The French AGM has to "receive" the report of the board and to "deliberate and decide on all questions that relate" to both the accounts and the consolidated accounts.[20] The latter accounts are separately voted. In Belgium, the shareholders have to "hear" the annual report and "to treat" the accounts. The AGM must approve the accounts.[21]

Some countries empowered the general meeting to decide on the allocation of the profit and the dividend. France has the most extensive provisions with respect to the procedure of the approval of the financial statements. After the accounts have been approved the French AGM has to approve the allocation of income and the dividend. The general meeting has the power to decide to fully or partially distribute the dividend in shares.[22]

In some countries the approval of the accounts is accompanied with the decision of the general meeting to discharge the directors.[23] The decision to discharge the directors limits claims against the directors for breach of duty which is disclosed in the annual accounts and report. According to article 554 of the Belgian Companies Act, the general meeting of shareholders must vote on the discharge of the directors and the auditor. While discharging the directors can be found in other countries, like Germany and the Netherlands, where the general meeting of shareholders discharges both the members of the management board and the members of the supervisory board,[24] discharging the auditor seems to be a unique power of the Belgian general meeting. In the UK it is neither provided in the Companies Act to discharge the directors, nor is it practiced. A decision of the UK AGM to discharge the directors would even be void.[25] However, the UK provides for a case-based but broader (non-current) exception. The general meeting of shareholders can ratify the behavior of a director which would give rise to liability for negligence, default, breach of duty or breach of trust in relation to the company unless there are ad-

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19 Book 2:101 Dutch Civil Code.

20 Article L225 100 French Commercial Code.

21 Article 554 Belgian Companies Code.

22 Article L232 18 French Commercial Code.

23 For a detailed comparative overview see S. Cools, "Europe's Ius Commune on Director Revocability", *European Company and Financial Law Review* 2/2011, 199 234.

24 Section 11 the German *Aktiengesetz*. In the Netherlands the law only provides that the adoption of the accounts cannot be qualified as a discharge of the directors or the supervisory board members. As a consequence Dutch companies provide in a separate agenda item to discharge the directors and supervisory board.

25 Section 232 UK Companies Act.

ditional legal requirements.[26] The French commercial code does not provide for the discharge of the directors, nor is it practiced. Contrary to section 239 CA 2006, the French Civil Code states in article 1843–5 that no decision of the general meeting can prevent a claim against the director for any kind of breach of duty.

As we referred to the non-current UK item of ratification of director's misbehavior we must make note of the Belgian and German law empowering the general meeting of shareholders to start a claim against (supervisory) board members.[27] French law provides this power to individual shareholders or groups of shareholders and explicitly denies the general meeting of shareholders the power to intervene.[28] In the Netherlands, claims against directors are organized according to the rules applicable for conflicts of interest.[29] Where appropriate, and unless the articles of association do not provide for an alternative procedure, the supervisory board represents the company.[30] However, the general meeting of shareholders has always a right to elect another person to represent the company.

The election and dismissal of directors is considered to be one of the most important duties of the general meeting of shareholders. However the right of the general meeting to elect and revoke board members has been curbed in a number of ways.[31] First, many countries have a mandatory or optional two-tier board system. If a two tier system is adopted, the division of powers between the general meeting of shareholders and the supervisory board is more complex. In Germany, the supervisory board has as most important legal duties the appointment, supervision, and removal of members of the management board. The general meeting of shareholders elects the supervisory board but, in companies with more than 2,000 workers, half of the supervisory board members are labor representatives appointed by representatives of the employees, in accordance with the codeterminations laws. In companies with 500 to 2,000 employees, one third of the board members are employee representatives. In France[32] and the Netherlands, the supervisory board is

[26] Section 239 UK Companies Act.

[27] Section 147 German *Aktiengesetz*; including the auditors in Belgium (Article 561 Belgian Companies Act).

[28] See Article L 225 253 French Commercial Code

[29] G. Van Solinge and M.P. Nieuwe Weme, *Rechtspersonenrecht Deel II De naamloze en besloten vennootschap*, Kluwer Deventer 2009, 446, 551.

[30] Book 2:146 Dutch Civil Code.

[31] This is also the case in the US. For an overview of the election procedure in the US see M. Ventoruzzo, "Empowering Shareholders in Directors' Elections: A Revolution in the Making", *European Company and Financial Law Review* 2/2011, 105 144.

[32] And the company has opted for a two tier board.

elected by the general meeting,[33] but in case the Dutch company is a *structuur-NV*,[34] the power of the general meeting to elect the members is significantly restrained.[35] The supervisory board selects its own members and the employees' council must provide an opinion. The general meeting of shareholders only has a recommendation right with respect to the nomination of members. Even this recommendation right is limited, as one third of the members on the election list must be recommended by the employees' council. Next, the general meeting appoints the proposed candidates. In case the majority of the meeting votes against the election and this majority also represent at least 1/3 of the company's capital, a new meeting can be called. In case the candidate is neither appointed nor rejected with the required majority, the supervisory board may itself appoint the member.[36] The election right of the Dutch general meeting can be further restrained by the articles of association. The French supervisory board of listed entities must be composed of one or more representatives of the employees in case the employees hold more than 3 per cent of the capital.[37] Also the articles of association can provide for a right for employees to have one or more representatives elected. The number of employees' representatives must not exceed four or one third of the number of other members.[38]

The supervisory board elects the members of the board of directors of a German *Aktiengesellschaft*, a Dutch *structuur-NV*, as well as the French members of the executive committee. In a two-tier board structure of a Dutch non *structuur-NV* the general meeting retains the power to elect both the management board and the supervisory board. The articles of association can restrict the freedom to elect the members and allow in specific nomination rules (binding nominations). However, it is possible for the general meeting to overrule this limitation via a supermajority vote.

In most countries the general meeting of shareholders elects the board members of the one-tier board. However binding nominations are common in the Netherlands.[39] Similarly it is not uncommon to provide in nomination rights for large shareholders in the articles of association of Belgian companies. However the election right of the shareholder might

[33] Article L 225 59 French Commercial Code.

[34] It is a specific regime for large companies. These companies must mandatory adopt a two tier board structure.

[35] Book 2:162 Dutch Civil Code.

[36] Book 2:158 Dutch Civil Code.

[37] Article L 225 71 French Commercial Code.

[38] Article L 225 79 French Commercial Code.

[39] B. Santen, F. Kloosterman, "Bad governance of goede bescherming? Benoe ming van bestuurders en commissarissen in de niet structuur beursvennootschap", *Tijd schrift voor Ondernemingsbestuur* 2/2007, 49 56.

not be too much scooped. In the UK the articles can provide in detailed appointment processes according to the Companies Act, but provision B.7.1. of the Combined Code requires that directors of FTSE 350 companies must be subject to annual election by shareholders and all other directors should be subject to election by shareholders at the first annual general meeting after their appointment. The Companies Act provides individual votes for directors of public companies.[40] The articles of association of French boards can provide the right for employees to elect up to five directors but not more than 1/3 of the total number of other board members.[41]

The general meeting of shareholders is free to remove directors from office. This is the case in the UK, the Netherlands, Belgium and France. Section 168 and 169 of the UK Companies Act requires a special notice of a resolution and provides the right for directors to be heard, while the French and the Belgian Supreme Court consider the right to dismiss directors as a right of public order.[42] The requirement to provide in a special notice and hearing protects the interests of the directors but limits the power of the general meeting which hardly can make use of its right to dismiss the director pending the meeting. Under Belgian law, the general meeting does not have to provide any reason for its decision to dismiss the director, nor does the company have to pay any damages. In France the revocation of a director must not even be announced in the agenda but can be decided pending the meeting.[43] For removing Dutch board members, the articles of association may provide for supermajority requirements not exceeding two thirds of the represented votes and half of the capital.[44]

In two-tier boards the right to dismiss the board is more regulated. In the Dutch *structuur-NV* the supervisory board dismisses the management board but the general meeting of shareholders has the right to be heard.[45] The German general meeting can even issue a vote of no-confidence which the supervisory board can use to revoke the management board member. In the Netherlands, a similar procedure exists for the members of the supervisory board. The general meeting has the right to issue a vote of no-confidence on the supervisory board members supported by more than half of the votes at a meeting of shareholders where more than 1/3 of the capital is represented.[46] It results in the automatic

[40] Section 160 Companies Act.

[41] Article L 225 27 French Commercial Code.

[42] Cass. 13 April 1989, *Tijdschrift voor Belgisch Handelsrecht* 1989, 878; *Tijd schrift voor Rechtspersoon en Vennootschap* 1989, 321, nt. Wyckaert and Bouckaert.

[43] Article L 225 105 French Commercial Code.

[44] Book 2:134 Dutch 2 Civil Code.

[45] Article 162 Book 2 Dutch Civil Code.

[46] Book 2:161a Dutch Civil Code.

revocation of all supervisory board members. In that case, the management board must summarize the Enterprise court to provide in one or more supervisory board members.[47] In France, the supervisory board elects the members of the management board. However, the general meeting of shareholders is empowered to dismiss the members of the management board.[48]

Related to the right to "hire and fire" the members of the board of directors is the right to determine the remuneration of the board. When the company has a one-tier board the general meeting of shareholders sets the board fee. The law can explicitly empower the general meeting of shareholders to provide in an appropriate remuneration, like in France or implicitly, like in Belgium. In two tier boards, the remuneration of the supervisory board is generally set by the general meeting of shareholders, while the supervisory board sets the remuneration of the members of the management board. This is the case in Germany where according to section 113 *Aktiengesetz*, the general meeting determines the remuneration of the supervisory board, unless it is set in the articles of association. The supervisory board determines the aggregate remuneration of a member of the management board. Both the supervisory board and the general meeting must take care that a "reasonable relationship" exists between both the duties of the board members and the condition of the company.

In most countries, the role of the shareholders in the determination of the remuneration of the board members is strengthened. Although these items can be considered as non-current, since remuneration policies or severance payments are not issues that always need a yearly shareholder approval, we decided to discuss these issues together with the election and remuneration of the board. In the UK and Belgium, the general meeting of shareholders must approve the remuneration report.[49] The report must contain information of both the remuneration policy as well as the total fee that the members of the board of directors receive. When the report is voted down, the remuneration of the directors must not be repaid but the company has to consider another remuneration policy. On top of this voting right, both the Belgian and the UK's general meetings have an additional voting right. The UK general meeting must approve director's service contracts of more than two years,[50] whereas the Belgian meeting must approve severance pay packages of more than 12 months of executive board members, members of the management board and officers in charge of the day-to-day management.[51]

47 Section 84 par. 3 German *Aktiengesetz*.

48 Article L 225 61 French Commercial Code.

49 Hence, it must be considered as a current agenda item.

50 Section 188 UK Companies Act.

51 Article 554 Belgian Companies Act.

In the Netherlands only the remuneration policy requires a shareholder vote. The German general meeting of listed entities can be empowered to vote on the remuneration system of the members of the management board. The vote is not binding and the members of the supervisory board must guarantee the appropriate remuneration of the management board. The French Commercial Code has a different approach regarding director's remuneration. It assimilates the decision of the remuneration package to a conflict of interest between the company and its board member and requires a similar procedure. We will discuss this decision as a non-current agenda item next.

Specific rules have been issued with respect to incentivising board members and senior executives with shares and share options. In 2010, Belgium introduced a complicated remuneration system related to the variable remuneration of executive directors and senior executives and the granting of shares and share options, which must be deferred for at least three years. Fifty per cent of the variable remuneration of executive directors and senior executives must be deferred for two to three years.[52] However, the general meeting of shareholders is granted the right to deviate from both the requirement for deferred variable remuneration and the deferred vesting of shares and share options.[53] The articles of association can also depart from the legal requirements, and altering the articles of association requires the general meeting's consent.[54]

For sake of completeness, we add that only Belgian law explicitly empowers the general meeting of shareholders to determine the remuneration of the auditor.

Table 2: Overview of current powers of the general meeting in five European countries

	Belgium	France	Germany	The Netherlands		UK
				one tier	two tier	
current items						
approve annual financial statements	x	x	(x***)	(x)	(x)	(x)

[52] Article 520ter Belgian Companies Act

[53] For an analysis of this system see H. De Wulf, C. Van der Elst, S. Vermeesch, "Radicalisering van corporate governance regelgeving: remuneratie en transparantie na de wet van 6 april 2010", *Tijdschrift voor Belgisch Handelsrecht* 10/2010, 909 963.

[54] The difference between the two alternatives is twofold. First, deviations that the general meeting approves are only valid for one program while the articles of association can be applied for each program. Second, the modification of the articles of association requires the intervention of a notary, a specific quorum and a supermajority approval.

approve consolidated financial statements		x	(x***)			
approve the allocation of income		x	x			
approve the dividend		x	x	x	x*	
elect and revoke board of directors	x	x		x		x
Provide in vote of no confidence in member management board			x			
elect and revoke management board						
elect and revoke supervisory board		x	x	x**	x	
determine compensation of directors	x	x		x	x*	x
determine compensation of supervisory board		x	x		x	
determine compensation of auditor(s)	x					
approval of the remuneration report	x					x
approve remuneration policy of the board				x	x	
Approval of the remuneration system of the members of the management board (optional)			x			
approve large severance pay for board members or senior executives	x					
Share and share price related incentive scheme	x			x	x	(LSE)
approve service contract of more than two years with director						x
discharge the liability of directors (related to the disclosed information)	x		x	x	x	

ratify conduct by a director amounting to negligence, default, breach of duty (or waive a claim)			x			x
start a claim against directors (in name and on behalf of the company)	x		x	(x)	(x)	x
discharge the liability of supervisory board			x		x	
discharge the liability of auditors	x					
TOTAL OF ITEMS	11	9	13	10	11	9

Source: own research based on the analysis of the Belgian Companies Act, the French Commercial Code, the German Aktiengesetz and Handelsgesetzbuch, the Dutch Civil Code (Book 2) and the UK Companies Code 2006 and LSE listing requirements;

*: delegation of power is possible; ** removal requires supermajority; ***: only if required by boards or supervisory board did not approve the accounts

Table 3 provides a summary of the non-current decision rights of the general meeting of shareholders in five Western European countries. First, in some countries the general meeting is provided with specific rights regarding transactions between corporate incumbents and the company. Since 2007, the UK Companies Act requires the general meeting's approval for substantial property transactions with directors. "Substantial" transactions are transactions of assets with a value of either 100.000£ or 10% of the company's balance sheet and more than 5.000£.[55] Similarly, the UK general meeting must approve a (quasi-)loan to a director as well as any kind of guarantee or a provision of security in connection with a loan to a director. Other countries have introduced different mechanisms to address these conflicts of interests between a director and the company. In Germany, loans can be provided to both the members of the management board and the supervisory board with the approval of the supervisory board.[56] The member of the board of a Belgian company that directly or indirectly has a patrimonial interest related to a decision or transaction of the company should disclose this interest to the other directors, and in listed entities, abstain from the discussions and decision-taking process. The external auditor must report on the transaction.[57] The general meeting of shareholders is not involved. The French approach related to loans, guarantees or provision of security to a director is straightforward. Any contract of this kind is null and void. All other "con-

[55] Section 190 191 UK Companies Act 2006.

[56] Section 89 and 115 German *Aktiengesetz*.

[57] Article 523 Belgian Companies Code.

ventions" which includes all contracts between a director[58] and a company must be submitted to the approval of the general meeting so shareholders. In the Netherlands, there are no specific provisions regarding the allotment of loans to directors. Where appropriate, and unless the articles of association do not provide in an alternative procedure, the supervisory board represents the company in case a board member has a conflict of interest.[59] However, the general meeting of shareholders has always a right to elect another person to represent the company.

Next to the right to approve transactions with directors, there are some non-current decisions that are considered of general importance and require shareholder approval in all countries. Next to the amendments of the articles of association, the conversion of the company and the liquidation of the company need shareholder approval. In most countries there are specific quorum and majority rights applicable to take these types of decisions.

Other powers of the general meeting of shareholders are more country specific. If a company enters into an enterprise agreement, the German general meeting must approve the agreement with a majority vote of not less than 75 per cent of the represented share capital. In the Netherlands, the general meeting of shareholders must also approve similar agreements, like important joint ventures and the acquisition or disposal of a participation in the capital of the company with a consideration of more than 1/3 of the value of the balance sheet.[60] Companies listed on the London Stock Exchange must ensure that shareholders can vote on all major transactions. Transactions are categorised in classes according to their size related to the assets, profits and capital of the company.[61] Transactions that pass the threshold of 25 per cent must be accompanied with an explanatory circular to its shareholders and require prior approval in a general meeting.

Other powers of the general meetings in different countries are: (i) for Germany, the approval of transactions for which the supervisory board is withholding its consent whilst required according to the articles of association; the appointment of auditors for examining matters of formation or management; conferring the management board to prepare any matter for which the general meeting is empowered; and the squeeze-out of minority shareholders upon a request of the majority shareholder; (ii) for France, the issuance of bonds is since 1994 the responsibility of the board of directors, but the articles of association can reserve this power to the

[58] As well as the large shareholders of the company, the senior officers of the company and the controlling company (Article 225 38 French Commercial Code).

[59] Book 2:146 Dutch Civil Code.

[60] Book 2:107a Dutch Civil Code.

[61] See annex 1 to listing requirement 10 of the London Stock Exchange.

general meeting of shareholders; (iii) for the Netherlands, the authorisation of the board to file for bankruptcy and the delegation of power to set the record date, (iv) for Belgium, the granting of rights to third parties that can influence the company's capital or originating debt depending on the launch of a takeover bid;[62] and (v) for the UK, the granting of political donations of more than 5.000£.

Table 3: overview of "non-current" powers of general meetings in five Western-European countries

	Belgium	France	Germany	The Netherlands		UK
non current items				one tier	two tier	
approve substantial property transaction with director or relative						x
approve loans, quasi loans with director						x
approve contracts with board members and large shareholders*		x				
Elect representative in case of conflict of interest between board member and company				x	x	
Entering or changing enterprise agreements			x			
Squeeze out minority shareholder upon request large holder			x			
Issuing bonds		(x)				
amendments to the company's bylaws**	x	x	x	x	x	x
liquidation of the company	x	x	x	x	x	x
Approve transaction for which articles require supervisory board approv al and the latter withheld consent			x			
Appointment of auditors for examining matters of formation or management			x			
Delegation setting record date				x	x	

[62] In particular different kinds of change of control clauses in loan agreements will require Belgian listed entities to acquire shareholder approval at the general meeting of shareholders.

approve (larger) political donations						x
granting third parties rights that influences the company's capital or originating debt dependent on take over bid	x					
conversion of the company	x	x	x	x	x	x
Require board preparation of any matter the shareholder meeting is empowered to.			x			
important joint ventures				x	x	
file for bankruptcy				x	x	
acquire or dispose of a participation in the capital with a value of more than 1/3 of assets/ important transactions***				x	x	(LSE)
TOTAL OF ITEMS	4	5	8	8	8	7

Source: own research based on the analysis of the Belgian Companies Act, the French Commercial Code, the German Aktiengesetz and Handelsgesetzbuch, the Dutch Civil Code (Book 2) and the UK Companies Code 2006 and LSE listing requirements.

* owning more than 10%; **: includes many items like subdivide or consolidate share capital; ***: see listing requirements

3. THE GENERAL MEETING OF SHAREHOLDERS IN ACTION

The aforementioned comparison illustrates that the general meetings of shareholders in Western European countries have many common items on their agenda but also many different items. Overall we identified – other than the "European" empowerment of the general meeting of shareholders – between fourteen agenda topics for which the French general meeting can take a decision up to twenty one items that German meetings can address. In an accompanying study, we collected the agenda, the minutes and the polls of the general meeting 2010 of more than 150 blue chip companies in the five countries of which we studied the role and decision taking of the general meetings.[63] Article 5 and 14 of the European Directive 2007/36/EC require the (timely) disclosure of the convocation with the agenda and minutes with the voting results and the

[63] C. Van der Elst, *Revisiting Shareholder Activism at AGMs: Voting Determinants of Large and Small Shareholders* (July 16, 2011). ECGI Finance Working Paper No. 311/2011; Tilburg Law School Research Paper No. 019/2011, *http://ssrn.com/abstract 1886865*, last visited 1 December 2011.

proportion of the capital represented by the votes. The Directive had to be transposed by August 2009 but some Member States failed to timely transpose the Directive. As a consequence, not all companies disclosed all this information on their websites. Table 4 summarizes the findings. The individual agendas of the meetings provide the number of items the general meeting had to approve or to reject (column three Table 4). On average, the general meetings have to approve approximately 17 items. In the Netherlands the total number of items is significantly smaller; in France, the total number is significantly larger. In Germany one meeting had to approve not less than fifty items, while the maximum number of items was only twenty three in the Netherlands. Even the smallest number can be found in the Netherlands: five items. In the UK, each meeting had to approve at least eleven items.

In order to better compare the agendas of the meetings and to account for the formal legal differences between the countries, we individually studied the agendas to assess the different agenda items. It is e.g. common that companies (re)elect more than one director or, like in France, authorize the chief executive officer to execute the decisions of the meeting.[64] In the fourth column, the (re)election of directors has been counted as one agenda item and the authorization has been excluded as agenda item. We have seen that French companies have to vote on the accounts, the consolidated accounts, the allocation of the income and the dividend, while only the accounts are laid before the meeting – and *de facto* voted – in the UK. We counted the approval of the accounts as one agenda item in the third column. French meetings have to elect a college of external auditors (and deputy members) which are counted as one item in the third column. These modifications reduce the list of resolutions for which an average general meeting has to vote considerably, but the relative ratio remains the same: the Dutch meeting has the least work, the French meeting the most.

Board member (re)elections are omnipresent. Column five of Table 4 presents the results of the average number of directors that each meeting had to (re)elect. In two-tier board structures, the election of supervisory board members is concentrated in specific years and only a limited number of members need to be (re)elected in the other years. In the UK, it is common that all or a large number of directors stand up for (re)election. The average number of director elections is the highest in the UK. However, it was during a French general meeting that twenty directors stood up for (re)election.

[64] In other countries the approval of an agenda item implicitly includes the autho rization to execute the decision. From a more theoretical point of view the separation of the decision and the authorization to execute this decision has the advantage that it allows the meeting to choose the most reliable corporate officer. However as the agenda is set by the board of directors and the board provides the name of the officer, it risks that this of ficer is voted down and the execution is blocked. All French meetings approved almost unanimously the authorization of the corporate officer.

Column six of Table 4 provides the relative number of meetings that had to approve special resolutions or was combined with an extra-ordinary meeting. In those cases column seven of Table 4 shows the average extra items the meeting need to approve. Extra-ordinary or special resolutions require in Belgium and France a separate general meeting for which a specific quorum and majorities are applicable. In the UK and Germany these decisions must be considered as 'special' resolutions for which a 75 per cent majority is required. The Netherlands is more flexible; only some decisions require a supermajority approval at Dutch AGMs if less than half of the capital is represented. All German and UK companies combine regular items with special resolutions. It is also common in France to combine the general meeting with an extra-ordinary meeting or to combine regular with special resolutions in the Netherlands. Less Belgian companies organize extraordinary meetings, but when these companies combine the meetings, they list more special resolutions. One company had a list of eighteen extra-ordinary agenda items. Also French companies list a significant number of agenda items for which the extraordinary meeting must take a decision. Again, the shareholders of Dutch companies are those that only need to take a limited number of decisions.

The last column of table 4 provides the average number of total voting rights that were present or represented. The minutes of the meeting either disclose the relative attendance of shares either the absolute number of voted shares (for, against and withheld). In the latter case this number is compared with the total number of issued shares with voting rights. The latter information is either disclosed in the minutes of the meeting either in the annual report of the company. The average and median voting turnout at general meetings is 60 per cent. The voting turnout of 80 per cent of the meetings is above the threshold of 50 per cent and more than half of the meetings have an attendance of more than 60 per cent. A closer look at the voting turnouts in the different countries illustrate that the attendance is higher in the UK, with an average of approximately 67 per cent, and lower in France, with 62 per cent. In Belgium, the average remains beneath the threshold of 50 per cent. Especially Belgian companies experience low voting turnouts. Four of the five lowest attendance outcomes are from Belgian meetings.

Table 4: Summary of the role and duties of general meetings

2010	nr. of companies	Total number of resolutions	"different real" resolutions	board members to be elected	combined meeting or special resolutions	number of special resolutions	average attend ance
Belgium (BEL 20)	17	16,06	12,17	4,06	53%	8,56	49,10%
France (CAC 40)	37	20,16	13,27	5,32	89%	6,15	61,70%
Germany (DAX 30)	29	16,76	11,03	1,48	100%	5,41	55,50%
The Netherlands (AEX 25)	19	11,53	9,84	2,47	79%	3,47	51,30%
UK (Footsie 100)	51	16,67	11,61	6,02	100%	4,27	66,70%
All companies	153	16,82	11,75	4,33	90%	5,16	59,50%

Source: own research based on the hand collected agendas, minutes of the general meet ings and results of polls 2010 through the websites of the companies

It seems that all the different items that are on the agenda of general meetings do not directly change the behavior of shareholders to attend the general meetings. With more special resolutions to be voted Belgian meetings experience low voting turnouts.[65] However, the attendance of shareholders is only one technique to measure shareholder involvement that can help to support legislators in their development of an appropriate model for the division of power between the general meeting of shareholders and the board of directors.

We also collected the voting results of the most common items on the agenda of the meetings: the approval of the accounts, the discharge of the board, the remuneration of board members, and the election of board members. For comparability reasons the approval rates were calculated as the ratio of the votes for to the total votes including the votes withheld.[66] The results of the approval rates can be found in table 5. All accounts were approved with a supermajority rate of more than 99 per cent in all countries. Board members received their discharge with more than 97 per cent of the attending votes. The remuneration of the board and in particu-

[65] The results are not different for companies that combined the extraordinary meeting and the general meeting of shareholders and the companies that did not combine both meetings.

[66] In the UK the approval rate is calculated as the ratio of the votes for to the votes for and against with the exclusion of the votes withheld while companies in other coun tries generally include the votes withheld in the denominator.

lar the remuneration report or remuneration system received slightly higher disapproval rates. In the UK on average 10 per cent of the attending shareholders voted against the report. All directors were (re)elected with more than 92 per cent of the votes, with the exception of the French board members, of which some experienced somewhat more opposition. Considering all items on the agenda of the general meetings, the lowest approval rates were above 80 per cent in four countries and still almost 75 per cent in France. Often, the items that received the most opposition are the approval (of granting the right of the board of directors of) issuing new shares without the use of the preemptive rights.

It results from this part of the analysis that, whatever the kind of items that the general meeting has to approve, the opposition of shareholder remains very modest and agenda items are seldom voted down.

Table 5: Average approval rates of common agenda items (2010)

	accounts	Discharge board	discharge superv. board	remunera tion	remuneration report/system	lowest election	lowest overall
Belgium	99,12%	98,12%		98,40%		96,49%	93,25%
France	99,34%			93,67%		86,65%	73,88%
Germany	99,92%	97,89%	97,30%		93,34%	92,29%	84,80%
The Netherlands	99,30%	99,07%	98,26%	97,09%		97,85%	84,42%
UK	99,19%				90,83%	94,42%	85,67%
all companies	99,36%	98,24%	97,65%	95,66%	91,69%	92,97%	83,33%

Source: own research based on the hand collected agendas, minutes of the general meet ings and results of polls 2010 through the websites of the companies.

Third, we address one specific meeting's agenda item which experienced a recent legislative change in two countries. In Germany, the *Gesetz zur Angemessenheit der Vorstandsvergütung* (VorstAG) of 31 July 2009[67] provided the general meeting with a right to vote on the system of remuneration of the board members. In Belgium, the *Wet tot versterking van het deugdelijk bestuur bij de genoteerde vennootschappen*[68] of 6 April 2010 requires the general meeting of shareholders to vote on the remuneration report with information on the remuneration policy and remuneration of the board and senior executive officers. In accordance with the German law, a large majority of the DAX–30 companies required the

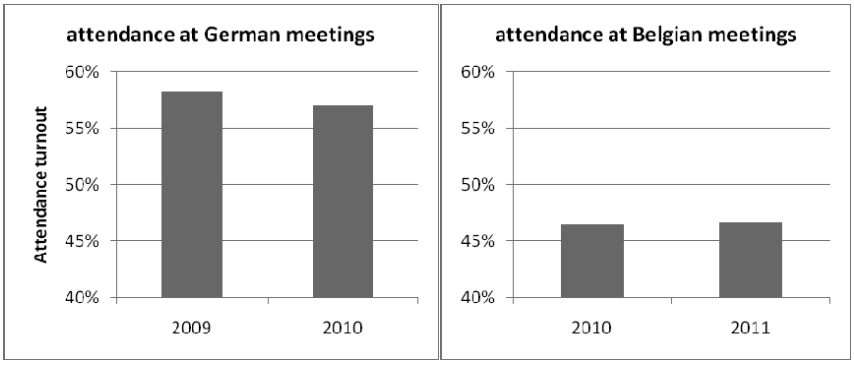
[67] The law on the adequacy of the remuneration of the management board, *Bundes gesetzblatt* I S. 2509 (No. 50).

[68] The law to enforce corporate governance of listed entities, *Belgisch Staatsblad* 23 April 2010.

general meeting of shareholders to vote on the adequacy of the remuneration of the management board in 2010. Some Belgian companies provided their general meeting with a similar right of voting for the remuneration report during the general meeting of 2011, although the Belgian law only requires companies to put this item on the agenda of the general meeting from 2012 onwards.

Comparing the effects of these legal developments, we collected the attendance rate of shareholders at the general meeting that had to take a decision on the remuneration report/system and compared the results with the attendance rate of the shareholders at the general meeting of the previous year. For Germany, the attendance at the 2009 meeting is compared with the attendance at the 2010 meeting. For Belgium, the years of the analysis are 2010 and 2011. The results of the analysis can be found in figure 1. At the 26 DAX–30 companies that approved the remuneration system in 2010, the average attendance was 57,0 per cent. It dropped from 58,2 per cent in 2009. Although the difference and decrease between 2009 and 2010 is not statistically significant, 17 of the 26 companies experienced a decrease in the attendance at the meeting where the remuneration system was approved. For Belgium meetings the results are similar. At 11 meetings where the remuneration report was placed on the agenda, only 4 of the companies experienced an increase in the attendance of shareholders at the 2011 general meeting. Overall, the attendance at these 11 meetings increased from 46,1 per cent to 46,7 per cent, a non-significant difference.

Figure 1 Attendance at German and Belgian meetings of the year during which the shareholders had to approve the remuneration system/report and the previous year



Source: own research based on the hand collected agendas, minutes of the general meet ings and results of polls of 2009 and 2010 for German companies and 2010 and 2011 for Belgian companies

Although the sample of companies is limited, the results confirm the previous findings that shareholders do not significantly change their behavior vis-à-vis the (role and position of the) general meeting.

4. CONCLUSION

An appropriate division of power between the board of directors and shareholders of the company is quintessential to equilibrate the board's responsibility to take discretionary business decisions and the shareholders rights to monitor board's behavior. When corporate governance became fashionable, both the European and the national member states' legislators refined corporate law and allocated more (monitoring) powers in the hands of the (general meeting of) shareholders. This study addressed the powers of the general meeting of shareholders in a comparative perspective. First, the powers that were provided in the European company law directives were briefly described. Next the "national" powers of (1) ordinary general meeting and (2) extra-ordinary meetings (or special resolutions) are addressed and compared and the restrictions to make use of these rights are provided. Third, the law in action is used to analyse the developments of shareholder rights and shareholder attendance and voting at general meetings of listed entities. Three different techniques are presented to assess how shareholders practice and make use of the powers of the general meeting of shareholders. First the importance of the general meeting of shareholders and the importance of the agenda items is used in comparison with the attendance of shareholders. We found no significant relationship between the number of items or the importance of items to be voted at the meeting and the attendance of the shareholders. Next we studied the voting results of a number of items on the agenda. All items received overwhelming support of the shareholders. Only exceptionally an agenda item is voted down. Third, we studied the interest of shareholders in say-on-pay and compared shareholder participation in Germany and Belgium when the remuneration report or system was an agenda item and the previous year when it was not an item. There is no evidence that the remuneration issue influences shareholders' attendance behavior.

In its Green Paper on corporate governance the European Commission recognized the importance of shareholder voting improving long-term value creation.[69] Our research sheds doubt on the current role of shareholder voting in listed companies as a strategic governance tool for this type of value creation. A large part of the shareholders are either free

[69] European Commission, *Green Paper The EU Corporate Governance Frame work*, Brussels, 5 April 2011, COM(2011) 164 final, 24.

riding or apathetic. Second, shareholders that attend the meetings support as good as all agenda items. Third, legislators struggle with the delineation of powers of the shareholders and the board as table 2 and 3 illustrates. It is more than likely that more serious consideration is necessary to optimize the role of general meetings. It seems unlikely that the suggestion to disclose the voting policies of investors[70] can be sufficient to reach the goal of a "stewardship committed" shareholder. We therefore would like to make a plea for an in depth analysis of the needs and requirements of shareholders to participate in the decision making process of the company and assess the alignment of their desires with the European view on the stakeholder interests in the company, before launching new initiatives.

[70] *Ibid.*, 12.

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PRIVATE CREDITORS AND SOVEREIGN DEFAULT: FROM ARGENTINA TO GREECE

Argentina' sovereign default in 2001 holds an important lesson for Europeans as they debate Greece's de facto insolvency and the framework for restructuring gov ernment debt. This paper will first survey strategy options for private creditors be tween mandatory restructuring, litigation and renegotiation. It will then assess mar ket oriented approaches towards sovereign debt restructuring before the legal frame work for crisis management by the IMF and the EU are introduced. A section on the future of private creditor renegotiation concludes.

Key words: *Sovereign debt. Renegotiation. Collective action problems. Cri sis management in the EU.*

1. SOVEREIGN DEBT IN CRISIS

1.1. Argentina

Argentina's sovereign default marked a watershed in the history of international finance. In 1991, the country had adopted a convertibility plan as a stabilisation device to contain hyperinflation.[1] Severe problems emerged when the Brazilian currency depreciated against the Argentine peso and public debt increased as the result of the economic recession.[2]

[1] International Monetary Fund, Independent Evaluation Office, *The IMF and Ar gentina 1991 2001*, 2004, 14 etc.; M. Mussa, *Argentina and the Fund: From Triumph to Tragedy*, Institute for International Economics, Policy Analyses in International Econom ics 67, July 2002, 20 etc.

[2] International Monetary Fund, *The IMF and Argentina*, 20 etc.; M. Mussa, 25 etc.

In 2000, Argentina had to turn to the International Monetary Fund (IMF) for financial support, as private lenders were unwilling to supply additional funds.[3] A stand-by arrangement was negotiated which did not provide for a mandatory adjustment of domestic policies or a coordination of policy announcements with the IMF.[4] Late in 2001, the IMF suspended the customary policy review of Argentina.[5] Bonded debt amounted to US $ 66 bn. There were 152 different series of bonds, governed by eight different laws from Anglo-Saxon and civil law jurisdictions.[6] Argentina offered a 'voluntary debt exchange'. On 20 December 2001, her long-term foreign currency sovereign credit rating was downgraded.[7] Four days later, the Argentine president decreed the suspension of all external debt.[8] A fortnight later, the country was unable to continue paying interest[9] because the government had run out of cash.[10]

In early 2002, Argentina's total public debt had risen to 150 % of the gross national product (GNP).[11] When Argentina eventually moved to restructure its sovereign debt more systematically, she opted for a strategy of financial independence, and discriminated between the International Monetary Fund (IMF), public lenders, and private creditors unwilling to settle on highly unfavourable terms.[12] Argentina settled with the IMF in order to escape mandated policy constraints.[13] By 2010, the country had

[3] *Ibid*., 4, 42 etc.

[4] *Ibid*., 4, 40, 48 etc.

[5] *Ibid*., 56; see also M. Mussa, 49 etc.

[6] R. Olivares Caminal, "To Rank *Pari Passu* or Not To Rank *Pari Passu*: That Is the Question in Sovereign Bonds After the Latest Episode of the Argentine Saga", *Law and Business Review of the Americas* 4/2009, 748; Banco de España, *Recent Episodes of Sovereign Debt Restructuring. A Case Study Approach*, Documentos Ocasionales No. 0804, 2008, 12.

[7] Moody's Global Credit Research, *Sovereign Default and Recovery Rates, 1983 2007*, Moody's Investor Service, March 2008, 13.

[8] J. Kim, "From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events", *Fordham Journal of Corporate and Financial Law* 5/2008, 769.

[9] Moody's, *Sovereign Default*, 13.

[10] M. Mussa, 49 etc.

[11] J.F. Hornbeck, *Argentina's Sovereign Debt Restructuring*, Congressional Re search Service, The Library of Congress, 19 October 2004, 1.

[12] J.F. Hornbeck, *Argentina's Defaulted Sovereign Debt: Dealing with the 'Hold outs'*, Congressional Research Service, The Library of Congress, 21 January 2010, 4 etc.; Banco de España, Documentos Ocasionales No. 0804, 2008, 13 etc.; J. García Hamilton, R. Olivares Caminal, O.M. Zenarruzza, "The Required Threshold to Restructure Sover eign Debt", *Loyola of Los Angeles International and Comparative Law Review* 2/2005, 255 etc. For a detailed account of Argentina's 2005 debt restructuring see also F. Sturzeneg ger, J. Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises*, MIT Press, Cam bridge, Massachusetts 2006, 187 etc.

[13] P. Sester, "Beteiligung von privaten Investoren an der Umschuldung von Staat sanleihen im Rahmen des European Stability Mechanism (ESM)", *Wertpapiermitteilun*

reached restructuring agreements with the 92.6 percent of the bondholders[14] who lost between 68 and 75 percent of their principal[15]. Argentina's default has changed sovereign debt contracting considerably. Her efforts to regain access to international financial markets hold important lessons for market-oriented restructuring efforts.

1.2. Greece

Greece's current financial predicament is due to a combination of international risk factors and domestic macro-economic shortcomings. As early as August 2007, markets changed their attitude towards the economies of EMU member states:[16] International risk factors and individual macro-fundamentals came to be priced on a country-by-country basis.[17] Greece was perceived as a country with a non-fully credible EMU commitment without fiscal guarantees.[18] The convergence in sovereign bond yields observed in the euro zone since 1999 had been reversed. There are remarkable yield spreads on sovereign bond markets for euro zone bonds.[19] Sovereign Credit Default Swaps (CDS's) mirrored this development.[20] In fact, the spreads for Greek CDS's were even more 'dynamic' than those for bonds.[21] By the end of 2012, Greek government debt will rise to over 160 percent of the gross national product.[22]

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gen Zeitschrift für Wirtschafts und Bankrecht 65/2011, 1057, 1062; cf. Banco de España, Documentos Ocasionales No. 0804, 2008, 19 etc.

[14] P. Sester, 1057, 1062.

[15] J. Sgard, "Restructuration de la dette: le cas argentin", *Problèmes économiques* 2892/2006, 22, 23, La documentation française.

[16] Cf. M.G. Arghyrou, A. Kontonikas, *The EMU sovereign debt crisis: Fundamentals, expectations and contagion*, European Commission, European Economy Economic Paper 436, February 2011, 2 etc., *http://ec.europa.eu/economy finance/publications/economic paper/2011/pdf/ecp436 en.pdf*, last visited 4 November 2011.

[17] *Ibid*., 3; N. Gaillard, *A Century of Sovereign Ratings*, Springer, New York 2012, 173.

[18] *Ibid*., 4.

[19] European Commission, Directorate General Economic and Financial Affairs, *European Sovereign Debt Markets Recent Developments and Policy Options*, Note for the attention of the European Parliament's Special Committee on the Financial, Economic and Social Crisis (CRIS), Brussels,14 January 2011 (ECFIN/E/E1), 2, *http://www.europarl.europa.eu/meetdocs/2009 2014/documents/cris/dv/bond markets 20 1 2011/bond markets 20 1 2011en.pdf*, last visited 16 July 2011.

[20] *Ibid*.; see also Bank for International Settlements, *BIS Quarterly Review*, June 2011, 9 etc., and A. Alfonso, D. Furceri, P. Gomes, *Sovereign Credit Ratings and Financial Market Linkages Application to European Data*, European Central Bank, Working Paper Series No. 1347, June 2011, 6 etc.

[21] See N. Gaillard, 177 etc.

[22] C. Alessi, *The Eurozone in Crisis*, Council on Foreign Relations, *http://www.cfr.org/eu/eurozone crisis/p22055*, last visited 4 November 2011.

In April 2010, a joint package was drawn up by the IMF and the EU whereby Greece was to receive a total of € 110 bn (as loans) over three consecutive years.[23] The IMF and Greece agreed on a Stand-by Arrangement, based on a conditionality whereby the Greek government pledges to implement fiscal policy and pro-growth measures until 2014.[24] The EU added a total of € 80 bn to the IMF funds payable in several tranches. Conditionality under EU law was achieved by a Memorandum of Understanding between the Greek government and the EU Commission and a Decision of the EU Council of ministers.[25]

When Greece called the second IMF tranche in 2011, the IMF conditioned its support on Greek restructuring efforts and the readiness of Eurozone governments to strengthen the European Financial Stability Facility (EFSF) and to establish programmes to ensure long-term sustainability.[26] On 21 July 2011 the Heads of State or Government of the Eurozone announced a new programme for Greece, including voluntary participation by the private sector.[27] The Heads of State or Government of the Euro zone decided to extend the maturity of future EFSF loans to Greece from 7.5 years to a maximum of 30 years with a grace period of ten years. Lending rates for EFSF loans were frozen at the level of those from the balance of payments facility (i.e. approximately 3.5 %) and the maturity dates of existing Greek facilities were postponed.[28] The international banking community issued a policy statement on a voluntary pro-

[23] See statements of the Eurogroup of 11 April 2010 (Statement on the support to Greece by Euro zone Member States) and of 2 May 2010.

[24] International Monetary Fund, *IMF Reaches Staff level Agreement with Greece on € 30 Billion Stand By Arrangement*, Press Release No. 10/176 of 2 May 2010, and Greece's Memorandum of Economic and Financial Policies of 3 May 2010, *http://www.greekembassy.org/Embassy/files/GREECE%20%E2%80%94%20MEMORANDUM%20TO%20IMF%20ON%20ECONOMIC%20AND%20FINANCIAL%20POLICIES14 05 20100.pdf*, last visited 7 July 2011.

[25] See the update Greek Memorandum of Economic and Financial Policies and the fourth update of the Memorandum of Understanding on Specific Economic Conditionality of 2 July 2011, addressed to the Eurogroup, the European Commission and the President of European Central Bank, in: European Economy Occasional Papers 82, *The Economic Adjustment for Greece Fourth review spring 2011*, Brussels July 2011, 82 etc., *http://ec.europa.eu/economy finance/publications/occasional paper/2011/pdf/ocp82 en.pdf*, last visited 16 July 2011.

[26] International Monetary Fund, *IMF Executive Board Completes Fourth Review Under Stand By Arrangement for Greece and Approves € 3.2 Billion Disbursement*, Press Release No. 11/273 of 8 July 2011, *http://www.imf.org/external/np/sec/pr/2011/pr11273.htm*, last visited 5 November 2011.

[27] Council of the European Union, Statement by the Heads of State or Govern ment of the Euro zone and EU Institutions, Brussels 21 July 2011, *http://www.consilium.europa.eu/uedocs/cms Data/docs/pressdata/en/ecofin/123979.pdf*, last visited 5 Novem ber 2011.

[28] *Ibid.*

gramme of debt exchange and buy backs. In what is essentially a bond swap plan, Greek government bonds would be exchanged into a combination of four instruments: a par bond exchange into a 30 year instrument, a par bond offer rolling over maturing Greek governments into 30 year instruments, a discount bond exchange into 30 years instruments or discount bond exchange via an insurance mechanism into a 15 year instrument.[29] By September 2011, less than 75 percent of private had indicated their inclination to sign up to the bond exchange plan.[30]

Financial assistance from the IMF and EFSF has added more debt to a country experiencing severe economic problems.[31] It is illusionary to expect that Greece will soon be able to obtain pre-crisis conditions for refinancing herself on the capital market. The 26 October 2011 summit of the Eurozone members implicitly acknowledges a *de facto* insolvency of Greece by announcing a 'voluntary' haircut of privately-held Greek bonds by 50 percent.[32] At the same time, the governments of the Eurozone area decided to raise the capital ratio of banks to 9 percent. The financial instruments of the EFSF are to be expanded by leveraging its financial resources.[33] The summit statement envisages two options. Private investors buying EFSF bonds will be offered risk insurance. Alternatively, the EFSF may establish a securitization programme through special purpose vehicles, and the bonds will be guaranteed under the insurance scheme.[34] International investors remain sceptical. On 9 December 2011, Euro area countries decided to accelerate the establishment of the permanent stability mechanism.[35]

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[29] Institute of International Finance, Statement by the IIF Board of 21 July 2011, and IIF Financing Offer of 21 July 2011, *http://www.iif.com/press/press+198.php*, last vis ited 15 September 2011.

[30] See Handelsblatt on line,16 September 2011, "Banken drücken sich um Griechen Rettung", *http://www.handelsblatt.com/politik/international/banken druecken sich um griechen rettung/4617904.html*, last visited 17 September 2011.

[31] Cf. D. Marsh, *The Euro The Battle for the New Global Currency*, Yale Uni versity Press, New Haven London, New edition 2011, 288.

[32] Euro Summit Statement, Brussels 26 October 2011, *http://www.consilium.eu ropa.eu/uedocs/cms data/docs/pressdata/en/ec/125644.pdf,* last visited 4 November 2011. The 'voluntary haircut' requires an agreement between Greece, private investors and "all parties concerned" to engineer a bond exchange with a nominal discount of 50 percent on notional Greek debt held by private investors. Euro zone Member States would be pre pared to contribute to the Private Sector Involvement Package up to 30 bn Euro.

[33] *Ibid.*

[34] The envisaged financing technique is reminiscent of the so called Brady bonds of the 1970s when syndicated sovereign debt was 'securitized' by converting loan obliga tions into bonds guaranteed by United States Treasury Bills: Cf. J.M. Hays II, "The Sov ereign Debt Dilemma", *Brooklyn Law Review* 3/2010, 916.

[35] See European Council, Statement by the Euro Area Heads of State or Govern ment, Brussels, 9 December 2011, *http://www.consilium.europa.eu/uedocs/cms Data/ docs/pressdata/en/ec/126658.pdf*, last visited 15 December 2011.

1.3. A Case for Contracting? – Outline of the Paper

Sovereign bonds are the flipside of government spending. Prior to the 1980's, syndicates of large commercial banks used to organise capital flows solicited by the borrowing countries.[36]. Nowadays, the vast majority of funds for emerging countries originate from bonded debt.[37] Conventional wisdom suggests that contracting with sovereign borrowers is riddled with enforcement problems. The Argentine experience reveals that in the face of default lenders have two strategy options: They may either opt for litigation or restructure debt by negotiation.[38]

Contracting is a crucial ingredient of any issue of sovereign bonds as specific clauses in a sovereign debt instrument may impact on its price.[39] Lenders devise their bond indentures to avert debtor opportunistic behaviour and make restructuring more costly: Securitised borrowing with collateral-like instruments creates obstacles for restructuring negotiations.[40] Credit rating agencies[41] and private organisations of derivatives traders have established *de facto* reputation mechanisms disciplining, both sovereign borrowers and lenders.[42] Enforcement by reputation mechanisms may be perceived as a market-friendly attempt to perform under a debt contract, but it may also disguise lobbying by interest groups for the best deal in the vicinity of a sovereign insolvency. After the Argentine crisis, sovereign debt restructuring has become a tripartite process, involving creditors, the government of the borrowing country and the IMF insisting on conditionality.[43] In the context of Greece's mounting debt, financial assistance and negotiations on a restructuring scheme are entangled in a complex web of private and public law rules where na-

[36] Cf. P.R. Wood, "Essay: Sovereign Syndicated Bank Credits in the 1970s", *Law and Contemporary Problems* 4/2010, 31.

[37] G. Lipworth, J. Nystedt, "Crisis Resolution and Private Sector Adaptation", *IMF Staff Papers* 47/2001, 190.

[38] For a detailed analysis see R. Olivares Caminal, in: R. Olivares Caminal *et al*., *Debt Restructuring*, Oxford University Press 2011, 387 etc.

[39] See *infra*, sub III.2.

[40] G. Lipworth, J. Nystedt, "Crisis Resolution and Private Sector Adaptation", *IMF Staff Working Papers* 47/2001,190.

[41] Cf. C.M. Bruner, "States, Markets, and Gatekeepers: Public Private Regulatory Regimes in an Era of Economic Globalization", *Michigan Journal of International Law* 1/2008, 125, 136 etc.

[42] See W.M.C. Weidemaier, "Contracting for State Intervention: The Origins of Sovereign Debt Arbitration", *Law and Contemporary Problems* 4/2010, 336, 353 etc., on 'contracts as tools to shape state behaviour'; see generally on reputation mechanisms as an element of sovereign 'respect' for contractual obligations: M. Tomz, *Reputation and International Cooperation Sovereign Debt across Three Centuries*, Princeton University Press, Princeton Oxford 2007, 14 etc.

[43] Cf. W.W. Bratton, G.M. Gulati, "Sovereign Debt Reform and the Best Interest of Creditors", *Vanderbilt Law Review* 1/2004, 3.

tional governments, the EU Commission, the IMF and private lenders are prominent actors. The EU's 2011 summits suggest that the relationship between state actors and the financial institutions may best be characterised as a prisoner's dilemma where repeated games will produce a minimum of cooperative behaviour.

In the following, proposals for mandatory restructuring mechanisms will be assessed prior to traditional litigation. The analysis will then focus market-oriented approaches towards sovereign debt restructuring. Market-mechanism will be monitored as private creditors seek insurance by entering into sovereign credit default swaps. A section on the future of private creditor renegotiation concludes.

2. MORE LAW THAN PRAGMATISM

2.1. Mandatory Instruments: The Sovereign Debt Restructuring Mechanism

In 2002, Anne O. Krueger of the IMF made a proposal on sovereign debt restructuring which was intended to improve the restructuring process, thereby strengthening the architecture of the global financial system.[44] Krueger's analysis focuses on the shortcomings of a bargaining process which suffers from considerable collective action problems. At the heart of her plea to make sovereign debt more attractive is the fundamental distinction between contractual and statutory approaches to crisis management.[45] Borrowing heavily from the corporate reorganisation model of US law, Krueger set out to propagate a mandatory mechanism, envisaging majority restructuring, stay on creditor enforcement during restructuring negotiations, protection of creditor interests while allowing for priority financing by fresh money.[46] The upshot of this new restructuring procedure is the role designed for the IMF. Based on the IMF's responsibilities for providing adequate safeguards, the IMF would acquire a central role in endorsing a stay on creditor action upon the request of a sovereign debtor. In order to trigger an extension of the stay, IMF would have to determine that the debtor country has started to implement the conditionality, making also progress with the creditors. Finally, the effectiveness of a restructuring agreement would have to be conditioned on IMF approval. Krueger's policy recommendations have never been im-

[44] Anne O. Krueger, *A New Approach To Sovereign Debt Restructuring*, International Monetary Fund, Washington, D.C., April 2002, *http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf*, last visited 18 July 2011.

[45] See analysis by B. Eichengreen, "Restructuring Sovereign Debt", *Journal of Economic Perspectives* 4/2003, 83 etc.

[46] Krueger, 11, 14 etc.

plemented because IMF members resented the *dirigiste* approach, discrediting freely negotiated settlements. Within less than a year after the publication of Krueger's report, the IMF had entered the camp of supporters of collective action clauses as a tool to defuse hold-up situations.[47] The IMF deserves, however, credit for initiating a debate on how much governmental suasion is permissible before a negotiated restructuring of sovereign debt turns into a mandatory one which credit rating agencies and other private institutions resent.

2.2. Litigation – Incentives and Obstacles[48]

The IMF's proposal on mandatory elements for restructuring procedures never sought to bar private creditors from taking a sovereign borrower to court.[49] In fact, the IMF implicitly acknowledges the potential of contracting for sovereign debt *ex ante* as much as it resents the 'poison pill effect' for rescheduling processes. A combination of relaxed standards for sovereign immunity and sovereign preference for quasi-voluntary restructurings[50] has provoked a vigorous strategy of creditor self-defence.[51]

Under the United States Foreign Sovereign Immunities Act of 1976 (28 USC § 1602) a foreign state shall not be immune from domestic jurisdiction, *inter alia*, if the foreign state has waived its immunity or, if the action in court is based on a commercial activity carried out in the United States by the foreign state.[52] When Argentina waived her sovereign immunity in several jurisdictions, she may have improved the marketability of bonds, but she also became more vulnerable to private litigation from

[47] See the comparative study: IMF, International Capital Markets, Legal and Poli cy Development and Review Departments, *Collective Action Clauses: Recent Develop ments and Issues*, Washington, D.C. 25 March 2003, *http://www.imf.org/external/np/psi/2003/032503.pdf*; and IMF, Policy Development and Review, International Capital Markets, and Legal Departments, *Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework*, Washington, D.C. 1 August 2003, *http://www.imf.org/external/np/pdr/sdrm/2003/080103.pdf*, last visited 18 July 2011.

[48] For a comprehensive survey see R. Olivares Caminal, in: R. Olivares Caminal *et al*., 389 etc,

[49] Landgericht (District Court) Frankfurt Main, judgment of 14 March 2003, *Die Deutsche Rechtsprechung auf dem Gebiete des Internationalen Privatrechts im Jahre (IP Rspr.)* No. 199/2003, 651 etc.

[50] Cf. A. Gelpern, "Domestic Bonds, Credit Derivatives, and the Next Transfor mation of Sovereign Debt *Symposium: Law and Economic Development in Latin Ameri ca: A Comparative Approach to Legal Reform*", *Chicago Kent Law Review* 1/2008, 172, on 'quasi voluntary' exchange offers.

[51] For an Argentine litigation perspective: C.M. Wilson, "Note Argentina's Repa ration Bonds: Analysis of Continuing Obligations", *Fordham International Law Journal* 3/2005, 821 etc.

[52] 28 USC § 1605 (a) (1), (2).

creditors[53] who had bought on the primary and secondary markets.[54] In the US, bondholders rely on class actions in order to engineer a more favourable outcome of restructuring proceedings.[55] In spite of Argentine protestations that a class action proceeding might jeopardize ongoing negotiations, US courts have certified a class action even though they were aware that some members of the class might opt-out at a later stage if an attractive restructuring offer would be made.[56] One court recognised the trade-off between a class action proceeding and restructuring negotiations: It pledged to accelerate the claim procedure to determine the participants in a class action.[57]

Apart from class action specificities, similar rules exist under German rules of civil procedure, as interpreted in the light of customary public international law.[58] When Argentina issued bonds she left the area of sovereign immunity. She could be taken to German courts. German courts could not take notice of temporary stay of payments imposed under Argentine law, if the choice of law clause in the indenture provided for the application of non-Argentine (i.e. German) law.[59] Moreover, as long as Argentina acted within the framework of private law, she was not entitled to raise a defence of a state of necessity in order to escape her payment obligations under a debt contract.[60] Private creditors are entitled to take

[53] Parallel developments were observed in the field ICSID arbitrations: The *mere* possibility of arbitration may have incentivised some bondholders to abstain from restruc turing negotiations: M. Waibel, *Sovereign Defaults before International Courts and Tribu nals*, Cambridge University Press, Cambridge 2011, 320.

[54] Cf. Lavaggi v. The Republic of Argentina, 2005 WL 2072294 (S.D.N.Y., 2005); Urban GmbH v. The Republic of Argentina, 2004 WL 307293 (S.D.N.Y., 2004); J.E. Fisch, C.M. Gentile, "Vultures or Vanguards: The Role of Litigation in Sovereign Debt Restructuring", *Emory Law Journal*, Special Edition 2004, 1088 etc.

[55] See the court's obiter in Seijas *et al*. v. The Republic of Argentina, 606 F. 3d 53 (57) (2nd Cir., 2010): "*... the hunt for assets capable of satisfying Argentina's obligations to plaintiffs is at present a predominant concern and is common to all members of the classes"*.

[56] See Brecher v. The Republic of Argentina, 2009 WL 857480 (S.D.N.Y., 2009); Urban GmbH v. The Republic of Argentina, 2006 WL 587333 (S.D.N.Y., 2006); Urban GmbH v. The Republic of Argentina, 2004 WL 307293 (S.D.N.Y., 2004); Applestein v. The Republic of Argentina, 2003 WL 21058248 (S.D.N.Y., 2003).

[57] See report by J. García Hamilton, R. Olivares Caminal, O.M. Zenaruzza, 27 *Loyola of Los Angeles International and Comparative Law Review* 2/2005, 265 etc.

[58] *Bundesverfassungsgericht* (Federal Constitutional Court), decision of 8 May 2007, *IPRspr.* 2007 No. 125, 344 etc.; *Bundesgerichtshof* (Federal Supreme Court), deci sion of 4 July 2007, *IPRspr.* 2007 No. 126, 353 etc.

[59] *Landgericht* Frankfurt Main, judgment of 14 March 2003, *IPRspr.* 2003 No. 111, 329.

[60] *Bundesverfassungsgericht*, decision of 8 May 2007, *IPRspr.* 2007 No. 125, 344 etc.; *Oberlandesgericht* (Court of Appeal) Frankfurt judgment of 13 June 2006, *IPRspr.* 2006 No. 105, 205. In another case, the Oberlandesgericht Frankfurt/Main explicitly re

Argentina to court even though this may slow down the country's financial restructuring.[61]

3. MARKET ELEMENTS IN SOVEREIGN DEBT

3.1. Credit Rating Agencies – Informational Intermediaries

Sovereign bond ratings transmit signals to the market which are decisive for pricing the risk associated with government debt. Ratings affect a sovereign's ability to borrow as they translate into interest rates which, in the case of Greece, had become unsustainable.[62] There is a direct spill-over from sovereign ratings to bond and CDS spreads.[63] Risk premiums in the Euro zone differ considerably, making arbitraging between government bonds highly attractive.[64] Moreover, ratings transmit signals to the market, operating as benchmarks for credit institutions whether to hold sovereign debt or to sell on secondary markets in order to fulfil their Basel II obligations.[65]

Credit rating agencies have been accused of ignoring a fundamental conflict of interest in performing their role as gatekeepers of information: They are paid by the issuers to whom they supply advice.[66] In fact, even governments accept that they have to pay for being assigned a rat-

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fers to the stand arrangement with the IMF which had enabled Argentine to resume re structuring processes: decision of 16 February 2006, juris.

[61] *Oberlandesgericht* Frankfurt, decision of 6 June 2008, *IPRspr.* 2008 No. 107, 352.

[62] Cf. S.L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox", *University of Illinois Law Review* 1/2002, 11 fn 69.

[63] R. Arezki, B. Candelon, A.N.R. Sy, *Sovereign Rating News and Financial Mar kets Spillovers: Evidence from the European Debt Crisis*, International Monetary Fund, IMF Working Paper WP/11/68, March 2011, *http://www.imf.org/external/pubs/ft/wp/2011/ wp1168.pdf*, and A. Afonso, D. Furceri, P. Gomes, *Sovereign Credit Ratings and Financial Markets Linkages Application to European Data*, European Central Bank Working Pa per Series No. 1347, June 2011, *http://www.ecb.int/pub/pdf/scpwps/ecbwp1347.pdf*, last visited 18 July 2011.

[64] For a study on risk premiums in pre crisis times see K. Bernoth, J. v. Hagen, L. Schuknecht, *Sovereign Risk Premia in the European Government Bond Market*, European Central Bank Working Paper No 369, June 2004, *http://www.ecb.int/pub/pdf/scpwps/ ecbwp369.pdf*, last visited 4 November 2011.

[65] See P. Van Roy, *Credit Ratings and the Standardised Approach to Credit Risk in Basel II*, European Central Bank Working Paper Series No. 517, August 2005, *http://www. ecb.int/pub/pdf/scpwps/ecbwp517.pdf*, last visited 21 July 2011; and D.E. Alford, "Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?", *Boston College International and Comparative Law Review* 2/2005, 289 etc.

[66] F. Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeep ers*, University of San Diego School of Law Research Paper No. 07 46, May 2006, *http:// papers.ssrn.com/sol3/papers.cfm?abstract id 900257*, last visited 4 November 2011.

ing.[67] The reputation of credit rating agencies has suffered considerably since the collapse of the Lehman Bank Group. Agencies were accused of announcing excellent ratings even though the writing of Lehman's downfall could be read at the wall. Nonetheless, it is crucial to reflect on the function of sovereign ratings as they are intended to assure market efficiency in the market for sovereign debt prior to insolvency.[68] Current ratings agencies proceed on a multi-item evaluation process[69] which may include interviews with officials of the sovereign if permission has been given.[70] Ideally, rating agencies should serve as intermediaries transmitting standardised information on sovereign borrowers to the market.[71] This is not to portray the role of credit rating agencies in an overly optimistic manner. But it is noteworthy, that standard setters and international credit institutions rely on ratings in order to structure their portfolios and to calibrate the liquidity and minimum capital reserves.[72] The ECB and central banks of the Member States of the EMU have a vital interest in relying on external ratings:[73] External ratings supply these institutions with a tool to maintain their independence from political lobbying. If the ECB and national central banks were to switch to exclusive in-house rating methods, political pressures to deliver favourable sovereign ratings are likely to increase dramatically.[74]

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[67] N. Gaillard, 36.

[68] Cf. S.S. Schwarcz, "Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach", *Cornell Law Review* 4/1999 2000, 993 maintaining that private funding will reduce moral hazard only if the IMF allows the market to work. Arguably, the main field of operation for credit rating agencies is the pre default phase of sovereign debt finance.

[69] Standard & Poor's, *Sovereign Government Rating Methodology And Assumptions*, Ratings Direct on the Global Credit Portal, 30 June 2011, *http://www2.standardandpoors.com/spf/pdf/japanArticles/1204866805563.pdf?vregion jp&vlang jp*, last visited 18 July 2011, Fitch, *Sovereign Ratings Rating Methodology*, *http://www.fitchratings.com.bo/UpLoad/methodology.pdf*, last visited 18 July 2011; for a detailed analysis see N. Gaillard, 39 etc.

[70] Fitch, *Sovereign Ratings*.

[71] Cf. the critical assessments by W. Gerke, C. Merx, "Chancen und Nutzen von Finanzmarktregulierung", *Festschrift für Klaus Jürgen Hopt zum 70. Geburtstag* (eds. S. Grundmann *et al*.), De Gruyter, Berlin 2010, 1844, 1848 etc., and D. Zimmer, "Rating Agenturen: Reformbedarf nach der Reform", *Festschrift für Klaus Jürgen Hopt zum 70. Geburtstag* (eds. S. Grundmann *et al*.), De Gruyter, Berlin 2010, 2692 etc.

[72] See the policy statements by the Financial Stability Board, "Financial Stability Board publishes principles to reduce reliance on CRA ratings", Press Release No. 48/2010 of 27 October 2010, *http://www.financialstabilityboard.org/press/pr 101027.pdf*, and id., Principles for Reducing Reliance on CRA Ratings, 27 October 2010, *http://www.financialstabilityboard.org/publications/r 101027.pdf*, last visited 16 July 2011.

[73] For a detailed analysis of the use of ratings for regulatory purposes Basel Committee on Banking Supervision, The Joint Forum, *Stocktaking on the use of credit ratings*, June 2009, *http://www.bis.org/publ/joint22.pdf*, last visited 7 November 2011; passim N. Gaillard, 186.

[74] See interview with President J. Weidmann of the German Bundesbank, in: *Die Zeit*, 14 July 2011, 24.

Sovereign ratings are the cornerstone of a system of bond contracts, credit default swaps and signalling devices which private lenders have devised to stave off a premature restructuring of sovereign debt. Credit rating agencies contribute to maintaining the reputation of 'credit event clauses' for the benefit of private lenders as long as moral hazard does not settle in.[75] Realistically, this system does not foreclose a sovereign default, but it drives up the price for a sovereign default in current Europe.[76] Involuntary restructurings, including 'haircuts', will trigger 'credit event clauses' under sovereign bond and CDS contracts. As a consequence credit rating agencies should downgrade the rating of the respective debtor country, thereby threatening financial institutions which bought or insured debt of the embattled government.

3.2. How to Address Collective Action Problems

US Treasury officials classified the IMF's proposals for a mandatory sovereign default as a challenge to market-based mechanisms.[77] The then US government began to campaign for having collective action clauses inserted into sovereign bond contracts in order to avoid creditor hold-up during negotiations for restructuring sovereign debt.[78] Collective action clauses which required a super-majority to reform the debt instrument won the favour of those attacking creditor hold-up and resolution schemes imposed by *fiat*. In 2003, Mexcico and Uruguay became the countries to issue bonds under New York law which incorporated collective action clauses.[79] In addition to its Mexican counterpart, the Uruguay bond indenture included aggregation rules and provided for a weak-trustee structure.[80] These bond indentures build on the insights of a report prepared in 2002 by a working group of the G 10.[81]

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[75] Private risk strategies are, of course, more refined. In devising their strategies, investors will go beyond the mere observance of sovereign debt ratings. R. Maronilla, K.D. Anderson, "The Changing Landscape of Global Sovereign Risk", *Journal of International Business and Law* 1/2011, 99.

[76] The 'voluntary haircut' envisaged by the Euro Summit Declaration of 26 October 2011 does not come without a price for the public budget as governments had to offer certain guarantees to private lenders: J. Aumüller, "50 Prozent sind nicht immer die Hälfte", *Süddeutsche Zeitung on line*, 27 October 2011, *http://www.sueddeutsche.de/wirtschaft/ergebnisse des bruesseler gipfels prozent sind nicht immer die haelfte 1.1174557*, last visited 4 November 2011.

[77] R. Quarles, "Herding Cats: Collective Action Clauses in Sovereign Debt The Genesis of the Project to Change Market Practice in 2001 Through 2003", *Law and Contemporary Problems* 4/2010, 30 etc.

[78] *Ibid.*, 35 etc.

[79] J.M. Hayes II, "Note The Sovereign Debt Dilemma", *Brooklyn Law Review* 3/2010, 922 etc.

[80] *Ibid.*, 925 etc.

[81] Group of Ten, *Report of G 10 Working Group on Contractual Clauses*, 26 September 2002, *http://debtagency.be/Pdf/gten08.pdf,* last visited 9 July 2011. See also the

The report by the G 10 working group is motivated by the quest for "effective procedures to resolve sovereign debt crises expeditiously". In order to facilitate an early dialogue with the sovereign borrower, the working group proposes the appointment of a bondholder representative to negotiate modifications of the bond instrument which would have to be ratified by the bondholders themselves. A supermajority clause in the indenture would ensure that the payment terms could be amended. In order to facilitate majority voting, the G–10 report distinguishes between amendments which reform payment terms and other terms. For the latter, a quorum of 66 2/3 is considered sufficient. The G–10 report expresses sympathy for aggregation clauses, but prefers a master agreement such as a medium-term programme in order to co-ordinate creditor behaviour.

Gelpern/Gulati find that collective action clauses as such do not produce signalling effects as to the quality of a sovereign debt instrument.[82] However, in the context of the Greek crisis, collection action clauses impacted on the prices of sovereign bonds. There is empirical evidence on how an EU and IMF-sponsored bail-out may set the wrong incentives for future contracting: Choi/Gulati/Posner have studied the pricing terms in Greek sovereign debt contracts.[83] In scrutinising the contractual stipulations of Greek government bonds, they found that the majority of indentures were subject to Greek law whereas only five percent had a choice of law clause for English law.[84] The stipulations of English law bonds offered better protection (including collective action clauses) from involuntary restructuring than their Greek counterparts.[85] Choi/Gulati/Posner find a discernible difference in yields from English and Greek law bonds. This spread was found to increase when, in November 2009, the probability of restructuring Greek sovereign debt increased.[86] Conversely, this spread disappeared when the 2010 bail-out by the EU and the IMF was announced. This suggests a subsidizing effect for the benefit of those creditors who had accepted riskier terms at the expense of those who had opted for risk management through private ordering.[87]

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comparative study by the IMF, International Capital Markets, Legal and Policy Develop ment and Review Departments, *Collective Action Clauses: Recent Developments and Is sues*, 25 March 2003, *http://www.imf.org/external/np/psi/2003/032503.pdf*, last visited 4 November 2011.

[82] A. Gelpern, M. Gulati, "Public Symbol in Private Contract: A Case Study", *Washington University Law Review* 7/2006, 1712.

[83] S.J. Choi, M. Gulati, E.A. Posner, "Pricing terms in sovereign debt contracts: a Greek case study with implications for the European crisis resolution mechanism", *Capi tal Market Law Journal* 2/2011, 163 etc.

[84] *Ibid.*

[85] *Ibid.*

[86] *Ibid.*

[87] *Ibid.*

The Choi/Gulati/Posner paper sends a complicated message. It alerts to potential moral hazard of EMU sovereign debtor who might delay restructuring because its co-partners have made it understood they are prepared to save the monetary union.[88] It also emphasises the risk of opportunistic creditor behaviour. Those who were better protected *ex ante*, might be tempted to extract a higher price *ex post* if they realise that monetary union and credit institutions of systemic importance are to be preserved at (almost) any cost. Conversely, if they are pressurised into burden-sharing in a restructuring, they will only oblige if appropriate incentives are given. Currently, private ordering for sovereign debt, diligent financial intermediaries (credit rating agencies) and concerns about bank liquidity largely offset efforts to impose a mandatory restructuring. Politicians tend to obscure, however, that a renegotiation of sovereign debt (i.e. a restructuring) basically entails the creation of a public good.[89] Sovereign lenders are required to bear the cost for the production of the public good.[90] They will only do so if the incentives to invoke a collective action clause are appropriate and negative external effects can be ruled out.[91] Insights from secured transactions and securitisation processes suggest that a voluntary restructuring is predicated on adequate securities, but not on a bail-out.[92]

4. CRISIS MANAGEMENT BY THE IMF AND THE EUROPEAN UNION

4.1. IMF – The Legal Framework

Under art. V (3) (a) of the IMF Agreement stand-by arrangements shall assist fund members to solve their balance of payments problems provided that the provisions of the Agreement and adequate safeguards for the temporary use of the general resources of the Fund are observed.[93] Stand-by arrangements are based on a letter of intent by the member country and an approval of the IMF setting out the terms of payments as a measure to support the policies and intentions as specified in the letter

[88] See generally on government moral hazard: J. Tirole, *Financial Crises*, 76 etc., 97 etc.

[89] R. Schmidtbleicher, *Die Anleihegläubigermehrheit*, Mohr Siebeck, Tübingen 2010, 45 etc.

[90] *Ibid.*

[91] Cf. *ibid.*, 63 etc.

[92] When collective action clauses were introduced, the Clinton Administration came to consider collective action clauses as an alternative to bail outs: A. Gelpern, M. Gulati, 1666.

[93] See Articles of Agreement of the International Monetary Fund *http://www.imf.org/external/pubs/ft/aa/index.htm*, last visited 13 July 2011.

of intent which sets out the terms of the payments, referring to the policy commitments setting out the sequence of payments.[94] Stand-by arrangements typically cover a period of 12 to 24 months, but in view of their temporary character may not exceed a total of three years.[95]

In deciding on a stand-by arrangement the IMF proceeds on a case-by-case analysis, depending on a member country's financing needs, its capacity to repay and history of using IMF resources.[96] Financing under stand-by arrangements (i.e. loans) has been used in crisis situations and is usually conditioned on members implementing significant policy adjustments. They will be paid out in tranches and allow for continuing IMF country reviews as the members anti-crisis plan proceeds.[97] Due to the technique of stand-by arrangements the IMF assumes a crisis prevention-resolution role,[98] and leaves an important mark on domestic policies of the applicant member.[99] IMF lending schemes are closely associated with conditionality. The Fund will not commit to a stand-by arrangement unless a guideline for macroeconomic and structural policy adjustments has been negotiated with the applicant member country.[100] Over the years the IMF has refined its conditionality, combining macroeconomic policy measures with specific efficiency criteria.[101] It has been recommended that the Fund should avoid overambitious timetables for implementation which are doomed to fail.[102] The conditionality for stand-by arrangements has been devised as an *ex post* policy instrument.[103] However, the financial crisis has demonstrated that an IMF *ex post* conditionality may create moral hazard problems if the solvency of the applicant member country will not be re-established.[104] Under these circumstances, it may be more

[94] J. Gold, 45.

[95] IMF, *IMF Stand By Arrangement*, Factsheet, 31 March 2011, *http://www.imf.org/external/np/exr/facts/sba.htm*, last visited 13 July 2011.

[96] *Ibid*.

[97] See IMF, Statement by the European Commission, the ECB and the IMF on the Fifth Review Mission to Greece, Press Release No. 11/359, 11 October 2011, *http://www.imf.org/external/np/sec/pr/2011/pr11359.htm*, last visited 4 November 2011.

[98] IMF, *Review of the Fund Facilities*.

[99] Cf. J. Morgan Foster, "Note The Relationship of IMF Structural Adjustment Programs to Economic, Social, and Cultural Rights: The Argentine Case Revisited", *Michigan Journal of International Law* 2/2003, 620 etc.

[100] IMF, *IMF Conditionality*, Factsheet, 18 March 2011, *http://www.imf.org/external/np/exr/facts/conditio.htm*, last visited 13 July 2011.

[101] IMF, Policy Development and Review Department, *Review of the 2002 Conditionality Guidelines*, 3 March 2005.

[102] *Ibid*.

[103] IMF, *IMF Conditionality*.

[104] O. Jeanne, J.D. Ostry, J. Zettelmeyer, *A Theory of International Crisis Lending and IMF Conditionality*, IMF Working Paper WP/08/236, October 2008.

efficient to announce *ex ante* under what circumstances a country would qualify for financial support from the IMF.[105]

4.2. European Union

4.2.1. Temporary Crisis Management

In order to stabilise monetary union, European Union relies on specific treaty provisions on monetary and economic policy. Although the language of the Treaty is comprehensive, Denmark and the United Kingdom have invoked a right to opt-out of monetary union. Other Member States which might eventually qualify for the introduction of the Euro are classified as "Member States with a derogation".[106]

With respect to the economic policy of the EU, art. 122 (2) TFEU specifies the circumstances under a Member State may apply for financial assistance from the Union. Thus a Member State which is in difficulties or seriously threatened with severe difficulties caused, *inter alia*, by exceptional circumstances beyond its control may be granted Union financial assistance from the Council of Ministers upon a proposal from the Commission. This provision has to be read in conjunction with art. 125 TFEU, which the President of the German Bundesbank classifies as a prohibition of sovereign bail-outs.[107] Under art. 125 (1) TFEU neither the Union nor a Member State shall be liable for or assume commitments of central governments, regional, local or other public authorities, or any public undertaking of any Member State without prejudice to mutual financial guarantees for the joint execution of a specific project. Moreover, overdraft facilities or any other credit facility with the European Central Bank or with the central banks of the Member States in favour of Union or Member State public bodies are outlawed (art. 123 (1) TFEU). Unless based on prudential considerations, privileged access by Union or Member public bodies are proscribed (art 124 TFEU). Art. 21 of the Protocol on the Statute of the European System of Central Banks and of the European Central reiterates this policy approach for the decision-making process of the ECB. The Protocol expressly bars the ECB and national central banks from the direct purchase of debt instruments issued by Union insti-

[105] *Ibid*., see also Banco de España, Documentos Ocasionales No. 0804, 2008, 10, 73.

[106] See Article 139 (1) TFEU: *"Member States in respect of which the Council has not decided that they fulfil the necessary conditions for the adoption of the euro shall ... be referred to as "Member States with a derogation.""*

[107] J. Weidmann, *The crisis as a challenge for the euro zone*, Speech at the *Verband der Familienunternehmer* (Association of Family Enterprises), Cologne 13 September 2011, *http://www.bundesbank.de/download/presse/reden/2011/20110913.weidmann.en.pdf*, last visited 4 November, and id., Finanzmarktreform: Was wurde erreicht, was bleibt zu tun?, Speech at the *Bayerischer Finanzgipfel*, Munich 27 October 2011, *http://www.bundesbank.de/download/presse/reden/2011/20111027.weidmann.pdf*, last visited 4 November 2011.

tutions, central governments or other public bodies, or undertakings of Member States.

When Greece suffered the first round of illiquidity in spring 2010, the Council of Ministers moved to step up Union efforts to ensure financial stability and to establish a medium rescue mechanism. The May 2010 plan for crisis management pretends to operate in accordance with the letter of framework of Union law, but also side-steps the prohibitions of bail-outs. In fleshing out art. 122 (2) for Union assistance to Member States, the Council of Ministers founded a (temporary) European Financial Stabilisation Mechanism (EFSM) which was intended to provide loans or a credit line to a Member State in distress.[108] The EFSM is modelled after Union legislation for non-euro Member States with balance of payments problems.[109] The EU Commission finances the EFSM assistance programme by contributions from Euro zone Member States and by issuing bonds on behalf of the Union. The proceeds from the sale of bonds will be disbursed as Union loans to the applicant Member State. The EU Commission has repeatedly placed bond issues in order to raise EFSM funds for Ireland, Romania and Portugal.[110] When the EFSM was launched, EU issuing notes received their AAA rating from major credit rating agencies.[111] When sovereign risk problems became more pressing there was some concern whether the sheer existence of AAA-rated bonds would not accelerate the down-spiralling of bonds issued by high-risk Member States.[112] Assistance under the EFSM scheme is predicated upon strict conditionality. The recipient Member State will usually have to submit to a programme of fiscal and structural adjustments.[113]

Under the May 2010 crisis resolution measures Greece was to receive loans up to € 60 bn. The larger part of financial assistance, however, was provided by the IMF under a stand-by arrangement[114] and the newly

[108] See Council Regulation (EU) No. 407/2010 of 11 May 2010 establishing a Eu ropean financial stabilisation mechanism, *O.J.* L 118/1 of 12 May 2010.

[109] European Commission, *Communication from the Commission to the Council and the Economic Financial Committee on the European Financial Stabilisation Mecha nism,* Brussels 30 November 2010 (COM(2010) 713 final).

[110] European Commission Press Releases, *€ 5 billion bond issue for Ireland*, Brussels 5 January 2011 (MEMO/11/4); *€ 4.6 billion bond issued to assist Ireland and Romania*, Brussels 17 March 2011 (MEMO/11/180); *€ 4.75 billion bond issued for EU's assistance packages to Ireland and Portugal*, Brussels 24 May 2011 (MEMO/11/336); *Second € 4.75 billion bond issued this week to support EU's assistance packages*, Brussels 25 May 2011.

[111] European Commission Communication on the EFSM, 5.

[112] Cf. European Commission Communication on the EFSM, 9.

[113] K. Regling, Chief Executive Officer of the European Financial Stability Facili ty, *Europe's Response to the Financial Crisis*, Speech Singapore 1 December 2010.

[114] EFSF Framework Agreement between Belgium, Germany, Ireland, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia, Finland, Greece and the European Financial Stability of 7 June 2010, § 18 (1),

established European Financial Stability Facility (EFSF).[115] The EFSF is a temporary crisis mechanism to expire by 30 June 2013. The EFSF Framework Agreement of 7 June 2010 shall be construed in accordance with English law[116]. The EFSF is a *société anonyme* established under Luxembourg law.[117] Its shareholders are the Member States of the euro zone. The authorised share capital is relatively small in view of the total amount of € 440 bn of loans which the EFSF may make to Member States in distress.[118] The EFSF is to raise funds by issuing bonds, notes, commercial paper, debt securities and other financing instruments which, in turn, are guaranteed irrevocably and unconditionally be the euro zone Member States.[119] Each euro zone Member State has made a guarantee commitment in proportion to its economic strength.[120] As under the EFSM, an applicant country will have to implement the conditionality attached by the EFSF to a loan.[121] As the results of the 26 October 2011 summit of Euro zone governments still have to be translated into legal rules, the Euro area has decided to establish a new fiscal rule which is intended to introduce greater budget discipline.

4.2.2. The Treaty on the Permanent Stability Mechanism

As the crisis deepened, it became clear that the EMU needed a permanent anti-crisis mechanism. Late in November, the Eurogroup issued a statement announcing a European Stability Mechanism based on a strict conditionality programme, rigorous surveillance, private creditor participation consistent with IMF policies, junior status only to IMF loans and reliance on collective action clauses to change the terms of payment.[122] Contrary to the EFSF, the establishment of the European Stability Mechanism (ESM) requires an amendment to the TFEU.[123] The ESM

http://www.efsf.europa.eu/attachments/20111019 efsf framework agreement en.pdf, last visited 4 November 2011.

[115] Cf. K. Regling, Chief Executive Officer of the European Financial Stability Facility, *Europe's Response to the Financial Crisis*, Tokyo 11 November 2010, Speech at the DAIWA Capital Markets Conference.

[116] EFSF Framework Agreement, § 16.

[117] See European Financial Stability Authority, *Société Anonyme*, *Status Coordonés suite à un Constat d'Augmentation de Capital du* 15 *décembre* 2010, Luxembourg.

[118] *Ibid*. (chapter II), EFSF Framework Agreement, Regling, Tokyo Speech, 11 No vember 2010.

[119] EFSF Framework Agreement.

[120] See Annex 3 to the EFSF Agreement (Contribution Key).

[121] Regling, Singapore speech, 1 December 2010.

[122] Statement by the Eurogroup, 28 November 2010, *http://www.consilium.europa.eu/uedocs/cms data/docs/pressdata/en/ecofin/118050.pdf*, last visited 14 July 2011.

[123] See also the term sheet on the ESM, prepared by the Dutch government's *Rijks overheid*, *http://www.rijksoverheid.nl/documenten en publicaties/verslagen/2011/03/22/term sheet esm.html*, last visited 14 July 2011.

will have a lending capacity of € 500 bn. Financial assistance from the ESM can be obtained by subscribing to a strict conditionality including a macro-economic adjustment programme and an analysis of public-debt sustainability.[124] The president of the ECB has observed that the ESM should discourage incentives for moral hazard by insisting on pre-emptive and macroeconomic adjustment.[125]

On 11 July 2011, finance ministers of the Euro zone Member States signed the Treaty establishing the permanent stability mechanism (the ESM Treaty) as an intergovernmental organisation under public international law.[126] The stability mechanism will be authorised to impose sanctions as envisaged by the European Stability and Growth Pact.[127] The new intergovernmental organisation shall be governed by a board consisting of the Ministers of Finance of the euro zone Member States with the European Commissioner for Economic and Monetary Affairs and the President of the ECB as observers.[128] The total subscribed capital of the ESM shall amount to € 700 bn which shall be raised in several instalments and by Member State guarantees.[129] It is understood that the ESM will cooperate with the IMF.[130] The Euro area governments insist on private sector participation in the Greek *de facto* sovereign insolvency while emphasizing that this scenario is highly unique and exceptional.[131]

5. WHITHER PRIVATE CREDITOR RENEGOTIATION?

In the aftermath of the Argentine default courts have adopted a more liberal approach towards the sovereign immunity defence. As sov-

[124] European Commission Press Release, *European Stability Mechanism (ESM) Q&A*, Brussels 1 December 2010 (MEMO/10/636).

[125] J. C. Trichet, *Introductory statement*, Hearing at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels 21 March 2011, *http://www.ecb.int/press/key/date/2011/html/sp110321 1.en.html*, last visited 14 July 2011.

[126] Treaty Establishing the European Stability Mechanism, *http://consilium.europa.eu/media/1216793/esm%20treaty%20en.pdf*, last visited 14 July 2011; see also European Commission News, Eurogroup Meeting, Brussels 11 July 2011, Ref. 78856, *http://ec.europa.eu/avservices/services/showShotlist.do?out PDF&lg En&filmRef 78856*, last visited 14 July 2011.

[127] European Council of 24/25 March 2011, Conclusions, Brussels 25 March 2011 (EUCO 10/11 CO EUR6/CONCL3), Annex II (Term Sheet on the ESM), *http://www.european council.europa.eu/council meetings/conclusions.aspx*, last visited 14 July 2011.

[128] *Ibid.* and Articles 5, 6 (2) of the ESM Treaty.

[129] Article 36 of the ESM Treaty and European Council Conclusions of 25 March 2011.

[130] See art 33 of the ESM Treaty and European Council Conclusions of 25 March 2011.

[131] See European Council, Statement of the Euro Area Heads of State or Government, Brussels, 9 December 2011.

ereign debt contracts came to be examined by judges (though not necessarily enforced), private lenders pursue contracting strategies to avert a restructuring situation or a coercive settlement. Realistically, this will not foreclose future sovereign defaults. But the interface between contractual stipulations about a 'credit event' and the activities of market intermediaries (such as rating agencies and professional organizations) drives up the price for a sovereign default.

Collective action clauses seek a way out of potential hold-up strategies by introducing a renegotiation mechanism. Nonetheless, collective action clauses will not deter opportunistic behaviour. The debtor may have an incentive to generate excessive crises, if creditors are pushed into co-operating in the face of an impending sovereign default.[132] Both, sovereign debt contracts and conditionalities by the IMF and the EU illustrate that moral hazard occurs when the sovereign borrower does not commit to put in an effort *ex ante*, and does not commit to bargain *ex post* either.[133] The current Greek debt crisis highlights to what extent interference by the IMF or the EU may distort the price mechanism for sovereign bond contracting and restructuring. When the ECB relaxed its rules on collateral, credit ratings became less damaging because the interface between private contracting and the signals issued by informational intermediaries was temporarily suspended.[134] It will become crucial again once the ECB tightens its rules on collateral.

Politically motivated insistence on private participation in restructuring has served to defuse the potential of private action clauses, as private lenders have found a way to extract promises for renegotiating or rescheduling bonds at acceptable rates or against securities offsetting losses.[135] As a corollary, the quest for a 'voluntary' participation has sharpened the awareness for private lenders' profit-maximising strategies, the laws of the financial markets and the role of informational intermediaries.

In addressing Greece's predicament, a series of Euro zone summits has attempted to pacify private lenders with forebodings about financial difficulties in other European countries. A combination of loans, guarantees and securitization programmes is intended to calm down the markets. But the European Union still has demonstrate that it is capable of handling national budget deficits which may translate into refinancing problems for banks and the need for additional stabilisation tools.

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[132] S. Ghosal, M. Miller, "Co ordination Failure, Moral Hazard and Sovereign Bankruptcy Procedures", *Economic Journal* 487/2003, 284.

[133] B. Eichengreen, A. Mody, *Would Collective Action Clauses Raise Borrowing Costs?*, National Bureau of Economic Research Working Paper 7458, January 2000, *http://www.nber.org/papers/w7458*, last visited 9 July 2011. For less credit worthy bor rowers, advantages of orderly restructuring will be set off by moral hazard and default risk associated with renegotiation friendly loan provisions.

[134] Cf. N. Gaillard, 185.

[135] From a procedural perspective: N. Jacklin, "Addressing Collective Action Prob lems in Securitized Credit", *Law and Contemporary Problems* 4/2010, 182.

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PROTECTION OF MINORITY SHAREHOLDERS FROM FINANCIAL TUNNELING: THE CASE OF BOSNIA AND HERZEGOVINA

In this article we examine legal protections against financial tunneling avail able to minority shareholders in Bosnia and Herzegovina. We analyze legal rules that specifically address the most common forms of financial tunneling in both entities of B&H, their application in practice, and compare them with the adequate protections provided to minority shareholders in comparative laws. Before introducing company law changes in 2008 in Federation of B&H was registered a significant number of cases of joint stock companies delisting and going private. There are indications that those transactions occured without any compensation given to minority shareholders of those companies. In the article we focus on these cases and use experiences from other transition countries to evaluate the protections offered by entity company laws and propose their future improvements.

Key words: *Minority shareholders. Financial tunneling. Delisting. Preemp tive rights.*

1. INTRODUCTION

The development of corporate governance is largely determined by the need to restore investors' confidence in capital markets. Studies have

shown that the nature of corporate governance problem differs significantly in companies that have a controlling shareholder.[1] Bosnia and Herzegovina, as well as other transition economies, is characterized by a relatively high level of ownership concentration, which indicates the presence of the so-called second agency problem i.e. conflict of interest between majority and minority shareholders and the possibility for abuse of minorities' rights.

It is often argued that transition economies should devote more attention to the rules to protect minority shareholders then developed market economies, considering the high ownership concentration and relatively weak non-regulatory restrictions on managers and controlling shareholders, which primarily refers to market efficiency. Unlike the US company law which Black (1990)[2] marks as "trivial", the shareholders in transition economies in fact have no "exit" option so the law must find separate methods of determining prices for withdrawal from the company.[3] There is also the view that corporate law plays a much greater role in transition countries because of its additional educational function.

Substantial expropriation of minority shareholders in those countries was made possible due to the privatization and "imported" regulations that did not correspond to institutional environment of markets in transition. It turned out that some of the problems that led to abuses resulted from the reliance on mechanisms ensuring the implementation of regulations designed for developed economies. Under the conditions of existing great need for protection it is suggested to consider the adoption of mandatory instead of default rules that can be changed by shareholder agreement.[4] Generally, because of the specific corporate governance issues, it is argued that formal legal rules should not rely on a basis of broad minimum standards, but on binding directives which describe legal behaviour in a simple and clear way.[5] In particular, the need for strict statutory provisions relating to financial tunneling is highlighted.[6]

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[1] L.A. Bebchuk, M.S. Weisbach, "The State of Corporate Governance Research", *The Review of Financial Studies* 3/2010, 948.

[2] B.S. Black, "Is Corporate Law Trivial?: A Political and Economic Analysis", *Northwestern University Law Review* 84/1990, 542 597.

[3] V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, "Learning from the General Prin ciples of Company Law for Transition Economies: The Case of Bulgaria", *Journal of Cor poration Law* 4/2006, 32, *http://ssrn.com/abstract 770288*, last visited 30 October 2010.

[4] M. Airaksinen, "Enforcement of Minority Shareholders' Rights", Presentation, OECD/World Bank Corporate Governance Roundtable for Russia, Moscow 2000, 1; G. Avilov *et al.*, "General Principles of Company Law for Transition Economies", *Journal of Corporation Law* 2/1999, 10 11, *http://ssrn.com/abstract 126539*, last visited 30 Octo ber 2010.

[5] U.C. Braendle, J. Noll, "Enlarged EU Enlarged Corporate Governance? Why Directives Might be More Appropriate for Transition Economies", Research Paper, 2004, *http://ssrn.com/abstract 556703*, last visited 26 November 2009.

[6] V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, 42 43.

Corporate governance system in B&H as a Continental European one is, among other things, characterized by significant ownership concentration[7], active role of block holders in governing companies, and minor role and importance of capital markets. Illiquid market means less ability to easily exit the investment by selling shares on the stock exchange.[8] Corporate governance issues specific to transition economies, as recognized by Bobirca and Miclaus (2007), apply to B&H as well and they involve weak legal system in terms of high court delays and corruption.[9] The fact of existing immature institutional investors should also be kept in mind.

It is worth noting that in B&H still operate two stock exchanges, one in Sarajevo and the other one in Banjaluka, which organize and supervise trade in securities on the regulated markets, accompanied by two institutions responsible for regulation and supervision of issuances, trade and other operations with securities, securities commissions in FB&H and in RS, which each separately keep registers of issuers. Securities accounts are also kept with the entity registers. Shares of almost all companies are traded on the stock exchanges, but only a small number of them belong to segments of the official stock exchange quotation or market.[10]

Analysis of the legal protection of minority shareholders against financial tunneling in Bosnia and Herzegovina will show the current state and indicate what is needed for its improvement. The analysis will focus on the open joint-stock companies of a general type that are listed at the exchange. The reason lies in the fact that these companies must solve the second agency problem i.e. protect their minority shareholders.[11]

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[7] E. Karić, "Kodeks korporativnog upravljanja SASE Rezultati istraživanja o stanju korporativnog upravljanja u FBiH", Presentation, 4. Međunarodna konferencija Sa rajevske berze 2009, 11 12; Z. Jeftić, "Istraživanje o dostignutom nivou korporativnog upravljanja u Republici Srpskoj", Presentation, III Međunarodna konferencija Banjalučke berze 2008, 6.

[8] D. Tipurić, *Nadzorni odbor i korporativno upravljanje*, Sinergija, Zagreb 2006, 3 etc.

[9] A. Bobirca, P.G. Miclaus, "Extensiveness and Effectiveness of Corporate Gov ernance Regulations in South Eastern Europe", *World Academy of Science, Engineering and Technology* 30/2007, 7 12.

[10] According to data from September and October 2010 only 3 companies and all investment funds were included in the quotation at the SASE, and 42 companies and all investment funds at the BLSE. The shares of all other companies were traded at the open market.

[11] C. Loderer, U. Waelchli, "Protecting Minority Shareholders: Listed versus Un listed Firms", *Financial Management* Spring 2010, 35 etc; International Finance Corpora tion, *Korporativno upravljanje Priručnik za firme u Bosni i Hercegovini*, IFC Sarajevo, Sarajevo 2009, 20.

2. FINANCIAL TUNNELING AND LEGAL MECHANISMS OF PROTECTION

Different forms of abuse of minority shareholders' rights are known in practice, most of them being covered by the concept of tunneling. Johnson *et al.* (2000) define tunneling in the narrow sense as "the transfer of resources out of a company to its controlling shareholder (who is typically also a top manager)"[12]. Typically, two types of tunneling are recognized: operational and financial. The operational tunneling includes self-dealing transactions as real transactions through which controlling shareholder or the manager transfers funds out of the company for his own benefit. A wider taxonomy is proposed by Atanasov, Black and Ciccotello (2011) which further differentiate between cash flow tunneling and asset tunneling.[13]

Financial or equity tunneling implies extracting values through financial transactions affecting ownership rights to the share capital, and not the company operations.[14] Atanasov *et al.* (2010) distinguish between the two main forms of equity tunneling: issuance of shares for the purpose of share dilution and freezing out minority shareholders. The first case refers to the issue of new shares (or securities convertible into shares) to insiders at a price that is below market or fair, while the other refers to forced sale of shares to controlling shareholder also at a below market price.[15]

As the prerequisites for share dilution are identified: relatively large issuances, disproportionate involvement of existing shareholders in the offering and the issuance of new shares at a price lower than fair price. The dilution also occurs in cases of exercise of options on shares of a company by the managers when it comes to acquiring shares at a price lower than the market price, assuming large compensation packages. The same effect on company will have buying its own shares at a price above the market. Precisely, loans from the firm to insiders, sales of controlling stakes, repurchases of shares from insiders for more than fair value and some equity based executive compensations also represent forms of equity tunneling.[16] Atanasov et al. (2007) prove the relationship between the existence of each of these forms of tunneling and the legal regulation,

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[12] S. Johnson *et al.*, "Tunnelling", NBER Working Paper Series, Working Paper w7523, 2000, 2 etc.

[13] V. Atanasov, B. Black, C.S. Ciccotello, "Law and Tunneling", *Journal of Cor poration Law* 1/2011, 3 etc.

[14] *Ibid.*, 9.

[15] V. Atanasov *et al.*, "How Does Law Affect Finance? An Examination of Equity Tunneling in Bulgaria", *Journal of Financial Economics* 1/2010, 1 2.

[16] V. Atanasov, B. Black, C.S. Ciccotello, 2011, 9.

showing complementarities of share dilution control and freezing out minority shareholders.[17]

National company laws recognize a series of measures aimed at protecting minority shareholders from abuse by the majority ones. The legal and regulatory framework for corporate governance in B&H should be viewed in context of a specific polity. Corporate governance is in jurisdiction of entities that have their own laws and institutions, which resulted in the establishment of two completely separate regimes. Legal sources that directly or indirectly regulate this area include a series of laws and regulations governing companies, securities and capital markets, accounting and auditing etc.[18] It is important to emphasize that the entity laws on companies differ significantly as regard to the board structures and mechanisms to protect shareholders. Still, one might not talk about the existence of regulatory competition between entities in the area of corporate law, most probably due to the participants' current attitude and understanding the role of corporate governance.

When it comes to the companies in FB&H, it is important to note that according to available data, only one of them issued shares through the public offering, which was carried out with the exclusion of preemptive rights of existing shareholders.[19] In RS several companies raised additional capital for development through a secondary public issue of shares, and the first IPO of shares in B&H was registered.[20]

On the other hand, a period of two years before the recent legislative changes in FB&H was marked by around 50 requests of joint stock companies to change their organizational form into the limited liability company.[21] This is considered to be the reason why the amendments to the LoC in 2008 prohibit change in the form of open joint stock company for the purpose of protecting investors and improving corporate governance.

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[17] V. Atanasov *et al.*, "How Does Law Affect Finance? An Examination of Finan cial Tunneling in an Emerging Market", EFA Ljubljana Meetings Paper, 2007, 2, *http:// ssrn.com/abstract 902766*, last visited 30 October 2010.

[18] Law on Companies in FB&H (further: LoC FB&H), *Official Gazette of the FB&H*, No. 23/99, 45/00, 2/02, 6/02, 29/03, 68/05, 91/07, 84/08, 88/08, 7/09 and 63/10; Law on Securities Market in FB&H (further: LSM FB&H), *Official Gazette of the FB&H*, No. 85/08; Law on Takeovers (further: LoT FB&H), *Official Gazette of the FB&H*, No. 7/06; Law on Companies in RS (further: LoC RS), *Official Gazette of the RS*, No. 127/08 and 58/09; Law on Securities Market in RS (further: LSM RS), *Official Gazette of the RS*, No. 92/06 and 34/09; Law on Takeovers (further: LoT RS), *Official Gazette of the RS*, No. 65/08 and 92/09.

[19] *http://www.sase.ba/DesktopDefault.aspx?tabid 299*, last visited 27 September 2011.

[20] BLSE, "Emisija hartija od vrijednosti", Publication, 2010, 6.

[21] A. Mujanović, "Krhko dioničarstvo: Kapital vrijedan 12,8 milijardi maraka u rukama 333.036 dioničara", 2009, *http://www.liderpress.hr/bih*, last visited 5 May 2009.

Without intention of entering into the analysis of the effects and justification of such a way of preventing companies' delisting, the view that a form of organization should not be imposed to the business and that it is better to have a smaller number of high quality companies listed at the market than more forcefully present issuers seems reasonable[22], what is also confirmed by the experiences of other transition economies. At the same time, and again with the same aim, limited liability companies which meet the criteria for an open joint stock company[23] are required to change the form into a joint stock company, otherwise the competent court issues a decision on their liquidation.

When it comes to experiences of other countries, some significant conclusions on protection of minority shareholders from financial tunneling in specific conditions of a market in transition derive from the case of Bulgaria. New regulations that were introduced in that country brought positive changes while dropping out reliance on market prices, courts and actions of minority shareholders. The first key change considered compulsory creation of warrants when issuing shares, which as long-term call options on the company's shares are publicly traded on the stock exchange. Another key legislative change related to introducing the institute of fair value along with the detailed rules on calculating the selling price at freeze-out tender offer. It is also required that majority of minority shareholders approve the conditions in a mandatory tender offer. The third key change involved the establishment and strengthening of the central regulatory body.[24]

3. LEGAL PROTECTIONS FROM DILUTIVE EQUITY OFFERINGS IN B&H

Atansov *et al.* (2010)[25] classify the rules that seek to limit the dilution of shares into three groups: preemptive rights, rules on the minimum share price during issue and rules on approval of minority shareholders, which is usually required for the larger share issuances or issuances above a certain percentage of share capital.

Preemptive rights are means to protect shareholders from dilution of their rights by issuing shares to favored investors and / or at prices

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[22] V. Trivun *et al.*, "Izmjene Zakona o privrednim društvima FBiH", VIII Među narodni seminar "Korporativno upravljanje Novosti u međunarodnim standardima, za konodavstvu i praksi Bosne i Hercegovine", Revicon, Dubrovnik 2008, 91

[23] LoC FB&H, Article 107.

[24] V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, 2 etc.; V. Atanasov *et al.*, (2010), 13 14.

[25] V. Atanasov *et al.*, (2010), 8 9.

lower than the market prices. Those are rights of existing shareholders to acquire new shares of the company in proportion to the nominal value of the shares they hold.[26] For transition economies it is recommended to include preemptive rights in case of any new issuances, with the possibility of limitation or exclusion of those rights only in certain cases requiring a majority or a qualified majority vote of shareholders.[27]

In order to protect shareholders who do not vote in favor of the limitation or exclusion, it is recommended to grant the so-called rights of participation that would enable them to participate in the offer of shares or purchase additional shares at a price from the main offer. It is important to provide a simple procedure for exercising preemptive rights. Due to dependency on the financial capabilities of the holders of rights, their transferability and organized public trading in the form of warrants are considered to be significant determinants of their effectiveness.[28]

Preemptive rights are established by the laws in both entities of B&H and may be excluded or limited in a single issue only by the general meeting's decision (in RS at the proposal of management board), which in FB&H must be adopted by a majority vote of the total number of voting shares. For example, for adopting such a decision in Croatia at least 3/4 of share capital votes represented at the meeting is needed. The Law in RS does not prescribe a special majority for making such a decision, but requires a written report stating the reasons for the limitation or exclusion including the rationale for the proposed issue price. The management board in RS may restrict or exclude preemptive rights in the issue of authorized shares according to the LoC. Comparatively, in Serbia preemptive right may be limited or excluded in the founding act and statute of the company. A substantial drawback is the fact that in FB&H, those rights are not transferable. In RS they can be transferred by a contract.

In FB&H preemptive rights also exist in the case of issuance of convertible bonds and bonds with a preemptive right. Effective deadline for exercise of these rights determined by the law is relatively short.[29] Companies in RS have an obligation to inform all shareholders of its intention to issue shares, including how to use preemptive rights to be de-

[26] M.S. Vasiljević, *Kompanijsko pravo: Pravo privrednih društava Srbije i EU*, Pravni fakultet Univerziteta u Beogradu, Beograd 2007[3], 317.; R. La Porta et al., "Law and Finance", *Journal of Political Economy* 6/1998, 1128.

[27] In case of voting on the limitation or exclusion of preemptive rights, future buy ers and related parties should be excluded from voting. The rules should also be applied to cases of issuance of convertible securities and stock options. See G. Avilov *et al.*, 26 27.

[28] V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, 24.

[29] LoC FB&H, Articles 213 215 and 223; LSM FB&H, Article 23 (2); LoCC, Article 308; LoC RS, Articles 203, 207 208 and 235.

termined on the section day. The provisions on preemptive rights also apply to convertible bonds. In addition to ordinary shareholders, the rights to acquire shares of a new issue have holders of warrants and convertible bonds, and preferred shareholders for shares of the same class. Comparatively, in Croatia and Serbia legal provisions on the preemptive rights appropriately apply when disposing of its own shares.[30]

Another means of protecting shareholders from dilution is a requirement for issuing shares at a price not lower than their market value i.e. price regulation, which provides some protection against the issuance of shares to insiders or related parties at very low prices. In case of using the concept of market value its precise definition is extremely important. *The General Principles* provide the following definition: "the price at which a seller and a buyer, having full information about the property's value and not obliged either to sell it or to buy it, would agree to sell and buy"[31]. Some jurisdictions require a detailed explanation of the necessity to increase the capital and the criteria for calculating the price of shares being issued. The limitations of this mechanism are recognized in terms of illiquid markets prone to manipulation.[32]

In FB&H preemptive rights represent the only mechanism for protection from share dilution. There are no provisions on the minimum price requirements except that the price of shares being issued cannot be lower than its nominal value.[33] Unlike the FB&H, the Law in RS establishes requirements regarding the selling price of the issue in order to exercise the preemptive rights.

As an alternative legal strategy Atanasov *et al.* (2007)[34] consider requesting approval of minority shareholders for related party transactions, which includes the case of a share issue to the controlling shareholder without preemptive rights. In some jurisdictions a qualified majority of shareholder's votes is required when deciding on changes in equity capital, large issuances of shares etc.[35] The approval of a class of shareholders whose rights will be impacted by the decision is usually required.[36]

Concerning the minorities' approval, it should be noted that the Law in RS recognizes the cases when a shareholder cannot vote at the meeting, and one of them includes deciding on the exclusion of preemp-

30 LoCC, Article 233 (2); LoCS, Article 213 (3).

31 G. Avilov *et al.*, 26.

32 V. Atanasov *et al.*, (2007), 11.

33 LoC FB&H, Article 130.

34 *Ibid.*, 10.

35 G. Avilov *et al.*, 27 etc.

36 Technical Committee of the IOSCO in consultation with the OECD, "Protection of Minority Shareholders in Listed Issuers", Final Report, OICV IOSCO 2009, 21 22.

tive rights in an issue of shares by a way of private offering in which he and / or related party is the buyer. The Law in FB&H contains no specific provisions on related parties and transactions approval,[37] so in the case of issue of new shares to the controlling shareholder, managers or related parties with the exclusion of preemptive rights no approval of minority shareholders would be required.

4. LEGAL PROTECTIONS FROM FREEZING OUT MINORITY SHAREHOLDERS IN B&H

The institute of squeeze-out or freeze-out is linked to the institute of takeover of open joint stock companies and regulated by the EU Thirteen Directive.[38] The offeror who acquires 90–95% of voting shares of the target company is entitled to purchase shares of the remaining shareholders at a fair price which will be considered as the one from the public offering. There is a tendency of providing this right as a general and not only in the case of a takeover by way of a public offer.[39]

As possible means to protect minority shareholders from freezing out at excessively low price Atanasov *et al.* (2010)[40] state the appraisal rights, rules on minimum pricing, fiduciary duties, and requesting price approval of minority shareholders or regulators. It is possible to demand that the purchase price cannot be lower than the market price before the release of an offer to buy shares. However, this mechanism provides little protection in terms of an inefficient, illiquid and prone to manipulation market. Another way of determining the price includes the use of liquidation value or the value of discounted cash flows in calculating fair value of the shares. Greater protection can be achieved if combining those two ways of calculating with the requirement for the use of a higher price.[41]

It has been shown that in transition economies the application of mandatory bid rule increases acquisition costs and affects companies in a way that they leave the stock exchange quotation.[42] A particular problem

[37] V. Trivun *et al.*, "Transakcije sa povezanim osobama: pojam i reguliranje", XIV Međunarodni simpozij "Računovodstvena profesija u funkciji unapređenja poslovanja", Neum 2011.

[38] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids*, Official Journal of the European Union* L 142, 30. 04. 2004., Articles 15 16.

[39] M.S. Vasiljević, 379 etc.

[40] V. Atanasov *et al.*, (2010), 9.

[41] V. Atanasov *et al.*, (2007), 12 13.

[42] E. Berglöf, A. Pajuste, "Emerging Owners, Eclipsing Markets? Corporate Gov ernance in Central and Eastern Europe", *Law and Governance in an Enlarged European Union* (eds. G.A. Bermann, K. Pistor), Hart Publishing, Oregon 2004, 308 etc.

with its implementation is the issue of determining a fair price, due to which this remedy can completely lose its protective function.[43]

It should be added that in some jurisdictions shareholders who voted against certain significant decisions or refrained from voting at the general meeting have the right to withdraw from the company by selling their shares to the company at the market value which is to be determined according to the certain rules. If the company does not redeem the shares or does that at a price they consider to be lower than the market price, the shareholders generally have the right to initiate proceedings before the competent court.

In FB&H the general meeting's decisions on the adoption or approval of the issue of new shares, bonds convertible or with preemptive rights to shares of the company, on the limitation or exclusion of preemptive rights, and on the change of form, division, merger and acquisition to another company or *vice versa*, will be considered a significant change in the company or shareholders' rights, which activate the provisions of Art. 255 of the LoC on minority protection pursuant to which, shareholders under certain conditions have the right to ask the company to redeem their shares. Exceptions are the cases of restructuring or reorganization of companies with majority state capital.

Share redemption is made at a fair market value for the period from the date of publication until the date of the meeting, whereby the important issue of the means of determining the fair market value of shares for a relatively short period is not regulated. Unlike the RS, where the company has a period of 30 days starting from the receipt of the shareholders' request to make the payment, the adequate period in FB&H is 3 months. In addition, if the total nominal value of shares in the request is greater than 10% of equity, and the total fair market value greater than the sum of the reserves and retained earnings, a company from FB&H shall carry out the obligations only to amount of specified limits in that period while for paying the remaining part has a further period of 6 months. In case of company's failure to fulfill its obligations, shareholders have the right to lodge a complaint to the competent court.

In the RS, a minority shareholder has the right to demand redemption of shares in the event of reorganization in terms of status changes and changes of legal form.[44] The company is required to redeem the shares at their market value which is calculated on the date of adoption of the decision, without taking into account any expected increase or decrease in value as its result. The market value is the average price that is regularly published on the stock exchange or another regulated market in the period immediately preceding the date for which it is determined,

[43] V.A. Atanasov, C.S. Ciccotello, S.B. Gyoshev, 43.; G. Avilov *et al.*, 30.

[44] LoC RS, Articles 330 and 435 436.

which is not shorter than 3 or longer than 6 months. In case the shares are not traded regularly or a regulated market does not exist, the market value is determined based on the estimated value of the company's capital applying appropriate methods. If he considers the amount paid to be less than the market value of shares or the company fails to make the payment, the shareholder has a right to approach the competent court according to the Law.

5. CONCLUSION

The paper explores the legal protections from financial tunneling available to minority shareholders in B&H. We start with the concept of financial tunneling and various measures of protection as defined by Atanasov et al. (2007, 2010), considering the experiences of individual countries in transition.

In the second part of the paper we analyze the provisions specifically targeted at the most common forms of financial tunneling in B&H including the available data on their application in practice. Prior to the recent legislative changes in FB&H a significant number of cases of joint stock companies changing the form into limited liability companies was registered which basically means their delisting. For comparison purposes we consider some of the adequate comparative solutions.

In terms of protection from share dilution we observe some major deficiencies in solutions of the LoC FB&H. The entity laws do not ensure a public trade of preemptive rights. The rules on the determination of share price in cases when they have a right to require redemption are not defined in favor of minority shareholders in FB&H, while minority shareholders in companies with the majority state capital do not even have the right to demand redemption.

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INDEPENDENT DIRECTORS AND NEW CORPORATE GOVERNANCE PARADIGM (*PROS & CONS* OF INDEPENDENT DIRECTORS)

In the last few decades there has been a powerful trend in favour of independ ent directors for public firms. For larger public companies around the world, it is the norm for the board of directors to include "outside" directors who are not involved in the day to day running of the company but are generally expected to take a central role in overseeing company managers. This paper presents the major drivers of the trend towards board independence and the main reasons for greater role of independent directors and stricter standards of independence, their number and diversity. The shift towards independent directors is reflected not just in the numbers or percent ages but also in the strengthening of various mechanisms of director independence.

The cummulative effect of the considered reasons led to a significant reconceptu alization of the board's role and structure. The effect of the reforms on the board's role is to make the role of the independent directors more important than ever. De spite the fact that evidences that connect the increased presence of independent di rectors to shareholder benefit are weak, the expectations of independent directors has become too large.

However, there are counter views and reasons which suggest that the role of independent directors is uncertain. Difficulties regarding the regulations of these is sues and reserves about expectations of independent directors are the final concerns of this paper. If the rise of independent directors is tied to a new corporate govern ance paradigm that looks to the stock price as the measure of most things, and "in dependent directors", namely independent boards, should serve as a "visible hand" to balance the tendency of markets to overshoot, there is the open question is wheth er the independent board has even independence from stock market and unknown market pressure.

Key words: *Board structure. Corporate Governance. Independent Directors. Monitoring board. Shareholder Value.*

1. THE RISE OF INDEPENDENT DIRECTORS AND DIRECTOR INDEPENDENCE

One of the most important developments in corporate governance over the past half century has been the shift in board composition away from insiders toward independent directors. The history also reveals that the shift towards independent directors is reflected not just in the numbers or percentages but also in the likelihood of independence in fact.[1] Nowadays, the move to independent directors, which began as a "good governance" exhortation, has become in some respects a mandatory element of new company law reform. The presence of independent directors has become commonplace on the boards of larger public companies around the world, and has become a widely accepted practice in most listed companies. Nowadays, it is the norm for the board of directors in these companies to include "outside" directors who are not involved in the day-to-day running of the company but are generally expected to take a central role in overseeing company managers. "Independent directors" – that is the worldwide accepted answer, but what is the question? The question could be phrased: Good governance means the right directors, and why do we need then independent directors? Or in the other words: What are the major factors which promote independent directors?

Some authors believe, with some suspicion, that the global corporate social responsibility movement has played a major role in motivating the changes in corporate governance practice and theory.[2] However, other reasons seem more convincingly. Thus, other authors point out that from the post-World War II era to the present, the board's principal role shifted from the "advising board" to the "monitoring board", and director independence became critical and connected with the monitoring of managerial performance in order to serve shareholder goals.[3] The hostile takeover movement (of 1980s) is also considered as a catalyst for this development – in this environment, managers turned to the monitoring board and to independent directors as the best available protection to preserve managerial autonomy against the pressure of the market in corporate control.[4] As an important

[1] J.N. Gordon, "The Rise of independent directors in the United States, 1950 2005: of shareholder value and stock market prices", European Corporate Governance Institute (ECGI), Law Working Paper No. 74/2006, 1472 1476, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 928100*, last visited 15 March 2011. This article shows on the basis of data assembled from a number of different sources, the fraction of independent directors for large US public companies has shifted from approximately 20% in the 1950s to approximately 75% by the mid 2000s.

[2] C.A. Williams *et al.*, "An Emerging Third Way? The Erosion of the Anglo American Shareholder Value Construct", *Cornell International Law Journal* 2/2005, 493, 550 551.

[3] J.N. Gordon, 1514 1520.

[4] *Ibid.*, 1522 1526. The author also points out that: "a complementary develop ment has been observed: managers who once vigorously resisted board independence as a

and key driver in changing board composition must be admitted is the shift toward shareholder wealth maximization as the dominant corporate purpose.

It is also doubtless that the prominent role in the current reform and the possible convergence of corporate governance was played by the recent financial collapses and scandals.[5] The number and scale of corporate scandals is frightening, and their effects have been dramatic – on confidence, on financial markets and on many people's lives and livelihoods. A series of corporate scandals such as Enron and Parmalat,[6] and the resulting loss of confidence by the investing public in the stock market, have led to dramatic declines in share prices and substantial financial losses to millions of individual investors.

The recent corporate scandals and business failures have prompted a lively debate on how public corporations should be governed. Both the public and the experts have identified failed corporate governance as a principal cause of these scandals.[7] Corporate governance reform has become a highly charged political issue. Countries around the world have responded to these debacles by enacting new laws and regulations aimed at improving corporate disclosure and governance practices, and many firms, in turn, have changed their corporate charters and altered their board structures. The American Congress rapidly responded by passing the Sarbanes-Oxley Act of 2002.[8] Taking the situation in the United States

limitation to their autonomy came to champion the independent board as a buffer from the hostile takeover and as a substitute for greater government intervention in the wake of scandals." *Ibid.,* 1472.

[5] Credit for this belongs primarily to U.S. corporate scandals, among which highli ghts the collapse of Enron Corp. (2001), WorldCom Inc. (2002), but also Global Crossing Ltd (2002), Kmart Corp (2002), Adelphia Communications (2002), and others. In Europe as examples of corporate scandals are set out: "Royal Ahold" (Netherlands), "Barings Bank" (U. K.), "Parmalat" (Italy), Elan (Ireland), EmTV (Germany), Vivendi (France), Swiss Life (Switzerland), Marconi (U.K.), Bipop (Italy), ABB (Sweden U. K.), MobilCom and Com Road (Germany), Cirio (Italy), and others.

[6] Some observers have gone so far as to state that Enron will stand out as a mark ing point in the chronology of regulation: the time before and after Enron. Lessons of "Enron" has prompted Europe to act promptly and as the key to European company and capital market law reform is stressed the improvement of European corporate governance. See K.J. Hopt, "Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron", ECGI, Law Working Paper No. 5/2002, updated January 2007, 446, 450, *http://papers.ssrn.com/sol3/papers. cfm?abstract id 356102*, last visited 15 May 2011.

[7] However, as some authors point out, there is little agreement as to what went wrong and what changes need to be made, or more fundamentally, "there is no consensus as to whether the existing corporate governance regime is deficient or has simply been poorly implemented." See J. Armour, Wolf Georg Ringe, "European Company Law 1999 2010: Renaissance an Crisis", ECGI, Law Working Paper No. 175/2011, *http://pa pers.ssrn.com/sol3/papers.cfm?abstract id 1691688*, 38, last visited 15 July 2011.

[8] Sarbanes Oxley Act of 2002, H.R. 3763, 107th Cong. (2002).

as alarming one, European countries, mindful of earlier financial scandals of their own, started examining their own systems of corporate governance in an effort to prevent similar abuses. In a direct reaction to Enron, the European Commission mandated the High Level Group of Company Law Experts (hereafter: High Level Group) to come up with a vision on where the priorities of the European company law should be and to include issues related to best practices in corporate governance and auditing, in particular concerning the role of non-executive directors and supervisory boards. The High Level Group came up with its report on 4 November 2002,[9] and the European Commission in its Action Plan of 21 May 2003, accepted many of the recommendations of the High Level Group.

The principle institutional failure that produced Enron and its followers was the failure of the gatekeepers, especially external auditors, not the insufficiency of director independence. Moreover, "what is stunning is not only the failure of the auditing control device, but that *all* control mechanisms failed".[10] The corporate scandals demonstrated weaknesses in the board governance system and pointed the way toward new roles for independent directors and standards of independence. After the Enron debacle the struggle for efficient internal management control has become a major focus of the corporate governance debate, regulatory initiatives and innovations in many countries.[11] As a consequence, board structure has become an issue for corporate governance reform.

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[9] Report of the High Level Group of Company Law Experts on a Modern Regula tory Framework for Company Law in Europe, 4 November 2002, *http://ec.europa.eu/ inter nal market/ company/docs/modern/report en.pdf* (hereafter: High Level Group), last visited 15 May 2011. The Report covers most of the topics of corporate governance, reflecting the fact that the company law and corporate governance practices widely differ from member state to member state, calls for significant legislative action by the E. C., that would occur in the form of recommandations non binding acts that are *soft law*, and directives binding acts that are *hard law*.

[10] K.J. Hopt, P.C. Leyens, "Board Models in Europe Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy", ECGI, Law Working Paper No. 18/2004, January 2004, 3, *http://papers.ssrn.com/ sol3/papers.cfm? abstract id 487944*, last visited 15 March 2011.

[11] Prestigious groups and organizations within individual countries produced over 30 recommended codes of best practices in corporate governance over the last decade. For a comprehensive listing of these codes and reports see Weil, Gotshal & Manges LLP, on behalf of the European Commission, Internal Market Directorate General, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States* (January 2002), 14 16, *http://ec.europa/internal market/company/docs/corpgov/ corp gov codes rpt part1 en.pdf*, last visited 15 May 2011. All these initiatives have ai med to establish principles, standards and guidelines for best practice corporate governan ce. They particularly emphasized the importance of transparency, accountability, internal controls, compesation scheme for members of the Board, presence of independent and non executive directors and interdependence of completed compensation and actual performance of the company. These proposals and recommendations also contains the Report of High Level Group.

2. THE NEW ROLES FOR INDEPENDENT DIRECTORS

Corporate scandals have launched a broad debate about the causes that led to the collapse of Enron, Parmalat and other corporations. The post-Enron reforms lay the groundwork for a revised model of corporate governance. The model operates at many different levels. It imposes new duties, new liabilities, and a new regulatory structure on certain gatekeepers, accountants in particular but also lawyers and, in a fashion, securities analysts. But, the prevailing opinion that the inadequacy of the board of directors was a major factor of corporate collapse,[12] has put the board back into the focus of regulatory initiatives. This perception of the board initiated a reform in two directions: to change its role and its structure. Thus, in these globalizing times, as a leading issue of corporate law has again arised the question whether one-tier or two-tier corporate governance system (or component thereof) possesses relative competitive advantage, while the scholars has become enchanted with the notion of "global" convergence in corporate governance.[13] The cumulative effect of the above pressures led to significant reconceptualisation of the board's role and structure. First, the advising board model was replaced by the "monitoring board", and this new model rapidly became conventional wisdom.

The shift towards to new corporate governance paradigm granted a new role for the board: the monitoring of financial controls and disclosure. Stock market prices were not spontaneously created – they could be manipulated and influenced by self-interested managerial action, and the new approach that incorporated stock prices into both compensation and termination of directors created powerful incentives for such behavior.[14] This has placed new and greater demands on the monitoring capacity of boards and the effect of the reforms on the board's role is to make the role of the independent director more important than ever. Both the state law and the stock exchange listing requirements imposed more rigorous stan-

[12] G. Ferrarini *et al.*, *Reforming Company and Takeover Law in Europe*, Oxford University Press 2004, 228, 232.

[13] D.M. Branson, "The Very Uncertain Prospect of "Global" Convergence in Corpo rate Governance", *Cornell International Law Journal* 2/2001, 321 323. However, this author believes that convergence in corporate governance is far more likely to be regional rather than "global", and may occur in discrete areas, such as financial accounting or disclo sure (362). During the last decade, a variety of academic disciplines, including law, finance, and sociology, have paid sustained attention to the potential convergence of these two sy stems of corporate governance. American law professors who study convergence have pri marily examined whether European companies are moving toward the Anglo American pattern either because of cross border mergers and acquisitions resulting from American institutional capital investing abroad, or as a consequence of global competition, each of which favors a focus on shareholder value. Contrary views suggest that corporate governan ce systems will not converge to any great extent because of politics, path dependence, and history.

[14] J.N. Gordon, 1540.

dards of director independence. Boards, in particularly the audit committee, are given a specific mandate to supervise the company's relationship with the accountants and thus to oversee the company's internal financial controls and financial disclosure. As a consequence, directors then, would have a particularized monitoring role, what might be called "controls monitoring," in addition to "performance monitoring."[15]

Another key issue of the reform concerned the composition of the board. This question is not of pure technical nature, but related essentially to governing relations in each company. In companies with dispersed ownership, shareholders are usually unable to closely monitor management, its strategies and its performance for lack of information and resources. The role of non-executive directors in one-tier board structures and supervisory directors in two-tier board structures should be to fill this gap between the uninformed shareholders as principals and the fully informed executive managers as agents by monitoring the agents more closely.[16] Even in controlled companies, there is a need for monitoring by non-executive directors or supervisory directors on behalf of minority shareholders, given that the position of the controlling shareholder(s) creates potential conflicts of interests with minority of shareholders who lacks sufficient information and resources to monitor management and the controlling shareholder(s).[17] In a public company with a controlling shareholder, outside directors can also plausibly play a productive corporate governance role by acting as a check on the blockholder. The newest analysis also suggests that board composition is a key determinant of corporate value, but not the reverse, and the evidence supports causality running from an increase in allied directors leading to a reduction in corporate value.[18]

Outside directors of public companies play a central role in overseeing the company's management. Non-executive and supervisory directors normally have a role of oversight of the executive managers in areas like the financial performance of the company and major decisions affecting its strategy and future. However, there are three areas where there is a specific need for impartial monitoring by non-executive and supervisory directors: the nomination of directors, the remuneration of directors and the audit of the accounting for the company's performance. In these three areas, executive directors clearly have conflicts of interests. Lack of monitoring by independent, disinterested non-executive directors in these

[15] *Ibid.*, 1539 1540.

[16] High Level Group III 59.

[17] *Ibid.,* 60.

[18] J. Dahay, O. Dimitrov, J.J. McConnell, "Dominant Shareholders and Allied Di rectors: A Simple Model and Evidence from 22 Countries, ECGI", Working Paper Series in Finance, No. 99/2005, 33 34, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 805544*, last visited 15 March 2011.

three areas has been a major cause for the various corporate scandals that we have witnessed in the last decade, and an important element of the regulatory responses that followed therefore has focused on strengthening the independent monitoring by non-executive directors in these areas.

It is likely that the optimal number and degree of diversity of independent directors will vary from industry to industry, from firm to firm, and from time to time. Any recommendation for a minimum number of independent directors and for a higher degree of diversity among directors is likely to be good for some companies and bad for others. High Level Group does not express views on composition of the full one-tier board or supervisory board, and to what extent independent non-executive or supervisory directors should be members of it. But, promoting the role of non-executive and supervisory directors, the Group expressed the view that, for all listed companies in the EU, should to be ensured that nomination, remuneration and audit committees should consist exclusively of independent non-executive or supervisory directors, but rejected this as a European rule, considered it neither appropriate nor necessary.[19] It is therefore recommended by High Level Group that the European Commission issue a Recommendation to Member States that they have effective rules in their company laws or in their national corporate governance codes ensuring that the nomination and remuneration of directors and the audit of the accounting of the company's performance is decided upon by non-executive or supervisory directors who are at least in the majority independent, and it should be enforced at least on a *comply or explain* basis.[20] In most countries the recommendations on these issues are not binding, since listed companies are free to decide whether to comply with them or to explain why they do not. This approach relies on the free market response, and companies and their CEOs, however, one may find it hard to explain convincingly why they have deviated from recommended behavior, and the cost in terms of lower investor confidence of such a move may be higher than the cost of following commonly-adopted corporate governance recommendations.

Outside directors constitute a key component of most prescriptions for good governance of public companies. The core assumption is that outside directors can make a pivotal contribution by monitoring the performance and conduct of senior executives, thereby enhancing manage-

[19] High Level Group III 60 61. The Group noted that: "In Europe, we have to take account of particular situations relevant to board structures, like the existence of control ling shareholders and boards which are partly codetermined by employees".

[20] *Ibid.,* 61. Principle *comply or explain* means that the listed companies are obli ged to fully comply with this requirement or to disclose in their annual corporate governan ce statement to what extent and why they deviate from it. The European Commission adop ted the Recommendation on the role of non executive/supervisory directors on 06 October 2004., which urges Member States to ensure a strong role for independent directors.

rial accountability, and also contributing to the strategy development. It is believed that independent directors have a comparative advantage for these different tasks. They are less dependent on the CEO and more sensitive to external assessments of their performance as directors; they are less devoted to inside accounts of the company's prospects and less worried about the disclosure of potentially competitively sensitive information. They also have credibility in the "checking" of market signals and they might create significant value in the allocation of resources. This emphasizes the critical role of independent directors as an efficiency and justified strategy for importing stock market signals into the firm's and the economy's decision-making.[21] Thus, this role of outside directors requires the development of various mechanisms of director independence aimed at producing directors who will be independent in fact.

3. NEW STANDARDS OF DIRECTOR INDEPENDENCE

Independence of directors is viewed as the most important corporate governance issue, and it is one of the cornerstones for efficient control, and the shift towards independent directors is reflected not just in the numbers or percentages but also in the likelihood of independence in fact. In the last decades we have observed the common trend to stricter standards of independence which today serve as a common denominator for good corporate governance. Independent directors are individuals who serve on the board of a company but do not act in any sort of executive capacity. They are obliged to comply with various legal duties, the details of which vary across countries. Although definitions vary in detail, convergence can be noted in the growing tendency towards stricter standards of director independence and the strengthening of various mechanisms that enhanced the independence-in-fact of directors.[22]

A popular view present on both sides of the Atlantic, holds that outside directors should be more independent, as reflected also in their selection and nomination process, more numerous and more diverse, more active and more in control of the board's monitoring activity.[23] But, the unresolved question still is what exactly constitutes "independence". The concepts of what 'independence' is meant by and who or how many of directors should be independent in the sense of the relevant rule differ widely. As it is well known, no definition of independence will ever assure that an independent director will indeed act as such. Regardless of

[21] J.N. Gordon, 1471.

[22] K.J. Hopt, P.C. Leyens, 21.

[23] D. Higgs, *Review of the Role and Effectiveness of Non Executive Directors,* 20 January 2003, 6 7, 42 44, *http://www.berr.gov.uk/files/file23012.pdf*, last visited 15 March 2011.

the debate on the notion of independence there is a practical need to establish what are the criteria and standards of independence (property, status, personal, moral, competence and experience), according which to evaluate whether the non-executive or supervisory directors are eligible to be considered independent or not. That is why the High Level Group recommended to the Commission to establish the minimum list of the principles of independence, that should include a list of relationships which would cause a non-executive or supervisory director to be considered not to be independent. In the view of the High Level Group, "such a list should at least include: [24]

- Those who are employed by the company, or have been employed in a period of five years prior to the appointment as non-executive or supervisory director;
- Those who receive any fee for consulting or advising or otherwise, from the company or its executive managers;
- Those who receive remuneration from the company which is dependent on the performance of the company (e.g. share options or performance related bonuses, etc.);
- Those who, in their capacity as non-executive or supervisory directors of the company, monitor an executive director who is non-executive or supervisory director in another company in which they are an executive director, and other forms of interlocking directorships;
- Those who are controlling shareholders, acting alone or in concert, or their representatives. Controlling shareholder for the purposes of this rule could be defined, as a minimum, as a shareholder who, alone or in concert, holds 30% or more of the share capital of the company.
- In defining relations which disqualify a non-executive or supervisory director from being considered to be independent, related parties and family relationships should be taken into account."

The regulatory approach in the United Kingdom to the determination of independence is more flexible. According to the revised Combined Code independence primarily means that there are no "relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement".[25] In addition to this general definition the revised Combined Code lists the following seven indicators where a director, in

[24] High Level Group III 62 63. Such the Law on Commercial Companies, *Official Gazette of the Republic Serbia*, No. 125/04, Article 310 (3), Article 318 (1), Article 325 (1), also provide the criteria to director's independence.

[25] Combined Code section A.3.1, *http://www.fsa.gov.uk/pubs/ukla/lr comcode2003.pdf*, last visited 15 May 2011.

principle, should not be deemed independent: employment contract with the company or group within the last five years, a material business relationship within the last three years, additional remuneration apart from the director's fee, close family ties, cross-directorships, representation of a significant shareholder, or a directorship for more than nine years. The board should explain its reasons in the annual report if it determines that a non-executive director is independent although one of the specific examples indicates that he is not. Similar to the approach of the Combined Code, the general definition of independence in the France code of Corporate Governance is supplemented by specific examples that indicate non-independence.[26]

However, a paradigm of independence is even wider. Central issues in post-Enron debate has focused on conflict of interest rather than competence. But, it has been observed from the beginning of the independent director movement and since the foundation of practical experience in respect of the directors' independence that the specific management knowledge and business relations of the board of directors can be highly useful both the running and the control of the company. The codes stress a director's competence and experience as key qualities that should be regarded separately and in addition to independence. However, it is not so easy to ensure simultaneously competence and independence, and sometimes it could be a case of trade-of between loyalty and competence. While non-executive directors do not face the same conflicts of interest as executive directors, they may be less familiar with the company's affairs and less competent than executive directors. This is already the case for supervisory board members, particularly under labour co-determination. If strict independence requirements for non-executive directors are set up, ensuring competence becomes a real problem.[27]

Specifying what competence involves – for example, being able to read balance sheets or demonstrating 'financial literacy – could help, but it may unduly restrict companies' choice of directors. A way out of this dilemma may be disclosure, that is, a rule requiring the company to disclose why each non-executive director is considered competent or fit and proper for his office.[28] Another solution might be to require competence, but to ask for training, including continuous professional education as in other professions, or forming pools of candidates for directorships. In any case, ensuring of non-executive directors of competence is a real problem, not

[26] Principes de gouvernement d'entreprise résultant de la consolidation des rapports conjoints de l'AFEP et du MEDEF de 1995, 1999 et 2002, Paris Octobre 2003, section 8, *http://www. natixis.com/upload/docs/application/pdf/2009 03/afep medef oct 2003.pdf*, last visited 15 May 2011.

[27] K.J. Hopt, 459 460.

[28] *Ibid.*, 460.

only for countries in transition, but also for developed countries. In view of this requirement the High Level Group considers that the existing rules on the competence which is expected of non-executive and supervisory directors are generally abstract. In the light of the collective responsibility of all board members for the financial statements of the company, the High Level Group considers that basic financial understanding is a fundamental skill all board members should possess or acquire upon their appointment, but other skills may be of high relevance as well and board members may be elected for their expertise in particular areas.[29]

A different mechanism for director independence focuses on incentives – sanctions and rewards – for particular director behavior. Most commonly these are economic, but reputation matters too. An important mechanism for director independence is the creative use of board structure to create a spirit of teamwork and mutual accountability among independent directors that helps foster independence-in-fact. Structural innovations multiplied over the last decades, including board committees tasked with specific functions in areas where the interests of managers and the shareholders may conflict.[30]

Recent proposals have stressed the importance of having a higher number (usually a majority) of independent directors on the board. Besides to a number of independent directors, emphasis has been given also to the importance of putting together a diverse set of board directors, because "the interplay of varied and complementary perspectives amongst different members of the board can significantly benefit board performance".[31] In order to ensure independence, emphasis has been given to the process of selecting and nominating independent directors. A director's independence-in-fact may be seriously affected by the route by which the director arrived on the board.[32] In addition, more time and money should be allocated by companies for this. Some of the initiators emphasize the need to establish special pools and funds for the recruitment and refreshing the knowledge and skills of directors.[33] On the other hand, if we allow the independent director can be removed without cause, we must ask whether he can then really be independent.

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[29] High Level Group III 63.

[30] J.N. Gordon, 1483 1490.

[31] D. Higgs, 42.

[32] J.N. Gordon, 1496. The author points out that: "Until recently, CEOs heavily influenced if not controlled outright director selection. Directors picked in this way are likely to feel a strong sense of loyalty, even gratitude, to the CEO".

[33] D. Higgs, 6 7, 42 45. So, Higgs in his report suggests that directors are elected to the senior management, just below board level, that women are more represented, as well as foreigners and persons from the noncommercial sector sitting in the bodies of charities and public sector institutions.

4. THE REALITY OF THE EXPECTATIONS OF INDEPENDENT DIRECTORS

The global trend of corporate governance reforms have emphasized on the importance of board independence. The reform efforts over the last decades enhance substantially the conditions that foster director independence and the cumulative effect of innovations in these various mechanisms significantly increased director independence-in-fact. Legal institutions encourage the appointment of at least some indpendent directors in all of the principal corporate law jurisdictions.[34] But, it is a well-known phenomenon that there are two main sets of legal rules on the supervision on corporate management: one-tier board system and two-tier-board syistem, where issues related to independent directors do not reflect in the same way.

This tendency toward independent non-executive directors is less marked in countries with a two-tier board system such as Germany. In Germany, some argue that the supervisory board members are *per se* outside or non-executive directors.[35] As their task is clearly defined and limited to the control of the company, it is not necessary for them to have the same degree of independence as the non-executive directors on the unitary board. Therefore, typically, the two-tier countries advocate a minimum standard for the inclusion of independent directors on the boards of listed companies.[36] But, there are some structural deficiencies of two-tier system which are unfavorable for the independence-in-fact. Thus, the separation of management and control – the key advantages of the two-tier system – somewhat dilutes the independence of the members of supervisory board. Namely, the members of the supervisory board are not involved in the decision-making process at all. The way in which the supervisory board exercises its control is always reactive and never active. This necessarily leads to a decrease of the quality of control. The need for information is another weak point in the two-tier system of control, which stems from the supervisory board's non-involvement in the decision-making process and the fact that its members are not present at the meetings

[34] R.R. Kraakman *et al.*, *The Anatomy of Corporate Law, A Comparative and Func tional Approach*, Oxford University Press 2004, 50.

[35] K.J. Hopt, 459 461. This author points out that: "Yet as a European rule for all Member States, this creates considerable difficulties for countries with labour co determi nation, in particular for Germany". It is obviously that a common standard of independence proves difficult for labour participation. Representatives from workers' unions could qualify as being free from any direct business relationship but they are bound to the interests of the union's members, i.e. the employees of the company.

[36] C. Jungmann, "The Dualism of One Tier and Two Tier Board Systems in Eu rope", 2009, 13, *http://www.duslaw.eu/files/TheDualism of One Tier and Two Tier Boards in Europe (Jungmann). pdf*, last visited 15 May 2011.

of the management board. Therefore, there is a strong information asymmetry between two boards, since all information concerning of questions of strategy, future projects, business opportunities, budgetary questions, etc. lies in the hands of management board. In addition to the structural deficiensies of the two-tier system, there are problems originating solely from the German laws of co-determination – it complicates the introduction of mandatory qualification standards for all members of the supervisory board. Such standards would be considered as an obstacle to employees to freely choose their representatives. However, without common standards concerning qualification and professional experience, it is extremely difficult to ensure the quality of work performed by the members of the supervisory board.[37]

In the unitary system, non-executives directors have, contrary to members of the supervisory board, direct right to information. But, the one-tier system has an inherent weakness – the members of unitary board fulfill both managerial and supervisory roles, i.e. they should make decisions and, at the same time, monitor these decisions. The mere fact that there are executive and non-executive directors is not sufficient to guarantee the adequate execution of the monitoring role of the board. Therefore, independence is deemed to be a necessary precondition for the ability to handle the combination of two tasks in practice. This has led to a further class of board members: within the group of the non-executives directors, only some are deemed independent. It thus remains a problem of the one-tier system to find ways to guarantee that a certain number of board members are independent and to name criteria for independence. In addition, the independence non-executive directors face the dilemma of being colleagues with the other board members but also having to monitor them at the same time. It is mainly the responsibility of the chairman to hold meetings in an environment in which there is a clear understanding of the different tasks of the board members and in which problems and questions can be discussed frankly and openly. What remains, however, is the structural weakness of the one-tier system, in which the effectiveness of corporate control depends not only on the personality of the non-executive directors, but foremost on the personality of the chairman. Thus, a minimum formal requirement should be that the chairman is not a also the CEO and that he is independent.[38]

But, regardless of whether one or another corporate governance system is concerned, the difficult problem remains: independence is more a disposition, a state of mind, rather than a concrete fact. However, adoption of these various governance innovations both reflected a cultural

[37] *Ibid.,* 5 6.

[38] *Ibid.,* 10 11. Thus, both requirements are recommended in Sec. A.2.1 and Sec. A.2.2 of Combined Code.

change in the expectations of director behavior and helped create the cultural change, so that board composition and board attitude have notably shifted toward independence-in-fact.[39]

There is a tendency to think that simply having independent directors improves corporate governance, but the reality sometimes may be the opposite. Evidences that connect the increased presence of independent directors to shareholder benefit are weak. Even in the United States, which are the birthplace of today's reforms, it is unclear how much independent directors actually contribute to the improvement of corporate governance.[40] There are numerous surveys which point out that there was a tremendous gap between the current performance of independent directors and the expectations of the public, and there is only limited evidence that board independence generates differences in board behavior, and the differences are not clear.[41] Nowadays it is certain that the high expectations of independent directors have been only partially fulfilled.[42]

On the other hand, it is obvious that the expectations of independent outside directors are still too high. Independent directors are expected to have an enhanced role in committees, not to sit idle in them. They are expected to get familiar with the company and its organization, to be informed, to control the executive directors, to set them intelligent and unsentimental questions, to review their most important decisions, to monitor the external auditors, to determine appropriate compensation for executive directors, and etc. But as first and foremost, integrity, probity and high ethical standards are a prerequisite for all directors, so that we can ask whether they are expected to more than human. Bearing in mind the qualities required of an independent director and the task given to him by corporate governance best practice codes, it is natural wonder, such as professor Enriques, "whether there are indeed enough human beings around who may qualify to serve as independent directors or whether, instead, such an independent director will have to be a sort of *homo no-*

[39] J.N. Gordon, 1499 1500.

[40] R.R. Kraakman *et al.*, 51.

[41] J.N. Gordon, 1500 1501. The author points out that "[m]ost studies find little correlation, but a number of recent studies report evidence of a negative correlation be tween the proportion of independent directors and firm performance but the conclusion is the same: that increasing the degree of board independence does not improve firm per formance".

[42] K.J. Hopt, "Comparative Corporate Governance: The State of the Art and Inter national Regulation", ECGI, Law Working Paper No. 170/2011, 38, January 2011, *http:// papers.ssrn.com/sol3/papers.cfm?abstract id 1713750*, last visited 15 May 2011. In ad dition, the author says that: "Independent directors seem to have had an impact on replac ing executive directors, but this was often mainly due to pressures from institutional in vestors. More recently, independent directors have not been able to prevent huge scandals, e.g., Enron, where the board was composed of a majority of qualified independent direc tors."

vus, created by capitalism in order to overcome its current crisis" – because, in fact, "anyone displaying this plethora of personal qualities would qualify for sainthood".[43]

Hyperactivity of independent directors can also produce counter-effects, because it is obvious that CEOs of public corporations will have much less freedom to serve their own interests, but also much less freedom (and less time) to make innovative and profit-generating business decisions. Therefore, the warning that "the increased bureaucratization of business decision-making within public corporations may well be the most negative long-term consequence of Enron and its progeny of scandals, fostering going-private transactions and delaying plans to go public by existing private companies", should be taken very seriously.[44]

Given that outside directors are important, one is led to wonder what will motivate the individuals serving in this capacity to carry out their responsibilities in an effective manner. It is also said that independent directors may have fewer incentives to monitor management activity than other directors because their pay is less and has not included stock options. Remunerating independent directors had always been a big question mark for companies. The immediate doubt which arises as soon as the remuneration of an independent director is specified is whether the director's independency still stands good.[45] Companies seeking to recruit top-flight boardroom candidates theoretically could increase directors' fees. Moreover, if director's remuneration becomes genuinely lucrative, some directors might become too dependent on their positions and lose the independence that is felt to be critical to good corporate governance, since outside directors play a central role in overseeing management.[46] On the other hand, if companies increase a risk of personal liability of independence directors it could also result in a counterproductive effort by directors to formalize boardroom procedures and create a paper record

[43] L. Enriques, "Bad Apples, Bad Oranges: A Comment from Old Europe on Post Enron Corporate Governance Reforms", *Wake Forest Law Review* 3/2003, 931 932, *http:// papers.ssrn. com/sol3/ papers.cfm?abstract id 464241*, last visited April 2011.

[44] *Ibid.,* 931.

[45] The remuneration of directors and "pay without performance" has become a prominent topic in the US, the UK and more recently in many other European and non European countries as well. The recent corporate scandals and the current financial crisis has led to the detailed rules on remuneration, in order to prevent perverse incentives in financial institutions for corporations. The tendency of these rules is to balance the vari able and non variable components of remuneration, to define performance criteria in view of long term value creation, to defer a major part of the variable component for a certain period of time, to have contractual arrangements permitting the reclamation of variable components under certain circumstances and to limit termination payments.

[46] B.R. Cheffins, B.S. Black, M. Klausner, "Outside Directors, Liability Risk and Corporate Governance: A Comparative Analysis", ECGI, Working Paper No. 48/2005, 31, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 800584*, last visited March 2011.

for everything they do. An additional potential negative consequence of increased out-of-pocket liability risk is that capable people will be less willing to serve as outside directors and those individuals who agree to serve as outside directors despite a significant risk of out-of-pocket liability may well demand higher fees to compensate for that risk. If companies do raise director's pay substantially to recruit and retain quality outside directors, the change could impair the quality of corporate governance.[47]

The rise of independent directors is a very important change in the political economy landscape, and should be evaluated in light of new corporate governance paradigm, that places shareholder value as the primary corporate objective, and looks to the stock price as the measure of most things. Maximizing the stock price serves to promoting the interests of shareholders and making use of the information impounded by the market to allocate capital efficiently. This new paradigm also opens up space for a distinctive role for the independent board: deciding when prevailing prices misvalue the firm and its strategies. In this environment, independent directors are more valuable than insiders, because they are less committed to management and less captured by the internal perspective. In this way, independent directors are an essential part of a new corporate governance paradigm, and have become a complementary institution to an economy of firms directed to maximize shareholder value.[48]

The responses by countries and firms aimed at improving corporate governance practices, primarily through altered board structures, raise the question whether or not such changes in corporate governance are reflected in improvements in corporate valuation. Some authors find that improvements in corporate governance over and above what can be considered the norm and average practice in the country have a positive effect on firm valuation, the market provides incentives for firms to improve corporate governance and enhance shareholder value.[49] The turn to independent directors serves a view that stock market signals are the most reliable measure of firm performance and the best guide to allocation of capital in the economy, but that a "visible hand," namely, the independent board, is needed to balance the tendency of markets (as an "invisible hand") to overshoot. In this time of increased shareholder activism, one important question is whether the enhanced independence of directors will create a

[47] B.R. Cheffins, B.S. Black, "Outside Directors, Liability Across Countries", ECGI, Law Working Paper No. 71/2006, 1479 1480, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 438321*, last visited March 2011.

[48] J.N. Gordon, 1563.

[49] V. Chhaochharia, L. Laeven, "The Invisible Hand in Corporate Governance", ECGI Working Paper Series in Finance, No. 165/2007, 27 28, *http://papers.ssrn.com/sol3/papers.cfm? abstract id 965733*, last visited 15 Jun 2011.

space for a public firm to resist stock market or whether the very pressures that give rise to director independence will in the end defeat this possibility. Another open question is whether the independent board has even this independence from the stock market. If the apogee of a corporate governance paradigm resting on independent directors, in that case the independent board may also mark the moment of its decline.[50]

It is not to easy to observers to be very optimistic about the role of independent directors in corporate governance around the world. Bearing in mind that the independence of directors is only one element of corporate governance structure, it is probably still too early to give a final answer, and it remains to be seen whether the movement for independent directors will provide a better quality of corporate governance. By making independent directors a key aspect of good corporate governance, companies and regulators may be lulled into a false sense of security by compliance with it. Therefore, for the sake of precaution, in the meantime, we should bear in mind that the growing importance of codes of conduct, listing rules, and corporate governance ratings leads to a considerable unknown market pressure,[51] and the powerful "invisible hand" of market could defeat "visible hand" (independent directors – namely, independent board) with role to balance it. In this case, the possible failure of this part of corporate governance reform will once again require government interference and the "helping hand" of government will be needed to improve corporate governance by force through new laws and regulations. We can conclude that "independent directors" is the answer, but it seems that there are still more questions than answers.

[50] J.N. Gordon, 1469 1472, 1564.

[51] K.J. Hopt, P.C. Leyens, 20.

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WHY GOING PRIVATE IS (WAS) PROHIBITED IN SERBIA?

This paper deals with the problem of permissibility of public companies' going private transactions in Serbia. The Securities Commission of Serbia caused that problem by an odd interpretation of the current Serbian securities law. It is of the opinion that going private of public companies in Serbia is prohibited due to a loop hole in the Securities Market Act concerning the procedure for the process. That was the ground for the Companies Register to start the practice of denying the registration of conversion of public companies into private ones. The courts confirmed that practice as the legal one in judicial review procedures, which stopped going private process in Serbia for a longer time in spite of the explicit statutory permission. The paper points out that such a practice is illegal, because it is not grounded on the law, but on the decision makers' arbitrariness.

Key words: *Going Private. Company. Securities.*

1. INTRODUCTION

Going private is the process of converting a public company into the private one. Unlike the going public process, in which a company introduces its shares into the public trade converting itself from private into the public one, in this process it withdraws the shares from the public market by shifting them on the private market.[1] The main consequence of

[1] Compare this definition with: T.L. Hazen, *The Law of Securities Regulation*, Thomson Co., St. Paul, Minn. 2002, 514; M.I. Steinberg, *Understanding Securities Law*, Matthew Bender, New York 1996, 298, 357; D.C. Kreymborg, *Going Private with Public Concern,* Montreal 2003, 7, *http://digitool.library.mcgill.ca/webclient/StreamGate?folderid 0&dvs 1312025028200~112*, last visited 30 July 2011; D.A. Rice, "Going Private

this process for the company's shareholders is that they may not trade their shares any more by making public offerings for selling or buying, but exclusively by private offerings, which may not be announced. Since it reduces the marketability of their shares (the possibility to sell or buy), the law usually protects dissentient shareholders from the abuse of the majority, recognizing special rights to them and regulating the procedure for that process. For that reason, the company must take a set of actions toward its shareholders (for instance, passing a decision in the general meeting, paying money to the dissentients for their shares), market professionals (for instance, notifying the stock exchange, the corporate agent), the public (announcement) and the market regulator (for instance, awarding its approval).

Going public and going private in Serbia is regulated by two statutes. One is the Commercial Companies Act from 2004 (Zakon o privrednim društvima; hereafter: Companies Act), which regulates companies[2] and the other is the Securities and Other Financial Instruments Market Act from 2006 (Zakon o tržištu harija od vrednosti i drugih finansijskih instrumenata; hereafter: Securities Market Act), which regulates securities and their trade.[3] These statutes have made a problem in regulating the going private process by explicitly allowing it, but with no explicit regulation of the procedure itself nor the protection of dissentient shareholders. That has been a ground for different interpretations in practice and arbitrary behavior of the competent authorities. The new Serbian Capital Market Act (*Zakon o tržištu kapitala*) from 2011 explicitly regulates the going private process, terminating legal uncertainty caused by the current regulations.[4]

Transactions An Overview", 2007, 1, *http://www.haynesboone.com/files/Publication line*, last visited 30 July 2011.

Some jurists distinguish going private from going dark. In their opinion, going pri vate is a *transaction* of converting a public company into the private one in which a per son (a controlling shareholder, an outsider by takeover bid or the company itself) buys out shares from the minority of dissentient shareholders, reducing their number to the level enough to satisfy legal requirements for withdrawing shares from the public market. The consequence is that the company does not have any more reporting duties to the public. In contrast to that, *going dark* is not a transaction (i.e. a contract for buying shares), but an act of a public company by which it deregisters itself from the list of public companies with the competent authority, under certain legal conditions, excluding its obligation of public disclosure. See P. Broude, T. Harman, P. Underwood, "Going private and Going Dark", 1 2/2005, *http://www.foley.com/files*, last visited 30 July 2001.

[2] Companies Act, *Official Gazette of the Republic of Serbia*, No. 125/2004 (here after in footnotes: CA).

[3] Securities and Other Financial Instruments Market Act, *Official Gazette of the Republic of Serbia*, No. 47/2006 (hereafter in footnotes: SMA).

[4] The Capital Markets Act [Zakon o tržištu kapitala], *Official Gazette of the Re public of Serbia*, No. 31/2011 (hereafter in footnotes: CMA) will enter into force on De cember 17th 2011.

2. REASONS FOR GOING PRIVATE

Both ways of carrying on business, public and private, have some advantages and disadvantages for a company and its shareholders. Basically, the advantages of a public company are the access to the public market, raising big capital from investors by public issues, which is cheaper than bank loans,[5] and a free transfer of shares for their holders. These are the main reason for the trend of going public process in the countries with market economies.[6] However, the public way of carrying on business requires from the company a regular disclosure of its financial situation to the investment public, which is connected with many formalities with supervisory authorities and big costs of producing financial reports.[7]

In the last decade there has been a wave of the going private process in many developed countries. The main reason for that is saving the company big costs that disclosure duty causes. Informing the investors implies many types of costs for the company. They are the cost of drawing reports (pays to employees, lawyers, accountants, corporate agent and auditors), fees to supervisory authorities for approving their publication, the cost of printing, publication and distribution of reports, as well as the stock exchange fees for quotation, if the shares are listed. The burden of these costs lies upon the public company not only for issuing securities for the publication of an offer and prospectus, but also after that, for reporting its economic state as long as its shares are in the public trade. These costs especially affect the company with a weak dispersion of shares among the investment public (i.e. small free float).[8] Besides, there are costs for a complex managerial structure within the company, because the law compels them to have the board of directors, executive directors, a supervisory board (in civil law system), special committees and the secretary. They all have to be paid for their functions. A private company does not have these costs, which enables it to use that part of the profit

[5] S. Radmilović *et al*., *Finansijska tržišta* [Financial Markets], Financing Centar, Novi Sad 1994, 35.

[6] D. Radonjić, *Pravo privrednih društava* [Law on Companies], Pobjeda, Podgor ica 2008, 24.

[7] S.D. Girvin, S. Frisby, A. Hudson, *Charlesworth's Company Law*, Sweet & Maxwell, London 2010, 54 56; D. Keenan, J. Bisacre, *Company Law*, Pearson, Harlow 2005, 9 10; P.L. Davies, *Gower and Davies Principles of Modern Company Law*, Sweet & Maxwell, London 2003, 12 17; S.W. Mayson, D. French, C.L. Ryan, *Company Law*, Blackstone Press, London 2001, 54 56; D. Kelly, A. Holmes, R. Hayward, *Business Law*, Cavendish Publishing, London 2002, 348 350; N. Jovanović, "Otvaranje i zatvaranje privrednih društava" ["Going Public and Going Private of Companies"], *Pravo i privreda* [*Law and Economy*] 1 4/2005, 69 70.

[8] There is a saying that "the last remaining shareholder is incredibly expensive". See D. Kreymborg, 12.

for investment in business, distribution of dividends or for other purposes (reserves etc.).

Other reasons for a company to go private are: 1) flexibility and speed in adapting its structure and organization (corporate governance), as well as its business to the changed market conditions due to fewer formalities in the decision-making process,[9] 2) excluding duty to disclose sensitive business information to the public and especially to the competitors, 3) a better control of the shareholders base by controlling shareholders and directors, 4) elimination of takeover risk, 5) reducing the risk of liability of directors for contravention of fiduciary duties, 6) upholding the real market value of the shares and company's capital in case they are undervalued by investors on public market due to the insufficient demand during an economic crisis, inappropriate marketing of the company or inadequate coverage by financial analysts, 7) enabling the strategic business orientation of the company toward long-term reliable profitable plans, instead of toward a short-term profitable business policy under the pressure of the investment public, which is "hungry" for quick profit and capital gains in dealing of shares. Finally, in recent years a strong private share market has been created, which has enabled private companies to have a much easier access to capital from the investors who seek long-term profitable investments, rather than short-term capital gains in trade on the public market.[10]

Apart from these general reasons, in Serbia there are two special legal reasons for the public companies' attempts to become private ones in the last several years.[11] The first one is coercive going public process and the second one is the system of concentrated privatization of the state-owned enterprises. Both of them were imposed by the statutes which were enacted at the beginning of this century.[12] Namely, all companies in

[9] D. Marković Bajalović, "Upravna i nadzorna funckija u otvorenom akcionar skom društvu" ["Managerial and Supervisory Function in an Open Company Limited by Shares"], *Pravo i privreda* [*Law and Economy*] 5 8/2005, 187 197.

[10] D. Rice, 1; P. Broude, T. Hartman, P. Underwood, 2, D. Kreymborg, 12 15; V. Popović, "Otvoreno ili zatvoreno akcionarsko društvo ili neko treće društvo" ["Open or Closed Company Limited by Shares or Some Other Company"], *Pravo i privreda* [*Law and Economy*] 5 8/2005, 276 286; The above mentioned reasons, as well as differences among laws of the EU member states forced even the EU to try to regulate the form of the European Private Company. See T. Jevremović Petrović, "Evropsko zatvoreno društvo" ["Societas privata Europea"], *Pravo i privreda* [*Law and Economy*] 9 12/2009, 15 35.

[11] The experts have anticipated the wave of going private in Serbia. See A. Jovanović, "Zatvorena i otvorena privredna društva i ekonomski aspekti inicijalnog javnog otvaranja (i obrnuto)" ["Open and Closed Companies and Economic Aspects of Initial Going Public and *vice versa*"], *Pravo i privreda* [*Law and Economy*] 5 8/2005, 148; S. Bunčić, "Pretvaranje akcionarskog društva u društvo sa ograničenom odgovornošću" ["Transformation of Company Limited by Shares into the Limited Liability Company"], *Pravo i privreda* [*Law and Economy*] 5/8/2005, 253.

[12] The Securities and Other Financial Instruments Act from 2002 [Zakon o tržištu hartija od vrednosti i drugih finansijskih instrumenata], *Official Gazette of the Republic of*

Serbia which issued shares anytime in the past, especially in privatization, are considered to be public ones, irrespective of whether their issues were by private offerings. They are obliged to include their shares in the organized market, which exists in Serbia only in the Belgrade Stock Exchange. Also, the Privatization Agency of Serbia is under obligation to sell 70% of capital of every state-owned enterprise (i.e. company) just to one investor, thus concentrating the vast majority of shares in the hands of only one person. The other 30% of capital has to be distributed to the employees of the privatized company and to the citizens of Serbia. By coercive going public of companies, the government wants to create a liquid share market for domestic issuers and investors, while by concentrating the vast majority of shares in the hands of one shareholder it wants to create a strong management in the company. However, these two government's wishes are inconsistent, because a liquid share market can exist only when the capital of an issuer is well dispersed among many investors, whereby a big controlling shareholder wants to have "free hands" in managing the company. That is why going private is more appropriate for controlling shareholder.

There is another group of public companies in Serbia that are interested in becoming private ones. They are the companies which were privatized under the former privatization regimes (e.g. 1988, 1997). Those regimes were based on the employees share schemes, for which reason their shares are usually well dispersed. However, these companies are very exposed to the risk of a takeover, because they were forced to become public companies with freely transferable shares on the organized market. Also, they are usually well-off companies, which makes them interesting to tycoons. Tycoons took over many of these companies and ruined most of them, making substantial personal fortunes for themselves (e.g. Jugoremedija, Milan Blagojević, Alpis, Magnohrom, Sever).[13] That frightened the rest of the stable public companies, whose managements wanted them to go private at any cost. That caused the first applications of public companies with the Companies Register for registering them as private ones in 2006.

Serbia, No. 65/2002, Article 261; SMA, Article 262; Privatization Act from 2001 [Zakon o privatizaciji], *Official Gazette of the Republic of Serbia*, No. 38/01, 18/03, 45/05, 123/07 and 30/10, Article 25.

[13] The newspapers wrote a lot about canceling the privatization contracts by Serbian Privatization Agency. See *http://www.blic.rs/Vesti/Ekonomija/235464/Novi tender za proda ju Jugoremedije*; *http://www.naslovi.net/2011 06 18/economy/eu zatrazila proveru privatiza cija sartida nacionalne stedionice mobtela c marketa jugoremedije/ 2615742*; *http://www. novosti.rs/vesti/srbija.73.html:356851 Jugoremedija na ivici bankrota*; *http://www.sdcafe.rs /viewtopic.php?f 2&t 15255&start 0*; *http://www.kraljevo.in.rs/2011/08/15/poternica za bivim vlasnicima/*; *http://www.subotica.info/eventview.php? event id 35981*, last visited 30 July 2011.

3. SERBIA'S REGULATIONS

The applicants for going private registration grounded their applications on two articles in two statutes. The first statute is the Companies Act 2004, which explicitly regulates public and private companies limited by shares, under the names of "open company limited by shares" and "closed company limited by shares" (Art. 194). It explicitly provides that a closed company can become an open one, while an open company can become a closed one "in accordance with this act and with the statute that regulates securities market" (Art. 194, par. 5). The Companies Act also provides that converting a private company limited by shares into the public one (i.e. going public) and converting a public company into the private company limited by shares (i.e. going private) has to be done by amending the "establishment act" (i.e. the contract of association; Art. 194, par. 6). Lastly, it emphasizes that such a conversion is not a transformation of the legal form of the company (e.g. from company limited by shares into the limited liability company), because the company stays in the form limited by shares. The Companies Act regulates neither the special protection of the rights of dissentient shareholders in the going private process, nor it regulates the special procedure for it. It is strange, because its first draft contained these rules, which means that they were deleted from it in the later phase of the bill drafting process.[14]

An average jurist would understand the above-mentioned rules in the way that going private is allowed by the Companies Act, with the possibility of clarifying any ambiguities in that process by applying other rules of the same act (e.g. protection of dissentients; Arts. 444–446) and of the Securities Market Act. This interpretation is in accordance with the entrepreneur's statutory freedom of choosing the organizational form for carrying on business among the forms regulated by law. The freedom of entrepreneurship is also a constitutional freedom, which can be limited only by statute "for the protection of human health, living environment, natural resources and the security of the Republic of Serbia".[15] Thus, if a public company wants to go private by transforming itself into the organizational form which is not a private company limited by shares (e.g. into the limited liability company), it is free to do that under the rules of the Companies Act, which regulates the transformation of the legal form of the company (Arts. 421–446). If it wants to retain the form of a company limited by shares, it is also free to do that under the general rules of

[14] The Draft on Companies Act of Serbia from 17th May 2003 regulated going private in detail (Article 794) under the influence of the UK Companies Act 1985 (1989).

[15] The Constitution of Serbia from 2006, *Official Gazette of the Republic of Serbia*, No. 1/2006, Articles 82 83.

Companies Act related to making decisions and protection of dissentient shareholders. Lastly, if there are some special rules in the Securities Market Act concerning that process (for instance, the approval of the Securities Commission, informing the public, redemption of shares from dissentients), they have to be applied as well, on the ground of the principle lex spetialis derogat legi generali.

The second statute which is relevant for the going private process is the Securities Market Act. It is relevant because that subject matter is often explicitly regulated by the statute covering securities trade in comparative law and because the Companies Act of Serbia explicitly refers to it. However, the Securities Market Act does not regulate the going private process at all. The obvious "intention" of the Act is to compel all companies limited by shares to be public ones in order to develop the public trade of securities in Serbia.[16] The Securities Market Act, however, contains just one rule about the going private process, which relates to delisting securities from the stock exchange. Under that rule, the stock exchange can exclude the securities of an issuer from the listing "when an *issuer claims* it in the case of transformation of its organizational form and in the case of its *transforming from an open company* limited by shares *into the closed company* limited by shares in accordance with the statute which regulates companies" (Art. 107, al. 6). This rule clearly allows the going private process returning the legal coverage of the matter to the Companies Act.

4. DIFFERENT INTERPRETATIONS

Serbia's regulation of the going private process raised two opposite interpretations immediately after the publication of the Companies Act in 2004. The discord even deepened after bringing the Securities Market Act in 2006. While legal theory almost unanimously assumed that the current law permits the going private process,[17] bureaucracy in the Securities Commission and governmental authorities took the opposite view. The main argument of the bureaucratic interpretation is that the Companies Act does not regulate the procedure of the going private process, but refers to the Securities Market Act. Since the Securities Market Act does not regulate that procedure either, there is a legal loophole which can be

[16] N. Jovanović, "Suzbijanje privatne trgovine vrednosnicama" ["Repression of Private Securities Trade"], Conference book of the Belgrade Stock Exchange, Belgrade 2007.

[17] N. Jovanović, (2005), 72; A. Jovanović, 139 140; M. Tasić, "Standardni i regu latorni mehanizmi inicijalne javne ponude (ne)mogućnost sprovođenja u Srbiji ["Stan dards and Regulatory Mechanisms of Initial Public Offer (Im)possibility of its Enforce ment in Serbia'], *Pravo i privreda* [*Law and Economy*] 5 8/2009, 643 644.

filled up only by the amendments to the Securities Act.[18] Until then, going private should not be allowed.

The bureaucratic interpretation is directly contrary to the Companies Act and Securities Market Act, which explicitly permit the going private process. In fact, there is no loophole, because the insufficiency of the special rules could be compensated by the application of the general provisions of the Companies Act relating to the decision-making process in companies and the protection of shareholders. The Companies Act and the Constitution recognize the right of a company to choose and amend its organizational form in carrying on business. That right cannot be terminated by insufficient statutory provisions and bureaucratic interpretations. Thus, even if there is a loophole in regulating the going private procedure, it does not mean that it is prohibited, because in democratic legal systems, all actions are allowed unless they are explicitly legally forbidden. The bureaucratic interpretation is also nonsensical due to its controversy. Namely, the Companies Act explicitly regulates the procedure for transforming a company into another organizational form (say, from a company limited by shares into a limited liability company or a partnership company) and that is a more serious process than the going private process is. The reason is that in the going private process a company stays in the same form, while in transformation a company has to change its form. Since it regulates the procedure for transformation, there is not a loophole, which means that it is permissible even in the bureaucratic interpretation, though it is just one method of the going private process. The same is with a merger, because the Companies Act regulates that procedure as well. Accepting the bureaucratic interpretation would lead to the conclusion that a public company limited by shares can go private by its transformation into the form of a company which is not limited by shares (i.e. a limited liability company, a partnership company or a limited partnership company), but not into a company which is limited by shares. Nonsensical, isn't it? How can a legally more complex and serious transaction, as the transformation of a company is, be permitted, while a less complex transaction with the same consequences for the securities market (i.e. revocation of share from the public trade) be prohibited?

Economic theory also insists that the freedom of choice of an organizational form for business is crucial for efficient business. It assumes that mandatory going public process is damageable for Serbian economy. It produces too many public companies, which is inconsistent with the domestic economic conditions. There is no demand for the publicly offered shares of the most public companies in Serbia and that causes il-

[18] See Holdings of the Securities Commission in connection with going private process, *http://www.sec.gov.rs/index.php?option co*m, last visited July 2011; first ap peared on July 14 2005.

liquid public market for them. Since public companies have considerable costs for keeping their shares in the public trade, it means that they spent that money in vain.[19]

5. PRACTICE AND CASES

5.1. Practice

In practice, the public companies interpreted the above-mentioned rules of the Companies Act and of the Securities Market Act in the way that they are free to convert themselves into the private companies if they fulfill the prescribed legal requirements. The requirements are those which are needed for the foundation of a company limited by shares under the Companies Act. To achieve this, a public company has to: 1) bring a decision of converting itself into the private company by majority of votes of the shareholders present in the general meeting (company's assembly);[20] 2) amend the act of establishment to adapt its organs and structure to the ones prescribed for the private company limited by shares; 3) provide minimum share capital in money (10,000 Euros payable in dinars); 4) reduce the number of its shareholders to 100 or less; 5) redeem the shares of dissentient shareholders under the fair market price; 6) apply to the stock exchange for delisting of its shares; 7) inform the Securities Commission (its approval is not needed); 8) register as a private company with the Company Register.

The main obstacle for going private among the prescribed conditions is the statutory limitation of the maximum number of shareholders to 100 for the private company limited by shares (or to 50 for the limited liability company), because a public company usually has several hundred or even several thousand of them.[21] Public companies in practice used to solve that problem by grouping their shareholders within several newly founded private companies, which in turn became the shareholders of the public company (i.e. its parent companies). This was the technique of doing it. A certain group of accordant shareholders (say, 50 of them) of the subject public company transferred their shares to the new private

[19] The research on the average number of quoted companies on stock exchanges per a million of inhabitants in a country showed the following results. In common law countries there are 35 quoted companies per a million of inhabitants, in Latin European countries it is 10, in Germanic countries it is 5 and in Scandinavian countries it is 27. See A. Jovanović, 140 141, 147. Since there are around 1500 public companies quoted on the organized markets of the Belgrade Stock Exchange, Serbia has around 190 quoted com panies per a million of its inhabitants (1500/8 187)! That is too many companies in the public trade for such a small and poor country.

[20] CA, Articles 293, 339, 345, 375, 390, 414, 430 and 445.

[21] CA, Articles 104 and 194.

company, which they had founded, obtaining in that way a proportionate stake of its capital. The new company was usually a limited liability company, because its foundation was cheaper (500 euros of minimum capital).[22] The shareholders left the public company by that transfer of shares and became the members of the new private company. The new company in return became a new shareholder of the public company. Dissentient shareholders used to stay in the public company or get a cash payment for their shares from some other shareholder or the public company itself.[23] The Securities Commission approval for going private is not needed, because none of the statutes prescribe that.

Following their own interpretation of the statutes and in spite of the Securities Commission's interpretation, a number of public companies fulfilled statutory requirements for going private and applied to the Company Register for registration as private ones. Surprisingly, the Companies Register used to reject their applications, explaining the rejections by the statutory loophole, just as the Commission did it.[24] Such reasoning of the Companies Register is based on substantive law, though that organ may examine only procedural law requirements (i.e. the completeness and correctness of the submitted documentation).[25] However, the Companies Register did accept the applications for the registration for going private of some "privileged" companies in the same legal situation as the majority of rejected companies. It means that the Register violated the constitutional principle of equality of all market participants.[26] The worst thing is that the Supreme Court of Serbia has created different practice in judicial review cases for nullification of the Companies Register's decisions in the going private procedures.

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[22] The disadvantage of that form is the limit of maximum 50 members in a com pany, which is less than for a private company limited by shares, where the limit is 100.

[23] In that way, a public company with, say, 400 shareholders could reduce their number to less than 100 (say, 90), which is the prescribed maximum of shareholders for a private company limited by shares. Its shareholders would found six new private compa nies, each with 50 members (6 x 50 300). Supposing that, say, 16 dissentients ask for and get the cash payment for their shares, while the rest of 84 do not ask for it. There will be only 90 shareholders left in the public company, together with the six new companies as shareholders (400 300 16+6 90).

[24] See the files of the Register no. BD 144034/2007; BD 10289 1/2007; BD 66498 2/2007.

[25] Zakon o registraciji privrednih subjekata Srbije from 2004 [The Registration of Economy Entities Act], *Official Gazette of the Republic of Serbia,* No. 55/2004 and 72/2005, Articles 22 and 24.

[26] The Constitution of Serbia 2006, Article 84. Among the privileged companies were the Belgrade Stock Exchange, which went private at the end of 2006, and Vojvođanska banka [Vojvodina's Bank], which went private in 2007.

5.2. Cases

Among the majority of unprivileged companies, whose applications the Companies Register rejected, were "Vunil", "Utva Silosi" and "Mladost-Turist".

In the first case, the public company "Vunil" from Leskovac submitted the application for the registration as a private company limited by shares to the Register in 2007, with all the prescribed documentation. The Register rejected the application and the Ministry of Economy confirmed the rejection on December 7th 2007 in the second-degree administrative appeal procedure. The Supreme Court confirmed the Ministry's decision on November 19th 2008, grounding its judgment in the judicial review procedure on the above-mentioned opinion of the Securities Commission.[27]

In the second case, "Utva Silosi", a public company from Kovin, submitted the application for the registration as a private company to the Register on March 2nd 2007. The Register rejected it on March 7th 2007 in spite of the fact that the applicant submitted all the necessary documentation. The applicant complained to the Ministry of Economy, but the Ministry let the statutory time limit of 60 days for making a decision pass. That is why the applicant sued the Register on June 6th 2007 seeking a judicial review of the Supreme Court on the ground of "the administrative silence". After the commencement of the judicial review procedure, the Ministry overturned the rejection of the Register and informed the Supreme Court about that. The Register again rejected the application on July 16th 2007 for the same reasons as in the first decision, but this time with just a longer explanation. Then, on April 30th 2008 the Supreme Court ordered the company, as a plaintiff, to inform the Court, if it was satisfied with the Ministry's decision. By that time, the plaintiff was compelled to introduce the shares to the off-exchange organized market of the Belgrade Stock Exchange. The market intermediaries increased the number of the plaintiff's shareholders considerably above 100 within a week. For that reason, the plaintiff lost his interest in the judicial review and he did not respond to the Supreme Court, who stopped the procedure on April 18th 2009.[28]

The third case involved the public company "Mladost-turist" from Belgrade, which applied for the registration for going private to the Register on June 27th 2007. The Register rejected it on July 30th 2007 and the

[27] The judgement was brought by the council of judges comprising Jadranka Injac, Zoja Popović and Jelena Ivanović (U. 664/08). The most shameful part of the judgment is not the decision itself, but the reasoning behind it, because the judges ignorantly consid ered that the opinions of the Securities Commission is a source of law, whereby they are not source of law in the legal system of Serbia.

[28] Judgment no. U. 5202/07.

company appealed to the Ministry of Economy. The Ministry confirmed the Register's rejection on November 16th 2007 and the company sued the Ministry to the Supreme Court. The Court nullified the Ministry's decision on May 7th 2009, considering that the plaintiff fulfilled the legal requirements for going private process.[29]

The consequence of the above described practice is that it stopped the wave of the going private process and a vast majority of companies in Serbia was compelled to become public companies with their shares included in the organized off-exchange market, in spite of the fact that they were not ready at all for the public trading of securities, as their issuers.[30] That caused the enormous cost to them at the macro-economic level.[31] Also, the selective practice of the Register, the Ministry of Economy and the Supreme Court of Serbia caused disappointment and feeling of legal uncertainty among the public companies wanting to go private.

6. COMPARATIVE OVERVIEW

Regulating the going private process is difficult even for developed countries, because of the conflict between the aim of company law and the aim of securities law. The aim of company law is achieving business efficacy by choosing the best organizational form for the company, whereas the aim of securities law is protection of investors.[32] While it could be in the company's best interest to go private, it might not be appropriate for its shareholders, because it reduces the marketability of their shares. However, laws in all the "serious" countries allow the going private process, regulating it either by special rules, or by general rules of company and securities laws. A general presentation of several national legislations might be useful pattern for understanding the way of solving the conflict of company law and securities law aims, with no ambition to present detailed rules on method of going private.

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[29] Judgment no. U 172/08.

[30] At present, there are only five issuers on the prime market (i.e. first market) and three on the standard market (i.e. second market) of the Belgrade Stock Exchange, where by all others are on the organised off exchange market (around 1500), for which no crite ria of economic stability and for dispersion of shares of issuers are required.

[31] One analyses of the Ministry of Economy of Serbia showed that every year the public companies in Serbia together spent at least 6.000.000 Euros just for publication of their financial reports, out of which at least 5.000.000 Euros is spent by the companies whose shares have been not traded at all since they have become public companies (See *http://www.srp.gov.rs/srp/*, last visited 30 July 2011). That sum should be increased with the costs of companies for the services of corporate agents, provisions of auditors, charg es of the stock exchange and charges of the Securities Commission. It means that the stated sum would be probably doubled.

[32] D. Kreymorg, 1.

The most developed is the law and practice of the *USA*. In that country, the securities law is within the competence of the federal government, while company law ("corporation law") is within the competence of the state governments. That country imposes the duty of going public to all the companies which meet certain criteria concerning the size and dispersion of shares. Thus, every issuer which is engaged in intrastate commerce (i.e. commerce through more than one member state) must be registered with the Securities Commission, as an issuer with the reporting duties ("registered issuer", i.e. public company), if it has more than $1,000,000 of total assets in one financial year with at least 750 registered shareholders. Also, the same duty has the issuer which is engaged in intrastate commerce if it has more than $1,000,000 of total assets in the two consecutive years with less than 750 registered shareholders, but with at least 500 registered shareholders. If the registered issuer wants to deregister, it has to reduce the number of shareholders under 300 and to file the proof of it with the Securities Commission. If the Commission finds that the number of shareholders is not reduced under 300, the Commission shall deny deregistration, which means that it has to continue with its reporting duties. If the Commission finds that the request of the issuer is true, it does not have to bring any formal decision, because the issuer's reporting duties terminate by expiration of the 90 days after filing the request.[33]

The US law is very detailed and strict in protecting the shareholders if the issuer goes private, especially when a takeover, a merger or redemption of shares (so called, self-tender) are used to reduce the number of shareholders. It insists on providing shareholders with detailed information about all the advantages and disadvantages of the going private process and about all the other facts which they need to bring an informed decision. If the management of the corporation initiates the going private procedure (so called, management buyout), the managers have to be completely fair toward shareholders and pay them a fair price for the shares. Otherwise, the Commission or courts can impose rigorous penalties on them and award damages in favor of the shareholders. Therefore, in order to evade trials because of their conflicts of interest, managers usually establish a committee of experts, who are independent from the management, corporation and their connected persons. The independent committee has a task to negotiate the fair price of the shares with the shareholders and other terms of a takeover, a merger or other method of going private of the corporation.[34]

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[33] Securities Exchange Act 1934 (hereafter: SEAUS), Section 12 (g) (1) and 12 (g) (4).

[34] US SEA, Sec. 13 (e) (3) and 13 (e) (4). See M. Steinberg, 298 300; T. Hazen, 513 517; P. Broude, T. Hartman, P. Underwood, 3 8; A. Darrel, 3 8.

The United Kingdom regulates the going private process within the regime of *re-registration* of a company. Re-registration comprises both going public and going private process, either by conversion of a company's organizational form (e.g. from a public company limited by shares to the private company limited by shares or partnership company, or vice versa) or by revocation of shares from the public trade and the company's staying limited by shares. If a public company wants to go private, a special resolution for that process has to be passed in the general meeting of its shareholders by 3/4 majority of those voting. That resolution has to include the change of the company's name to emphasize that it is a private one. It also must contain all the necessary amendments to the articles of association so that the company can become a private one. After that, the company files the application for re-registration to the Registrar, which has to check if the legal requirements are satisfied. If they are satisfied, the Registrar must re-register the company and issue a certificate of incorporation. The company by virtue of the issue of the certificate becomes a private one.

Dissentient shareholders can make an application to court for the cancellation of the company's resolution to go private. If dissentients do that, the company cannot re-register herself as a private one until they withdraw the application or until the court refuses the application, confirming that re-registration is legal. The right to challenge the resolution to go private requires only shareholder(s) with at least 5% of the company's issued share capital, or a group of at least 50 shareholders. A shareholder who voted for the resolution cannot challenge it. The application must be filed to court within 28 days after passing the resolution. The court can postpone the re-registration to give the company time to reach an agreement with the dissentients, or it can amend the resolution to protect the dissentients.[35]

Germany does not have any explicit rules on going private of a public company, but it is clear that it is permissible under the general rules of company law and securities law.[36] The company law distinguishes the public companies limited by shares from the private ones. It also regulates the transformation of the company's form, a takeover, a merger and redemption of shares, which are the usual methods of going private

[35] UK Companies Act 2006, Sec. 97 99. See S.D. Girvin, S. Frisby, A. Hudson, 58 60; D. Keenan, 65 66.

In 2000 there were 99.1% of private companies out of all British companies. Britain was limiting the maximum number of members in a private company to 50 from 1908 to 1980, when the limitation was abolished. It reduced the minimum number of members of a private company to one in 1992, so that today almost 90% of companies have four or fewer members. See S.W. Mayson, D. French, C.L. Ryan, 56 58, 203.

[36] Since the sources which the author used for presenting German and French law date from almost a decade ago, the description of German and French law might be out dated (author's remark).

process.[37] Securities law does not regulate going private at all, but only going public and delisting.[38] Under the rules of securities law the stock exchange may revoke the shares from the listing on the issuer's request, unless it is damageable to investors' interests. After the acceptance of the issuer's request, the stock exchange publishes the revocation in at least one mandatory stock exchange newspaper of nationwide circulation at the issuer's expenses. The revocation takes effect at the latest two years after its publication, which means that trading of the revoked shares in the stock exchange may continue even after the revocation, but not longer than two years. Therefore, if a listed company wants to go private, it has to revoke its shares from the listing.[39]

France also does not have any explicit rules on the going private process, which is very similar to Germany. French law recognizes not only public companies limited by shares (*societes anonyme avec appel public a l'epargne*), but also private ones (*societes anonyme sans appel public a l'epargne*). It also provides that a private company limited by shares can be founded not only as a completely new company, but also by the conversion of an existing company if it satisfies the requirement for founding the private company.[40] It means that the going private process is allowed under the general rules of company law on making decisions, mergers, takeovers, protection of dissentient shareholders and redemption of shares (*offre publicque de rachat d'actions*) to 100.[41] It is interesting that France limits the maximum number of members of a limited liability company (*societe avec responsibilite limite*; abr. *S.A.R.L.*). If there are more than 100 members, it has to transform itself into the company limited by shares, or otherwise it will be liquidated.[42] If a public company limited by shares wants to go private by transforming itself into the simplified company limited by shares (*societe par action simplifie*), which is a special type of a private company limited by shares, the shareholders have to pass a decision about that unanimously.[43]

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[37] M. Fromont, *Droit allemande des affaires*, Montchrestien 2001, 226, 242 245; Act on the Acquisition of Securities and on Takeovers, Par. 10 33; G. Apfelbacher *et al*., *German Takeover Law*, Verlag C.H. Beck, Munchen 2002, 122 333; D. Kreymborg, 28 30, 49, 52, 54, 58, 59.

[38] Securities Prospectus Act 1998 (amended 2000), par. 1 13; Stock Exchange Act 1998 (amended 2000), par. 43.

[39] M. Sebastian, "Going Private in Germany", *http://www.foley.com/files/tbl s31Pub lications/FileUpload137/2691/NDI GoingPrivate FINAL.pdf*, last visited 30 July 2011.

[40] J. Mestre, *Droit commercial* (Alfred Jauffret), L.G.D.J., Paris 1997, 250, 338 340.

[41] H. de Vauplane, J.P. Bornet, *Droit des marches financiers*, Litec, Paris 2001, 766 768.

[42] P. Merle, *Droit Commercial Societes commerciales*, Dalloz, Paris 2005, 134, 288, 289. It is the same regime as in Serbia, with one difference regarding the maximum number of members in the company, which is 50 in Serbia.

[43] *Ibid*., 607, 713.

Croatia does not regulate explicitly the going private process neither by company law, nor by securities law.[44] Croatian company law is almost identical to German company law concerning the questions related to the status of the company which wants to go private. Therefore, its solutions are almost the same as German in this matter. Securities law, however, does regulate the termination of the public trade of securities, but only in the sense of exclusion the securities from a regulated market. Thus, the Securities Supervisory Agency, as well as the stock exchange, can exclude the securities of an issuer from the regulated market, if it is necessary for the protection of the investors or for regular and honest functioning of the market.[45] These rules do not cover two situations. The first one is when a public issuer of securities wants to retire the securities from the public trade, which is the case in the going private process. The second situation is when the issuer's securities are in the public trade, but not on the regulated market (so-called off-exchange trade). So, the stock exchange can exclude a public issuer only from its regulated market, but not from the off-exchange market (so-called over-the-counter market). Only the Commission could do that, though it does not have an explicit statutory authorization for that. Also, if the Securities Agency excludes the securities from the regulated market, it does not have to mean that it excludes them from the public trade outside the regulated market. These situations are the loopholes in Croatian law, which can be filled up by the general rules of company law and securities law. Namely, since there is no more coercive going public for the companies in Croatia, which was provided by the old Securities Market Act, the going public process must be understood as a voluntary one.[46] Therefore, if it is not coercive any more, public companies may go private under the general rules of company law. The approval of the Securities Agency is not needed, because there is no explicit statutory rule for that.

7. METHODS

The going private process can be done by very different methods. The main problem is protecting the interest of dissentient minority of shareholders in the subject company, because it reduces the marketability

[44] Zakon o trgovačkim društvima Hrvatske from 1993 [Croatian Companies Act], *Official Gazette of the Republic of Croatia*, No. 11/93, 34/99, 52/00 and 118/03; Zakon o tržištu kapitala Hrvatske from 2009 [Croatian Capital Markets Act], *Official Gazette of the Republic of Croatia*, No. 88/09, 146/09 and 74/09.

[45] Capital Market Act, Articles 330 and 341.

[46] Securities Market Act of Croatia from 2002 [Zakon o tržištu vrijednosnih pa pira], *Official Gazette of the Republic of Croatia*, No. 84/02 and 138/06, provided that every company which has more than 100 members and capital above 30,000,000 Kunas (about 4,000,000 Euros) must become a public company limited by shares (Article 114).

of shares. Therefore, the best method is the one which enables the majority of shareholders to reduce the number of dissentients to the level which can not prevent the company from becoming a private one. There are four usual methods for going private: 1) a takeover, 2) a merger, 3) the amalgamation of shares and 4) the redemption of shares.

A takeover it is the most frequent method. It enables the bidder to convert the target public company even against the will of the management and even if at the beginning of the process the majority of shareholders are dissentient. If the bidder offers a high enough price, it is likely that majority of shareholders will accept it. After the successful bid, the number of shareholders in the target public company is reduced to the level which disables the liquid trade of its shares. Later on, the new controller of the company can make a decision to go private, squeezing out the rest of dissentients. The bidder can be: 1) any of the present shareholders of the target company or a group of them (insider bid), 2) a manager of the target company or a group of them, especially if they are also its shareholders (management buyout), 3) a person out of the target company, because it is neither the shareholder, nor the manager (outsider bid). A bidder, who is a shareholder or a member of the management or both, in practice establishes usually a new private company just for the purpose of becoming the bidder in the takeover procedure. After the successful takeover, that company merges with the target company, making it private one. The disadvantage of the takeover as a method for the going private process is the necessity to have huge resources to buy the shares and the risk of the competitive bid. The bidder can compensate the lack of resources by borrowing the money from the bank, securing his debt by mortgaging his or the company's assets.[47]

A merger is an applicable method when management and the majority of shareholders of a public company are consentient to go private by merging the company with another company, which is private one. It is usually combined with the takeover and squeeze-out, as it is explained within the takeover method.

The amalgamation of shares ("reverse stock split") is, in fact, the method for squeezing out small shareholders from the company. It is rarely used and its procedure is as follows. The controlling shareholder(s) votes in the company's general meeting to reduce the number of issued shares by increasing their nominal value. It means that every shareholder has to exchange his several outstanding shares for one or a few new shares which the company has to issue in accordance with the stated proportion. The company pays money to every shareholder, who does not have the number of outstanding shares devisable by the stated proportion,

[47] D. Kreymborg, 28 30, 49 57; P. Broude, T. Hartman, P. Underwood, 2, 7 8; D. Rice, 2.

for the indivisible fraction of the total number of his outstanding shares. The stated proportion (ratio) can be so high that only big shareholders stay in the company, because the small shareholders can not satisfy the criterion for the exchange. Say, the nominal value of a share is 100 Euros and the proportion (ratio) is 200 outstanding shares for the new one with the nominal value of 20,000 Euros. It means that every shareholder who has less than 100 shares (say, 58), receives money for his stake in the company, whereas the one who has a number of shares between the stated proportions gets only one new share for each 100 of outstanding shares, obtaining the money for the residue (say, 180 outstanding shares gives right to one new share and to money for 80 shares).[48] When the controlling shareholder(s) reduces the number of the shareholders in the company by this method, it is easy to finalize the going private process.

The redemption of shares (self-tender offer, share buy-back) is a method by which the public company buys the shares which it has issued, from its own shareholders. The common law countries consider that transaction as a type of a takeover, where the bidder is the issuer instead of a third party. Therefore, it is rather liberally regulated.[49] Conversely, the civil law countries impose considerable statutory limitations on that operation, considering it as a method of capital dilution.[50] A public company can redeem its shares to reduce the number of shareholders and after that go private, justifying it by the illiquid market for its shares.

8. SERBIA'S NEW REGULATIONS

Serbia passed two new statutes in 2011, which are relevant for the going private process. They are the Capital Market Act, which explicitly regulates the going private process, and the Companies Act, which contains general rules for the decision-making process in companies, a merger, the redemption of shares and the protection of minority shareholders.[51] Though the Capital Market Act retains the rule for coercive going public, the new Companies Act does not limit the number of members in private companies, as it was done in the current Companies Act.[52] Therefore, there is no more coercive going public for private companies limited by

[48] D. Rice, 3; D. Kreymborg, 58 59.

[49] M. Steinberg, 298 300; E. Ferran, *Priciples of Corporate Finance Law*, Oxford University Press, Oxford 2008, 203 226; I. MacNeil, *An Introduction to the Law on Fi nancial Instruments*, Hart Publishing, Oxford 2005, 243 245;

[50] D. Kreymborg, 49 57.

[51] The Companies Act [Zakon o privrednim društvima], *Official Gazette of the Republic of Serbia*, No. 36/2011 will enter into force on Febryary 1st 2012.

[52] CA, Article 194 (3).

shares, which have had more than 100 shareholders for more than a year.

Under the new regime, a public company may go private if it fulfills the prescribed requirements and within the prescribed procedure. The requirements are: 1) the public company must have fewer than 10,000 shareholders and fewer than 100 holders of publicly issued debt securities, 2) it has to redeem the shares from dissentient shareholders and 3) the Securities Commission has to deregister the company from its register of public companies. The public company may not go private in the year in which it has successfully gone public, but at the end of any of the following calendar years in which it has decreased the number of holders of debt securities under 100. However, the company may go private at any time in the following cases irrespective of the prescribed requirements: 1) when the bidder in the takeover buys out all securities which the target company has publicly issued, 2) when the controlling shareholder in the squeeze-out procedure buys all the shares which the company has publicly issued and 3) when all shares of the company are nullified due to its merger or division. These exceptions to the general requirements of going private are allowed because the protection of dissentients is covered by special regimes applicable to them.[53]

The procedure of the going private process is as follows. The company must pass the decision on revocation of its shares from the organized public market by 3/4 majority of all issued voting shares. It may increase this statutory prescribed majority by its articles of association, in which case it jeopardizes the going private process. The decision can be passed only under the following conditions: 1) the company must have less than 10,000 shareholders, 2) the total number of traded shares in the previous six months was less than 0.5% of all the shares issued by the company, 3) the monthly number of its traded shares during at least three months in the previous six months was less than 0.05% of all the shares issued by the company and 4) the decision has to contain the irrevocable statement that the company is ready to redeem all shares from the dissentient shareholders, including the ones which were not present in the general meeting when the decision was passed. The compensation in redemption has to be the highest value of the shares calculated in accordance with the company law.[54] After registering the decision on going pri-

[53] CMA, Article 70.

[54] The CA 2011 provides that the company has to pay the market, book or evalu ated value of the shares to dissentients, whichever is the highest on the day of the convo cation of the general meeting, when the resolution to go private has been passed (Article 474 475). The market value of a share of the public company is a ponder average price on the regulated market or multilateral trading platform within the period of the last six months before the establishment of the price on condition that the number of traded shares of the company is at least 0.5% of the aggregate number of shares, which it has issued,

vate with the Companies Register, the company has to inform the organized market, where its shares are traded. The Securities Commission deletes the company from its register of the public companies.[55]

In this way, the new Serbia's regulation puts the end to the controversial and illegal practice of the Securities Commission, Companies Register, Ministry of Economy and courts. It means that the common sense has won at last, because the going private process may not be prohibited any more in practice. However, the damage which that practice has produced is irreversible.

9. MOTIVES

Since the practice of prohibiting the going private process in Serbia is illegal, arbitrary and damageable, two questions arise. The first one is why the new statute was needed to terminate it, when the current (old) law explicitly allowed the going private process. The second question is why it took the state almost seven years to solve the problem in practice by passing the new statute, when the problem arose immediately after the enactment of the Companies Act in 2004. The new statute and such a long period of time were not needed in other countries, although most of them do not explicitly regulate the going private process (e.g. the USA, Germany or France). Is it possible that the creators of the Serbian practice of prohibiting the going private process really thought that a company has to stay public forever once it has gone public? The positive answer to that question is not probable, because it would mean a severe lack of intelligence on the part of the creator, which would not be a correct conclusion.

If one wants to find the answers to these two questions, one must examine the possible motives for such an obviously illegal administrative and judicial practice. There are three possible motives.

The first one, which the Government emphasizes, is the wish to protect the shareholders in public companies from the loss they would suffer by revocation of the shares from the public trade.[56] That motive really exists, but it is not the real one, because of two reasons. The first

and that at least 0.05% of the aggregate number of shares, which it has issued, is traded during any of three months within the period of the last six moths. The evaluated value of a share is the value which is established by the expert, who is officially authorized. The general meeting of shareholders has to accept that value on the basis of the explanation provided in the directors' proposal (Article 259 and 51).

[55] CMA, Article 123.

[56] See Explanation of the Securities Market Act Proposal by the Ministry of Fi nance, *http://www.zakon.co.rs/predlog zakona o trzistu kapitala html*, last visited 30 July 2011.

one is that the shareholders could be protected by amending the statute within much shorter period than seven years. Also, dissentient shareholders have the right to redemption of shares toward the subject company under the general rules of the current (old) Company Act (Arts. 444, 445), so that the new act was not needed to establish that right especially for the case of going private. The second reason is that shareholders were not protected by compelling the companies to be public, because majority of public companies did not have the liquid market of shares. The illiquid market has three causes. The first one is the system of concentrated privatization, in which the buyer of the state-owned stake in the company's capital gets the vast majority of votes (70%). Since he does not have to make a takeover bid under the current law, that majority enables him to govern the company as he wishes, disregarding the interests of minority shareholders.[57] There is no serious investor who would like to buy the shares in such a company and, consequently, minority shareholders cannot sell their shares. The second cause of the illiquid market of shares is that the shares of many companies are not attractive to investors, because the companies, as their issuers, are not economically prosperous. The third cause is that there is a number of companies with a small number of shareholders (say, between 50 and 200), where the public trade cannot be active due to such a small number of investors.

The second motive for the illegal practice of prohibiting public companies to go private is exposing the companies to takeovers in order achieve a fast change in the ownership structure of the Serbian economy. The risk of takeovers threatens mostly the economically prosperous companies, in which none of the shareholders has enough resources to take over the control in the company. This group of companies was and still is the most attractive to tycoons, who succeeded in taking over many of them as outside bidders, due to the system of coercive going public and the illegal practice of prohibiting the going private process.

The second motive is backed up by the third one and that is the high-level corruption. That is not the corruption among low-level administrative clerks, but the corruption on the top of the Serbian political structures. The corruption involves financing political parties by rich people and companies, who have to return the favour after winning the elections. The shadow financiers (tycoons) of the parties require from the top government officials (i.e. ministers, secretaries of the ministries, members of government) to fit the regulations of general economic flows to their personal business interests. One of these regulations is the retroac-

[57] Zakon o preuzimanju akcionarskih društava from 2006 [Takeover of Companies Limited by Shares Act], *Official Gazette of the Republic of Serbia*, No. 46/06 and 107/09), Article 8. See N. Jovanović, "Povlašćenost države kao akcionara u delimično privatizo vanim privrednim društvima" ["The State as a Privileged Shareholder in the Partially Privatized Companies"], *Pravo i privreda* [*Law and Economy*] 5 8/2007, 147 162.

tive coercive going public of the companies privatized under the former statutes. When the regulations do not suit the financiers' personal interests, the high-level politicians have to make the practice favourable to them by influencing the low-level clerks in the competent state organs. That is probably the case with the illegal practice of prohibiting the going private process.

When one adds to the last two motives the servile and obedient mentality of the Serbian present-day top-level politicians toward influential officials from the powerful international organisations (the IMF, the IBRD, the EBRD, the WTO, the EU) and countries (the USA, Russia, China), the appearance of the illegal administrative practice is quite understandable. It is also protected by the voluntary and selective judicial practice. One can ask why the statute terminates the practice of prohibiting going private just now**.** A possible explanation is that the practice no longer suits the tycoons, because they bought all the public companies which they wanted and could buy during the last decade of the regime of the coercive going public process. Nowadays, they want their companies to go private in order to run their business inconspicuously, away from the public gaze.

10. CONCLUSION

The creators of the transitional model of the Serbian economy mixed the aims of economic policy by introducing concentrated privatization and coercive going public process and by allowing the illegal prohibition of going private process in practice. The main aim of economic policy is achieving economic welfare in the society by supporting stable and prosperous companies. The achievement of this long-term aim requires the protection of the prosperous companies from unnecessary business risks (e.g. takeover) and retention of the moderate role of the state in economy. Instead of that, Serbian transitional model is based upon the neo-liberal approach, under which the free market can solve all the problems. Therefore, it accepted that the main aim of transition is the fast change of the ownership structure of the economy (from the state-owned one to privately-owned one), which is a short-term aim, with no plans for the future economic flows after the transition. That approach is the reason why some shady businessmen took over many prosperous companies, ruining them in order to make their personal fortune, which they could not achieve if the companies could protect themselves by converting them into the private ones. That is an important cause of the Serbian present-day economy crises and probably is the actual motive of the accepted transitional model of economy in Serbia.

Since the administrative practice of prohibiting going private is a direct contravention of the current statutes and since it is highly prejudicial to the companies, the question of responsibility of the creators of such illegality should be posed. The officials of the Company Register and the Ministry of Economy who created the illegal practice cannot excuse themselves by their ignorance of the illegality, because they are experts at the interpretation of the regulations. Since they were aware of their contraventions of the law, they were intentionally violating the statutes. Their intention to violate the statutes is the ground for their responsibility under the Administrative Officials Act.

Finally, a question could be posed concerning the role of the judicial practice in the Serbian legal system. Namely, if the judicial practice can prevent the application of clear statutory rules by confirming the illegal administrative decisions in judicial review procedures, it means that the judicial practice in Serbia is not only the interpreter of law, as it is stated in the Constitution (Art. 142), but also its creator. If the judges can amend the rules of the current statutes by their controversial decisions, it means that the judicial practice is a source of law in Serbia, in spite of the widespread opinion that it is not.[58] If it is a source of law, like the statutes are, the question is what is the ground for the courts' decisions? In common law countries, the ground is the judge's feeling for justice (so-called, equity), which is a highly developed concept. Since the Constitution of Serbia does not recognize justice as the ground for judgments, is it possible that the ground is the judges' ignorance of Serbian legal system or, maybe, their self-will and obedience to politicians?

[58] K. Čavoški, R. Vasić, *Uvod u pravo* [*Introduction to Law*], Službeni glasnik, Beograd 2009, 489 503; O. Stanković, V. Vodinelić, *Uvod u građansko pravo* [*Introduction to Civil Law*], Nomos, Belgrade 2007, 41; M. Vasiljević, *Kompanijsko pravo* [*Company Law*], Faculty of Law, Belgrade 2010, 31.

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THE INTEREST OF A COMMERCIAL COMPANY AND THE LIABILITY OF ITS MANAGEMENT IN SERBIA

There are three main questions that are analyzed in this article. Firstly, what can be understood to be the interest of a commercial company? There are two ap proaches to this question that need to be considered: one, according to which the interest of a company is the interest of an enterprise involving not only the interests of members, but also those of personnel, creditors, clients and the state as well; and another, traditional approach, according to which the interest of a company should be understood as an own company's interest established in the interests of members, but in such way that overcomes their individual interests. Secondly, who are the per sons liable for obligations to act in the interest of a company and what are their duties in this context? The primary liability for acting in the interest of a company rests upon management that in this context has a duty of care, a duty to notify about transactions and activities where personal interest exists, a duty to avoid a conflict of interest,a duty not to compete with the company's business interests and a duty to keep business secrets. Thirdly, what are the consequences for managers who breach these fiduciary duties in terms of status law, property law and penal law.

Key words: *Interest of a commercial company. The care of a prudent business man. Management. Duty. Liability.*

1. INTRODUCTORY REMARKS

According to the Law on Commercial Companies[1] (LCC), which was in force until 1 February 2012, partners of a business partnership and general partners of a limited partnership, controlling members of a limited

[1] Law on Commercial Companies LCC, *Official Gazette of the Republic of Serbia,* No. 125/04.

liability company and controlling shareholders of a joint stock company; representatives of a company; members of boards (board of directors, executive board, members of a supervisory board, members of an audit committee and internal auditors of a limited company or a joint stock company); other indviduals who are authorized by contract to exercise management authority in a commercial company and liquidator of a company, are obliged to act in the interest of a commercial company.[2] The common law concept of duties of persons listed above, was thereby introduced into Serbian law. According to that concept the interest of a commercial company is the only immediate interest for whose account these persons must work.[3] However, in the rules of so-called "soft law" found in the Codex of Corporate Governance,[4] emerges to the fore the Continental multi-interest orientated model that promotes social responsibility as a standard for a company,[5] which means that during the process of making business decisions, many interests should be taken into consideration. In this regard, the Codex determines that a board of directors should strive to make a company profitable while having respect for the interests of shareholders, investors[6], employees, creditors, consumers and the public interest.[7]

The newly introduced LCC[8] (henceforth referred to as N-LCC) also contains laws that regulate issues related to the interests of company, but in slightly different manner in relation to the foregoing rules. Hence, in the light of solutions offered by the LCC and N-LCC, this article will analyze the following questions. Firstly, what is considered as the interest of a company? Secondly, who are the individuals who are obliged to act in the interest of a company; what are their duties in that respect and which criteria should be used to determine whether someone acts in the interest of a company? Finally, in relatation to the management's duty to act in the interest of a company, this article will also consider the issue of management's liability in the case of a breach of a duty.

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[2] Article 31.

[3] M. Vasiljević, *Kompanijsko pravo* [*Company Law*]*,* Pravni fakultet Univerziteta u Beogradu Službeni glasnik, Beograd 2007a, 142.

[4] Codex of Corporate Governance, *Official Gazette of the Republic of Serbia,* No. 1/06

[5] See M. Vasiljević, "Korporativno upravljanje (od problema do rešenja)" [*Corporate Governance from problem to Solution*], *Pravo i privreda* [*Law and Economy*] 5 8/2008, 14; N. Petrović Tomić, "Poslovna etika i OECD principi korporativnog upravljanja", ["Business ethics and OECD Corporate Governance Code"] *Pravo i privreda* 5 8/2008, 384; V. Savković, "Društvena odgovornost kompanija" ["Corporate social responsibility"]. *Pravni život* [*Legal life*] 12/2009, 425.

[6] In order to clarify the difference between the shareholders and investors, the term "investors" in this context should be understood as "participants who have not yet invested in the company.

[7] Article 113.

[8] Law on Commercial Companies LCC, *Official Gazette of the Republic of Serbia,* No. 36/11 and 99/11.

2. THE INTEREST OF A COMMERCIAL COMPANY

The term "interest of a commercial company" has appeared among Serbian Commercial Law rules for the last twenty years. Since then, there has always been a controversy in the legal theory about the definition of that term, determination of its content and determination of the persons who are obliged to act in the interest of a company. The basic reason for such theoretical dilemmas lies in the fact that analysis on interest matters spreads from a commercial company, as a legal entity founded to perform activities in order to make a profit,[9] to an enterprise, as a means of company in order to realize profit, but also as a means to satisfy other interests on the grounds of invested work (employees, management) or some other grounds (creditors, state, consumers). That is why it is still necessary to emphasize the need to protect the rights belonging to an enterprise as a social institution that has and carries a special responsibility in a society[10] and that a company's interest cannot be considered only in the light of making profit.[11] At the end of this extended analysis, we may come to the conclusion that company's management cannot be only concerned with the interests of shareholders, but also must take into account the existence and balance of many conflicting interests.[12] To achieve that, the management of a company should be, to the greatest posible extent, dislocated from the reach of shareholders[13] with the assistance of a bicameral management system and powers given to the supervisory board to appoint company's directors.[14]

The authors of the analysis mentioned above argue that the interest of a company is the interest of an enterprise and that it involves not only the interests of its members, but also the interests of employees, creditors, cli-

[9] Article 2 N LCC.

[10] On interests of commercial companies and enterprises: Š. Ivanjko, "Suprotni ili jedinstveni interesi u trgovačkom društvu" ["Converging or diverging interests in commercial companies"], *Zbornik radova Pravnog fakulteta u Zagrebu* [Annals of the Faculty of Law in Zagreb], special edition 2006, 170.

[11] N. Petrović Tomić, 384.

[12] M. Vasiljević, "Razvoj regulative upravljanja kompanijama u uporednom pravu i pozitivno pravo Srbije", ["Corporate governance regulation development in comparative law and Serbian law"] *Pravni život* 11/2010a, 41.

[13] Z. Arsić, "Interes akcionarskog društva" ["Limited liability company's interest"], *Pravo i privreda* 5 8/1998, 54.

[14] In recent times, the idea of a bicameral management system has been largely abandoned because a unicameral system has proved to be more efficient; it has been shown in practice that when an enterpise was doing well then supervisory board was not needed, and when enterprise was going doing badly a supervisory board could not do a lot to help. See Š. Ivanjko, 173.

ents, state.[15] "The interest of a company" is therefore a synthesis of all individual interests. A problem with this approach, however, is that the interest defined in this way is not well determined. That allows the management to make unprincipled coalitions with particular interests that prevail at a certain moment, and because the company's interest is not clearly defined it is hard to argue that directors did not act in the interest of the company.[16]

By contrast, proponents of the so-called traditional concept emphasize that under the interest of a company it should be understood the own interest of a company, one that is established in the interest of its members, but that is going beyond their own personal interests. A company is established in the common interest of members who contribute to the social wealth in proportion to their individual rights.[17] The interest of every company is to provide a stable and prosperous business.[18] All other interest groups associated with a commercial company are interested in achieving this goal. Otherwise, in the case of an unsuccessful business, the interest of a company will not be achieved, nor the interest of other interest groups. Bringing the interest of a company to the fore enables also the protection of interests of other interest groups related to an entreprise as an organizational tool of a company, even though their (partial or personal) interests are often opposed to the interest of a company itself (for example, the interest of employees may be to improve working conditions or to increase wages).[19] Legislators acknowledge the existence of such interests and provide protection to some extent using certain legal mechanisms and rules.

The mode of corporate governance depends on the choice between those two concepts. Namely, that choice determines who sets the interest of a company (management or assembly), as well as the scope of authorization and liability of persons who are obliged to act in certain interest.[20] In any case, in order to avoid disputes and dilemmas, if preference is given to the first concept, then instead of "interest of a company", we should use the term "interest of an enterprise".

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[15] J. Paillusseau, "Les fondements du droit moderne des sociétés", *J.C.P. éd E.* 1/1995, 488.

[16] M. Vasiljević, (2010a), 43.

[17] Ph. Merle, *Droit Commercial,* Dalloz, Paris 2000, 73.

[18] D. Martin, "L'interêt social dans le contentieux des ordonnances sur requête, en référé et en la forme des référés", *RTD com* 3/2010, 485.

[19] Š. Ivanjko, 170.

[20] A. Couret *et al.,* "Actionnaires et dirigeants: où se situera demain le puvoir dans les sociétés cotées?"*Revue de droit bancaire et de la bourse* 55/196, 72.

3. THE RESPONSIBLE PERSONS AND LEGAL FRAMEWORK FOR ACTING IN THE INTEREST OF A COMPANY

Unlike the LCC which lists a wider range of persons who are obliged to act in the interest of a commercial company,[21] under the N-LCC this duty belongs to the directors, the members of supervisory board, representatives, the procurator and the liquidator of a company.[22] This change in the law bring us closer to the solution that was contained in the earlier Law on Enterprises,[23] or in numerous laws on companies of other countries where the management has a fiduciary duty, i.e., an obligation to act in the interest of a company.[24] The difference is that representatives were placed at the same level with company's management (directors and members of the supervisory board, if the management of the company is bicameral).

Besides the legal obligation to act in the interest of a company it is necessary to consider whether management has such an obligation regarding other interests, especially the interests of shareholders, creditors and employees. With regard to shareholders, there are different views: positively, that management has direct a fiduciary duty towards shareholders,[25] as suggested in set of rules (shareholders' complaint for damages caused by corporate decisions of the director, collective action which protects the rights of all shareholders who find themselves in the same position, minority shareholders;[26] and negatively, that management does not have a fiduciary duty towards shareholders, because such a duty would often lead management to face a conflict between its duty to act in the interest of a company and any duty to act in the interest of sharehold-

[21] Similar to LCC, in the Code of Business Ethics, *Official Gazette of the Republic of Serbia,* No. 1/06 it is stated that duty to act in the best interests of business entities at taches to directors, members of management, executive and supervisory board, persons authorized to represent business entities, members of a commercial company (partners, general and limited partners, members of limited liability company and shareholders) Article 32.

[22] Article 63 (1).

[23] Members of management and of the executive board of directors must perform their functions in the interests of joint stock company and in conducting business must act with the care of a good businessman Article 268.

[24] See M. Vasiljević, *Korporativno upravljanje* [Corporate Governance], Pravni fakultet Univerziteta u Beogradu and Profinvest, Beograd 2007b, 144; D. Jurić, "Pravo manjinskih deoničara na podnošenje tužbe u ime deoničkog društva protiv članova uprave i nadzornog odbora" [Minority shareholders' right to litigate on behalf of the company against management and supervisory board members], *Zbornik Pravnog fakulteta u Rijeci* 1/2007, 554; J.S. Heckles, "Obaveze i dužnosti direktora u engleskom pravu" [Director's duties and liabilities in UK law], *Pravni život* 11/2000, 71; Ph. Merle, 71.

[25] Such view is also expressed in the Code of Corporate Governance: the board of directors has fiduciary duty to a company and to all shareholders including all minority shareholders Article 114.

[26] M. Vasiljević, (2010a), 44.

ers.[27] In exceptional cases, such a fiduciary duty towards shareholders does exist, but only in cases when members of management act akin to shareholders' agents.[28] When it comes to the creditors, although Company Law contains a set of rules on their protection,[29] the prevailing view is that management does not have a fiduciary duty towards them, except in the case of company bankruptcy. Then management's fiduciary duty towards the company ends and there is instead a duty towards the company's creditors.[30] Furthermore, in legal theory is also argued that management does not have a fiduciary duty towards employees.[31]

Regarding the scope of management's fiduciary duties, we may conclude as follows. Firstly, if management performs its fiduciary duty to act in the interest of a company, it acts at the same time for the benefit of other special interests. If a company conducts its business successfully and makes profit within the relevant legal framework, that means that under such conditions other special interests of management will also be satisfied. Secondly, management's fiduciary duty to a company should be analyzed separately from legal rules that protect other special interests. Judging by its content, the fiduciary duty of management is always the same, regardless to the existence and number of rules that protect special interests. Of course, the legal position of shareholders or creditors depends on the existence of those rules and the question of management's liability could arise if it does not act pursuant to legal rules.

The full analysis of fiduciary duty, separate from issues concerning individuals and the determination of who owes a fiduciary duty and who is a beneficiary, imposes the obligation to determine the content, scope and legal framework of fiduciary activities. As in the previous issue, there is no consensus on this matter. Therefore, many scholars consider that fiduciary duty includes a duty of loyalty, a duty of care (business judgement) and a duty to inform.[32] According to common law practice, a fidu-

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[27] D. Vujisić, "Dužnosti direktora u zakonodavstvu, poslovnoj i sudskoj praksi" [Duties of directors in law, business life and case law], *Pravo i privreda* [Law and Economy] 1 4/2009, 186.

[28] M. Vasiljević, (2007b), 144.

[29] Those rules serve to: prevent reduction of basic capital of a company that does not conduct its business with losses, without securing the interests of creditors; protect the interest of creditors in case of a company's status change; keep the value of basic capital as a general "pledge" for securing creditors; limit distributions from a company's assets to the shareholders if that will lead a company to insolvency; establish directors' liability for unlawful distributions and bad decisions. See *Ibid.,* 151.

[30] M. Vasiljević, "Privreda i pravna odgovornost" [Economy and legal responsibil ity], *Pravo i privreda* [Law and Economics] 4 6/2010b, 38.

[31] M. Vasiljević, (2007b), 151; D. Vujisić, 187.

[32] D. Jurić, 544; S. Bunčić, "Mogući sukobi interesa članova uprave i njihova odgovornost" ["Potential conflict of interest of management board and their responsibili ty], *Pravo i privreda* [Law and Economics] 1 4/2009, 176.

ciary duty involves:a duty of professional care, a duty not to create competition for a company, a duty to act in a good faith and to deal fairly; a duty of loyalty; a duty not to extract profit on information available to the management, a duty not to gain an advantage to the detriment of a company; and conflict of interests prevention.[33] Many scholars argue that an interest cannot be generally determined because the term represents a legal standard which should be determined through the decision making process of a competent authority.[34] There are also opinions that duty of care should not fall under fiduciary duty and that distinction needs to be made[35] because in order to determine negligence in the interest of a company (fiduciary duty), it is not necessary to determine a lack of proscribed level of care, unlike in the case where duty of care exists.[36]

If we take the above mentioned Article 268 of the former Law on Enterprises as a valid starting point for addressing the question of legal framework for fiduciary activity, it could be said that fiduciary activity shall be performed in frameworks which are, on the one hand, determined by the principle of loyalty and, on the other hand, by the standard of a prudent businessman. The mentioned principle and standard shows that fiduciary activity has two dimensions: an internal one, activity towards company; and an external one, the procedure of conducting business and representing the company.

When exercising their functions, members of management are obliged to act loyally[37] to a company (Article 33 (1) LCC).[38] From the need to protect the interests of a company and in order to create conditions for its successful development, derives an obligation for members of management to act loyally to a company. That means they must not act in their own interests, but should take care about the interests of a company and obey to certain limitations in terms of exercising their authority. These limitations can be divided into two groups. One group of limitations, indirectly, through the authorizations of management's members, enables the protection of a company's interest, by predicting that members of management can perform their functions only in the interest of a company[39] and that

[33] M. Vasiljević, (2007a), 145.

[34] Z. Arsić, 53.

[35] M. Vasiljević, (2007b), 144; N. Petrović Tomić.

[36] *Ibid.,* 145.

[37] Loyalty means a state of faithfullness, fairness, legality (and in addition to that, under that term is understood loyalty, devotion, honour, and sincerity). For more see M. Vujaklija, *Leksikon stranih reči i izraza* [Dictionary of foreign words and expressions], Prosveta, Beograd 1975, 524.

[38] This "crown" rule, which is of importance for defining one aspect of fiduciary activity was not involved in N LCC, which is an omission that removes the possibility to finally and clearly determine fiduciary duty.

[39] In the Law on Commercial Companies of the Republic of Montenegro, *Official Gazette of the Republic of Montenegro,* No. 6/02, 17/07 and 80/08 it is determined that the

they must not perform them in their own interest or in the interest of persons associated with them (duty to avoid conflict of interests).[40] In respect of that duty they must not: improperly use the property of a company; use information they have gained in that capacity, and that is not otherwise publicly available; abuse their position in a company; take business opportunities of a company for their personal gains.[41] Another category involves limitations that directly serve to protect the interests of a company by putting a company to the fore. In this case protection is based on preventive measures by prescribing three special duties. These are: a duty of non-competition, a duty to disclose business and activities where there is personal interest (in both of the mentioned duties one person cannot have certain positions in other company; for example, to enter a transaction or undertake any legal activity without previous authorization)[42] and a duty to keep business secrets (information that is determined by law, by-laws or by company agreement as business secret).[43] In addition to these duties, the LCC allowed commercial companies to determine other duties on an autonomous basis (such a possibility is not offered by the N-LCC), as well as the restrictions in terms of exercising their authority.[44]

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members of the board of directors are obliged to perform their functions only in the inter est of a company. including: not to use property of a company for their pesonal needs as if it was their own property; not to use confidential information of a company in order to achieve personal gain; not to abuse their function for personal enrichment causing damage to a company; not to use possibilities acquired by a company for entering in their own personal transactions Article 44 (5).

[40] The conflict of interests can be defined as a situation when the interests of one person are opposed to his duties. Generally, this conflict should be solved in favor of du ties. For more about conflict of interests see P. F. Cuif, "Le conflit d'intérêts", *RTD com* 1/2005, 1.

[41] Article 69 (1) N LCC.

[42] In terms of diclosure of business and activities where there are personal interests, N LCC (Atricle 65 66) brings several innovations concerning determination of: who should submit a report (board of directors or assembly, if a company has one director or to supervisory board, if it there is bicameral management of a company), majority that gives the authorization (in this case, the decision is made by the majority of voters by the persons who do not have personal interests), the cases when authorization is not needed (that is: the existence of personal interest of one company member; the existence of personal interest of all company's members; registration or buying of shares or contributions on the ground of preemptive right to acquire new shares, acquiring own contributions or shares if that is per formed according to rules that governing own contributions or shares).

[43] In N LCC (Articles 72 and 74) a business secret is defined for the first time; it is a proposed time limitation for keeping business secrets for a period of at least two and a half years, starting from the moment when someone has lost the capacity that imposed such a duty onto him; it is proposed that a company in the case of a breach of the duty, besides damages compensation, has the right to demand exclusion from the company if that person is a member of a company and termination of employment if the person is employed in a company.

[44] Article 39 (1) LCC.

In terms of external dimensions of fiduciary duty, which come to the fore when conducting business and representing a company to third parties, members of management are obliged to perform their duties in a good faith, with the care of a prudent businessman[45] and with reasonable belief that they act in the best interest of a company.[46] Such a solution is also adopted in some other legislations,[47] and it is supported by theory with the explanation that the business conduct of every business entity is connected with many business risks, so overly strict liabilty (it would be the case when liability was regulated pursuant the legal standard of good expert) could reduce business initiative of authorized persons.[48]

Members of management loyally perform their duty of care if their judgements are based on information and opinions of professionals in certain areas (the case when they lack needed average knowledge) or if they act pursuant to specific knowledge, skills and experience they possess.[49]

The legal standard of a prudent businessman can be found in the Law on Obligations (Article 18), and in General Trade Customs as well (no. 60). It is used to determine how a party in a commercial contractual relation should act during the performance of its contractual obligation. Since the object of conducting business and representation may go beyond commercial affairs, in the Commercial Code of Kingdom of Yugoslavia from 1937, instead of acting pursuant to the standard of a prudent businessman, it was predicted that a member of management is due to act with the accuracy of a responsible businessman (par. 300), which was judged by the object of company's business conduct.[50]

4. THE LIABILITY OF A COMPANY'S MANAGEMENT FOR THE BREACH OF FIDUCIARY DUTY

If members of management do not act with due care, in accordance with the interests of a company and if they do not perform their duties in

[45] In N LCC, the standard of a prudent businessman is defined as a level of care according to which a reasonably careful person would act and that is the person who would possess knowledge, skills and experience that would reasonably be expected for performing that duty in a company Article 63 (2).

[46] Article 63 (1) N LCC.

[47] Par. 93 (1) of the German Law of Joint Stock Companies; Article 252 (1) of the Croatian Law on Trade Companies; Article 263 (1) of the Slovenian Law on Commercial Companies.

[48] M. Vasiljević, (2007b), 156; M. Mićović, *Privredno pravo* [Commercial law], Pravni fakultet Kragujevac, Kragujevac 2010, 51.

[49] Article 63 (3) N LCC.

[50] D. Godina (ed.), *Commentary on the Trade Law*, Svetlost, Beograd 1937, 240.

that respect or if they cause damage to a company when performing their duties, then we can speak about management's liability for a breach of fiduciary duty. That liability may be status liability, civil and criminal liability.

Status liability[51] for the breach of fiduciary duty makes a legal ground for dismissal of management's members i.e., for the termination of employment if a person is employed in a company or exclusion from a company if such person is company's member. Otherwise, according to the dominant position which is accepted in Serbian law as well, members of management can be dismissed by the competent body of a company at any time, even without the existence of a valid reason.[52]

Civil liability is liability for damage. It has long been challenged,[53] but today it is a widely accepted form of liability for the breach of the duties that management members owe to a company. Pursuant to the general rules on liability for damage, there are three requirements to be met cumulatively: the existence of fault, damage caused, and a causal relation between fault and damage. Proving of these requirements in practice is very difficult, at least when it comes to business decisions made by management. More rigorous assessments of the mentioned requirements would actually lead to a court intervention for the evaluation of reasonableness of business activities and could undermine the relationship between the owners and management of a company, which are based upon control and freedom of appointment and dismissal.[54]

In connection with the aforementioned, the LCC does not contain any explicit rule in order to determine which party has the burden of proof i.e., which party has a duty to prove that the requirements for establishing liability for damages have been met. There is an opinion in theory that burden of proof rests upon plaintiff[55] as well as the opinion according to which every party is supposed to submit its own evidence so the court could assess it and determine the existance of liability.[56] In N-LCC, similar to the solution that was adopted in the Croatian Law on Commercial Companies, the burden of proof is shifted to the members of manage-

[51] M. Velimirović, "Traktat o odgovornosti u kompanijskom pravu" [Treaties on responsibility in Company Law], *Pravni život* [Legal life] 11/2001, 19.

[52] M. Vasiljević, (2007b), 219; Ph. Merle, 502; G. Ripert, R. Roblot, *Traité de droit commercial,* t. I, Dalloz, Paris 1998, 1221.

[53] It was considered that management's members perform their functions on be half of the company, so every consequence of their activities or non activities should go in favor or to the detriment of a company. Besides that, the amount of damage can be so large that members of management cannot compensate it. About that: M. Velimirović, 20.

[54] D. Radonjić, *Organi društva kapitala* [Organs in limited liability companies], CID, Podgorica 1998, 138; Ph. Merle, 458.

[55] M. Velimirović, 20: Ph. Merle, 458; G. Ripert, R. Roblot, 1304.

[56] M. Vasiljević, (2010b), 69.

ment. It is adopted the system of assumed guilt, so the members of management will not be liable for damage if they prove that they were conducting business with due care.[57]

If members of management conduct business with due care, they will not be liable to a company for the success of their business decisions.[58] They do not guarantee the achievement of certain results, which means that they, within the scope of their duties, carry out the obligations that fall into the category of obligation of means (method), and not the obligation of results (goal).[59] If members of management were exposed to the risk of personal liability for the negative concequences of their business decisions, they would hesitate to make business decisions, which would reduce good business decisions as well.[60]

Members of management who breach their duty are to be severally or jointly liable for the damage they cause to a company. Several liability exists if the breach of duty was made by a specified member of management, because other members do not have their part in this (for example, where a business activity was individually carried out or when a decision was prepared and performed by an individual). Generally, members of management have the joint liability, which is a consequence of collective corporate governance.[61] However, mistakes are personal, which means that the one who did not made them should not be liable.[62] Because of that, in instances of co-liablity, the court should determine what is the contribution of every management member in compensation to a company.[63] A member of management who wants to be relieved from liability for damages incurred as a result of a decision by a body in which work he took part, must explicitly express his disagreement with the decision (it is not enough to abstain from voting). And if he was not present when the decision was made nor voted for it in another way, it is necessary to oppose this decision in writing within eight days after becoming aware of its passing.[64]

In addition to the foregoing, members of management can be relieved from liability if they conducted business on the grounds of (lawful)[65]

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[57] Article 63 (5).

[58] It is necessary that they believed they acted in the best interests of a company making that that decision, that they had available necessary information and opinions of the experts, that they were not in the conflict of interests and that they had no financial benefit on which they did not have right. See D. Jurić, 583.

[59] About that: M. Vasiljević, (2007b), 155; F. Lemeunier, 217.

[60] D. Jurić, 548.

[61] D. Radonjić, 140.

[62] G. Ripert, R. Roblot, 1304.

[63] Ph. Merle, 461.

[64] Article 415 (4) (5) N LCC.

[65] Article 263 (3) of Slovenian Law on Commercial Companies.

decisions by a company's assembly[66] (the fact that they were acting on the ground of a risky assembly decision is irrelevant for the determination of their liability)[67] or if the assembly confirms their decisions afterwards. An assembly cannot confirm the decisions and thus relieve management's members from liability if the decisions were misleading, unlawful or if they led to a loss of company's property.[68] In any case, a standard rule has developed according to which a company cannot confirm a decision afterwards and renounce the right to compensation if the shareholders who possess or represent at least 10% of a company's basic capital oppose that decision.[69]

Along with the compensation, a company can demand the transfer of benefits that a person who owes a fiduciary duty (in case of breach of duty of non-competition and duty to avoid conflict of interest) or people associated with him achieved by breach of the duty.

Members of a board are subject to criminal liability as well. This liability can have different legal forms (economic offence, regulatory offence, fine, criminal offence). The LCC solely regulates liability for economic offences (in the case of a breach of a duty of non-competition) and liability for regulatory offences (in the case of an existence of conflict of interests and the breach of keeping business secrets).

In contrast to Serbian law, some other legislations prescribe criminal liability for management's members, as well. For example, the Croatian Law on Trade Companies determines that members of management will be sentenced to one or two years of imprisonment if they reveal business secrets without authorization in order to obtain a benefit for themselves or for others.[70] In addition to this, French law determines a penalty of imprisonment up to five years and a fine up to € 345 000 for management's members who contrary to the interests of a company abused the company's property and authority they have in their own interest or favored other companies they were directly or indirectly connected with.[71] Justification for such solutions can be found in the fact that damage caused to a company can be rarely compensated by personal property. Because of that fact, property liability should be followed by criminal liability, which has dual functions at the same time: a repressive one, but also a preventive one (deterrence from doing a damage).[72]

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66 Article 415 (2) N LCC.

67 F. Lemeunier, *Société anonyme,* Dalloz, Paris 2002, 207.

68 M. Vasiljević, (2007b), 161.

69 Article 263 (3) of Slovenian Law on Commercial Companies; Article 252 (4) of Croatian Law on Trade Companies; Article 415 (7) N LCC.

70 Article 629.

71 Article 242 6 (3) (4).

72 Ph. Merle, 468; G. Ripert, R. Roblot, 1298.

The need for introducing criminal liability has also been recognized by the N-LCC in terms of concluding legal transactions or taking legal actions in the case where personal interest exists, as well as regarding the breach of duty to avoid conflict of interests. In both cases, a penalty of imprisonment up to one year is perscribed, i.e., from six months to five years if the damage exceeds the amount of 10 million dinars.[73]

5. CONCLUSION

In between the two approaches about the interest of a commercial company, as a solution for avoiding conflict situations, it has been imposed the so-called traditional concept, according to which the interest of a company should be understood as a own company's interest, the one that is established in the interests of members, but that goes beyond their personal interests.

Acting in the interest of a company or fiduciary activity must be carried out inside the limits which are determined, on the one hand, by the principle of loyalty and, on the other hand, by the standard of a prudent businessman. The mentioned principle and standard indicate that a fiduciary activity has two dimensions: an internal one, acting toward a company and, an external one, the procedure of conducting business and representing the company.

In relation to a company, during the decision making process, management's members are obliged to act loyally to the company. That means they are obliged to: disclose to a company all legal transactions and legal activities where they have personal interest; to avoid a conflict of interests; to respect the rules on non-competition; to keep business secrets. Regarding the procedure of conducting business and representing the company, management members are obliged to conduct their business in good faith, with the care of a prudent businessman and with the reasonable belief that they act in the company's best interests.

If members of management do not act with due care, in accordance with the interests of a company, if they do not perform the duties connected with that or they perform them causing damage to a company, they have liability that can be of status, property and criminal nature. It can be noticed that in the rules that are adopted or will be adopted in Serbian or in other legislations, management's liability becomes more strict. That is achieved by accepting that management is liable for damage in accordance with the principle of assumed guilt, as well as by introducing criminal liability for certain breaches of fiduciary duty.

[73] Articles 582 583.

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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.

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SUPRANATIONAL REGULATION OF EXERCISING SHAREHOLDERS' RIGHTS IN INDIRECT HOLDING SYSTEMS

The author focuses exercising rights attached to indirectly held shares. The paper discusses the current state of the supranational regulation in this field and proposes some necessary improvements in order to achieve a better protection of indirect investors. It begins with a brief elaboration of the nature and structure of indirect holding systems in the cross border context. The main problems of enabling indirect investors' influence on the way shareholders' rights are exercised by the intermediary are also analysed. The author argues that these problems should be tackled on a supranational level, which has been done in the EC Shareholders' Rights Directive and the UNIDROIT Geneva Securities Convention. The core part of the paper contains a detailed analysis of the relevant provisions in these two documents and points out their limitations. It shows that the achieved level of harmonisation or unification is insufficient to protect indirect investors, which is why these issues are in need of further supranational regulatory attention.

Key words: *Shareholders' rights. Intermediary. Indirect investor. Account holder. EC Shareholder' Rights Directive. UNIDROIT Geneva Securities Convention.*

1. INTRODUCTION

Investing in company shares is nowadays becoming increasingly cross-border.[1] For many reasons the cross-border investment is com-

[1] I. Gómez Sancha Trueba, "Indirect holdings of securities and exercise of share holder rights (a Spanish perspective)", *Capital Markets Law Journal* 1/2008, 33. Some research shows that 30% of shares in listed companies in the EU are held by foreign in vestors. See U. Noack, "Die Aktionärsrechte Richtlinie", 2008, *http://papers.ssrn.com/*

monly held indirectly, usually through a chain of two or more intermediaries.[2] However, indirect holding of shares means that the direct relationship between the investor and the company is lost. Instead, the status of a shareholder (as the person who has legal title to shares) belongs to the last intermediary in the chain – the one that is closest to the company and furthest from the investor. In such circumstances, the indirect investor can only influence the way in which the rights attached to shares are exercised, if the shareholder (i.e. intermediary) puts into effect his/her respective instructions, or authorises him/her to personally exercise shareholders' rights (as a proxy or a nominee).

Unfortunately, national company law can sometimes prevent the intermediary, who is acting as a shareholder on behalf of others, from enabling indirect investors to influence accordingly the way shareholders' rights are exercised. Additionally, inadequate national capital market regulation can result in lack of incentives for intermediaries to engage in exercising shareholders' rights in their clients' best interests. Hence, in order to stimulate cross-border investment there have been several supranational regulatory attempts to remove national barriers to the efficient enfranchisement of indirect investors, namely the EC Shareholders' Rights Directive and the UNIDROIT Geneva Securities Convention. Apart from that, preparations are currently under way for dealing with these issues in the forthcoming EC Securities Law Directive.

This paper discusses the current state of supranational regulation in this field and proposes some necessary improvements in order to achieve better protection of indirect investors.

2. INDIRECT HOLDING OF SHARES

Indirect holding systems have been developed in many countries worldwide and have become typical for cross-border investment in shares.[3] The expression 'indirect holding of shares' means that the inves-

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sol3/papers.cfm?abstract id 1138735, last visited 5 September 2011, 2 3; cf. D. Zetzsche, "Shareholder Passivity, Cross Border Voting and the Shareholder Rights Directive", 2008, *http://ssrn.com/abstract 1120915*, last visited 10 December 2011, 2.

[2] See Final Report of the High Level Group of Company Law Experts, 2002, 53; M.M. Siems, "The Case against Harmonisation of Shareholder Rights", *European Business Organization Law Review* 4/2005, 541; R.C. Nolan, "Shareholder Rights in Britain", *European Business Organization Law Review* 2/2006a, 551; I. Gómez Sancha Trueba, 33.

[3] This development was caused by the need for proper functioning of capital markets, as well as the need for more efficient, cost effective and simplified cross border trade in shares. See M.M. Siems, *Convergence in Shareholder Law*, Cambridge University Press, Cambridge 2008, 142; E. Wymeersch, "Shareholder(s) matter(s)", *Festschrift für Klaus J. Hopt: Unternehmen, Markt und Verantwortung* (Hrsg. Stefan Grundmann *et al.*), Band 1, De Gruyter, Berlin New York 2010, 1567.

tor is holding shares not directly but via the intermediary who is registered as a shareholder in the shareholder register and has an obligation to safeguard and administer these shares on behalf of the investor as its client.[4] As a result, in the indirect holding of shares the investor stays hidden behind his intermediary and remains anonymous to the company (the issuer of shares).[5] Consequently, the indirect holding leads to the loss of a direct relationship between the company and the investor.[6]

In the simplest scenario, there are only three persons involved in the indirect holding: 1. the company (the issuer of shares), 2. the intermediary (the registered shareholder or the formal shareholder), and 3. the investor (the real shareholder or the indirect investor).[7] In practice, however, especially in the cross-border situations, the indirect holding structures tend to be more complicated, since intermediation is often multitiered, so that two or more intermediaries are interposed between the company and the indirect investor (i.e. the ultimate account holder or the underlying beneficiary).[8] In addition to that, indirect holding is commonly organised on a pooled basis, where one intermediary takes up the position of a formal shareholder on behalf of its many clients.[9] This, of course, further separates the investor from the company and makes the identification of persons on whose behalf shareholders' rights are exercised even more difficult.

3. EXERCISING RIGHTS ATTACHED TO INDIRECTLY HELD SHARES – INDENTIFYING PROBLEMS

Indirect holding of shares induces specific problems with regard to exercising shareholders' rights. On the one hand, the intermediary as the

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[4] Cf. F.J. Garcimartín Alférez, "The UNIDROIT Project on Intermediated Securities: Direct and Indirect Holding Systems", *InDret Revista para el análisis del derecho* 1/2006, Barcelona, *http://www.raco.cat/index.php/InDret/article/view/80981/105453*, last visited 8 July 2011, 3; cf. Er. Johansson, *Property Rights in Investment Securities and the Doctrine of Specificity*, Springer Verlag, Berlin – Heidelberg 2009, 43; cf. P.E. Masouros, "Is the EU Taking Shareholder Rights Seriously?: An Essay on the Impotence of Shareholdership in Corporate Europe", *European Company Law* 5/2010, 196.

[5] Cf. M.M. Siems, (2008), 142; cf. I. Gómez Sancha Trueba, 39.

[6] E. Wymeersch, 1567; M. Ooi, *Shares and other securities in the conflict of laws*, Oxford University Press, New York 2003, 48.

[7] For definition of the term 'indirect investor', see R.C. Nolan, (2006a), 552.

[8] Cf. R.C. Nolan, (2006a), 551; cf. E. Johansson, 44; Final Report of the High Level Group of Company Law Experts, 2002, 53; Final report of the Expert Group on Cross Border Voting in Europe, August 2002, 18; P.E. Masouros, 196.

[9] L. Gullifer, "Ownership of Securities: The Problems Caused by Intermediation", *Intermediated Securities: Legal Problems and Practical Issues* (eds. L. Gullifer, J. Payne), Hart Publishing, Oxford – Portland (Oregon) 2010, 12; cf. Final report of the Expert Group on Cross Border Voting in Europe, August 2002, 18.

registered shareholder is the only person entitled to all the powers and privileges attaching to shares, although it does not bear any economic risk regarding those shares.[10] Therefore, any potential damage caused by its way of exercising shareholders' rights only affects the real shareholder as the indirect stakeholder of the company. Furthermore, the intermediary does not have any economic incentives to exercise shareholders' rights responsibly or to efficiently control the management, since all the potential benefits thereof are accrued to the indirect investor.[11] On the other hand, the indirect investor does not appear on the shareholder register, and hence has no rights against the company,[12] even though he does indeed have adequate economic incentives to responsibly exercise shareholders' rights.[13] All this leads to the conclusion that indirect investors should be enabled to exercise shareholders' rights or at least influence the way these are exercised, whereas intermediaries should be prevented from using (or in fact, misusing) these rights in their own personal interest.[14]

The problem of exercising rights attached to indirectly held shares does not equally apply to all kinds of shareholders' rights. In this respect, rights attached to shares can be roughly divided into three categories:[15]

1. *'Mandatory' rights*: shareholders can only accept legal consequences of a certain corporate action (for example, to receive payments of declared dividends).

2. *'Discretionary' rights*: shareholders can choose whether to exercise certain rights or to take up certain obligations with regard to a specific corporate action (for example, to exercise pre-emptive rights in connection with a given share issue).

3. *'Voluntary' rights*: shareholders are free to initiate a certain corporate action (for example, to propose convening an extraordinary general meeting).

Only the last two categories are in need of specific regulation since they encompass the right to choose whether or how to exercise rights against the company. Conversely, consequences of mandatory rights

[10] R.C. Nolan, (2006a), 570; R.C. Nolan, "The Continuing Evolution of Share holder Governance", *The Cambridge Law Journal* 1/2006b, 94; R.C. Nolan, "Indirect Investors: A Greater Say in the Company?", *Journal of Corporate Law Studies* 1/2003, 75.

[11] Cf. R.C. Nolan, (2006a), 570; R.C. Nolan, (2006b), 94; R.C. Nolan, (2003), 75.

[12] M. Ooi, 94; Final report of the Expert Group on Cross Border Voting in Europe, August 2002, 19.

[13] Cf. R.C. Nolan, (2006a), 570.

[14] Final Report of the High Level Group of Company Law Experts, 2002, 54.

[15] Cf. J. Benjamin, M. Yates, G. Montagu, *The Law of Global Custody*, Butter worths, LexisNexis, London 2002^2, 104.

should be automatically forwarded down the chain of intermediaries to the indirect investor as the beneficiary of shares and hence do not present a particular concern for legislators.

With regard to the discretionary and voluntary shareholders' rights, specific regulation should put indirect investors in a position which is in effect equal to those investing in shares directly.[16] Consequently, even though the intermediary is recognised as a shareholder against the company, it should only function as an 'extended arm' of the ultimate beneficiaries. However, in the absence of specific regulation to this end, the intermediary as the formal shareholder will be the only person in direct communication with the issuer of shares. In such circumstances, in order to enable the influence of indirect investors on the way shareholders' rights are exercised, the intermediary should forward any information from the company as well as authorisation forms down the chain of intermediaries to the ultimate beneficiaries.

There are, generally, two ways of enabling indirect investors to engage in exercising shareholders' rights.[17] Firstly, indirect investors can give instructions as to how these rights are to be exercised by the intermediary.[18] Secondly, the intermediary can authorise indirect investors to personally exercise shareholders' rights: either as proxies with full discretionary powers, i.e. in the name of the intermediary (the registered shareholder),[19] or in their own name as nominees of the registered shareholder.[20] Unfortunately, each of these methods can be confronted with problems regarding their application in practice.[21] In the cross-border context the specific problems are derived from inadequate or incomplete regulation of these issues, which is why they can be described as regulatory barriers to the efficient enfranchisement of indirect investors.

Engaging indirect investors in exercising shareholders' rights will become more difficult or even impossible if national laws, for example:

– prohibit one shareholder from exercising rights differently for different parts of his holding; or

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[16] Cf. J. Payne, "Intermediated Securities and the Right to Vote in the UK", *Intermediated Securities: Legal Problems and Practical Issues* (eds. L. Gullifer, J. Payne), Hart Publishing, Oxford Portland (Oregon) 2010, 195.

[17] Cf. Final Report of the High Level Group of Company Law Experts, 2002, 54; J. Payne, 196 etc.

[18] R.C. Nolan, (2006a), 571; R.C. Nolan, (2003), 79.

[19] R.C. Nolan, (2006a), 572; R.C. Nolan, (2003), 79.

[20] P.L. Davies, *Gower and Davies' Principles of Modern Company Law*, Sweet & Maxwell, London 2008[8], 432.

[21] For practical issues with regard to appointing indirect investors as proxies in the USA, see M. Kahan, E. Rock, "The Hanging Chads of Corporate Voting", *The George town Law Journal* 4/2008, 1249 etc.; E. Wymeersch, 1568.

– prohibit one shareholder from granting more than one separate proxy with complete discretionary powers; or
– prohibit or leave unregulated the possibility for a shareholder to nominate another person as authorised to exercise shareholders' rights in his name; or
– impose cumbersome conditions for intermediaries when they exercise rights attached to shares on behalf of their clients; or
– allow the intermediary to exclude its obligation to exercise certain shareholders' rights in its agreement with the client; or
– do not impose adequate sanctions when the intermediary refuses to act upon instructions of indirect investors or refuses to grant them proxies or to nominate them; or
– allow the intermediary to exercise shareholders' rights even when it is not properly authorised by the indirect investor; etc.

Some of the aforementioned regulatory barriers concern the relationship between the company and its shareholder and therefore fall under company regulation, whereas others deal with the relationship between the intermediary and its client, which is traditionally within the domain of capital market regulation. However, these two 'separate' fields of law are sometimes not harmonised to the detriment of ultimate investors in indirectly held shares. In other words, protection of indirect investors provided by capital market regulation can be annulled by opposing company regulation, and vice versa.[22]

The growth of cross-border investment, which is more often than not based on indirect holding of shares, has made all of the above-mentioned potential problems international. Hence, the main goal of supranational regulatory instruments is to remove national regulatory barriers to the efficient enfranchisement of indirect investors.

4. CURRENT STATE OF SUPRANATIONAL REGULATION

Removing regulatory barriers to exercising shareholders' rights in indirect holding systems can be achieved on a national level – through reliance on competition of legal systems, or on a supranational level – through harmonisation or even unification of the regulation.[23] Even

[22] For example, if capital market regulation guarantees that ultimate investors have the right to instruct the intermediary on how to vote at the general meeting, company regulation can prevent them from exercising this right if it prohibits casting of votes dif ferently with respect to different shares of one shareholder.

[23] Cf. L. Gullifer, "The Proprietary Protection of Investors in Intermediated Secur ities", *Rationality in Company Law: Essays in Honour of DD Prentice* (eds. J. Armour, J. Payne), Hart Publishing, Oxford Portland (Oregon) 2009, 225.

though fostering competition of legal systems has its many advantages,[24] it should still not be overestimated as a means of solving some fundamental problems of exercising rights attached to indirectly held shares. Just like purchasers of goods need some minimal protection by supranational regulatory instruments, so do purchasers of shares (i.e. investors).[25] Thus, there is a general consensus that at least the core problems in this field should be covered by supranational regulation, whereas regulation of issues that go beyond what may be described as minimum standards should be left to national legislators. This is why there have been up until now two attempts to harmonise or unify these issues on a supranational level. On the one hand, this was done by the European Community through the adoption of Article 13 of the Shareholders' Rights Directive, and on the other hand, by the international organisation UNIDROIT within the framework of the Geneva Securities Convention.

4.1. EC Shareholders' Rights Directive

Since indirect holding of shares is typical for cross-border investments, any problems with regard to enabling indirect investors' influence on the way shareholders' rights are exercised present a potential threat to the development of the internal market of the EU. Therefore, removing national regulatory barriers in this field is an important issue on the EU level. Here, regulators can in principle focus their attention on three relationships: a) between the company and the intermediary (i.e. the formal shareholder), b) between the company and the indirect investor (i.e. the real shareholder), and c) between the intermediary and the indirect investor.[26] To date, the Community *acquis* has only regulated the first relationship in the EC Shareholders' Rights Directive. Conversely, the relationship between the company and the real shareholder has been completely neglected, whereas regulating the relationship between the intermediary and the indirect investor should become a part of the pending proposal for the new EC Securities Law Directive.[27]

Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies (hereafter, the EC Shareholders' Rights Directive or the SRD)[28] came into force in August 2007 and had to be im-

[24] Cf. M. Andenas, F. Wooldridge, *European Comparative Company Law*, Cam bridge University Press, Cambridge 2009, 33.

[25] Cf. M.M. Siems, (2005), 544: "international investors want their... cross border exercise of rights... to have a uniform pattern."

[26] R.C. Nolan, (2003), 77 and 78.

[27] For more information about preparation of a draft *Directive on legal certainty of securities holding and transactions* (*Securities Law Directive*), see *http://ec.europa.eu/inter nal market/financial markets/securities law/index en.htm*, last visited 10 December 2011.

[28] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, *Official Journal* L 184, 14.7.2007 (hereafter, Shareholders' Rights Directive), 17 24.

plemented by Member States until August 2009.[29] The main goals of enacting the SRD were: to strengthen certain rights of shareholders in connection with voting at the general meeting;[30] to remove the barriers to exercising those rights in the cross-border context;[31] to facilitate exercising rights attached to shares held indirectly via intermediaries[32] and thereby facilitate the engagement of beneficiaries in the corporate governance process.[33]

Unfortunately, the very notion of a shareholder is not harmonised by the SRD, leaving it to the national laws of Member States to provide a precise definition of this term.[34] Hence, in the indirect holding system the SRD provisions on exercising shareholders' rights will apply exclusively to the formal shareholder and will protect his position as against the company. Conversely, under the SRD the real shareholders (i.e. the indirect investors) are not given any directly enforceable rights against the company or the formal shareholder (i.e. the intermediary).[35] Indeed, many provisions of the SRD indirectly affect the position of ultimate beneficiaries, by protecting the formal shareholder who holds shares on their behalf and enables their influence on corporate governance. Still, only one provision, namely Article 13 of the SRD directly addresses the problem of enfranchising indirect investors in the company.

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[29] Shareholders' Rights Directive, Article 15 (1 2). The only exception to this general rule is Article 10 (3), which has to be implemented until August 2012. See F. Ochmann, *Die Aktionärsrechte Richtlinie: Auswirkungen auf das deutsche und europäische Recht*, Schriften zum Europäischen und Internationalen Privat , Bank und Wirschafts recht, Band 35, De Gruyter Recht, Berlin 2009, 7; S. Pluskat, "Auswirkungen der Aktion ärsrichtlinie auf das deutsche Aktienrecht", *Wertpapiermitteilungen Zeitschrift für Wirtschafts und Bankrecht* 46/2007, 2135; J.C. Kunz, *Das Recht der Hauptversammlung unter Berücksichtigung der RL 2007/36/EG*, Dissertation, Universität Wien, Wien 2008, *http://othes.univie.ac.at/3232/1/2008 10 28 0104881.pdf*, last visited 5 September 2011, 7; Eckart Ratschow, "Die Aktionärsrechte Richtlinie neue Regeln für börsennotierte Ge sellschaften", *Deutsches Steuerrecht* 2007, 1402; P.E. Masouros, 196.

[30] J. Payne, 213; D. Zetzsche, (2008), 34.

[31] F. Ochmann, 13; S. Pluskat, 2136; S. Grundmann, N. Winkler, "Das Aktion ärsstimmrecht in Europa und der Kommissionsvorschlag zur Stimmrechtsausübung in börsennotierten Gesellschaften", *Zeitschrift für Wirtschaftsrecht* 31/2006, 1424; D. Zetz sche, (2008), 34.

[32] J. Payne, 213.

[33] A. Hainsworth, "The Shareholder Rights Directive and the challenge of re en franchising beneficial shareholders", *Law and Financial Markets Review* 1/2007, 11; cf. U. Noack, M. Beurskens, "Einheitliche "Europa Hauptversammlung"? Vorschlag für eine Richtlinie über die (Stimm)Rechte von Aktionären", *Zeitschrift für Gemein schaftsprivatrecht* 2006, 88.

[34] E. Ratschow, 1402; D. Zetzsche, "Die neue Aktionärsrechte Richtlinie: Auf dem Weg zur Virtuellen Hauptversammlung", *Neue Zeitschrift für Gesellschaftsrecht* 2007, 686; F. Ochmann, 192; J. Payne, 214; U. Noack, (2008), 15; I. Gómez Sancha Trueba, 52.

[35] J. Payne, 214.

4.1.1. Narrow Scope of Application

One of the reasons why the SRD offers only insufficient protection of indirect investors stems from its narrow scope of application. The SRD applies only to companies (i.e. issuers of shares) "which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State".[36] Thus, this Directive only deals with exercising certain shareholders' rights in listed companies[37] whose shareholders are usually widely dispersed, often in two or more states.[38] Consequently, the cross-border issues of exercising rights attached to indirectly held shares are considered inherent in listed companies, which led to the adoption of specific European harmonisation rules that are confined to tackling precisely these problems.[39]

With regard to enabling indirect investors' influence on the way shareholders' rights are exercised, the SRD only harmonises certain problems in connection with voting at the general meeting. Hence, its rules apply exclusively to voting shares[40] and not to preferential shares[41] even though these can also be indirectly held via intermediary. Moreover, the SRD completely neglects harmonisation of rules which protect indirect investors when it comes to exercising other shareholders' rights, except voting rights (e.g. the right to ask questions, the right to add items to the agenda of the general meeting, the right to table draft resolutions, the right to convene an extraordinary general meeting, etc.).[42] Of course, one must acknowledge that voting right is an extremely important shareholders' right,[43] especially from the corporate governance perspective, but still it is only one of numerous rights with regard to which indirect investors require protection. Bearing in mind that indirect investors' involvement in exercising other shareholders' rights is an important (although not the most important) problem of indirect holding of shares, the achieved level of harmonisation can only be assessed as insufficient and therefore incomplete.

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[36] Shareholders' Rights Directive, Article 1 (1); F. Ochmann, 17; S. Pluskat, 2135; S. Grundmann, N. Winkler, 1424; U. Noack, (2008), 3; U. Noack, "Der Vorschlag für eine Richtlinie über Rechte von Aktionären börsennotierter Gesellschaften", *Neue Zeitschrift für Gesellschaftsrecht* 2006, 322; E. Ratschow, 1403; D. Zetzsche, (2007), 686.

[37] J. C. Kunz, 13; U. Noack, M. Beurskens, 88.

[38] S. Pluskat, 2135; cf. S. Grundmann, N. Winkler, 1424; cf. U. Noack, M. Beurskens, 88.

[39] S. Pluskat, 2135.

[40] F. Ochmann, 17; E. Ratschow, 1403.

[41] J.C. Kunz, 14.

[42] D. Zetzsche, (2008), 38.

[43] M. Kahan, E. Rock, 1229: "Never has voting been more important in corporate law."

However, the described downsides of the determined scope of application of the SRD are diminished by the fact that this Directive only contains minimal harmonisation.[44] Consequently, in the implementation process Member States can enhance the level of protection of indirect investors, so that the harmonised rules equally apply to other (non-listed) companies,[45] other shareholders' rights (except voting rights), preferential shares, etc. Apart from that, Member States can provide additional mechanisms for the protection of indirect investors besides those harmonised by the SRD.[46]

4.1.2. Harmonisation of exercising shareholders' rights in indirect holding systems

Article 13 of the SRD deals with exercising rights attached to shares held indirectly via intermediary.[47] The first paragraph of this article states that its provisions apply to a person who is recognised as a shareholder by the applicable law and acts in the course of a business on behalf of another natural or legal person (the client).[48] This clearly encompasses financial intermediaries who, in the course of their business, provide services of safeguarding and administering shares for others, by taking up the position of a formal shareholder against the company.[49] On the other hand, the SRD neither defines nor uses the term "indirect investors" or any other equivalent, but only refers to the "clients" of the formal shareholder.[50]

Indirect protection of intermediary's clients in the SRD consists of harmonising the following legal provisions of the Member States.

1. Member States shall allow the intermediary as the formal shareholder to cast votes differently with regard to different parts of his holding on behalf of clients.[51] In this way, the intermediary will be able to respect the instructions and act in the best interest of each client.[52]

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[44] S. Pluskat, 2136; S. Grundmann, N. Winkler, 1424, J. C. Kunz, 23; U. Noack, (2008), 6; U. Noack, M. Beurskens, 88; E. Ratschow, 1403; D. Zetzsche, (2007), 691.

[45] U. Noack, (2006), 322.

[46] S. Pluskat, 2136; U. Noack, M. Beurskens, 88; E. Ratschow, 1403.

[47] F. Ochmann, 174.

[48] Shareholders' Rights Directive, Article 13 (1); D. Zetzsche, (2007), 687. Wheth er a person is acting as a shareholder in the course of a business on behalf of another natural or legal person, is determined by *legis societatis*. See F. Ochmann, 175.

[49] J.C. Kunz, 140; U. Noack, (2006), 324.

[50] J.C. Kunz, 141.

[51] Shareholders' Rights Directive, Article 13 (4); A. Hainsworth, 16; D. Zetzsche, (2007), 687; J.C. Kunz, 144; U. Noack, M. Beurskens, 90; J. Payne, 213; R.C. Nolan, (2006a), 582.

[52] R.C. Nolan, (2006a), 582; F. Ochmann, 177; D. Zetzsche, (2008), 38.

2. Even when the national law of the Member State limits the number of proxies that one shareholder can appoint to vote at the general meeting, Member States shall make an exception to this rule when a formal shareholder is in fact an intermediary acting on behalf of others. Namely, the intermediary should be able to give a voting proxy to each client or another person designated by the client.[53] This rule enables the intermediary's client to exercise voting rights personally or through a third party of his choice, notwithstanding the fact that he is not recognised as a shareholder by the company.
3. The SRD allows Member States to prescribe certain conditions for exercising voting rights by the intermediary on behalf of its clients, with a view to increasing transparency of the indirect holding system. However, these conditions cannot go beyond revealing the identity of each client and the number of shares safeguarded and administered on his behalf.[54]
4. Finally, the SRD aims to protect the intermediary's clients from unnecessary formalities regarding voting authorisations and instructions. In this regard, national laws of the Member States shall not impose formal requirements that go beyond what is necessary to ensure the identification of the client, or the possibility of verifying the content of his instructions, and is proportionate to achieving those objectives.[55]

4.1.3. Limitations of the Achieved Level of Harmonisation

Closer analysis shows that the achieved level of harmonisation in Article 13 of the SRD is incomplete and therefore insufficient for the protection of indirect investors. Firstly, the SRD neither determines how the intermediary is going to prove to the company that it is holding shares as a registered shareholder on behalf of its clients, nor does it regulate whether the company can or should require such confirmatory evidence.[56] Unless it is closed by national laws of the Member States, this regulatory gap can lead to *fraus legis* by shareholders who want to make use of exceptions to the general company law with regard to exercising shareholders' rights by the intermediary on behalf of clients.

[53] Shareholders' Rights Directive, Article 13 (5); cf. U. Noack, (2008), 11; U. Noack, M. Beurskens, 90; D. Zetzsche, (2007), 687; S. Grundmann, N. Winkler, 1427; J.C. Kunz, 144.

[54] Shareholders' Rights Directive, Article 13 (2); J.C. Kunz, 142; U. Noack, (2008), 14; E. Ratschow, 1408; D. Zetzsche, (2007), 687; cf. F. Ochmann, 176; D. Zetz sche, (2008), 38.

[55] Shareholders' Rights Directive, Article 13 (3); F. Ochmann, 176; A. Hainsworth, 16; J.C. Kunz, 143; E. Ratschow, 1408.

[56] J. Payne, 198.

The SRD enhances the transparency of the indirect holding of shares by allowing Member States to require the disclosure of clients' identities as a precondition for exercising voting rights by the intermediary. However, this rule refers solely to clients of the intermediary who is a registered shareholder, whereas it completely neglects the fact that indirect holding systems (especially in cross-border context) are often multi-tiered and organised on a pooled basis. Therefore, clients of the formal shareholder will usually be other intermediaries acting on behalf of their respective clients, and so on until the ultimate beneficiaries (who are the indirect investors). In such a scenario, the formal shareholder will not know the identities of indirect investors. Nevertheless, the SRD does not oblige him to gather such information or to reveal it to the company.

The fact that the protection of Article 13 only encompasses clients of the intermediary who is a registered shareholder shows that the SRD is turning a blind eye to the problem of multi-tiered structure of holding intermediated shares.[57] Bearing in mind that clients of the formal shareholder are often other intermediaries who safeguard and administer shares for their clients, the Directive fails to provide rules that would enable indirect investors as ultimate beneficiaries to effectively engage in exercising shareholders' rights. Consequently, the SRD does not contain any rules that would apply to sub-custodians in the potential chain of intermediaries.[58]

Furthermore, Article 13 only regulates certain aspects of the relationship between the company and the intermediary (i.e. the formal shareholder), whereas it completely leaves out the relationship between the intermediary and its clients, as well as the relationship between the company and indirect investors.[59] This is why Article 13 does not grant indirect investors any directly enforceable rights against the company or against the intermediary. In addition to that, the SRD does not prescribe an obligation of the intermediary to enable indirect investors' influence on exercising shareholders' rights, or its obligation to distribute information from the company to the account-holders,[60] but leaves these issues to national laws of the Member States or to the agreement between the intermediary and its client. In this respect the SRD does not achieve the necessary level of harmonisation, since there is no guarantee that the intermediary will facilitate the engagement of indirect investors in exercising shareholders' rights.[61]

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[57] Cf. F. Ochmann, 177.

[58] J. Payne, 213; F. Ochmann, 176; D. Zetzsche, (2008), 37.

[59] Cf. U. Noack, (2008), 6.

[60] F. Ochmann, 177.

[61] Cf. R.C. Nolan, (2006a), 574: "...the mere existence of... possibilities may not be adequate to enfranchise indirect investors in shares. It may well be necessary to put

Not only does the SRD avoid regulating intermediary's obligations towards its clients, but it also contains no rules regarding the right of the intermediary to vote at the general meeting on behalf of clients. As a consequence, Article 13 does not specify whether the intermediary has the right to vote in any case, or only if it is properly authorised or explicitly instructed by the indirect investor.[62] Therefore, the conditions under which the intermediary as the formal shareholder can exercise shareholders' rights are left to national laws of the Member States.

It can be concluded that the protection of indirect investors under the SRD is inadequate and incomplete. This Directive only deals with some company law issues, although company regulation can only enable indirect investors to exert influence on the way shareholders' rights are exercised, while it does not force the intermediary to acknowledge their influence. For that reason, focusing exclusively on company law aspects of the problem proves to be insufficient for the protection of indirect investors.

Company regulation has to be coupled with capital market regulation in order to achieve the optimal level of protection of indirect investors.[63] This means concentrating on the relationship between the intermediary and its client, that is, on the rules under which the service called "safeguarding and administering shares" is provided. Of course, the European Commission is well aware of this, which is why these issues were planned to become a part of the new Securities Law Directive. In the meantime, under the auspices of UNIDROIT, 37 states as well as the European Community have adopted the international Convention on Substantive Rules for Intermediated Securities (shortly called "the Geneva Securities Convention").[64]

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further pressure on intermediaries to realise those possibilities to enfranchise indirect in vestors in the company." Cf. D. Zetzsche, (2008), 49 50.

[62] S. Grundmann, N. Winkler, 1427.

[63] Cf. M.M. Siems, (2008), 44: "...shareholder protections through company law and through securities law have differing orientations: securities law serves to protect the assets of the investor, while company law has its focus on shareholder participation in the firm and on the share as an investment."

[64] Final Act of the final session of the diplomatic conference to Adopt a Conven tion on Substantive Rules Regarding Intermediated Securities, UNIDROIT 2009, CONF 11/2 Doc 41, Appendix, Convention on Substantive Rules for Intermediated Securities & Resolutions No 1, 2, 3, *http://www.unidroit.org/english/conventions/2009intermediated securities/finalact.pdf*, last visited 14 December 2011; J. Than, "Der funktionale Ansatz in der UNIDROIT Geneva Securities Convention vom 9. Oktober 2009", *Festschrift für Klaus J. Hopt: Unternehmen, Markt und Verantwortung* (Hrsg. S. Grundmann, *et al.*), Band 1, De Gruyter, Berlin New York 2010, 231.

4.2. UNIDROIT Geneva Securities Convention

The Geneva Securities Convention (hereafter, 'the GSC' or 'the Convention') was adopted on 9 October 2009.[65] However, it still has not come into force due to the fact that the requirement of at least three ratifications has not yet been met.[66] Instead of specifically dealing with problems of exercising shareholders' rights in indirect holding systems, the main purpose of adopting the GSC was to achieve general unification of rules that govern holding securities via intermediaries (which comprise indirect as well direct holding structures). Still, this Convention is relevant to exercising shareholders' rights by an intermediary on behalf of indirect investors since its general rules on rights of ultimate account holders also apply to investors in indirectly held shares.

4.2.1. Scope of Application

The very definition of 'securities' in the GSC shows that shares are one type of financial instruments typically covered by this term.[67] Furthermore, the Convention applies to 'intermediated' shares, which is an expression used to describe shares credited to a securities account or rights or interests in shares resulting from the credit of shares to a securities account.[68] This means that the rules of the Convention encompass not only the relationship between the intermediary, who is the registered shareholder, and his client (where shares are being credited to a securities account) but also to the relationships between lower-tier intermediaries (i.e. sub-custodians) and their respective clients (where, in the indirect holding system, the assets credited to a securities account are not shares, but rather rights or interests in shares).[69] Therefore, the GSC clearly respects the fact that holding systems are usually multi-tiered, so that (interests in) shares are held through a chain of two or more intermediaries. In this respect, the scope of application of the GSC is wider than that of the SRD which only regulates certain rights of the intermediary acting as a registered shareholder on behalf of its immediate clients.

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[65] For more details, see C.W. Mooney, H. Kanda, "Core Issues under the UNID ROIT (Geneva) Convention on Intermediated Securities: Views from the United States and Japan", *Intermediated Securities: Legal Problems and Practical Issues* (eds. L. Gul lifer and J. Payne), Hart Publishing, Oxford Portland (Oregon) 2010, 70 71.

[66] For the status of the UNIDROIT Convention on Substantive Rules for Interme diated Securities (hereafter, Geneva Securities Convention), see *http://www.unidroit.org/english/implement/i 2009 intermediatedsecurities.pdf*, last visited 11 December 2011; J. Than, 233.

[67] Geneva Securities Convention, Article 1 (a).

[68] Geneva Securities Convention, Article 1 (b); cf. J. Than, 234.

[69] For detailed explanation of interests in securities, see J. Benjamin, *Interests in Securities: A Proprietary Law Analysis of the International Securities Markets*, Oxford University Press, New York 2000, 28 etc.

In addition to that, unlike the SRD, which covers different types of relationships between the registered shareholder and his client that can lead to exercising shareholders' rights by the former on behalf of the latter, the GSC only applies to relationships arising from account agreements where clients of the intermediary are qualified as account holders. Therefore, the rules of this Convention do not protect indirect investors who are holders of depository receipts or holders of shares (or units) in a collective investment scheme.[70]

The GSC primarily regulates the relationship between the so-called 'relevant intermediary' and its immediate client (the account holder), which is traditionally considered to be the subject of capital market law.[71] In this respect, it sets out rights of an account holder and corresponding obligations of the intermediary, some of which directly refer to exercising rights attached to intermediated securities. Conversely, the relationship between the company (i.e. issuer of shares) and ultimate account holders (i.e. indirect investors) is completely left to non-Convention law. Finally, the relationship between the company (i.e. issuer of shares) and its shareholders is generally outside the scope of this Convention, since it endorses the principle of neutrality with respect to company law.[72] However, one important exception to this principle was made in Article 29 subparagraph 2, precisely concerning exercise of shareholders' rights via the intermediary in indirect holding systems. Hence, unlike the SRD, which exclusively focuses on company law issues, the GSC combines detailed regulation of capital market law issues with some rudimentary regulation of company law problems.

Finally, the rules of the GSC are intended to cover all situations where the law of a Contracting State is the applicable law, whether as a result of the conflict of law rules or because the circumstances of a particular case are purely domestic (with no foreign element).[73] This provision enhances the importance of GSC as a unification instrument, which should help minimise difficulties arising out of holding shares through intermediaries in cross-border as well as exclusively national contexts.

4.2.2. Specific Regulation Relevant to Exercising Shareholders' Rights

There are several provisions of the GSC that are particularly relevant to exercising shareholders' rights in indirect holding systems. On the one hand, the Convention clarifies that the person entitled to all the benefits stemming from intermediated shares is the ultimate account holder

[70] Unlike the Convention, Article 13 of the Directive also applies to holders of depository receipts. See F. Ochmann, 179.

[71] Cf. P. Keijser, "Die Verabschiedung der Genfer Wertpapierkonvention (Bericht von der Diplomatischen Konferenz)", *BKR* Zeitschrift *für Bank und Kapitalmarktrecht* 2010, 152.

[72] Cf. C.W. Mooney, H. Kanda, 80.

[73] Geneva Securities Convention, Article 2; C.W. Mooney, H. Kanda, 80.

– that is, the account holder who is not an intermediary or is an intermediary acting for its own account.[74] Therefore, the intermediary is under obligation to regularly pass on to its account holders any distributions (e.g. dividends) received in connection with intermediated shares.[75] Moreover, in the indirect holding system the ultimate account holder has the right against his relevant intermediary to exercise any rights attached to intermediated shares.[76] In effect, such a provision empowers indirect investors to influence the way shareholders' rights are exercised by the intermediary against the issuer. Hence, the GSC explicitly obliges the intermediary to respect and to give effect to account holder's instructions in this regard.[77] In addition to that, the Convention prescribes certain obligations of the intermediary whose main purpose is to aid indirect investors in making an informed decision about the way shareholders' rights are to be exercised. For example, according to the Convention the intermediary has to regularly forward information regarding intermediated shares from the company to its account holders.[78]

In principle, the GSC does not deal with the relationship between the formal shareholder and the company or that between the company and the ultimate account holder.[79] However, Article 29 subparagraph 2 of the Convention prescribes that Contracting States must allow an intermediary to exercise not only the voting rights but also other shareholders' rights differently in relation to different parts of a holding of shares. In other words, this rule introduces not only split voting but also split exercise of other shareholders' rights, and thereby goes beyond the requirements of the SRD. This particular exception to the general principle of neutrality with respect to company law was considered a necessary minimum provision, without which the functioning of cross-border indirect holdings could be seriously hindered. Apart from that, the GSC contains no further regulation of exercising shareholders' rights against the company on behalf of indirect investors.[80]

Like the SRD, the GSC sets only minimal standards with a goal to achieve compatibility of different legal systems.[81] For that reason, all of

[74] Geneva Securities Convention, Article 9 (1) (a) (i); cf. C.W. Mooney, H. Kanda, 84 fn. 66.

[75] Geneva Securities Convention, Article 10 (2) (f); P. Keijser, 157.

[76] Geneva Securities Convention, Article 9 (1) (a).

[77] Geneva Securities Convention, Article 10 (2) (c); P. Keijser, 157.

[78] Geneva Securities Convention, Article 10 (2) (e); P. Keijser, 157.

[79] Geneva Securities Convention, Article 8.

[80] Therefore, conditions under which the intermediary is authorised to exercise these rights against the company are not specified in the Convention.

[81] P. Keijser, 153; H. Kronke, "Das Gesellschaftsrecht im Genfer UNIDROIT Abkommen über intermediär verwahrte Effekten", *Wertpapiermitteilungen Zeitschrift für Wirtschafts und Bankrecht* 43/2010, 2009; H. Kronke, "Remarks on the Geneva Se curities Convention's Development and its Future", *Intermediated Securities: Legal Prob*

the above-mentioned obligations of the intermediary as well as rudimentary company regulation can and should be further specified by non-Convention law.

4.2.3. Limitations of the Attempted Unification

When focusing exclusively on its regulation relevant to exercising shareholders' rights in indirect holding systems, it can be concluded that the GSC has its limitations, which brings into question its overall ability to completely protect ultimate account holders as indirect investors in intermediated shares. Namely, in this Convention many important issues are left unregulated, such as: the account holder's authorisation of the intermediary for exercising shareholders' rights; the consequences of exercising shareholders' rights by the intermediary who is not properly authorised by its client; the formalities with regard to authorisation and instructions; the conditions for exercising rights attached to intermediated shares on behalf of account holders (for example, revealing the identity of indirect investors to the company); intermediary's obligation to enable indirect investor to personally engage in exercising shareholders' rights (e.g. through appointing him as a proxy, or through empowering him as a nominee); the right of the intermediary as the formal shareholder to grant more than one separate proxy with complete discretionary powers; etc. Additionally, intermediary's obligations that are explicitly regulated by the Convention are only sketched out abstractly, so that their elaboration is left to non-Convention law or the account agreement.

5. COMPARISON AND COMPATIBILITY OF THE TWO SUPRANATIONAL REGULATORY INSTRUMENTS

The previous analysis has shown that the two current supranational regulatory instruments offer only partial solutions to the identified problems of exercising shareholders' rights in the cross-border context. However, their approach to dealing with specific regulatory issues in this regard is substantially different. While the SRD contains only company regulation and leaves out all questions that fall within capital market regulation, the GSC has in principle adopted the opposite approach. Another important distinction between these two documents lies in the fact that the GSC treats the ultimate account holder (i.e. the indirect investor) as the sole beneficiary of intermediated shares, while the SRD only recognises the need for (indirect) protection of intermediary's immediate clients, without taking into account the prevailing multi-tiered structure of cross-border holdings.

lems and Practical Issues (eds. L. Gullifer and J. Payne), Hart Publishing, Oxford Port land (Oregon) 2010, 247; L. Gullifer, (2009), 226.

Bearing in mind the divergent ways of tackling problems in connection with exercising shareholders' rights in indirect holding systems in the SRD and the GSC, the question is whether these two regulatory instruments are complementary, so that they can build a complete set of supranational rules in this field. In other words, could the ratification of the GSC, coupled with the implementation of the SRD, suffice to fully protect indirect investors? On the basis of the analysis conducted in this paper the resulting answer to the posed question is negative, because a lot of important gaps would remain, especially in company regulation, which is incomplete in the Directive and completely marginalised in the Convention. Admittedly, if the GSC was ratified by the European Community, the regulation of many issues planned for the Securities Law Directive would become superfluous. However, since this Convention has not yet come into force, it remains to be seen whether and to what extent it will actually influence the cross-border problems with regard to exercising rights attached to indirectly held shares.

6. CONCLUSION

When shares are held indirectly via intermediary, exercising shareholders' rights poses specific problems, especially in the cross-border context. However, indirect investors cannot rely upon the protection provided by divergent national rules, as some of them completely ignore these problems. For this reason, there is a strong need for supranational regulation in this field, which has up until now resulted in adopting the EC Shareholders' Rights Directive and the UNIDROIT Geneva Securities Convention. Unfortunately, a closer analysis has shown that each of these regulatory instruments is in itself incomplete and hence incapable of offering full protection of indirect investors. Additionally, the combination of these two documents would not lead to the desired result either, since a lot of important issues would still be left unresolved (primarily in the field of company law). Therefore, as long as indirect holding systems are common for cross-border investments, further supranational regulatory activity in this regard will remain necessary.

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PUBLIC DISCLOSURE OF INSIDE INFORMATION

Inside information is the central concept of the notion of public disclosure of inside information as well as of insider dealing. This paper aims to determine wheth er the notion of inside information is the same within the two concepts and whether it should be. Two hypotheses have been analyzed firstly, the need to separate the unique concept of inside information, which has been accepted in Serbian and EU law, and secondly, the need to limit the issuer's broad discretion with regard to the issue of delaying public disclosure. Finally, the concept of delaying public disclosure of inside information in connection with problem of rumors and "leaked" informa tion has been looked into in details.

Key words: *Disclosure. Inside information. Delaying disclosure.*

1. INTRODUCTION

Public disclosure of information is necessary to ensure that the public is adequately informed. Consequently, the disclosure of inside information is significant as a part of reporting to the public on inside information. Public disclosure should be carried out in such a way that information is made easily and promptly accessible, which is best achieved by placing on the Internet sites of the companies. It is interesting that the term "data" is used in spoken language to refer to the registration of data, while the term "information" is used concerning the disclosure. Data refers to a fact, while information can be knowledge of the fact and not the fact itself.[1] Therefore, on the basis of the above, the right term to use with

[1] See S. Bunčić "Privilegovane informacije u evropskom i srpskom pravu određenje pojma" ["The Notion of Insider Information in the European and Serbian law"], *Poslovna ekonomija* [*Business Economics*] 2/2008, 17.

regard to disclosure is "information". Taking into account that it is reported to the public, i.e. to an unspecified number of persons for whom it is assumed that they are not in the possession of the inside information, a question may be posed as to whether such information is intended to the general public or to a particular group of persons. Amongst the persons to whom the information is certainly intended are investors. On one hand, these are potential investors, i.e. investors from the primary issue and secondary market buyers and on other are shareholders who have already decided to invest their capital, to whom the information is of multiple significance (e.g. to decide on sale of shares if information is adverse to the company). Lately, much has been written about the creditors as persons to whom the disclosure is addressed to.[2] All of them must be equally informed in order to be able to make economically rational decisions which will result in the establishment of appropriate share prices thus contributing to the market efficiency.[3] The total symmetry of information and absolutely efficient market are just theoretical models, i.e. utopia. The task of a legislator is to try to find a solution that will enable the establishment and maintenance of markets that are as efficient as possible. That is the main goal of the notion of disclosure. It could be asserted that disclosure is a matter of public importance, as a process that involves a large number of persons leading to a decline in information asymmetry.[4]

Disclosure can be divided into the one relating to company law and another relating to the capital market law. In either case, the connection between these two approaches is unbreakable provided that investors become shareholders by purchasing securities of the issuer. The disclosure is an area where company law and capital market law overlap and are observed jointly, pursuant to the Report of the High Level Group of Company Law Experts for the reform of EU company law in 2002.[5] It is also important to note that both legal and economic sciences are equally involved in the issue of disclosure. For this reason, there is empirical evi-

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[2] See, for example, T. Jevremović Petrović, "Obavezno objavljivanje kao instru ment zaštite poverilaca u kompanijskom pravu" ["Creditor Protection Through Mandatory Disclosure Rules"], *Pravo i privreda* [*Law and Economy*] 4 6/2011, 195 197.

[3] See, for example, T.L. Hazen, "Indentifying the Duty Prohibiting Outsider Trad ing on Material Non Public Information", *Hastings Law Journal* 4/2010, 1 2, *http://ssrn. com/abstract 1472090*, last visited 20 August 2011; E. Čulinovic Herc, "Povreda obaveze objave podataka na tržištu kapitala i sporovi ulagatelja (dioničara) protiv uvrštenih društava" ["Infringement of the Obligation to Disclose Information in the Capital Market and Disputes Between Investors (Shareholders) and Listed Companies"], *Zbornik Pravnog fakulteta Sveučilišta u Rijeci* [*Collected Papers of the Law Faculty University of Rijeka*] 1/2009, 148.

[4] See C. Villiers, *Corporate Reporting and Company Law*, Cambridge 2006, 15, 30 32; J.L. Hansen, "The trinity of market regulation: Disclosure, inside trading and mar ket manipulation", *International Journal of Disclosure and Governance* 1/2003, 83.

[5] 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, 32.

dence of how disclosure affects the operations of the company, for example, how larger companies adopt more rigorous measures of disclosure, which in turn leads to the employment of more capable and better-paid management.[6] There are also opinions that the purpose of public disclosure, as a form of disclosure, is not to protect investors nor shareholders (because, for example, investors are protected by diversification of risk) but to improve corporate governance instead due to the impact of disclosure on behavior of the management, as well as greater liquidity of capital markets, which leads to better allocation of recourses.[7] Furthermore, even the rules relating to disclosure in connection with corporate governance cannot be entirely subsumed under the rules of company law nor the capital market law.[8]

If the time of establishment of the company is used as the criterion, disclosure can be divided into preceding one which is a precondition for the foundation of the company, i.e. disclosure through the prospectus and the disclosure in the course of business operations of the company. The latter type of disclosure can be divided into periodic and *ad hoc* disclosure depending on the time when duty arises, at specified time points or when the disclosure time is unknown in advance. *Ad hoc* disclosure primarily relates to the duty to disclose inside information, to inform about the acquisition or loss of major holdings or major proportions of voting rights as well as to disclose in the case of takeover. Information about change of major holdings does not constitute inherently inside information concerning the issuer but market information instead since they relate only to the market (price change is likely to happen if number of shares is large), as evidenced by the special legal regulation thereof, while the takeover presents a concretization of the general rules of the Directive 2003/6/EC on insider dealing and market manipulation (market abuse) (hereinafter: the Market Abuse Directive).[9]

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[6] B.E. Hermalin, M.S. Weisbach, "Information Disclosure and Corporate Gover nance", Fisher College of Business Working Paper No. 2008 03 16, 1 3, *http://ssrn.com/abstract 1082513*, last visited 20 August 2011.

[7] M. B. Fox, "Civil Liability and Mandatory Disclosure", *Columbia Law Review* 2/2009, 16 17, *http://ssrn.com/abstract 1115361*, last visited 20 August 2011; J.R. Brown, Jr., "Corporate Governance and Corporate Disclosure", Working Paper 09 10, 2B 5, *http://ssrn.com/abstract 1396353*, last visited 20 August 2011.

[8] Thus, with regard to company law, information is disclosed at the assembly or in annual reports, while, with regard to the capital market law information is disclosed through the market and sometimes also on Internet site of the company, as is the case with disclosure in the company law. See K. Engsig Sørensen, "Disclosure in EU Corporate Governance A Remedy in Need of Adjustment", *European Business Organization Law Review* 2/2009, 258 259.

[9] Directive 2003/6/EC of the European Parliament and of the Council of 28 Janu ary 2003 on insider dealing and market manipulation (market abuse), *OJ L* 96, 12/04/2003, 16 25; Regarding the character of the information on change of major holdings see Z.

The unique concept of inside information for the notion of public disclosure and insider dealing has been adopted in Serbian and EU law. It is necessary to define public disclosure of inside information in order to decide on whether it is advisable to separate the notion of inside information and limit the issuer's broad discretion with regard to the issue of delaying public disclosure.

2. DEFINITIONS

2.1. Definition of Public Disclosure

Public disclosure of inside information is a form of *ad hoc* disclosure, given the fact that it is not possible to determine in advance the time when the duty to disclose arises in the sense of its concretization. It could also be categorized as continuous disclosure, bearing in mind that the duty to disclose exists as long as the company itself.[10] By its character, it belongs to mandatory disclosure, because of legal obligation of such disclosure in the fulfillment of prescribed conditions, as opposed to the vol-

Arsić, "Insider Trading", *Pravo i privreda* [*Law and Economy*] 1 2/1996, 45; Directive 2004/109/EC of the European Parliament and of the Council of December 15, 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, *OJ L* 390, 31/12/2004, 38 57, Article 9; See also S. Grundmann, F. Möslein, *European Company Law Organization, Finance and Capital Markets*, Antwerpen Oxford 2007, 432 437; Regarding disclosure in the case of takeover see Article 6 (1 2) and Article 8 of the Directive 2004/25/EC of the European Parliament and of the Council of April 21, 2004 on takeover bids, *OJ L* 142, 30/04/2004, 12 23, and S. Grundmann, F. Möslein, 604 606.

[10] Disclosure from the Directive on Market Abuse some authors also call a continuous disclosure or ongoing duty to disclose. See J.L. Hansen, D. Moalem, "The MAD disclosure regime and the twofold notion of inside information: the available solution", *Capital Markets Law Journals* 3/2009, 323; C. Di Noia, M. Gargantini, "The Market Abuse Directive Disclosure Regime in Practice: Some Margins for Future Actions", *Rivista delle società* 4/2009, 6, *http://ssrn.com/abstract 1417477*, last visited 20 August 2011. A division can also be made into disclosure at the primary market, secondary market, i.e. periodic disclosure and *ad hoc* disclosure, see E. Člinovic Herc, (2009), 135. In the law of the United States there is no identical duty because the issuer has the duty to disclose information periodically and to disclose information about certain events, which further means that the issuer from the US would have to disclose the information earlier than it would be the case under the law of the US, if its shares were quoted at regulated EU market. See E.F. Greene, "Resolving Regulatory Conflicts between the capital markets of the United States and EU", *Capital Market Law Journal* 1/2007, 25. See 8 K form of United States Securities and Exchange Commission, *http://www.sec.gov/about/forms/form8 k.pdf*, last visited 20 August 2011. Duty to disclose arises in three cases: in case of disposing of own shares, when the omission is necessary to prevent the statement from misleading the public and when such a duty is determined by law or rule. See M. Cain, "Corporate Law Securities Fraud Impact of *In re Time Warner* on Corporate Information Management: Hyping One Business Strategy May Give Rise to a Duty to Disclose an Alternate Strategy Under Rule 10b 5", *South Texas Law Review* 4/1994, 761.

untary disclosure that depends on the willingness of the issuer. There have been many theoretical debates as to whether disclosure should be mandatory or not. Although expensive for the issuer, it reduces the costs of investors in their search for information because of the fact that each investor has to find the information first in order to make sure that it is correct.[11] Afterwards, the analysis of the information itself is carried out and only then a decision is made whether to invest or not. Therefore, the disclosure is significant for competitors – to be aware of their own position in the market, for creditors, employees, suppliers and consumers – to improve their position in negotiations, also for investors – to evaluate whether they should purchase securities or not, and ultimately for the shareholders – to decide whether they still want to stay shareholders or they want to sell their shares and thus leave the company.[12] If the disclosure of inside information were voluntary, the decision to disclose would be adopted by the management of the company. Thus, depending on the type of inside information (e.g. if it was negative and showed the inability of management to lead the company properly or that members of the management would gain profit using the ignorance of another), management could often decide not to disclose inside information. It can be concluded that the disclosure of inside information has to be mandatory for the above-mentioned reasons.

A division can also be made on the basis of the manner of disclosure of inside information – written and oral. In regards to the manner of disclosure, posting of inside information on the Internet site of the issuer is compulsory and other means of disclosure can also be set forth.[13] Making written disclosure mandatory is the only acceptable solution bearing in mind the nature of disclosure, i.e. the fact that it is reported to the public. In conclusion, disclosure of inside information presents *ad hoc* reporting to the public, which is mandatory during the issuer's business operations pursuant to the law.

2.2. Definition of Inside Information

In general, information has to arise at some point, and it is then inevitable that a small circle of people becomes aware of it.[14] The information is necessary for all above-mentioned persons; thus, information through disclosure is a method of teaching these people.[15] The term in-

[11] See Z. Goshen, G. Parchomovsky, "The Essential Role of Securities Regulation", *Duke Law Journal* 4/2006, 737.

[12] *Ibid*., 756.

[13] Market Abuse Directive, Article 6 (1) (2).

[14] See E. Engle, "Insider Trading: Incoherent in Theory, Inefficient in Practice", *Oklahoma City University Law Review* 1/2008, 503.

[15] Information (lat. *informatio*) is teaching, referencing, instruction, notice, notification, etc. See Milan Vujaklija, *Leksikon stranih reči i izraza* [*Lexicon of Foreign Words and Phrases*], Belgrade 1991, 353.

side information is a central concept of two different legal notions which, to a certain extent, have the same goal – notion of insider dealing and notion of public disclosure of inside information. Concerning that these are two different notions, the question is posed whether such information is defined in the same way with regard to both notions and whether it should be the case.

Duty to disclose inside information in Serbia is regulated by the Capital Market Act.[16] Compared to the previous Act which regulated this field, the Securities and Other Financial Instruments Market Act, one of the novelties is that the new Act determines its objectives, namely*: protection of investors, ensuring* fair, efficient and *transparent market* and reduction of systemic risks in the capital market (Italic by the author).[17] In the new Act, the term inside information is used instead of privileged information that was used in the old one. It is defined as information on precisely specified undisclosed facts that directly or indirectly relates to one or more issuers or to one or more financial instruments which would, if they were disclosed in public, probably have significant effect on the prices of those financial instruments or related derivative financial instruments.[18] Thus, the information must meet four conditions to be considered as inside information. The first one is that it must not be disclosed; the second is that it refers to a precisely specified fact; the third is that this fact relates, directly or indirectly, to one or more issuers or one or more financial instruments; and lastly is that it has to be price sensitive, i.e. that the disclosure thereof would probably have significant effect on the prices of those financial instruments.[19] The Capital Market Act also defines significant effect on the price that exists if a reasonable investor would probably take into account the inside information as part of the basis for making investment decisions, i.e. to buy or sell a financial instrument. In order for the fact to be considered precisely defined, two cumulative conditions have to be fulfilled: 1) that it is about a set of cir-

[16] Capital Market Act (hereinafter in footnotes referred to as CMA), *Official Ga zette of Republic of Serbia*, No. 31/11. Application of this Act is postponed for 6 months from the date of its entry into force.

[17] CMA, Article 1 (2); Securities and Other Financial Instruments Market Act, *Official Gazette of Republic of Serbia*, No. 47/2006.

[18] CMA, Articles 2 (46) and 75 (1). The same definition is also in Article 1 (1) of the Market Abuse Directive.

[19] See M. Vasiljević, *Kompanijsko pravo* [*Company Law*], Belgrade 2011, 408; J. Lepetić, "O pojmu *insider* a u pravu Sjedinjenih Američkih Država" ["About the Concept of Insider in the Law of the United States of America"], *Pravo i privreda* [*Law and Economy*] 4 6/2010, 161 162. On the concept of inside information see K.J. Hopt, "The European Insider Dealing Directive", *Common Market Law Review* 27/1990, 57 61; S. Bunčić, 15 18. In the US law, disclosure of material information is mentioned, i.e. infor mation that would be of significance to the investors due to the effect of such information on the price of securities, see D. C. Langevoort, M. G. Gulati, "The Muddled Duty to Disclose Under Rule 10b 5", *Vanderbilt Law Review* 5/2004, 1644.

cumstances[20] or an event, i.e. more precisely, a *set of circumstances* that exists or *may be reasonably expected to come into existence*, or an event that has already occurred or *may be reasonably expected to occur* (Italic by the author); 2) the information is identifiable enough so that it can bring a conclusion on the possible effect thereof on the prices of financial instruments. Thus defined inside information satisfies the need for application of the notion of insider dealing. With regard to derivatives on commodities, inside information is separately defined as information on precisely specified undisclosed facts, which directly or indirectly relate to one or more such derivatives, which market users would expect to receive in accordance with established market practices in those markets. Notable difference from the general definition of inside information is the fact that not only is the effect on price not mentioned but also the concept of established market practice is introduced.[21] Regarding the persons responsible for the implementation of client orders, inside information is also specifically defined, but the effect on price is mentioned in this case.[22]

Concerning the notion of public disclosure of inside information from Article 79 of the new Capital Market Act, the situation is somewhat different. The difference in establishing the definition of inside information with regard to these two notions is contained in the fact that, in terms of the notion of disclosure, the inside information may relate only directly to the issuer in order for the mentioned duty to arise, which is not the case with inside information in terms of the notion of insider dealing.[23] The above restriction is reasonable because one cannot expect the issuer to disclose information that would affect the prices of its securities and that do not depend on the issuer nor come from it, such as financial crisis in the country where the company is registered or the Central Bank decision on interest rates.[24] On the other hand, if a company opened a new plant or appointed a new director or if a merger with other compa-

[20] Concerning a set of circumstances, inside information is a group of information, where each of them is not inside information itself. See C. Di Noia, M. Gargantini, 12 fn. 54.

[21] CMA, Article 75 (3 6). The European Commission also recognizes non men tioning the effect on price of financial instruments as a problem. See Working document of the European Commission, Public Consultation on a Revision of the Market Abuse Directive MAD, 25 June 2010, 4, *http://ec.europa.eu/internal market/consultations/docs/2010/mad/consultation paper.pdf*, last visited 20 August 2011.

[22] CMA, Article 75 (7).

[23] Also C. Di Noia, M. Gargantini, 8.

[24] As well as M. Siems, "The EU Market Abuse Directive: A Case Base Analy sis", *Law and Financial Market Review* 2/2008, 12, *http://ssrn.com/abstract 1066603*, last visited 20 August 2011. There is also a division of information into untested, unsafe or soft information as, for example, projections, opinions, analyses, and statements on proven facts or hard information. See J.E. Kerr, "A Walk through the Circuits: The Duty to Disclose Soft Information", *Maryland Law Review* 4/1987, 1071.

nies would take place that would have a direct influence. This is the only difference provided by Serbian law, but is it sufficient?

2.3. Definition of Insider Dealing

It is necessary to briefly define insider dealing for greater clarity of this paper in general. It has already been stated that inside information is not only the central concept of the notion of public disclosure but also of insider dealing. Insider dealing is defined in Capital Market Act as a use of inside information by acquiring or disposing of financials instrument to which that information relates or trying to acquire or dispose of the same, directly or indirectly by insider for his/her own account or the account of a third person.[25] The time of the use of information is before the time of its disclosure. By abusing inside information, insiders try to make a profit or avoid a loss.[26] The purpose of banning the abuse of inside information is above all to ensure investors' confidence in financial markets.

3. THE PROBLEM OF ANTICIPATING FUTURE EVENTS

3.1. Formulation of the problem

Is it justified to require from an issuer to publicly disclose inside information which presents a set of circumstances which still does not exist but for which it may be reasonably expected that it will come into existence or an event which has still not occurred but may be reasonably expected to occur? According to the Capital Market Act, there is no difference between inside information for the needs of the notion of insider dealing and the one for needs of public disclosure. There is a possibility that this difference would be made in a by-law regarding the information to be taken into account in deciding upon disclosure, to be adopted by the Serbian Securities Commission. The said distinction should be made for many reasons. Public disclosure of uncertain and unverified information which has not come into effect, could lead to serious consequences and have little benefit. If the set of circumstances or the event does not come into existence, the following situations could occur: a company would have to disclose new information that would disprove the old one which would certainly cause costs for the company; numerous court cases could arise, in which the investors could claim they were misled, because their reached and implemented investment decisions were a consequence of

[25] CMA, Article 76.

[26] See N. Jovanović, *Berzansko pravo* [*Stock Exchange Law*], Belgrade 2009, 413.

something that was officially announced but in fact did not happen; investors' confidence in a particular company could be quite destabilized, which in turn could lead to a decrease in prices of its shares; an issuer who does not know how to act might seek the opinion of the Securities Commission, which would additionally burden the its work and would definitely lead to prolonged disclosure; issuers would use the possibility of delaying public disclosure more often in order to avoid possible costs and responsibility; disclosure itself could change the course of events. The only potential benefit from disclosure in this phase would be the early supply of information to all market participants which would prevent an insider from making a profit, as he/she would not be in the possession of inside information any longer. On the other hand, penalties for insider dealing, obligation to draw up lists of insiders and duty to notify the competent authority on the existence of transactions are sufficient instruments of protection in this regard. Therefore, the previous argument is not sufficient to deem disclosure of unverifiable information justified.

The disclosure of major new developments was regulated by the old Securities and Other Financial Instruments Market Act. The phrase "once a set of circumstances comes into existence" which was contained in Article 64 clearly indicates that the duty to disclose did not comprise future events. The answer to the question of how and why the situation has been changed by the Capital Market Act should be looked for in EU law. Public disclosure of inside information in EU law is regulated by the Market Abuse Directive which has adopted the unique concept of inside information for the notion of public disclosure and insider dealing.[27]

[27] Distinction between the two notions has not been made in Article 6 (1) of the Market Abuse Directive, which regulates the duty to disclose inside information, nor in Article 79 (1) of the Serbian Capital Market Act. The unique concept of inside informa tion for both insider dealing and public disclosure has been interpreted in different ways in EU member states, which resulted in many attempts to solve this problem in theory. See the Report of European Securities Markets Expert Group ESME, Market abuse EU legal framework and its implementation by Member States: a first evaluation, Brussels, 6 July 2007, 5, *http://ec.europa.eu/internal market/securities/docs/esme/mad 070706 en. pdf*, last visited 20 August 2011. In the Report of European Securities Markets Expert Group from 2007 a suggestion was made that the definition of inside information with regard to the issue of public disclosure was clarified, or that certain amendments to the regulation of delaying public disclosure were made. EU sources of law regulating public disclosure of inside information consists of: Market Abuse Directive, Commission Direc tive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the Euro pean Parliament and of the Council as regards the definition and public disclosure of in side information and the definition of market manipulation, *OJ L* 339, 24.12.2003, 70 72, Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspi cious transactions, *OJ L* 162, 30.04.2004, 70 75, Committee of European Securities Reg ulators (CESR), Market Abuse Directive, Level 3 Second set of guidance and informa

3.2. Distinguishing the notion of inside information

It seems logical that the prohibition of the abuse of inside information occurs before the obligation to publish the information. A possible scenario could be that a secretary of a company's management board director attended a part of the director's meeting with another company's director about a possible merger of the two companies. The secretary heard a sentence in which the director said that a merger with that company would be very desirable and that he/she would do his/her best to make it happen. The directors led an informal discussion and an agreement was made that they would be in touch. Bearing in mind that the secretary had worked for the director for a long time, based on her experience, she assumed that the job would be completed successfully. The whole set of these and other circumstances (e.g. it is a single-member company; the directors of companies negotiating are in family ties) makes the secretary, who is in hold of the inside information, a primary insider. From that moment, she must not abuse this information, but it could not be claimed that this is the moment when the duty to disclose information on a possible merger of the two companies arises under the Capital Market Act. The fact that the secretary would have to risk, to a certain extent, to make her investment decision cannot absolve her of the liability because she has an informational advantage over the other contracting party.[28] Duty to disclose for the company arises significantly later, i.e. after preparing a draft contract that the company is obliged to publish on its website and deliver to the register of economic entities not later than one month prior to the meeting of the Assembly in which the decision on the merger is brought under the new Company Act.[29] It could be argued that the duty to disclose does not arise until the start of implementation of work planning, negotiations, etc.[30] It is true that every disclosure prevents insider dealing because the inside information thus loses its inside character. Nevertheless, the purpose of prescribing the duty to disclose in the Market Abuse Directive in Article 6 (1) is not to prevent insider dealing only, because this is achieved by prescribing the prohibition of trade in

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tion on the common operation of the Directive to the market, ref: CESR/06 562b, *http://www.esma.europa.eu/popup2.php?id 4683*, last visited 20 August 2011, Committee of European Securities Regulators (CESR), Market Abuse Directive, Level 3 Third set of guidance and information on the common operation of the Directive to the market, ref: CESR/09 219, *http://www.esma.europa.eu/popup2.php?id 5727*, last visited 20 August 2011.

[28] See also J.L. Hansen, D. Moalem, 331.

[29] See Company Act, *Official Gazette of the Republic of Serbia*, No. 36/11, Article 495. This Act shall apply as of 01 February 2012, except for Article 344 (9) and Article 586 (1) (8) that shall apply as of 01 January 2014.

[30] H. Krause, "The German Securities Trading Act (1994): A Ban on Insider trad ing and an Issuer's Affirmative Duty to Disclose Material Nonpublic Information", *Inter national Lawyer (ABA)* 3/1996, 584.

financial instruments, referred to in Article 2 (1) and Article 4, and prohibition of selective disclosure from Article 3 of the Directive.[31]

The definition of inside information, i.e. the part relating to the precisely specified facts from Article 75 (5) of the Capital Market Act has been taken from Article 1 (1) of the Directive No. 124/2003. The obligation of Member States to ensure that issuers comply with their duty concerning disclosure with regard to a set of circumstances or an event that was not yet formalized is provided for in Article 2 (2) of that Directive which relates to the time of disclosure of inside information. Such disclosure must ensue promptly after the occurrence. This Article does not mention a set of circumstances that still does not exist but can be reasonably expected to exist or an event that did not occur but can be reasonably expected to occur as it the case in Article 1 (1) of the same Directive and in Article 75 (5) of Serbian Act. It can be concluded that the notion of inside information is different in relation to the concept of insider dealing and in relation to the disclosure of inside information because the notion is narrower in the latter where it refers only to an event or set of circumstances which has occurred although it has not been formalized.[32] If there has already been a selective disclosure of inside information, duty to disclose a set of circumstances or an event that has still not occurred will arise. This is the case where the issuer or a person acting on its behalf reveals inside information to a third party in the normal course of the exercise of their employment, profession or duties, because then the issuer has a duty (unless the information was discovered to a person that has a duty to maintain confidentiality, for example, a physician regardless of the basis for this duty) to disclose such inside information as well as in the case when the governing authority orders so in the exercise of its powers in order to allow adequate public information.[33] There is another difference which is of minor importance at first sight but can be significant in practice. The Market Abuse Directive, in Article 6 (1), provides the duty for an issuer to disclose inside information "as soon as possible", while Serbian law uses the phrase "without delay" in Article 79 (1) of the Capital Market Act. Furthermore, the Directive No. 174/2003, in the above-mentioned Article 2 (2), uses the term "promptly" which, according to some authors, is not accidental because the Market Abuse Directive mentions events that have not occurred, which is an additional argument

[31] See J.L. Hansen, D. Moalem, 331; S. Grundmann, F. Möslein, 469 470. On the other hand, some authors consider it the best form of fight against insider dealing, for example, E. Čulinović Herc, (2009), 148, or prevention of insider dealing and means to achieve allocative efficiency of capital markets, for example, M. Siems, 12.

[32] See J.L. Hansen, D. Moalem, 329.

[33] See Capital Market Act, Article 82 and Market Abuse Directive, Article 6 (3) (1 2) and Article 6 (7). See J.L. Hansen, D. Moalem, 338 339.

for the previous claim.[34] In any case, if there is a significant change in the already published inside information, for example, a contract is not signed after all, meaning that there was no formalization but the obligation of disclosure did occur and where there was no legitimate interest to delay disclosure, the issuer is obliged to disclose the new information immediately upon the occurrence of such change.[35] The issue of negotiations and the contract itself is a subject matter of contract law, and accordingly, this interpretation would create a need for special understanding of the contract, with a view to distinguish between the finalization of negotiations, i.e. a formal closure of a contract and the moment when it is already clear that the contract will be concluded, which would further mean that the closure of the contract would have a special meaning in the field of capital markets law, which would, at least, complicate the situation.[36]

Theoretically, it could be argued that the time when the duty to disclose occurs precedes the time of realization of the duty to disclose thus the uniformity of the concept of inside information is not brought into question, that is, Article 2 (2) of Directive No. 124/2003 does not aim to define inside information itself for the needs of the notion of disclosure but rather only the time of disclosure of inside information.[37] It seems that this explanation has no practical significance because if it is claimed that inside information is uniformly defined and that it refers to an event or set of circumstances that has still not occurred, while an obligation of disclosure of inside information exists, then the whole notion of disclosure would in fact refer only to a part of inside information because some of the events to which the information refers would never be realized. It is true that it is all about the moment, not the subject of disclosure as the main problem. However, it is also a fact that this subject can also change in the meantime. If it were claimed that all inside information had to be disclosed, then unsafe information would also have to be disclosed as well as the changes that would occur subsequently as a form of its correction. In this case, the whole concept of disclosure would be an excep-

[34] See J.L. Hansen, D. Moalem, 329. More details on the problem of defining the terms immediately, as soon as possible or without delay are available in: T.M.J. Möllers, "The Immediateness of *Ad hoc* Disclosure Statements in the Context of National and European Legal Doctrine", *International Company and Commercial Law Review* 11/2007, 373 376.

[35] See Directive 124/2003, Article 2 (3).

[36] See J.L. Hansen, "A Stricter duty to Disclose Information to the Market in Den mark", *European Company Law* 2/2008, 48. In the Nordic legal systems the "reality prin ciple" is known, according to which information should not be disclosed before it can be safely said that, for example, event to which this information applies will really occur. This principle was accepted in the Danish law thus a dispute arose whether it was contrary to the Market Abuse Directive and Implementing Directive 124/2003. *Ibid.*, 55.

[37] C. Di Noia, M. Gargantini, 12 13.

tion. In fact, regardless of possible theoretical setting, inside information is a different notion in terms of its usage for the two concepts. It can be concluded that all of the above information is inside, while some of it is suitable for disclosure and some is not. Although, in general, all inside information must be disclosed, if some of it is not realized in material terms, i.e. if it does not grow into an event, the disclosure will not occur. In any case, regardless of the accepted concept, it will have only theoretical significance.

Liability for failure to fulfill the duty to disclose or improper fulfillment in terms of contents and manner of disclosure is also in close connection with the duty to disclose non-verifiable, i.e. uncertain inside information. The issue of liability in case of disclosure of inside information that has changed is particularly important with regard to the problem of anticipating future events and the subsequent duty to disclose those changes.[38] Any tightening of liability, especially liability for disclosure of incorrect information (announcement that something will happen – and it does not happen, is an incorrect information for investor) could lead to reduction in the volume of voluntary disclosure thus to the lack of information and certainly to a delay in disclosure with a view to avoid sanctions and disputes.[39] In this respect, this is another argument for the need of splitting the notion of inside information.

4. DELAYING DISCLOSURE

4.1. Conditions

Under Serbian law, issuers are given the opportunity to delay the public disclosure of inside information on their own responsibility under three conditions: 1) if such disclosure would jeopardize their legitimate interests (closer circumstances which indicate the existence of a legitimate interest will be defined by the Commission in the new rulebook which is yet to be adopted);[40] 2) if the public would not be misled in this

[38] On responsibility with regard to disclosure in Serbian law see: N. Jovanović, "Izveštavanje o poslovanju akcionarskog društva" ["Reporting on Joint Stock Company's Business"], *Korporativno upravljanje drugi deo* [*Corporate Governance Second Part*], (eds. M. Vasiljević, V. Radović), Belgrade 2009, 201. For comparative legal solu tions see E. Čulinović Herc, (2009), 152 156.

[39] See U. Noack, D. Zetzsche, "Corporate Governance Reform in Germany: The Second Decade", *European Business Law Review* 5/2005, 1050.

[40] At the moment, the Rulebook on Contents and Manner of Reporting of Public Companies and Reporting on Possession of Voting Shares, *Official Gazette of the Repub lic of Serbia*, No. 37/09, 100/06 and 116/06 and the Rulebook on the Sale of Securities to which Inside Information Relates, *Official Gazette of the Republic of Serbia*, No. 100/06 and 116/06 are still in force. Article 11 of the latter Rulebook provides for the obligation

manner and 3) if issuers can ensure confidentiality of that information.[41] The Securities Commission has no authority to decide whether an issuer may delay disclosure but an issuer is obliged to inform the Commission of its decision to delay disclosure of inside information without delay. Under the old Securities and Other Financial Instruments Market Act, the Commission had more powers, i.e. it made decisions on termination of obligation of disclosure on important events at an issuer's request, which meant that the issuer could not make a decision to delay the disclosure itself.[42] The existing legal solution in Serbian law is fully compliant with provisions from Article 6 (2) of the Market Abuse Directive. In EU law the answer to the question, what the legitimate interests for delaying the disclosure of inside information are, is given in Article 3 of the Directive No. 124/2003 where two examples are provided – one relating to negotiations and other concerning decisions or contracts concluded by the company's management which must be approved by another authority in the company.[43] Another question here is whether a situation in which it is upon the issuer itself to decide on whether to delay the disclosure presents sufficient protection. It is possible that there would be some changes in this respect, i.e. that there would be restrictions on such a broad discretion provided to the issuer.[44]

Bearing in mind that the moment when the duty to disclose inside information arises has already been defined, it can be concluded that the possibility to delay the disclosure occurs only after the duty to disclose has arisen. The delay is possible only when there is an adequate level of safety, i.e. that an event or a set of circumstances has arisen but has still not been finalized. The closure of the contract through which the company would overcome the financial crisis would present an event which ought to be published before its finalization, i.e. before it is signed but not

of the issuer to submit a request to the Commission for exemption from the obligation to disclose any major new developments when there are legitimate reasons, meaning that disclosure would seriously endanger the company's business operations. Disclosure of major new developments is regulated by Article 64 of the old Securities and other Finan cial Instruments Market Act. On disclosure of major new developments see P.L. Davies, *Gower and Davies' Principles of Modern Company Law*, London 2003, 591.

41 See Capital Market Act, Article 81.

42 Compare Capital Market Act, Article 81 (2) and old Act, Article 64 (5).

43 The latter example is particularly significant in legal systems with two tier boards, due to the existence of managing and supervisory boards. See Edita Čulinović Herz, "Zlouporabe na tržištu vrijednosnih papira nova europska smjernica i Zakon o tržištu vrijednosnih papira" ["Abusive Transactions on Securities Market New EU Di rective on Market Abuse and Croatian Law on Securities Market"], *Zbornik Pravnog fakulteta Sveučilišta u Rijeci* [*Collected Papers of the Law Faculty University of Rijeka*] 2/2004, 766.

44 See European Commission Working Document entitled: Public Consultation on a Revision of the Market Abuse Directive, 25.06.2010, 14.

during the negotiations or, for example, closure of a pre-contract, because it could undermine the closure of the contract, i.e. lead to withdrawal of the other contracting party thus threatening the survival of the company (in case of fulfillment of the requirements for initiating bankruptcy proceedings the delay cannot occur).[45] As for the condition relating to the issuer's ability to ensure confidentiality of information is concerned, its fulfillment is assessed in consideration of the following: whether the issuer controls the access to information, i.e. whether the issuer has taken effective measures to prevent the access to inside information to persons who do not need it for the exercise of their employment within the issuer; whether the issuer has taken measures to ensure that the person who has access to that information is made aware of his/her duties and possible sanctions; and whether the issuer is able to immediately disclose information if it fails to ensure its confidentiality.[46] Looking at the whole situation, it can be concluded that the disclosure of unsafe inside information will not occur in most cases. The question is whether it is justified to delay the disclosure of inside information if a large number of employees have that information, even though it is for the purpose of regular work performance. It is then questionable whether the issuer can ensure the confidentiality of information at all, since that many persons already have it. In fact, the permitted selective disclosure of information without real constraints occurs in this case, which in turn increases the possibility of insider dealing.[47] The idea of restricting the selective disclosure to employees or disabling delay of disclosure should be at least considered in this case.

4.2. The problem with rumors and relationship with "leaked" information

As previously noted, one of the conditions for the delay of disclosure of inside information to be allowed is that it would not mislead the public. The question is how to interpret this condition. For example, there were rumors that a company was performing a research with a view to introducing new technology in order to reduce production costs and to lower prices of final products thus gaining advantage over its competitors. The research proved successful on the basis of the first results but a large number of experiments were still needed to safely argue that it was not harmful, that the products were at least as good as before and so on. The information that the research had a positive outcome would certainly be the inside information. However, there would be no difference be-

[45] See Directive No. 124/2003, Article 3 (1).

[46] See Directive No. 124/2003, Article 3 (2).

[47] See more in C. Di Noia, M. Gargantini, 19 20.

tween the rumor and the inside information to investors, since they could not know whom the information originated from. For the purposes of this study, rumors as unverified information are being defined.[48] Their existence in the market is unavoidable.[49] The rumors may circulate for at least three reasons: firstly, because the information has "leaked"; secondly, because someone has guessed it right; and thirdly, because someone has deliberately let such rumors (for example, competitive company in order to provoke the subject issuer to comment because it performs similar research). Overall, rumors may arise from the within the company or outside of its sources.

It is necessary to divide unverified information into rumors not originating from the company and to "leaked" information relating to inside information that comes from the company, which is again not relevant from investor's perspective because investors cannot know which one it is.[50] It is logical that the disclosure and the issuer's comments refer only to "leaked" information, but how does the company itself know whether the information originated from its source or not? Therefore, the issuer must not delay the disclosure of information if it has "leaked", because the issuer failed to ensure its confidentiality. In this way the situation with "leaked" information is adequately regulated.

The situation is different with rumors, i.e. unverified information, with a source outside the company. There is currently no duty to comment the rumors on the basis of above Directives regardless of whether they suit the actual situation, i.e. whether they are true or not. Despite the lack of duty, issuers are likely to voluntarily comment on false rumors if they adversely affect the price of its shares, but may choose not to do so if they are favorable to them. Arguments in favor of obliging the issuers to comment on false rumors given the fact that investors may be misled are: 1) investors do not distinguish between rumors and "leaked" information and 2) issuers have no interest to comment on false rumors that are favorable to them. According to CESR guidelines, the issuer, in principle, has no obligation to comment on rumors or speculations, including false rumors, which are, for example, published in a newspaper article or on the Internet but not by the issuer, unless the information is precise enough to indicate that it is a "leaked" information.[51] Another problem is

[48] See J.L. Hansen, D. Moalem, 326.

[49] See K.J. Hopt, 59.

[50] See J.L. Hansen, D. Moalem, 326 327.

[51] See the Second Set of CESR Guidelines from 2007, 4 5 and the Third Set of Guidelines from 2009, 14 15. In the case of Electronic Specialty Co. v. International Controls Corp., the Court stated that the issuer is not required to give a statement to refute the claim of the magazine, while the U.S. Commission for Securities took a different stance regarding rumors in some cases. See D.J. Block, N.E. Barton, A.E. Garfield, "Af

to define the notion of enough precise information, therefore the solution used is the same as the one used for defining inside information.

If a rumor is false, it certainly misleads the public. One possible solution to the situation when there are false rumors in the market could be to prescribe the obligation for a company to make a statement and deny such rumors or at least to introduce the prohibition of delay of disclosure in this case. On the other hand, this would preset an additional cost and a burden to the company to monitor rumors. Moreover, the company would not have any interest in doing so, especially if the false rumor was positive for the company. The strongest argument against this solution is that there is adequate legal protection in the field of market manipulation.

If the rumors were correct, it would, regardless of their source, be unjustified to require the company to make a statement, because the abuse could be significant and the benefit would be small as in the example with a competitive company. On the other hand, the fact that rumor was correct would indicate that this was a "leaked" information as confidentiality was not ensured, and if it were incorrect then it should not be commented because the issuer was not a likely source.[52] In any case, a rule that would clearly establish (non)existence of this obligation in a single way would be useful. If it were left to issuers to decide whether they would comment on rumors or not, they would act in line with their own interest, and would thus deny the information if it were negative for them or not so if the information were positive even though inaccurate.[53] If a denial statement were prescribed, or if the rumor were correct but imprecise and not from the company and if there were no possibility to delay the disclosure, it could be disastrous for the company (for example, in a financial crisis because that would impair the company's ability to "pull out"). In a broader sense, an investor is misled as soon as the disclosure is delayed, especially if the information is negative, and the investor buys shares of the company during that time because the investor does not know that the disclosure is delayed.[54] Such an exception must exist, because it would not be possible to ensure normal business operations of companies, which is not in favor of shareholders or investors, as they would not have a reason to invest in that case. Having considered all the arguments, it seems that the best solution is to keep the practice of non-commenting.

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firmative Duty to Disclose Material Information Concerning Issuer's Financial Condition and Business Plans", *Business Lawyer (ABA)* 4/1985, 1253.

[52] This is how it is done in Great Britain and Spain. See C. Di Noia, M. Gargan tini, 25 26.

[53] For division of inside information to positive and negative see J. Lepetić, 162 163.

[54] See C. Di Noia, M. Gargantini, 23.

5. CONCLUSION

Public disclosure of inside information, i.e. reporting to the public on inside information is necessary to all market participants in order to make economically rational investment decisions, which is a precondition for the existence of efficient market. Disclosure is a subject matter of study by both, company law and capital market law, which makes it very significant. The range of persons who could use such information is very wide as it includes shareholders, investors, competitors, creditors, employees, suppliers and consumers.

Public disclosure of inside information can be defined as a type of *ad hoc* reporting to the public which is required in the period of the issuer's business operations pursuant to the law, given the fact that it is not possible to determine in advance the time when the duty to disclose arises. On the other hand, this type of disclosure is categorized as continuous disclosure since the duty to disclose exists as long as the company itself.

Inside information is the central concept of the notion of public disclosure of inside information as well as of insider dealing. In EU law the unique concept of inside information has been adopted for both notions. Inside information is information on precisely specified undisclosed facts, which directly or indirectly relates to one or more issuers or to one or more financial instruments which would probably have significant effect on the prices of those financial instruments or on the prices of related derivative financial instruments, if they were disclosed to public. The problem arises due to the part of the definition concerning the unique definition of precisely specified facts that the information relates to, which is one of the conditions for the information to be considered as the inside one because it includes a set of circumstances that still does not exist, i.e. an event that has not occurred yet. Such a definition meets the needs for the notion of insider dealing but not for the notion of public disclosure of inside information due to the problem of anticipating future events. It is necessary to make that distinction because the anticipated set of circumstances need not necessarily occur, nor the event must come into existence, no matter how likely it seemed at the time when the duty to disclose arose due to several previously mentioned reasons. The grounds for the statement that the difference should also exist in relation to future events can be found in EU law, in the Directive 2003/124/EC implementing Market Abuse Directive. Given the fact that anticipation refers to the result of negotiations and that it is the crucial moment in the closure of a contract, a need to separate the definition of the concepts of negotiations and contracts would arise for the capital market law needs, which would further complicate the situation and disturb the cohesion of the legal system. The difference in establishing the definition of inside information with regard to these two notions is contained in the fact that inside infor-

mation may relate only directly to the issuer in order for the mentioned duty to arise in terms of the notion of disclosure, which is not the case with inside information in terms of the notion of insider dealing, in line with both Serbian law and EU law. For this reason, the concept of inside information is narrower in case of the notion of disclosure than in terms of the notion of insider dealing. It is true that, in the case of earlier disclosure, all the market participants would be provided with the same information which would prevent an insider from making a profit. However, the penalties for insider dealing, obligation to draw up lists of insiders and duty to notify the competent authority on the existence of transactions are sufficient protection instruments in this regard.

Another serious problem is the issue of liability of the issuer concerning the disclosure, bearing in mind that investors could be misled due to the significant change of the situation. In order to avoid penalty the issuer may delay disclosure, which would ultimately mean that the exception became the rule. The aforementioned is also contributed by the broad discretion of the issuer, which does not need permission to delay the disclosure. Accordingly, a limitation of this right should be at least considered.

The situation wherein there is reasonable duty to disclose a set of circumstances or events that have still not occurred exists in the case when selective disclosure of inside information has already occurred and when it is ordered by the competent authority in exercising of its competences in order to provide for adequate public information. If the information is received by a large number of people for the purpose of carrying out their duties, regardless of the duty of confidentiality, probability that the inside information will be used increases. Consequently, the need of restricting the allowed selective disclosure should be considered too.

Prohibition of delaying public disclosure in case of "leaked" information is an adequate response to that problem, since it can be considered as a form of penalty for the issuer who failed to ensure the sufficient confidentiality of inside information. A different situation is with rumours which are considered to be unconfirmed information whose source is outside the company. Practice of non-commenting is the most acceptable solution, especially given the existing protection in case of market manipulation, but it would be useful to provide for such rule in the secondary legislation in order to solve existing dilemmas.

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THE RIGHT TO AVOID THE CONTRACT

The article focuses on the right to avoid the contract under the CISG. It explores the concept of fundamental breach and its application to cases of seller's as well as buyer's breach. Limits of the right to avoid such as notice requirement, time limits and restitution of the goods are also discussed.

Key words: *CISG Avoidance of contract Fundamental breach Notice Restitution of the goods.*

1. INTRODUCTION

At first sight, there is hardly any agreement between different legal systems as to when a party may avoid the contract because its performance has been disrupted. Not only do they adopt divergent views on the means by which it is to be avoided – by court decision, by one party's simple declaration or *ipso iure* – but in particular, different approaches can be found as regards the preconditions for avoidance, particularly what significance is to be attached to the fault of the party in breach. However, a thorough comparative analysis reveals that under most legal systems it is decisive whether the breach reaches a certain level of seriousness.

This is also the starting point of the CISG. Avoidance is regarded as a remedy of last resort, an *ultima ratio* remedy.[1] Only if the aggrieved

[1] M. Müller Chen, "Art. 49", *Schlechtriem & Schwenzer: Commentary on the UN Convention on the International Sale of Goods (CISG)* (ed. I. Schwenzer), Oxford University Pres, Oxford 2010[3], para. 2; *e.g.* Bundesgerichtshof, 3 April 1996, CISG online 135; Oberster Gerichtshof, 7 September 2000, CISG online 642; Landgericht München, 27 February 2002, CISG online 654.

party cannot be adequately compensated especially by damages may it declare the contract avoided. The reason for this restrictive approach is that avoidance is the harshest of all remedies and that in an international context it may entail the necessity of transporting back the goods from their place of destination to their place of origin or another place with considerable costs involved.[2]

The CISG provides for avoidance in four different situations; in case of the seller's breach of contract (Art. 49 CISG), in case of the buyer's breach of contract (Art. 64 CISG), in case of an anticipatory breach (Art. 72 CISG) and finally in case of the breach of an instalment sale (Art. 73 CISG). In general, in all of these cases avoidance is only possible if the breach amounts to a *fundamental breach of contract*.

However, in cases of non-delivery by the seller (Art. 49(1)(b) CISG), non-payment or failure to take delivery by the buyer (Art. 64(1) (b) CISG) – but only in these cases – the aggrieved party may fix an additional time for performance and after the lapse of this time declare the contract avoided.

Let me first, however, discuss the concept of fundamental breach.

2. FUNDAMENTAL BREACH OF CONTRACT

According to Art. 25 CISG a breach is fundamental "if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract".

The first prerequisite is the breach of a contractual obligation. Unlike especially Germanic legal systems the CISG does not distinguish between different kinds of contractual obligations.[3] All kinds of contractual obligations – especially main and ancillary obligations, synallagmatic and non-synallagmatic obligations, obligations to perform or to refrain from doing something etc. – are treated alike.[4] The obligation may be expressly provided for in the CISG, such as delivery of conforming goods and documents at the right time, at the right place etc., but it may also be a *sui generis* obligation agreed upon by the parties, such as information, training of employees, refraining from reimport, non-competition etc.[5]

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[2] J. O. Honnold, H. M. Flechtner, *Uniform Law for International Sales Under the 1980 United Nations Convention*, Kluwer Law International, Zuidpoolsingel 2009[4], para. 181.2.

[3] *See* e.g. Art. 97 Swiss Obligationenrecht [OR Code of Obligations].

[4] F. Ferrari, "Fundamental Breach of Contract Under the UN Sales Convention 25 Years of Article 25 CISG", *The Journal of Law and Commerce* 25/2006, 493 494.

[5] U. Schroeter, "Art. 25", *Schlechtriem & Schwenzer: Commentary on the UN Convention on the International Sale of Goods (CISG)* (ed. I. Schwenzer), Oxford Univer sity Pres, Oxford 2010[3], para. 15.

Whether the breaching party was at fault is not decisive in establishing a fundamental breach, although some authors argue that an intentional breach should always be regarded as being fundamental.[6]

Second, the aggrieved party must be substantially deprived of what it was entitled to expect. Insofar the importance of the interest which the contract creates for the promisee is crucial. It is the contract itself that not only creates obligations but also defines their respective importance for the parties.[7] Thus, if delivery by a fixed date is required the interest in taking delivery on that very date is so fundamental that the buyer may avoid the contract regardless of the actual loss suffered due to the delay in delivery.[8] Likewise in the commodity trade where string transactions prevail and/or markets are highly volatile timely delivery of clean documents is always of the essence.[9]

Third, Art. 25 CISG provides for an element of foreseeability. A breach cannot be deemed fundamental if the breaching party "did not foresee and a reasonable person of the same kind and in the same circumstances would not have foreseen such a result". Some authors opine that lack of foreseeability and knowledge is a kind of subjective ground for excusing the party in breach. However, knowledge and foreseeability are instead relevant only when interpreting the contract and ascertaining the importance of an obligation.[10] The parties themselves can clarify the special weight given to an obligation; in English legal terminology this would be a "condition".[11] The importance may also be manifested by relying on trade practice and usage (Art. 8(3), 9 CISG). A reasonable person would have foreseen this. Once the importance of an obligation to the promisee under the contract has been established the promisor will not be heard when alleging that it did not or should not have foreseen the fundamentality of the breach of this obligation.[12]

As it all amounts to simple questions of contract interpretation it is clear that the decisive point in time to establish the importance of the

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[6] *Ibid.*, para. 19; U. Magnus, "The Remedy of Avoidance of Contract under CISG General Remarks and Special Cases", *The Journal of Law and Commerce* 25/2006, 426; s*ee* M. Karollus, "Art. 25", *Kommentar zum UN Kaufrecht* (ed. H. Honsell), Spring er, Berlin 2009[2], n.23 (writing that an intentional breach may be fundamental on the basis that the trust between the parties has been destroyed).

[7] P. Huber, A. Mullis, *The CISG A New Textbook for Students and Practition ers*, Seiler, München 2007, 214.

[8] Schroeter, para. 23.

[9] I. Schwenzer, "The Danger of Domestic Pre Conceived Views with Respect to the Uniform Interpretation of the CISG The Question of Avoidance in the Case of Non Conforming Goods and Documents", *Victoria University of Wellington Law Review* 36(4)/2005, 806.

[10] Schroeter, para. 27.

[11] Schwenzer, 796; *see* Sale of Goods Act 1979 (UK), s 11.

[12] *See* Appellationsgericht Basel Stadt, 22 August 2003, CISG online 943.

obligation is the time of the conclusion of the contract.[13] Later developments cannot upgrade a former minor obligation to an important one even if the obligor is aware of this fact.

3. SPECIFIC CASES

In order to exemplify the abstract notion of fundamental breach I will now briefly explore the different cases and discuss when the promisee may avoid the contract.

3.1. Seller's breach of duties

I will first discuss the seller's breach of duties which in practice account for the lion's share of litigated cases. The most important ones being; non-delivery, delay, and delivery of non-conforming goods including partial delivery. Where the seller must deliver documents, the same principles apply.[14]

Definite non-delivery almost always amounts to a fundamental breach.[15] The seller's refusal to perform constitutes a fundamental breach.[16] Exceptions to this rule apply where the seller may avail itself of a right to withhold performance or where due to fundamentally changed circumstances the seller is no longer obliged to fulfil the contract according to the initial terms but instead suggests to the buyer adjusted terms that a reasonable buyer should accept under the circumstances.[17]

In cases of delay where performance is still possible and the seller is still willing to perform the importance of the agreed delivery date is decisive. Whether time is of the essence primarily depends on the terms of the contract as well as on the respective trade sector. If the buyer insists on a certain delivery date because of its own obligation towards its sub-buyers, if the sale concerns seasonal goods or commodities time is usually of the essence making any delay a fundamental

[13] *See* Ferrari, 498; Oberlandesgericht Düsseldorf, 24 April 1997, CISG online 385.

[14] CISG AC Opinion No. 5: The Buyer's Right to Avoid the Contract in Case of Non Conforming Goods or Documents, 7 May 2005, Rapporteur: Professor Dr. Ingeborg Schwenzer, Badenweiler (Germany), para. 5

[15] Schroeter, para. 37; ICC Arbitration Case No. 9978 of March 1999, CISG on line 708: "[a]n absolute failure to deliver the goods definitely constitutes a fundamental breach."

[16] Schroeter, para. 37; Cour d'appel de Grenoble, 21 October 1999, CISG online 574.

[17] Schroeter, para. 37.

breach and thus allowing the buyer to immediately avoid the contract.[18] If time cannot be deemed of the essence the buyer has to fix an additional time for performance before it may avoid the contract (Art. 47(1), 49(1)(b) CISG).[19]

Unlike in many other legal systems – especially those belonging to the Civil law – delivery of defective goods and partial delivery are treated alike under the heading of non-conformity (Art. 35(1) CISG).[20] Thus the same principles apply concerning the possibility of avoidance.

Again, primary consideration must be given to the terms of the contract. It is up to the parties to stipulate what they consider to be of the essence of the contract.[21] Thus a breach can be held to be fundamental if the parties agreed on certain central features of the goods, such as for example soy protein products that have not been genetically modified or goods where no children were involved in manufacturing them or that have been traded fairly.[22]

If the contract itself does not make clear what amounts to a fundamental breach one of the central questions is for what purpose the goods are bought. The decisive factor is whether the goods are improper for the use intended by the buyer.[23] If the buyer wants to use the goods itself it is not relevant whether they could be resold even at a discount price. However, where the buyer is in the resale business, the issue of a potential resalability becomes relevant.[24] The question then is whether resale can reasonably be expected from the individual buyer in its normal course of business.

A fundamental breach will usually not exist if the non-conformity can be remedied either by the seller, the buyer or a third person – e.g. by repairing or delivering substitute or missing goods – without causing un-

[18] Schroeter, para. 38; Bundesgericht, 15 September 2000, CISG online 770 (finding a fundamental breach for delayed delivery which prevented the buyer from meeting its own obligations); *Diversitel Communications, Inc. v. Glacier Bay Inc.,* Ontario Superior Court of Justice, 6 October 2003, CISG online 1436.

[19] Schroeter, para. 40.

[20] For a comparison of liability for defective goods under different legal systems *see* I. Schwenzer, "Art. 35", *Schlechtriem & Schwenzer: Commentary on the UN Convention on the International Sale of Goods (CISG)* (ed. I. Schwenzer), Oxford University Pres, Oxford 2010[3], para. 4.

[21] CISG AC Opinion No. 5, Comment 4.2; Schwenzer (2005), 800.

[22] *See* Oberlandesgericht Stuttgart, 12 March 2001, CISG online 841; Appellationsgericht Basel Stadt, 22 August 2003, CISG online 943.

[23] CISG AC Opinion No. 5, Comment 4.3.

[24] *See* ICC Arbitration Case No. 8128 of 1995, CISG online 526; Bundesgerichtshof, 8 March 1995, CISG online 144; Landgericht Ellwangen, 21 August 1995, CISG online 279.

reasonable delay or inconvenience to the buyer.[25] Here again, due regard is to be given to the purposes for which the buyer needs the goods. If timely delivery of conforming goods is of the essence of the contract repair or replacement usually will lead to unreasonable delay. In finding such unreasonableness the same criteria have to be applied as in case of late delivery. Furthermore, the buyer should not be expected to accept cure by the seller if the basis of trust has been destroyed, e.g. due to the seller's deceitful behaviour.[26] If the seller refuses to remedy the defect, simply fails to react, or if the defect cannot be remedied by a reasonable number of attempts within a reasonable time, then a fundamental breach will also be deemed to have occurred.[27]

3.2. Buyer's breach of duties

Let me now turn to the buyer's breach of duties, the main obligations being the payment of the purchase price and taking delivery of the goods.[28]

In general, failure to pay the purchase price on the date due will not amount to a fundamental breach of contract, as the seller's interest to receive payment is not substantially impaired by the delay.[29] However, where timely payment is of the essence, e.g. in case of highly fluctuating exchange markets, a fundamental breach is conceivable.[30] The same holds true if payment by letter of credit against presentation of documents is agreed upon. The letter of credit must be opened for the seller no later than the first day of the period for shipment. Finally, the definite refusal by the buyer to pay the purchase price amounts to a fundamental breach of contract.[31] The same holds true in case of insolvency of the buyer.[32]

Failure to take delivery of the goods by the buyer, again, in general will not constitute a fundamental breach.[33] However, where the seller has

[25] CISG AC Opinion No. 5, Comment 4.4; Bundesgerichtshof, 3 April 1996, CISG online 135.

[26] CISG AC Opinion No.5, Comment 4.4; I. Schwenzer, "Avoidance of the Contract in the Case of Non conforming Goods (Article 49(1)(a)(CISG)", *The Journal of Law and Commerce* 25/2006, 439.

[27] Landgericht Berlin, 15 September 1994, CISG online 399.

[28] CISG Art. 53; for a discussion of trends in cases that deal with the obligations of the buyer *see* H.D. Gabriel, "The Buyer's Performance Under the CISG: Articles 53 60 Trends in the Decisions"*, The Journal of Law and Commerce* 25/2006, 273.

[29] *See* Secretariat Commentary on Article 60 of the 1978 Draft Convention on Contracts for the International Sale of Goods, Art. 60, para. 5.

[30] Schroeter, para. 66.

[31] *Ibid.*

[32] *Ibid.*; *Roder Zelt und Hallenkonstruktionen GmbH v. Rosedown Park Pty Ltd et al.,* Federal Court of Australia, 28 April 1995, CISG online 218.

[33] Schroeter, para. 67; *see* Secretariat Commentary on Article 60, para 5.

a special interest in the buyer taking delivery at the exact contractually agreed upon date, e.g. due to sparse warehouse or transportation capacities, a fundamental breach can be assumed.[34] A fundamental breach also exists if the buyer definitely refuses to take delivery.

If according to the foregoing no fundamental breach can be ascertained or if the seller is in doubt about the weight of the breach it may fix an additional time for the buyer to pay the price or take delivery and after the lapse of this *Nachfrist* it may avoid the contract (Art. 64(1)(b) CISG).

4. NOTICE

The CISG requires that the party having the right to avoid the contract gives notice to the other party (Art. 26 CISG). Unlike in many other legal systems there exists no *ipso iure* avoidance under the CISG.[35] The notice must be communicated to the other party by appropriate means, whereby dispatch of the notice suffices (Art. 27). Today usually notice will be given by email.

5. TIME LIMITS

In general, under the CISG no special time limits exist to declare the contract avoided.[36] Thus the general statute of limitations applies. Depending upon the applicable law this period of time may vary between one year (Switzerland, Art. 210 Code of Obligations) and six years (UK, Sec. 2 Limitation Act 1980). In exceptional cases this time period may be reduced and the party precluded from relying on the otherwise possible remedy of avoidance especially if it has led the other party to believe that it will not exercise this right.

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[34] Huber, Mullis, 328; *See* Oberlandesgericht Düsseldorf, 24 July 2004, CISG online 916: "[i]n case of the usual sales contract concerning non perishable goods and without peculiarities of storage or transport, neither a breach of the obligation to accept the goods nor a breach of the obligation to make payment of the purchase price automati cally constitutes a fundamental breach of contract." (translation from <http://cisgw3.law.pace.edu/cases/040722g1.html>).

[35] Ch. Fountoulakis, "Art. 26", *Schlechtriem & Schwenzer: Commentary on the UN Convention on the International Sale of Goods (CISG)* (ed. I. Schwenzer), Oxford University Pres, Oxford 2010[3], para. 3; Honnold, Flechtner, para. 187.1; *See* Convention Relating to a Uniform Law on the International Sale of Goods (ULIS) Arts. 25, 61 (The Hague, 1 July 1964) (convention pre dating the CISG permitted *ipso facto* avoidance of the contract).

[36] P. Schlechtriem, P. Butler, *The UN Convention on the International Sale of Goods,* Springer, Berlin 2009, para. 162.

However, the CISG itself provides for a time limit to exercise the right of avoidance in two situations.

If the seller has delivered the goods the buyer has to declare the avoidance of the contract within a reasonable time after the delivery of the goods or after it has become aware of the breach or an additional period to remedy the breach has elapsed (Art. 49(2) CISG). A comparable rule in case of buyer's breach of contract exists. If the buyer has paid the price – albeit delayed – the seller must react before it has become aware of the payment or – in respect of any breach other than late performance – within a reasonable time after it has become aware of the breach or after an additional period has expired (Art. 64(2) CISG).

6. RESTITUTION OF THE GOODS

In accordance with Roman law and thus Civil law tradition the buyer is precluded from exercising its right of avoidance if it cannot make restitution of the goods substantially in the condition in which it received them (Art. 82(1) CISG). However, there are numerous exceptions to this rule (Art. 82(2) CISG) so that in practice this rarely becomes an obstacle to the buyer avoiding the contract.[37] In fact, this rule is hardly appropriate for modern international commerce. Thus neither the UNIDROIT Principles for International Commercial Contracts (2004), nor the Principles of European Contract Law (2000), nor the Draft Common Frame of Reference (2008) have followed this example. If the buyer cannot return the goods it may still avoid the contract with due compensation for their value.[38]

7. CONCLUSION

Although the concept of fundamental breach as a prerequisite for avoidance has been criticised by some authors for its vagueness in practice it has proven to yield just and reasonable results. On the one hand it is flexible enough to be applied to the vast variety of possible breaches of

[37] Ch. Fountoulakis, "Art. 82", *Schlechtriem & Schwenzer: Commentary on the UN Convention on the International Sale of Goods (CISG)* (ed. I. Schwenzer), Oxford University Pres, Oxford 2010[3], para. 12; Oberster Gerichtshof, 29 June 1999, CISG on line 483; F. Mohs, "The Restitution of Goods on Avoidance Contract for Lack of Con formity within the Scope of Art. 82(2)(c) CISG: On the Different Treatment of Defects in Quality, Third Party Intellectual Property Rights, and Defects in Title as Elements of Remedies for the Buyer", *Review of the Convention on Contracts for the International Sale of Goods (CISG)* 2003 2004/2005, 55.

[38] Art. 84(2)(b) CISG; Huber, Mullis, 245 246.

contract; on the other hand the necessary legal certainty has been achieved by case law and scholarly writing. The superiority of this concept is not the least proven by the fact that all later international attempts to further harmonization and unification of the law of obligations – such as PICC, PECL and DCFR – as well as many domestic laws that have been revised lately have taken over this basic concept of the CISG coupled with the possibility of fixing a *Nachfrist*. Similarly, the CISG's concept of avoidance by notice has gained ground on an international as well domestic level.

To sum up: the CISG concept of the right of avoidance has proven most adequate in practise. It certainly contributes to the fact that nowadays the CISG can be called a true story of worldwide success.

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COERCIVE ENFORCEMENT AND A POSITIVIST THEORY OF LEGAL OBLIGATION*

The concept of legal obligation is utterly central to legal practice. But positivism lacks a comprehensive account of legal obligation, focusing only on the second order recognition obligations of officials with no account of the first order legal obligations of citizen. As legal obligations are conceptually related to legally valid norms, this failure calls into question positivism's theory of legal validity. In this essay, I develop Hart's account of social obligation and supplement his account of the second order legal obligations of official qua official with an account of the first order obligations of citizens. The latter is constituted, I argue, by social pressure in the form of the authorization of the state's coercive machinery for non compliance.

Key words: *Legal obligation. Coercion. Enforcement. Legal positivism*.

Perhaps no concept is more central to legal practice than that of legal obligation. Statutes, case law, and legal arguments are characteristically framed in terms of what some person or class of persons is "obligated" to do. Such practices presuppose that legal norms – at least those

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making certain actions mandatory – regulate behavior by creating legal obligations. Law characteristically regulates behavior by creating obligations.

Both officials and citizens are subjects of legal obligations. Citizens are obligated to honor their contracts and to refrain from violence under most circumstances; these are first-order obligations defined by primary norms. Judges are obligated to decide cases under the relevant norms; these are second-order obligations (usually) created by recognition norms.

Hart appears to have at least the beginnings of a comprehensive theory of legal obligation. As is well known, Hart believes that legal obligation is a form of social obligation and that social obligations arise when accepted norms are thought sufficiently important to back with social pressure to conform. The second-order legal obligations of officials are explained by their taking the internal point of view towards the rule of recognition. Although he rejected Austin's sanction theory of obligation as not accurately expressing either the sense in which civil law binds or the sense in which officials are bound, he seemed to intimate that first-order legal obligations of citizens are explained by the availability of institutional coercive mechanisms for enforcing first-order legal norms against citizens. As Hart puts the point, "the typical form of legal pressure may very well be said to consist in such threats [of physical punishment or unpleasant consequences]".[1] (*CL* 179, 180).

In this essay, I wish to develop what I take to be *Hart's* account of social obligation and supplement his account of the second-order legal obligations of official in their capacities as official with an account of the first-order obligations of citizens. The latter is constituted, I argue, by social pressure in the form of the authorization of the state's coercive machinery for non-compliance.

At the outset, it is important to understand that there is a difference between the *authorization* of coercive enforcement mechanisms and the *application* of such mechanism in a case of non-compliance. These are two distinct notions. The idea that such mechanism are *authorized* for non-compliance simply means that officials have *authority* to use these mechanisms as legally justified responses to non-compliance. The idea that such mechanism are *applied* simply means that those coercive mechanisms have been used against someone on the ground that he failed to comply. But it is important to note that this does not entail even that the use of such mechanisms are *legally justified* – as one would expect if legal mistakes are possible. The authorization of coercive enforcement of a legal norm provides a legal justification for the appropriate application of the relevant mechanism for non-compliance with the norm.

[1] H. L. A. Hart, *The Concept of Law*, Rev. ed., Oxford University Press, Oxford 1994, 179 180. Hereinafter *CL*.

One might object that the violation of a legal obligation justifies the application of coercive mechanisms and thus that a legal obligation cannot be constituted by coercive enforcement applications.[2] This misunderstands the thesis of the paper. The claim being defended here is that the authorization of such mechanisms for non-compliance is, in part, what constitutes a legal norm as binding and hence legally obligatory and hence provides the justification for application in genuine cases of non-compliance. The obligation is constituted, in part, by the *authorization* of such mechanisms and is not identical with the existence or application of such mechanisms.

1. THE CENTRALITY OF OBLIGATION TALK TO LEGAL PRACTICE

The concept of obligation is everywhere in legal practice. For example, a plaintiff in a contract dispute typically claims the defendant is obligated to perform some act, while the defendant argues that the defendant's performance is excused by the plaintiff's own breach of obligation. Likewise, a prosecutor will argue that the defendant breached some obligation or duty defined by the criminal law, while the defense will argue that the defendant did not breach such a duty or obligation. Finally, judges frequently couch their decisions in terms of what some party is obligated to do. In, for example, *Henningsen v. Bloomfield Motors, Inc.*, the court held that "[i]n a society ... where the automobile is a common and necessary adjunct of daily life, and where its use is so fraught with danger to the driver, passengers and the public, the manufacturer is under a special *obligation* in connection with the construction, promotion, and sale of his cars".[3]

As these obligations arise under *law*, they are thought to be *legal* in source and character. This, of course, is not to suggest that moral obligation is irrelevant to ordinary talk about legal obligation; it is simply to assert ordinary legal talk and practice presupposes the existence of *legal* obligations analytically distinct from *moral* obligations. Although the content of law and the content of morality frequently converge, they frequently diverge as well; in such cases, however, the law defines a legal obligation if not a moral one.

The law regulates behavior by a variety of means, including power-conferring norms like those governing the creation of binding contracts and wills, but characteristically *constrains* the behavior of citizens by creating such obligations. The law does not generally traffic in weaker

[2] I am indebted to Scott Shapiro for this line of argument.

[3] 161 A.2d 69 (1960), at 85 (emphasis added).

"ought"s that encourage behavior without making it mandatory in some sense. Legislative enactments that do not create obligations are not "actionable" and cannot support a claim for damages or punitive measures.

This is the view that Hart takes. Hart observes, for example, that Austin correctly assumes that systems of law necessarily create some legal obligations:

> "[T]he theory of law as coercive orders, notwithstanding its errors, started from the perfectly correct appreciation of the fact that where there is law, there human conduct is made in some sense non-optional or *obligatory*. In choosing this starting point the theory was well inspired, and in building up a new account of law in terms of the interplay of primary and secondary rules we too shall start from the same idea".[4] (*CL* 82, emphasis added)

Further, Hart asserts that it is a conceptual truth that primary legal norms generally define legal obligations (some confer legal liberties): "*Rules of the first type impose duties* [i.e., primary rules]; rules of the second type [i.e., secondary rules] confer powers, public or private (*CL* 80–81). If Hart is correct, then law regulates the behavior of citizens by creating obligations that are legal in source and character.

Law is a normative institution and its normativity is conceptually linked to its capacity to generate obligations. This suggests an adequacy constraint on conceptual theories of law. While conceptual theories of law are most conspicuously concerned with giving an analysis of the concept of law, they must also be concerned to provide an account of all normative concepts figuring prominently in legal practice – including that of legal obligation.

2. THE CONCEPT OF OBLIGATION

If ordinary talk is any indication, there are different types of obligation. We distinguish, for example, moral, social and legal obligations and speak as if these types of obligation are conceptually distinct. Even so, many theorists believe they are instances of the same general type. As Joseph Raz puts it: "normative terms like 'a right', 'a duty', 'ought' are used in the same sense in legal, moral, and other normative statements".[5] While mor-

[4] H. L. A. Hart, *The Concept of Law*, Rev. ed. (Oxford: Oxford University Press, 1994), 82; emphasis added. Hereinafter *CL*.

[5] J. Raz, *The Authority of Law* (Oxford: Clarendon Press, 1979), 158. See also Richard Brandt, "The Concepts of Obligation and Duty," *Mind* p. 380 ("[I]t is dubious whether there are sharply distinct moral and non moral senses [of 'obligation']. It may be that 'obligation' and 'duty' preserve an identical core of meaning throughout moral and non moral uses. This, in fact, is the view of the matter best supported by the evi dence".)

al, social, and legal obligation differ in important ways, there are certain elements essential to the notion of obligation and these elements are present in moral, social, and legal obligations.

This is certainly true of various kinds of *norm*. For example, moral and legal norms are conceptually distinct; the content of moral norms sometimes diverges from the content of legal norms, as is presumably true of the content of the moral and legal norms governing promise-keeping. But moral and legal norms are both kinds of norm; as such, they instantiate properties that are necessary and sufficient for being "norms". Although legal and moral norms have many different properties, both satisfy the application-conditions for the concept-term "norm".

One would expect, as Raz believes, that the same would be true of the various kinds of obligation. Legal and moral obligations presumably have different properties, but both satisfy the application-conditions for the concept-term "obligation" in the following sense: satisfaction of the application-conditions for "obligation" will be necessary (though not sufficient) for something to count as either a "legal obligation" or a "moral obligation". If so, then the set of application-conditions for "obligation" will be a subset of the set of application conditions for "moral obligation" and "legal obligation".

If this is correct, then we cannot understand the concept of *legal* obligation without understanding the general notion of *obligation*.[6] In what follows, I will sketch what I take to be the central elements of the general concept of obligation.

2.1. Obligations and mandatory prescriptions

It is tempting to think that this much is clear about obligations: obligations are conceptually related to norms. While the existence of a norm prescribing act X might not be a sufficient condition for X to be obligatory in the relevant sense, it is a necessary condition. There simply could not be an obligation unrelated (perhaps in the strong sense of being defined by) to a norm.

[6] Hart was concerned with analyzing the concept of obligation though he focused on social obligation, apparently believing that all obligations are social in character: (1) "[I]t is crucial for the understanding of the *idea* of obligation to see that in individual cases the statement that a person has an obligation under some rule and the prediction that he is likely to suffer for disobedience may diverge"; (2) "It is clear that obligation is not to be found in the gunman situation, though the *simpler notion* of being obliged to something may well be *defined* in the elements present there"; (3) "To understand the *general idea of obligation* as a necessary preliminary to understanding it *in its legal form*, we must turn to a different social situation which, unlike the gunman situation, includes the existence of social rule; for this situation contributes *to the meaning* of the statement that a person has an obligation in two ways"; (4) "The statement that someone has or is under an obligation does indeed imply the existence of a rule"; and (5) "Rules are *conceived and spoken as* imposing obligations when the general demand for conformity is insistent and the social pressure brought to bear upon those who deviate or threaten to deviate is great" (*CL* 85 86; emphasis added)..

Although plausible, the idea that the existence of a norm prescribing X is a necessary condition for someone to be obligated to X is problematic for the following reason. It cannot be applied to morality without assuming a substantive account of morality that is controversial – namely, the idea that morality is grounded in general norms. Moral particularists deny this assumption, believing that the morality of any particular behavior is too context-dependent to be captured by general norms – even those that state, so to speak, their own exceptions; however, particularists are not skeptics about morality or about the idea that we have moral obligations. A theory that purports simply to articulate the content of the general concept-term "obligation" should not have controversial substantive implications about morality.

What we can say, however, is that obligations are associated with prescriptions, which include claims – claims about what someone (or some class of persons) ought to do in some state of affairs – and norms. Obligations arise only where there are prescriptions that guide and enable the appraisal of human acts. If I have an obligation to do *A* at *t*, then there is some prescription that either expresses or implies that I ought to do *A* at *t.* That is, it is a necessary condition for someone's being obligated to perform some act that there is a prescription that expresses an obligation owed by that person to perform that act.

Not every prescription expresses or implies an obligation. Although all prescriptions purport to commend some behavior (or abstinence), not all prescriptions *require* them; there are things I ought to do that I am not obligated to do. There are, for example, prudential norms that, other things being equal, express the idea that one ought to exercise regularly, but those norms do not create or express obligations because prudential norms are prescriptive but do not create "requirements" or "obligations" in any meaningful sense and therefore could not be "mandatory" in the relevant sense. The only prescriptions that create or express obligations are mandatory prescriptions – i.e., prescriptions that require some act.

It therefore appears to be a necessary condition for *P* to be obligated to do *a* that there is a *mandatory* prescription that *requires* that *P* do *a*. If there is no mandatory prescription requiring *a*, then there is no obligation to perform *a;* the claim that *a* is obligatory but not required by a mandatory prescription seems self-contradictory. Obligations are thus correlated with mandatory prescriptions.

2.2. Obligations as reasons

Obligations are commonly thought to correlate with reasons. On this view, the claim that X has an obligation to do *a* implies that X has a

reason to do *a*.[7] If Y asks X for a justification for X's doing *a*, "X was obligated to do *a*", if true, is always relevant in assessing whether doing *a* was justified from the standpoint of practical rationality.

The reason can be moral, but need not be. Some obligations are associated with moral reasons but not all obligations are. If, as many theorists believe, it is not true that the status of a norm as law does not afford a *prima facie* moral reason to obey it even in reasonably just states, then it is reasonable to think that one does not have even a *prima facie* moral reason to obey wicked laws that create legal obligations. There are clearly other kinds of reasons, such as prudential – although the number of different types of "basic" reason (i.e., reasons that are irreducible to other reasons) are limited.

Indeed, it is very difficult to think of any other basic reasons than prudential and moral reasons. Perhaps there are aesthetic reasons as well. But if there are no other basic reasons, then every other kind of reason, including legal reasons, will ultimately be "compound" in character, ultimately constituted by some combination of members of the set of basic reasons.

The reason might be conclusive, but it need not be. It seems that, as an objective matter of practical rationality, we have a conclusive reason for doing what we are morally obligated to do all things considered. I have a reason not to torture another innocent person no matter what else might be true and hence a conclusive reason for not doing so. But whatever prudential reason Nazis may have had to do morally wicked things, it was clearly not conclusive; taking into account the relevant moral reasons, they had a conclusive reason not to do these things.

If ordinary talk is any indication, obligations *are* reasons.[8] Again, it is always a relevant consideration in justifying the performance some act

[7] Not everyone accepts this view. For example, Scott Shapiro believes that obligations merely *purport* create or be reasons. On his view, there can be obligations that neither create nor are identical to reasons. The argument of this paper, however, depends on the denial of this view, which I cannot defend here. See Section VIB for a discussion of this possibility.

[8] It is worth noting here that ordinary talk about law (and the corresponding legal practices) presuppose that one can have a reason independent of one's mental states, which is incompatible with reasons internalism. According to the internalist, there are no reasons that are external to the agent's mental states; an agent has a reason for doing P if and only if the agent instantiates the appropriate mental state usually a belief desire pair. While the assumption that internalism is false is controversial, I am concerned with giving a conceptual account that harmonizes with our ordinary law talk and legal practices, which presupposes that there are other kinds of reasons than simply the belief desire pairs. Ordinary talk does not imply the denial of such reasons but characterizes such reasons as *subjective.* Ordinary talk and legal practice seem to presuppose that moral and legal reasons are *objective* in character. Internalism would entail something like an error theory of law. That might ultimately be correct, but it takes an argument to establish that.

a or, relatedly, in deliberating whether to do *a* that one has an obligation of some kind to do *a*. "Because I had an obligation to do *a*" might not be an adequate answer to the question "why did you do *a*?"; it might be false that I had an obligation to do *a* or it might be true that I had such an obligation, but it was outweighed by some a more important obligation. But if, as seems reasonable, only reasons can practically justify an act, then obligations are reasons. Genuine obligations are necessarily normative and hence are reasons for action.

2.3. Obligations as exclusionary

Obligations are defined by valid mandatory prescriptions, and mandatory prescriptions are fairly characterized as "exclusionary" in this respect: A's desires and prudential interests are generally irrelevant with respect to whether A should perform an act required by a mandatory prescription. If A fails to do *p* and *p* is required by a mandatory prescription, it is not a justification, other things being equal, that A did not want to do *p* or that doing *p* did not conduce to A's interests.[9]

This characteristic of obligation is also related to the concept of wrongness. An act is wrong if and only if it is not justified or excused (one justification would be, of course, that the behavior is permissible). Mandatory prescriptions, as a conceptual matter, *exclude* certain kinds of justifications for non-performance, and it is the exclusion of these stories as not constituting valid reasons for non-performance that helps to explain why the relevant acts are properly thought of as mandatory or required: an act that people are generally free not to perform because it is trivially justified under a prescription is not *required* by the prescription.

The claim here is that, as a conceptual matter, the reasons for doing *p* do not depend on its satisfying our own particular prudential interests *is entailed by the core of what we mean* when we say *p* is required by a valid mandatory prescription. The claim *p* is required by a mandatory prescription *N* is inconsistent with the claim non-performance of *p* can be justified *under N*, as a general matter, by purely prudential considerations – in much the same way that the claim that *p* is a bachelor is inconsistent with the claim that *p* is married. Obligations that are defeasible by reference to anyone's prudential interests, no matter how trivial, is as incoherent as the idea that some bachelors are married.[10]

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[9] This, of course, draws heavily on Joseph Raz's influential *Practical Norms and Reason* (Princeton, 1990).

[10] It is worth noting that the claim that obligations are exclusionary reasons logi cally entails that there are no prudential obligations. A prudential obligation would be a prudential reason indeed, a very strong one that excludes prudential reasons as a jus tification for non performance of an obligation, an implication that appears to be logically incoherent. A prudential obligation would require one to do what one has most prudential

Although the term "exclusionary" is sometimes thought to be synonymous with the Razian notion associated with the term "pre-emptive reason", they are not synonymous as defined above. A Razian pre-emptive reason has a certain structure consisting of a first-order reason to do (or not do) some act and a second-order reason not to act on one's assessment of the first-order reason. The idea that mandatory prescriptions are exclusionary claims or presupposes nothing about the structure of the relevant reasons, and hence does not assume that obligations give rise to second-order reasons. The claim is merely that a mandatory prescription is exclusionary in the limited sense of excluding certain stories as justifying or excusing non-performance.

2.4. The special normative force of obligations: obligations as binding

The concepts of obligation and wrongness are related to the concept of being (normatively) bound. Obligation-talk is frequently couched in terms of a relationship in which the subject of the obligation is bound to the norm. As Hart puts the point, "The figure of a *bond* binding the person obligated ... is buried in the word 'obligation'" (*CL* 87). Obligations, according to ordinary intuitions, bind us.

In what sense? The term "must" (and, less frequently, the term "shall") is frequently used to express that we have an obligation – and are hence *bound* – to perform some act. We *may* do what is permissible and *should* do what is good, but we *must* do what is obligatory.

It might be tempting to explain the concept of *bound* in terms of some sort of psychological or physical compulsion. The idea here is that persons are bound by a rule creating an obligation in the sense that they are psychologically or physically "unfree" to do other than what the rule requires. But not every obligation, as a conceptual matter, is supported by compulsion of this kind. Many persons do not feel psychologically compelled (i.e., psychologically unfree) to satisfy moral obligations. Further, there are many obligations not supported by physical compulsion; we are not physically compelled (i.e., unfree in some physical sense) not to lie. Here coercion and compulsion, it should be remembered, are two different things: a gunman coerces me with the threat of death but, other things being equal, cannot compel me to obey.

It might also be tempting to think that the exclusionary character of obligations (or mandatory norms) is enough to explain the binding quality of obligations but, *as that concept has been explained in this paper*, the exclusionary character of obligations, by itself, lacks the resources to

reason to do and hence could not exclude prudential considerations as justifying non performance. This strikes me as the correct result: we talk of the victim of a robber as being *obliged*, rather than *obligated*, to comply at least in the absence of other factors such as responsibility to his or her family.

explain the binding quality of obligations. The claim that a mandatory norm *is* exclusionary says something about its content or; that is, it expresses the idea, as we have seen, that the content of the norm is such that it disqualifies certain stories as justifying non-performance. But the claim that a mandatory norm *binds* us is a claim about its normative force; this is the point of the metaphor of a *bond* that ties us to rule (i.e., the normative force binds us to the rule).[11] Simply knowing that the content of a norm excludes certain considerations as justifying non-performance does not tell us much, if anything, about the nature of this bond or the special normative force that it has. Indeed, it doesn't even tell us whether a norm that functions this way has any normative force because it tells us nothing about whether the norm is valid or applicable. Invalid mandatory norms are exclusionary in this limited sense, but they have no normative force and hence do not bind.

3. HART'S THEORY OF SOCIAL OBLIGATION

Legal obligation, as conceived by Hart and most positivists, belongs to a special class of obligations. Since positivism explains law as a set of social practices, the concept of obligation applicable in legal practice must itself be explicable in terms of social practices. Legal obligation, then, is a species of social obligation.[12] A full explanation of the concept of legal obligation, then, requires an explanation of the concept of social obligation, which must harmonize with the explication of the general concept of obligation. Hart's account of social obligation is developed below.

3.1. Social prescriptions

The first element is straightforward. Although not every social norm gives rise to a social obligation (e.g., some create social powers), social obligations arise under general social prescriptions – or social norms, which are created, as Coleman puts it, by a convergence of attitude and behavior. Persons in the group converge on taking the internal

[11] Of course, as Raz defines the term, exclusionary reasons are capable of binding. See J. Raz, *Engaging Reason* (Oxford: Oxford University Press, 2000). I have not adopted the Razian account here because it is not obvious to me that it is a conceptual truth that legal obligations are exclusionary reasons in this sense Although it seems clear that moral reasons are such reasons, it is not clear that very wicked legal norms would generate a robustly exclusionary reason. I think most theorists would concede no more than that law "purports" to create exclusionary reasons in the stronger sense intended by Raz.

[12] It is unlikely that social obligations create social reasons that are basic (or irre ducible) in character. See Note 7, above.

point of view towards the norm, accepting it as a standard that governs the behavior of people in the group, and generally conform to its requirements. Thus, if people in the group (1) self-consciously accept the norm (this need not be for moral reasons); (2) generally conform to the norm; and (3) take a critical reflective attitude toward the norm using it to evaluate the behavior of other members of the group, then it is, on Hart's view, a social norm governing behavior in the group.

3.2. Acceptance and exclusionary norms

Taking the internal point of view towards a mandatory norm, on Hart's view, involves regarding oneself and others in the relevant group as being obligated by the rule. Acceptance of such a norm involves some sort of durable commitment to subject one's own behavior to governance of the rule and to evaluate the behaviors of other people according to the rule. Someone who genuinely commits to subjecting her behavior to the rule will accept and participate in a host of normative practices regarding the rule – including practices that treat members of the group, including herself, as obligated. Someone who *accepts* a rule defining an obligation will surely regard herself as being obligated by the rule.

This suggests that persons who accept a mandatory social norm will accept it as a reason for complying with and treat it as being exclusionary in the sense described above. A mandatory norm is exclusionary in character in the sense that it excludes certain justifications for non-conformity, but this does not imply that any particular person does treat or should treat the rule as what Raz calls a *pre-emptive* reason in her deliberations. Insofar as the person who accepts the mandatory social rule will treat it as a reason of some kind. But someone who accepts a mandatory social norm and conceives it as exclusionary reason might – but need not – treat the norm as a pre-emptive reason in her deliberations about what to do. Moreover, if accepting a rule gives one a reason for following it (for as long as one accepts it), such a person has a reason for treating the norm as exclusionary – at least for as long as she accepts the rule.

3.3. How social obligation binds

While unilateral acceptance alone can explain a person's adoption of a social norm as functioning as exclusionary, unilateral acceptance, by itself, cannot explain the normative force of the obligations to which social norms give rise. After all, unilateral acceptance can always be given and withdrawn at will, and if that is all there is to the story, it is hard to see how a durable social obligation could arise. What explains the binding (and hence durable) quality of a social obligation owed by a member of the social group is, in part, the attitudes of other members of the social group towards non-compliance.

Hart explains the binding character of social obligations in terms of considerations ordinary persons are likely to regard as having normative significance. According to Hart, "[r]ules are conceived and spoken of as imposing obligations when the general demand for conformity is insistent and the social pressure brought to bear upon those who deviate or threaten to deviate is great" (*CL* 85–86).[13] Social pressure in the form of a hostile reaction is something people with ordinary psychological characteristics tend to regard as having normative force. Not everyone responds in the same way to (or cares as much about) social disapproval, but it is an empirical fact that ordinary persons tend to dislike criticism and hostility and are willing to take at least minimal steps to avoid it.

A couple of points deserve attention. First, deviating behavior under the norm is generally regarded as a *reason* or *justification* for the application of social pressure. The claim is not just that, as a general matter, deviating behavior correlates with social pressure. Rather, it is that members who accept the rule regard the rule as a reason for applying social pressure: "For [those who take the internal point of view towards a rule], the violation of a rule is not merely a basis for the prediction that a hostile reaction will follow but a *reason* for the hostility" (*CL* 90). This will be true, as a conceptual matter, for any form of social obligation, on Hart's view, including legal obligation.

Second, the claim is not that social pressure is sufficient for social obligation; after all, the gunman exerts social pressure on his victim. Rather, it is that a convergence of attitude and behavior on a rule, *together with the appropriate kind of social pressure*, constitutes the norm as obligatory. Such pressure is likely supported by a belief that it is warranted (though not necessarily *morally* warranted), which is related to two factors: (1) the acceptance of the social norm; and (2) the belief that the norm is important because "necessary to the maintenance of social life or some highly prized feature of it" (*CL* 87).

Hart's explanation of social obligation can be summed up as follows:

> *Hartian Theory of Social Obligation (HTSO): X* has a social obligation to do *p* if and only if (1) members of the relevant group converge in attitude and behavior on a norm ***N*** governing *X* that requires *X* to do *p*; and (2) ***N*** is supported by significant social pressure and (3) because ***N*** is thought important because necessary to the maintenance of social life or some highly prized feature of it.

According to HTSO, it is the presence of the appropriate social pressure *in a context* that includes the existence of a practice along with

[13] Such social pressure "may take only the form of a general diffused hostile or criti cal reaction" (*CL* 86), but may also rise to the level for "physical sanctions" (*CL* 86); in this latter case, the rules are properly regarded as a "rudimentary" or "primitive" form of law (*CL* 86).

certain beliefs about the importance of the norm that explains the sense in which the obligation is, as a conceptual matter, binding: "*social pressure appears as a chain binding those who have obligations so that they are not free to do what they want*" (*CL* 87). No matter how important a social norm *N* might be thought by relevant members of the group, it is incorrect to characterize it as defining an obligatory and hence binding requirement if not supported, in some way, by the appropriate level of social pressure. As Hart puts the view, such pressure is the "primary" characteristic of obligation (*CL* 87).

This implies neither that every person feels the force of the social pressure that makes a social norm binding nor that any person *should* feel this force. The claims here are quite limited. They are purely descriptive because they make no claims about what people should regard as reasons. Further, they make no claim about what any particular person in a social group might feel in response to social pressure; as Hart points out, "there is no contradiction in saying of a hardened swindler ... that he had an obligation to pay the rent but felt no pressure to pay" (*CL* 88). The assumption is significantly weaker: as an empirical matter, people tend to care about social pressure enough to modify their behavior in many circumstances.

One might be tempted to interpret Hart's remarks on social pressure and social obligation as making the weaker claim that social pressure signals that people in the group regard the norm as obligatory, rather than the stronger claim that it contributes to constituting the norm as obligatory. I think this is mistaken for two reasons. First, Hart clearly takes himself as giving an analysis of the concept of social obligation: "To understand *the general idea of obligation* as necessary preliminary to understanding it in its legal form, we must turn to a different social situation which, unlike the gunman situation, includes the existence of social rules; for this situation *contributes to the meaning of the statement that a person has an obligation* in two ways" (*CL* 85). The elaboration of the idea that social pressure supports social obligation occurs two paragraphs later. Second, Hart rejects Austin's view largely on the strength of the gunman example. It would be uncharitable in the extreme to construe Hart as lacking a theory of social and legal obligation when he rejects Austin, in part, on his perceived failure to provide a satisfactory account! Finally, Hart himself is clear in thinking that an analysis of the concept of legal obligation is foundational to a conceptual theory of law: for example, he writes, "It will be recalled that the theory of law as coercive orders notwithstanding its errors, started from the perfectly correct appreciation of the fact that" – and it should be clear that this is a metaphysical claim about law – "where there is law, there human conduct is made in some sense non-optional or obligatory" (*CL* 82).

4. A COMPREHENSIVE THEORY OF LEGAL OBLIGATION

4.1. Second-order legal obligation as defined by a social rule of recognition

Ultimately, there are two conditions, on Hart's view, necessary and sufficient for the existence of law and legal obligation. First, officials converge in taking the internal point of view towards and conforming to a conventional rule of recognition. Second, citizens generally comply with the rules validated by the conventional rule of recognition. First– and second-order mandatory norms in such a system define legal obligations.

The idea that officials take the internal point of view towards the rule of recognition suggests that they accept and treat it as an exclusionary reason in assessing their own and other officials' behavior. Like all forms of obligation, legal obligations are exclusionary in the sense that certain stories are disqualified as excuses or justifications for non-compliance; this is just true in virtue of what it means for a behavior to be "required by a mandatory norm". But insofar as officials *accept* the rule as a standard governing their behavior, they regard it as a reason and have a disposition to treat the rule as exclusionary in character.

It is important to recall here that Hart does not argue that it is *unilateral* acceptance that binds an official to the rule of recognition; that would be problematic because unilateral acceptance does not provide anything that necessarily has independent normative force given what we know about the psychology of ordinary persons. Hart argues instead that it is the *joint* acceptance by officials *together with social pressure* on each to conform to the rule of recognition that together warrant characterizing the rule of recognition as being "obligatory".

Such pressure is likely to have normative force for officials because they can be presumed to care about what other officials think. *Voluntary* membership in a social group governed by norms signals that the member regards at least some of the beliefs and actions of the other group members as having significant motivational force. It is, thus, reasonable to think that someone who seeks out membership in a social group, at least if their motivations are sincere and non-subversive, will regard such pressure to conform as having significant motivational force.

This does not imply that the motivation for conforming to a social norm must be explained in terms of a desire to avoid the social pressure.[14] I assume that most people want to avoid the condemnation accompanying a murder conviction and hence regard the prospect as having motiva-

[14] As Hart puts this important point, "[t]he fact that rules of obligation are gener ally supported by serious social pressure does not entail that to have an obligation under the rules is to experience feelings of compulsion or pressure" (*CL* 88).

tional force – and this includes people who commit murders. But the motives that explain why most people do not commit murder make no reference at all to these prospects. What explains why most people do not commit murder is, in part, a subjective moral reaction to murder (any decent person would be horrified at the thought of committing such an act) and a lack of extreme anger and hostility.

The point of these sorts of social mechanisms in Hart's analysis, then, is not to explain why officials accept the rule of recognition. Officials who take the internal point of view towards the rule of recognition are presumably motivated to conform to the rule by whatever desires brought them to officialdom to begin with. While officials would also presumably want to avoid the disapprobation of other persons in the relevant groups, Hart is not committed to explaining their behavior in terms of some necessary motivation to avoid such social pressure. Social pressure explains how the rule of recognition obligates, and not why officials accept this rule.

4.2. Second-order obligation as explanation of first-order citizen obligation

Hart's theory of second-order obligation will not explain first-order legal obligation. Merely showing that officials can obligate themselves through some mechanism does not show that their acts *qua* officials can *obligate* citizens. The claim that you and I have obligated *ourselves* to behave in a particular way does not entail any claim about the obligations of *other* people.

Whether officials can obligate citizens depends, in part, on to *whom* the officials owe their obligations. If the officials' obligations under the rule of recognition are owed to *citizens*, then it is reasonable to think that citizens are obligated by the norms valid under it. Given the logic of obligation, it is hard to make sense of the idea that a judge owes an obligation to all citizens to incarcerate citizens who violate norm *N* if *N* does not obligate citizens. It would be odd if the concept of legal obligation behaved this way.

But Hart's practice theory implies only that the obligations owed by group-members are owed to *other members*. Hart has nothing that would explain how obligations binding members of the group could be owed to anyone *outside* it; there is nothing in the practice theory as it explains the obligations of officials that entails that the obligation is owed to citizens. All the theory claims is that officials owe these obligations to one another – and this says nothing that would justify thinking official acts obligate citizens.

Of course, non-members might be obligated to follow rules of groups to which they do not belong. Non-Muslims are required to abide

by certain conventions that Muslims have accepted regarding behavior inside mosques, but this is explained by *other* standards to which non-Muslims are subject; non-Muslims have a duty to respect those conventions when in mosques. Since admission to mosques is conditioned on consent to abide by certain standards, one shouldn't enter a mosque unless prepared to abide by the relevant standards.

4.3. Coercive enforcement and first-order legal obligation

Once law is explained in terms of a social rule of recognition accepted by officials in an efficacious legal system, citizen obligation in modern municipal legal systems seems best explained in terms of the authorization of formal institutional mechanisms of coercive enforcement. The idea here is not that coercive enforcement of a norm, *by itself*, constitutes the norm as obligatory; rather, it is that coercive enforcement of a social norm *in a system that satisfies certain properties* – including the institutionalization of the relevant set of norms – constitutes it as legally obligatory. Coercive enforcement of a legal norm constitutes it as legally obligatory upon citizens, in part, because (1) the norm belongs to an institutionalized system of norms (2) grounded in recognition norms accepted and practiced by officials and is (3) minimally efficacious in regulating citizen behavior.

Here it is important to emphasize the normative dimension of this practice. While officials of the legal system need not regard a first-order law as a *moral* justification for enforcing the law against non-compliance, they regard it as a *legal* reason or justification (i.e., a reason that is internal in the sense that it is *within* the system of law) for such enforcement. Obligation is explained by a normative web of practices that includes the legal *authorization* of formal enforcement mechanisms as a legal justification for *applying* them to citizens for non-compliance.

Formal institutional enforcement should be distinguished from sanctions. Enforcement sometimes involves punitive intent, as it does in the case of a defendant who is being prosecuted for murder under the criminal law. But it need not involve such intent,[15] as in the case of a judge ordering damages for breach of contract.[16] Such enforcement mechanisms

[15] It is worth noting that Austin is careful to point this out: "Considered as thus abstracted from the command and the duty which it enforces, the evil to be incurred by disobedience is frequently styled a punishment. But, as punishments, strictly so called, are only a *class* of sanctions, the term is too narrow to express the meaning adequately" (*PJ* 22).

[16] As natural law theorist John Finnis puts it: "Not all lawful coercion is by way of sanction or punishment. Even the most developed legal systems rightly allow ... the arrest of certain suspected offenders or potential offenders, and of persons and things (e.g. ships) likely otherwise to escape due process of adjudication. Judgments may be executed,

include sanctions but also include the court's power of contempt, which backs every court order. Moreover, the court's authority over these mechanisms includes the authority to refuse to enforce or recognize a defective instrument of some kind, which might include a contract, will, or even a statute. Refusal to enforce a defective contract is part of how courts coercively enforce the laws governing formation of a contract.

What constitutes a mandatory norm as legally obligatory in modern municipal legal systems is that coercive enforcement is legally authorized. If the application of coercive force for violations of a valid legal norm *N* is *authorized* by some valid legal norm as a normative response to nonfeasance, then *N* is legally obligatory and its binding force is constituted by the authorization of the relevant coercive mechanisms. Of course, it is probably true that it is also a necessary condition for the existence of a legal obligation is that the application of the relevant coercive mechanisms are reliably applied in cases where they are authorized. But this is not part of what constitutes a norm as legally obligatory.

5. SUPPORTING CONSIDERATIONS

5.1. The centrality of coercive enforcement in modern judicial practice

The availability of formal, institutional coercive enforcement mechanisms is a central feature of law in modern municipal legal systems. Most obviously, the criminal law is characteristically backed with punishment. But such mechanisms also play a central role in civil law: the point of bringing a civil lawsuit is to get a court order requiring the defendant to do something. Sometimes the plaintiff seeks damages; sometimes the plaintiff seeks specific performance. However, any plaintiff who brings a civil suit in *any* legal system remotely resembling this one is asking the court not only for a judgment, but also a court order.

The court has authority to enforce its lawful orders by a formal, institutional coercive mechanism known as the contempt sanction. It is this power that enables the judge to enforce her orders in civil cases where they cannot plausibly be characterized as imposing direct or indirect sanctions. In systems like ours, *every* court order is backed by the legal authorization of the contempt sanction for non-compliance.

This suggests that coercion is central to legal systems resembling that of the U.S. Since the contempt sanction is both coercive and universally available to courts to enforce its orders in civil and criminal matters, it follows that every criminal and civil law is ultimately backed with a

and some other classes of debts satisfied, by seizure, distraint, forced sale," J. Finnis, *Natural Law and Natural Rights* (Oxford: Clarendon Press, 1980), 261.

coercive mechanism (since the court's contempt sanction is coercive). The authority of the court to issue coercively enforced orders is foundational to its ability to decide disputes in systems like this one.

At the very least, this much seems reasonable: in cases where (1) f*ormal* coercive mechanisms are generally authorized for non-compliance and (2) officials lack authority to apply these mechanism in enforcing a particular judgment, norm, or order with coercive mechanisms, it is implausible to characterize the judgment, norm, or order as "obligatory." Such norms are more fairly characterized as "advisory" because there is no sense in which the relevant behavior is made mandatory by mechanisms reasonably presumed to have normative relevance given human beings as we understand them.[17]

This is not to suggest that legal obligation cannot exist in a legal system without formal, institutional coercive mechanisms, which would entail that such mechanisms are a conceptually necessary feature of law – that is to say, that law is necessarily coercive. For purposes of this paper, I am agnostic with respect to whether there could be a system of law in normative systems where only informal social pressure is available as a coercive mechanism. I tend to think that law is necessarily coercive in this respect but nothing in the argument here should be construed to presuppose that view. Although the Hartian account of social obligation, as I have construed it, entails that social pressure is a necessary condition for social obligation, the account of legal obligation here assumes only that some form of social pressure is a necessary condition for legal obligation. The specific view that the authorization of formal, institutional coercive mechanism constitutes the binding force of obligation applies only to modern municipal legal systems like that of the U.S.[18]

In any event, the authorization of such measures is a more reliable indicator of a legal obligation than the language in which the relevant law is expressed. A statement asserting that the defendant "must" or "shall" perform some act is, despite its language, best characterized as "advisory" if no coercive legal consequences are authorized for failure to comply.[19] Further, a statute asserting that people "should" perform some act is, de-

[17] This should not be understood as implying that legal reasons are purely subjec tive belief desire pairs. At most, it presupposes that objective reasons, if such there are, are capable of functioning as subjective reasons in our practical deliberations given what we know about our psychological characteristics.

[18] Nor is it to suggest that the coercive mechanisms must be applied by an agency that is part of a legal system. As a conceptual matter, the prison system could be priva tized, for example, without altering the status of an institutional system of norms as a le gal system.

[19] There are, of course, some laws that authorize sanctions but are chronically unenforced. Whether or not these count as legally obligatory will be determined by whether they count as valid under that system's recognition practices. In some legal sys

spite its language, best characterized as "obligatory" if courts are authorized to incarcerate people who do not perform the act.

As a general matter, officials are quite careful to ensure that the words of an authoritative statement of law adequately signal whether coercive enforcement mechanisms are available, but this is explained by non-conceptual considerations. Conscientious officials want to ensure that authoritative statements of law convey appropriate notice of what is required. The terms "must" and "shall," in contrast to "should" and "ought," signal that some behavior is *required* and provide constructive notice to citizens that courts have recourse to some coercive mechanisms – though such terms do not say anything about the nature or severity of such mechanisms.

Still, it is the availability or non-availability of coercive mechanisms, and not the language in which a rule of law is expressed, that ultimately determines whether that rule defines a legal obligation. When the language in which a legal norm *N* is expressed and the availability of coercive enforcement mechanisms do not agree, it is the latter that determines whether *N* is fairly characterized as "legally obligatory" upon citizens.

5.2. Is coercive enforcement a conceptually necessary feature of law?

Many theorists believe that coercive enforcement is a conceptually necessary feature of law. Natural law theorists frequently acknowledge the central role coercion plays in law. John Finnis, for example, observes that "[l]aw needs to be coercive (primarily by way of punitive sanctions, secondarily by way of preventive interventions and restraints)." Likewise, Ronald Dworkin believes the conceptual function of law is to justify the state's use of its police power and hence that the law includes the moral principles that show statutory and judicial law in their best moral light. Further, positivists, like Joseph Raz, also acknowledge the centrality of coercion in law: "The three most general and important features of the law are that it is normative, institutionalized, and coercive."[20]

Intuitively, there is something to be said for this view. No matter how closely it might resemble societies with legal systems, a "society of angels" with rules promulgated under a rule of recognition does not seem to have "law" if these rules are not subject to coercive enforcement; such a society seems utopian and as having transcended law.[21] Indeed, it is the

tems, the chronic failure to enforce or apply a norm suffices invalidate the law, a situation sometime described as "repeal by desuetude."

[20] J. Raz, *The Concept of a Legal System*, 2nd Ed. (Oxford: Clarendon Press, 1980), 3. Hereinafter *CLS*. Raz has changed his view on this issue. See J. Raz, *Practical Norms and Reason* (Princeton: Princeton University Press, 1990).

[21] For example, Finnis asks, "Would there be a need for legal authority and regula tion in a world in which there was no recalcitrance and hence no need for sanctions" (*NLNR* 266)?

absence of a centralized authority with coercive enforcement power that leads many scholars to believe that "international law," strictly speaking, really isn't "law" at all.[22]

If this view is correct, then the theory that explains first-order legal obligation in terms of coercive enforcement has the advantage of explaining the essential role of coercion in law by linking it to another concept central to law – namely, the concept of legal obligation. The central role coercion plays in every conceptually possible legal system is explained by its conceptual role in defining the first-order obligations of citizens. Moreover, it would provide a link between the claim that it is a conceptual truth that first-order legal norms are enforced by the state's police power and the claim that it is a conceptual truth that first-order legal norms define citizen obligations.

In any event, the theory defended here neither assumes nor implies that coercive enforcement is a necessary feature of law. This theory purports to explain legal obligation only in systems, like those most familiar to us, generally backed by coercive enforcement. It does not purport to explain legal obligation in systems where mandatory norms are backed only by generalized social pressure of the sort that typically backs social obligations. Of course, in such systems (which otherwise satisfy the conceptual prerequisites for law), the foregoing analysis suggests that what constitutes such norms as legally obligatory, in part, is that they are backed by generalized social pressure.

This is a virtue, I think, because the jury remains out on the conceptual necessity of formal coercive enforcement mechanisms in law. Though he sometimes characterizes systems lacking formal enforcement as "pre-legal," Hart more frequently characterizes them as being "rudimentary" or "primitive" systems of law (*CL* 84).[23] Indeed, Hart generally speaks of such mechanisms as being common but not necessary: "the *typical* form of legal pressure [supporting legal obligation] may very well be said to consist in such threats [of physical punishment or unpleasant consequences]" (*CL* 179, 180; emphasis added).

5.3. The binding force of obligation

This theory explains the bindingness of mandatory legal norms in terms of considerations likely to be regarded by subjects as normatively relevant. First, being subject to coercively enforcement is a clear sense in which that norm can plausibly be characterized as being non-optional. Second, the authorization of coercive enforcement mechanisms including

[22] Hart, for example, observes that one good reason for thinking that what we call "international law" is not really law at all is that "there is no centrally organized effective system of sanctions" (*CL* 4).

[23] I am indebted to Scott Shapiro for this point.

the contempt power) is something that is normatively relevant to any rational citizen. This, again, is not to claim that citizens are necessarily motivated to obey the law by a fear of sanctions; rather, the point is merely that rational self-interested citizen are, as descriptive matter, likely to care about avoiding the coercive enforcement power of the state.

One might worry, however, that the sort of reason provided this theory of legal obligation is, as a conceptual matter, the wrong kind of reason. In particular, one might object that this account explains the normative legal obligation in terms of prudential considerations and hence reduces legal reason to first-order prudential reasons. This is problematic insofar as one thinks (1) prudential reasons are not the only basic reasons constituting a legal reason and (2) legal reasons are pre-emptive reasons.

As to (1), it seems clear that legal reasons, on a positivist view, being the product of a human artifact manufactured by social processes (i.e., a legal system) would have to be a compound reason reducible to basic reasons. And it is clear that a positivist cannot hold that it is a conceptual truth that a legal reason is partly reducible to a moral reason without violating the Separability Thesis that there are no necessary moral constraints on the content of law. As, we saw above, there is a limited palate of basic reasons to choose from: there seem to be no other kinds of basic reason other than prudential, moral, and possibly aesthetic reasons. And it should be clear that legal reasons are not constituted, even in part, by basic aesthetic reasons if such there be. If legal reasons are compound, the only kind of reason they could be reduced to are prudential reasons.

As to (2), the idea that legal reasons are pre-emptive reasons is contentious. While it is clear that mandatory legal norms are, by the very nature, exclusionary in the sense that they exclude certain justifications for non-performance, this does not, by itself, imply that the reasons created by such norms are pre-emptive in the Razian sense. Given the fact that Razian account of authoritative reasons is contentious, the objection simply begs the question against the account offered here.

5.4. The right kind of normativity

The idea that the authorization of coercive enforcement constitutes a mandatory norm as legally obligatory harmonizes nicely with another important idea concerning legal obligation – namely that there is no *prima facie* moral reason to obey the law. Most theorists have come to reject not only the idea that the law necessarily gives rise to moral obligations, but also the weaker idea that it is necessarily the case that we have a moral reason to obey legal requirements; indeed, many theorists are even skeptical about the idea that law in a legitimate state necessarily gives rise to a moral obligation to obey. If this plausible view is correct, then

the fact that a mandatory legal norm creates a legal obligation does not imply that it creates a moral obligation to obey it – or even that there is a *prima facie* moral reason to obey it.

This harmonizes nicely with the theory of first-order legal obligation defended here. The only reasons for action that are necessarily provided by a legally obligatory norm, if the theory here is correct, are prudential in character. Clearly, first-order legal obligation would be prudentially normative on the story offered here: it is not in the interests of a person, other things being equal, to be subject to the sorts of coercive mechanisms that are used to enforce mandatory legal norms. Equally clearly, first-order legal obligation is not necessarily morally normative on this story: there is nothing in the claim that the state has backed a norm with coercive enforcement mechanisms that would imply that there is even a *prima facie* moral reason to obey that norm.

This is exactly what we would expect if the prevailing view that law does not necessarily give rise to *prima facie* moral reasons to obey the law is correct. An analysis of legal obligation that implies we have even a *prima facie* moral reason to satisfy our legal obligations would be inconsistent with this view. The fact that, on the analysis offered here, legal obligation is not necessarily morally normative is a strong point in its favor.

Nevertheless, it is important to note that legal obligation is, as a conceptual matter, normative on the analysis offered here. Insofar as people have a *prima facie* prudential reason to avoid having a norm coercively enforced against them, they have a *prima facie* prudential reason to obey any mandatory legal norm. But this coheres nicely with the prevailing view that it is a conceptual truth that law is normative; since mandatory legal norms are at least prudentially normative, they are, *a fortiori*, normative.

Accordingly, law provides content-independent considerations that a practically rational subject will regard as relevant from the standpoint or prudential rationality or, as it sometimes put, content-independent reasons for action. These reasons need not be conclusive and might be outweighed for the actor by other considerations, but the authorization of coercive enforcement for a valid law always seems to provide some reason for complying with the law's requirements.[24] Legal obligation is thus, on this analysis, necessarily normative but not necessarily morally normative.

[24] See footnote 14. Norms may become invalid through desuetude.

6. OBJECTIONS AND REPLIES

6.1. The minimal moral respectability of law

One might think that a proper account of the notion of obligation requires some sort of conceptual moral constraints; for example, one might think that a set of social rules must satisfy some minimal moral threshold to count as *obligatory*. Although Hart does not hold this view and I reject it elsewhere, [25] it is worth noting that there are a number of necessary connections between law and morality (all compatible with positivism's Separability Thesis) that show law might satisfy such a threshold of moral respectability (if it were part of a proper account of obligation). Law makes possible forms of social cooperation not otherwise possible among non-angels and hence performs a distinctively moral task. As Raz describe it, "The law's task ... is to secure a situation whereby moral goods which, given the current social situation in the country whose law it is, would be unlikely to be achieved without it, and whose achievement by the law is not counter-productive, are realized" (*ABNL* 12). [26]

First-order law must also include some moral rules. Insofar as law conduces to the "minimum purpose of survival which men have in associating with each other" (*CL* 193),[27] there could not, according to Hart, be a society in which violence isn't prohibited:

> Reflection on some very obvious generalizations—indeed truisms—concerning human nature and the world in which men live, show that as long as these hold good, there are certain rules of conduct which any social organization must contain if it is to be viable.... Such universally recognized principles of conduct which have a basis in elementary truths concerning human beings, their natural environment, and aims, may be considered the *minimum content* of Natural Law (*CL* 192–3).

No ostensible legal system lacking these rules, which reproduce certain moral rules, could be sufficiently efficacious to satisfy the minimum conditions for a legal system.

Finally, as Leslie Green has noted, it is a conceptual truth that law is "justice-apt" in two respects.[28] First, it is the kind of thing that is particularly apt for appraisal as just or unjust. Second, a system of law is an apt environment for realizing certain goals of justice. As Green puts this

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[25] K. E. Himma, "The Ties that Bind: An Analysis of the Concept of Obligation," forthcoming in *Ratio Juris*.

[26] Raz also argues that law necessarily claims morally legitimate authority. J. Raz, "Authority, Law, and Morality." While many theorists have accepted Raz's view that it is a conceptual truth that law claims legitimate authority, not all have. and R. Dworkin, "Thirty Years On," 115 *Harvard Law Review* 1655 (April 2002), 1667.

[27] This, of course, seems also to be "a moral task."

[28] See L. Green, "The Inseparability of Law and Morality", Henceforth ILM.

plausible idea, "[p]ositive law is something like one necessary condition for justice" (*ILM* 10).

On the assumption, *contra* Hart, that there is a some minimum moral threshold a type of endeavor defined by set of norms must satisfy to give rise to obligation, the moral quality conferred by these features of law is surely enough to distinguish law from ordinary crime gangs,[29] but it does not preclude truly awful systems of law. Most theorists, after all, characterize Nazi Germany as having "laws" that give rise to "legal obligations" – even though some of those laws and legal obligations were so wicked that citizens were morally obligated to disobey them.

6.2. Law necessarily purports to obligate, but does not necessarily obligate

Some theorists believe that the positivist need not explain how mandatory legal norms obligate because it is not a conceptual truth that mandatory legal norms obligate; sometimes a law stating behavioral requirements creates a legal obligation and sometimes it does not. On Coleman's view, it is a conceptual truth only that law *purports* to create legal obligations. Accordingly, the positivist need only, as Coleman puts it, "make intelligible" law's claim to obligate citizens by showing that it is *possible* for law to obligate citizens (*PoP* 98).

This is inconsistent with practices that contribute to core understandings of *our* legal concepts.[30] While there is nothing in our ordinary practices that entails that it is a conceptual truth that law gives rise to *moral* (or real) obligations, the claim that legal norms stating coherent behavioral requirements necessarily define legal obligations is entrenched in both ordinary linguistic and legal practice. We say, for example, that Nazis were morally obligated to disobey the many reprehensible Nazi laws that created *legal* obligations.

Of course, the fact that a view does not conform to core usages and practices does not imply it is incorrect; however, one should reject such

[29] There remains some question even here about whether some "crime gangs" might achieve this level of respectability because there is some vagueness in the notion of a crime gang. A group might arise for the purpose of establishing a protection service in an area where police protection is inadequate. If participation in the protection service is coercive, then the group, whether characterized as a "crime gang," probably does not meet the requisite threshold. If it is purely voluntary and there are no other endeavors of the group, then it probably does meet the threshold, even if its providing the service itself is illegal. I cannot attempt to provide a complete analysis here of where the threshold is since this is not the view Hart takes.

[30] The denial of ordinary obligation talk, to use Mackie's language, would be an "Error Theory." Given the centrality of legal obligation to our legal practices and the role that our beliefs, conceptions, attitudes, and practices play in determining the content of our concept of law, the denial of these views entails that these practices, conceptions, attitudes, and beliefs are grounded in deep and systematic confusion.

usages and practices only if there is some very good reason for doing so. As far as I can see, there are only two adequate reasons for rejecting some core convention regarding the use of a concept as central to legal practice as that of the concept of obligation: (1) the convention is self-contradictory; and (2) the convention is logically inconsistent with core conventions regarding the use of some concept that is more central to legal practice.

There is little reason to think that ordinary conventions get into trouble with either of the above two conditions. Again, while it is undoubtedly false (though not incoherent) that legal norms stating coherent behavioral requirements, as a conceptual matter, necessarily create *moral* obligations, the claim that such norms, as a conceptual matter, create or define *legal* obligations, if not obviously true, is surely self-consistent and coheres with other legal concepts and practices.

Indeed, Coleman's claim that the philosopher must make intelligible law's claim to obligate implies that the claim that law imposes obligations is coherent. One cannot make an incoherent claim intelligible without changing its content; after all, incoherent claims are, by definition, "unintelligible." If law's claim to impose obligations is intelligible, then the claim that law imposes obligations is coherent.

6.3. An illegitimately normative account of obligation?

This theory might seem to have a normative dimension inconsistent with legal positivism. The concern here is that an adequate theory must explain obligation in terms of considerations normatively relevant to subjects is itself a normative claim inconsistent with a purely descriptive theory of obligation.[31]

The claim that legal obligation must be explained in terms of considerations that subjects are likely to find normatively relevant *is* a purely descriptive claim. The theory defended here is not grounded in either the normative claim that subjects *ought* to comply with the law or the normative claim that subjects *ought* to care about the threat of coercion. Rather, it is grounded in the purely descriptive claim that people generally want to avoid social pressure of various sorts. The claim that the bindingness of obligation must be explained by considerations people find normatively relevant – which is, as a descriptive matter, presupposed by ordinary use of "obligation" – is a different claim than one that requires that it to be explained by considerations people *ought* to find normatively relevant.

It is true, of course, that people should, as a matter of practical rationality, regard the threat of social pressure as normatively relevant, but

[31] I am indebted to Kevin Toh for this line of objection.

this claim does not figure into the analysis here. The claim that the bindingness of obligation must be explained by considerations people find normatively relevant does not presuppose or imply this claim. What people find normatively relevant and what they should find normatively relevant are two different matters.

In any event, the claim that the binding character of first-order legal obligation is explained by the authorization of coercive enforcement mechanisms is as much a descriptive conceptual claim as the claim that mandatory norms are exclusionary reasons. The fact that an analysis of a concept that has a normative dimension makes reference to elements that are normative does not make the analysis normative. The theory defended here is, like the theory that explains mandatory norms as exclusionary reasons, descriptively conceptual.

6.4. Legally oblige or legally obligate?

One might be tempted to argue that all this simply cannot add up to something fairly characterized as "legal obligation." On this line of analysis, the authorization of coercive enforcement of a social norm – even if a member of a minimally respectable system of social norms – cannot obligate someone who has not taken the internal point of view toward the norm, the system of norms, or the recognition norms creating that system. At the very most, the presence of these elements in a system might "oblige" the subject to obey, but it would not "obligate" the subject to obey.[32]

There are a couple of different shapes this argument might take. First, one could argue that the most that the primary legal norms in a minimal legal system can do is create *oblige-ings* that are legal in character; on this view, it is simply not a conceptual truth that primary legal norms backed by coercive mechanisms create legal obligations. Second, one could take the position that the inability of the elements I described above to create obligations refutes the theory of legal obligation I have defended in this essay; since it is a conceptual truth that the relevant primary norms create obligation, the inability of my theory to explain them constitutes a fatal defect of the theory.

Either way, the reasoning is problematic. To begin, the idea that it is not a conceptual truth that primary legal norms requiring citizens to behave in certain ways create legal obligations simply does not line up with use of the concept-term "legal obligation." As discussed above, the concept-term "legal obligation" figures centrally in our ordinary talk about legal practices and in those legal practices themselves. It is part of the very core of our linguistic and legal practices that we characterize

[32] I am indebted to Brian Tamanaha for this concern.

such norms as creating "obligations" that are distinctively legal in character and as "obligating" the subjects of those norms; in contrast, we do not talk in terms of "legal obligings." In the absence of some reason to think that such talk is mistaken or incoherent, there is little reason to reject the associated conceptual presuppositions.

Moreover, the concept of an obliging, unlike the concept of an obligation, picks out an "ought" that is prudential hence grounded in probabilistic assessments of self-interest. One is obliged by self-interest to comply with the gunman's order because, other things being equal, it is clear that the expected cost of not complying (i.e. the cost of not-complying multiplied by the probability of incurring the cost) dramatically exceeds the expected benefit of not-complying (i.e. the benefit of not-complying multiplied by the probability of achieving the benefit); in consequence, the expected value (i.e. expected benefit of complying minus the expected cost) is quite high. Whether or not a person *P* is obliged to do *a*, as a conceptual matter, depends on exactly such probabilistic considerations of the effects of doing *a* and of not doing *a* on *P*'s self-interest.

If this is correct, then it would not be a conceptual truth that primary legal norms that require certain behavior "legally oblige" subjects to comply. Assuming, of course, that we could make sense of this peculiar notion, it is false that complying with such norms necessarily conduces to the self-interest of subjects. Whether or not any particular subject *P* would be legally obliged to comply with a law *L* would depend on the expected value of compliance. And this would depend on the cost of non-compliance (e.g., a coercive sanction of sorts) multiplied by the probability of incurring the cost – which would depend on the likelihood that non-compliance would be detected by the legal system. This, of course, is precisely the implication that correctly kills predictive theories that explain obligation in terms of the probability of incurring a sanction.

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ECCLESIASTICAL LAW AND STATE LAW

The recently published, revised, supplemented and expanded edition of the 1938 textbook "Ecclesiastical Law" by Sergei Victorovic Troicki in Serbian language is a befitting occasion to call to mind his study on the ecclesiastical law, to percieve the contemporary place of the ecclesiastical law among legal sciences and once again examine its relationship with the state law. That the contemporary ecclesiasti cal law, being partly public, private, international, internal, objective, subjective, etc., cannot with complete reliability be classified into a separate branch of the law seems closest to the truth. Therefore, the ecclesiastical law may be said to make a separate sub subsystem within the subsystem of the autonomous law. The place of the ecclesiastical law and its relationship with the state law does not genuinely reflect the contemporary influence of the church on the state and society, which is much more powerful and more comprehensive than the influence of its ecclesiastical law. That the connection between the church and the state, and the ecclesiastical law and the state law, has almost never been broken is also shown by the fact that, starting from the Middle Ages, jurists have been awarded the degree (and title) of the doctor of the ecclesiastical and secular law (doctorus iuris utrisque).

Key words: *Church. State. Types of ecclesiastical law. Relationship be tween ecclesiastical and state law. Church and state relations.*

The ecclesiastical law in the ecclesiastical-law literature[1] is usually defined as the "statutable" law as it is based on the customary practices or ordinances and canons, which regulates the position, organisation and

[1] Dr Sergey Victorovich Troicki (1878 1972) was a professor at the Faculty of Law, University of Belgrade, a leacturer of cannon law in the capacity of a pofessor at the Theological Faculty; an expert of the Holy Synod of Bishops of the Serbian Orthodox Church; an excellent jurist; a famous expert in canon law; a polyglot and a writer of many works in the field of the ecclesiastical law. See: S. V. Troicki, *Crkveno pravo* [Church Law], Belgrade 2011, 521. Also see: Blagota Gardašević, "Dr Sergije Viktorovič Troicki", *Bo goslovlje*, XXIV (XXXIX), 1 2/1980, 175 188, and Dimšo Perić, "Sergije Viktorovič Tro icki i njegovo *Crkveno pravo*", *Anali Pravnog fakulteta u Beogradu* 1 2/2002, 177 183.

activities within the framework of the church itself and society. Today, it is thought that the ecclesiastical law is the law "in the area of one or several (as the Roman Catholic Church) states, within which exist (legally recognised) autonomous communities or institutions".[2] The ecclesiastical law also denotes "canon law (body of legislation of the church) which determines specific spiritual and social activities of the church and its members, or the ecclesiastical law created by the state as the system of the state legal regulations within the province of the church (organisation of the church, its legal position as to the state and inter-confessional relationships)".[3] When the concept of ecclesiastical law is determined in its broadest possible extended meaning, it may also include the rules "created by the religious authority", i.e. religious rules.[4] In spite of the similar determination of the concept, there are few laws the meaning of which is being thus argued over. This is not surprising though, as in the history of mankind the influence of the ecclesiastical law has always been dependent on the reach and effects of the church in a society. On this intersection depends the contemporary place of the ecclesiastical law and its relationshp with the state law.[5]

1. CHARACTERISTIC VIEWPOINTS ON THE PLACE OF THE ECCLESIASTICAL LAW

There are at least five specific viewpoints on the place the ecclesiastical law holds among other legal sciences.[6] They came into being depending on the priorities given by the legal and church scholars in the ecclesiastical law: secular over spiritual or spiritual over secular, that which makes it dependent on or independent of the state law, their individual or traditional classifications and typologies of the scientific disciplines, etc.

1.1. Ecclesiastical law as a type of public law

According to this monistic-statist viewpoint, the ecclesiastical law belongs to the public law. The viewpoint that the *ius sacrum* belongs to

[2] Toma Živanović, *Sistem sintetičke filozofije prava*, III, Belgrade 1959, 15.

[3] See: D. Perić, *Crkveno pravo*, Belgrade 1997, 21; Nikodim Milaš, *Pravoslavno crkveno pravo*, Belgrade 1926; Čedomilj Mitrović, *Crkveno pravo*, Belgrade 1929; Ante Crnica, *Kanonsko pravo Katoličke crkve*, 1937; S. V. Troicki, *Crkveno pravo* (skripte), I III, Belgrade 1937 1938.

[4] See: T. Živanović, *Sistem sintetičke filozofije prava*, II, Belgrade 1951, 14 15, 56 57 and III, 141.

[5] See: D. M. Mitrović, *Teorija države i prava*, Belgrade 2010, 187 209, and *Au tonomno pravo*, Belgrade 2010, 43 63.

[6] See: V. Troicki, *Crkveno pravo*, 41 50.

the public law existed in ancient Rome. It was recorded in the *Digesta* (I, I, 2). It reads: "Publicum ius in sacris. In sacredotibus in magistratibus consistit".[7] Such viewpoint was defended by many protestant legal authorities (Varkoening),[8] and sometimes by the Eastern Orthodox jurists and canonists who believed that the state is the only source of the law (N. Suvorov, A. G. Rozenkampf, A. Djordjević).[9] According to them, there is no need to make the distinction between the public and private law in the ecclesiastical law since the overall ecclesiastical law is public in its character, as a kind of emanation of the state sovereignty. In favour of this viewpoint stands the fact that the state usually enacts laws on church organisation or confirms some ecclesiastical regulations which due to the confirmation become legal in their character. That was particularly the case in the Byzantine state where the so-called "theory of symphony" had been applied for centuries to regulate the relationship between the church and the state. Its essence is as follows: in the interrelationship between the church and the state there are two extremely unnatural situations. These are *Caesaropapism*, when the ruler is the supreme head of the church and the state, and *Papal-caesirsm*, when the spiritual head is vested with authority both over the church and over the state. Since both situations are unnatural for the church and the state and inflict damage on the community, the existence of the two authorities is the best: the ecclesiastic and the state, like two interweaving circles producing three areas: a purely ecclesiastical area, a purely state area, and a common area. That is why – it was thought – the best form of the state is the one in which exists "symphony".[10] In modern times, state legislation referring to the internal church organisation emerged from the Lutheran concept of the state authority as the bearer of the episcopal church authority.[11] However, at the time it was also thought that the idea of the confirmation of the ecclesiastical laws by the state authorities was important only to the state – the ecclesiastical regulations become legally valid because of the confirmation by the state, but for the church, these regulations may be legally valid before they are being confirmed by the state.

1.2. Ecclesiastical law as a type of private law

According to this viewpoint, the ecclesiastical law belongs to the private law. The idea underlying this viewpoint is found in Jean-Jacques

[7] *Ibid.*, 45.

[8] See: S. V. Troicki, 45; Taube, "La situation internationale actuelle du Pape", *Archiv fur Rechts und Wirtschaftphilosopie*, 1907, 360 369, 510 518.

[9] See: S. V. Troicki, *ibid*. Н. Суворов, *Учебник церковного права*, 3rd edition, Москва 1908, 7; G. A. Rozenkampf, *Обозрение Кормчей книги в историческом виде*, Москва 1839[2].

[10] See: D. Perić, 165 167.

[11] See: R. Sohm, *Kirchenrecht*, Leipzig 1892.

Rousseau's teaching. According to Rousseau, religion is needed as a personal feeling, though every religious organisation damages the state. (Since logic requires consistency, the opposite may also be claimed: every state organisation damages the church, though it is not always so.) This Rousseau's idea was later repeated in the Gothic and Erfurt programmes in the words as follows: "Religion is a private matter" (*Religion ist Privatsache*).[12]

Such system, usually called the system of separation of church and state, does not in the least help bring about the solution to the problem of determining the nature of legal regulations which govern the internal church life. These regulations *per se* or independently of the stand the state takes on them cannot be classified within the private law. Also, this system confuses the nature of the ecclesiastical regulations with the state's stand on them. Already in the Digesta (38, 2, 14) it was written: "Public law cannot be altered by agreements made by private individuals" (*Ius publicum pactis privatorum non potest*). The will of the state with the authority to command stands above the will of private individuals. In Germany, this viewpoint was most consistently advocated by Adalbert Falck despite the reasons disputing the relevance of the viewpoint on the ecclesiastical law as the private law.[13]

The next question which may be posed reads: "Can private individuals by their own will alter the regulations of the ecclesiastical law?" And, the answer is yet again the same: "They cannot!"[14] For the church membership these regulations are of an even more superior authority and unalterability than the state laws. Such answer renders possible the conclusion that the ecclesiastical law is public in its character, although that character is not the one of the state but is *sui generis*, i.e. ecclesiastical. [15] Ecclesiastical regulations may become "the public law of the state", this being but an option which depends on the will of the state authorities, which determines the position of the church.

1.3. The admixture of the public and private nature of the ecclesiastical law

According to this compromising viewpoint (dualistic-statist), the ecclesiastical law is an admixture. Its one part belongs to the private and the other to the public law. This viewpoint is advocated by the earlier ecclesiastical-legal authors, including Schulte, Niels, Schteckart, Schilling or Maretzoll.[16]

[12] See: S. V. Troicki, 47.

[13] *Ibidem*.

[14] *Ibidem.*

[15] *Ibidem.*

[16] *Ibidem.*

The viewpoint of Maretzoll is characteristic. According to him: "Any man by his faith joins a religious community; hence the appearance of more or less particular religious relationships, which fully coincide with the state relationships almost everywhere and without exception where there is a purely national religion. For example, the Romans had it that the *ius sacrum* belonged to the *ius publicum*. Where there is no coinciding between the state and religious interests, as is the case in all Christian states, there the relationships between the body of the faithful and their religious community – the church, constitute the ecclesiastical law. If it has to do with the relationships of the church with respect to the state, the ecclesiastical law belongs to the state law as its constituent part. However, as it touches individual interests and gives them another form, it thus comes under the private law as well. All other matters in the ecclesiastical law are found on the above-mentioned border between the private law and the public law".[17] Maretzoll explains his viewpoint by the fact that every man by his own free will and faith joins the church as a religious community. These relationships belong to the ecclesiastical law because they are private in character. However, when it has to do with the public relationships of the church with respect to the state, the ecclesiastical law at large belongs to the state law.

The mentioned Maretzoll's viewpoint is not acceptable, because on the basis of it even the opposite may be concluded: that the ecclesiastical law at large falls under the state law since the public law (*ius publicum*) and the private law (*ius privatum*) are two traditional types of the state law, and not an area of the state law and an area of *droit social*, as it might be thought.[18] Most often they differ in subjects, contents or procedures of enactment, but not in its original character or the capability of the state to impose its sanctions. That is why Maretzoll's viewpoint is seemingly admixed. In effect, it is only formally dual and essentially statist-monistic.

There are still a number of important reasons challenging the viewpoint on admixed character of the ecclesiastical law. First of all, such viewpoint would be truthful if the church were a state institution. However, the church, as well as the state, is a perfect, fully free and sovereign society, *societas perfecta et plane libera*. Also, although it is true that the ecclesiastical law touches interests of private individuals, it still does not follow therefrom that any part of the ecclesiastical law should be considered private law in the same sense in which it is done in reference to the

[17] Maretzoll, *Lehrbuch der Institutionen*, 1886, 5. 7. See: S. V. Troicki, 47 48.

[18] The first systematic classification of the law, for the sake of calling to mind, is usually associated with the Roman dual (bipartite) division of the law into the *ius publi cum* and the *ius privatum*. As the classical Roman dual division has remained prevalent all the time, so it has also been in the 19th and 20th centuries at the time when a more comprehensive teaching of the legal sciences was much more paid attention to.

secular civil law. While the secular civil law moves within a space bounded by the laws created by the state for individuals, the ecclesiastical law, which is concerned with the interests of individuals (e.g. matrimonial law, right to private prayer or private study), moves within a space bounded by the regulations created by the church itself. Moreover, in addition to the regulations governing personal lives of the church membership, the ecclesiastical law also includes the provisions regulating the organisation and relationships of a society as a whole. For example, the ecclesiastical-administrative law and the ecclesiastical-judicial law are similar to the public state law, while the matrimonial and ecclesiastical-property laws are similar to the private state law. However, "this is but a similarity, just an analogy, because the mentioned branches of the ecclesiastical law in terms of their substance do not fall under either the public or the private law".[19]

1.4. Ecclesiastical law as a type of *droit social*

According to this sociological-pluralistic viewpoint, the ecclesiastical law falls under a special type of the *droit social*. Especially insistent upon this viewpoint are jurists who advocate the trichotomy in the law, claiming that the law at large should be dived into the public, private and *droit social*. In the last mentioned they include also the ecclesiastical law.[20] An interesting trichotomous division of the law was made by Rudolph von Mohl. According to it, in addition to the public law and the private law, there also exists the *droit social*. It is created on the basis of the original social authority, rather than on the derivative state authority. As a result, the ecclesiastical law cannot be classified either into the public or into the private law, and makes a third separate group of the law "beyond the state law". An interesting trichotomous division of the law was also made by Fridrich Karl von Savigny and Georg Fridrich Puchta. They, too, classified the ecclesiastical law into a third, separate group, in addition to the public law and the private law as the ecclesiastical law is the most voluminous and developed among all types of the laws.

The farthest in the matter at hand acted Georges Gurvitch, who classified the law at large – therefore, the ecclesiastical law as well – into one single law – the *droit social*. According to Gurvitch, the object of social regulation is the internal life of a community, while its externality, the manifestation of the *droit social*, consists of *social power* which is not linked up with the power of the state. *Droit social* can be "pure", i.e. completely independent of the state, and can (remaining "pure" nevertheless) be subjected to the protection of the state. It stems from the collective sense which Gurvitch calls "We". This is the *droit social* of a com-

[19] See: S. V. Troicki, 49.

[20] See: T. Živanović, III, 351, 354 355.

munity, which includes in an objective way, every active real entity and which embodies a beyond-time positive value... no mater whether it is organised or unorganised with the aim to organise social life, which means that it derives its binding force from the social group within which it was created and integrated".[21] That is why the *droit social* is integrative, spontaneous, the law of collaboration and co-operation. It "in its organised form addresses specific subjects of law – complex collective persons – that should be equally distinguished from the isolated individual subjects, as well as from the legal persons... These different *droit social* centres may be superior to the state (international bodies and organisations) or subordinated to the state (trade unions, co-operatives, trusts, factories, churches, decentralised public services, international organisations, etc.)".[22] On this basis Gurvitch creates his famous typology of law, in which concurrently with the state law exist three main types of the *droit social*.[23]

If the social-pluralistic viewpoint were to accentuate only the thought that the ecclesiastical law does not depend on the will of the state and private individuals, it would be acceptable. However, it equates the church with other associations (trade, scientific, charity, economy, etc.), which is why it is wrong. Although the mentioned associations are established by the will of their members, they are nevertheless formed within the state and granted the approval for their existence by the state, they are subordinated to the state sovereignty and can be terminated by the will of their members or the state. Thus is shown that the *droit social* is not quite an independent branch of the law, but that it is comprised of the elements of the public law and the private law. This is also the case with the secular part of the ecclesiastical law.

The first four presented viewpoints classify the ecclesiastical law into the secular law. In particular the first three viewpoints which take as their point of departure the idea that the state is the only source of the law (*kein Recht ohne Staat*). Ecclesiastical norms become legal only upon being approved by the state. More modern, the fourth viewpoint determines the ecclesiastical law as a type of the pluralistic *droit social*: the state is like "a small, deep lake which is lost in the vastness of the sea of the law, surrounded from all sides by it... ".[24]

In favour of the opinion that the state is the only source of the law yet two more important reasons are given. Firstly, the church itself cannot create the law for the law exists only where there is a threat of imposing sanctions upon law-breakers; and sanctions always needs coercion which

[21] See: G. Gurvich, *L' idée du droit social*, Paris 1932, 15.

[22] *Ibid.*, 46 95.

[23] *Ibid.,* 80 81.

[24] *Ibid.*, 30.

in turn requires external forcible imposition. Since the church does not have at its disposal its own external force, i.e. it does not have "its own police or army to enforce its sanctions", it may be concluded that the church cannot have its law. Thus, the only source of the law is the state. It can to a varying extent authorise other subjects to themselves create and to implement their law in its stead. However, in that case, it is the sanction of the state that is needed to punish the violators of such autonomous social regulations. And secondly, in the same territory only one sovereign body can exist, and it is the state.[25] It follows therefrom that the provisions of the ecclesiastical law also stem from the state sovereignty, i.e. that the ecclesiastical law is a type of the law dependent on the state and its law, which is not in agreement with all the ecclesiastical-legal writers.[26]

1.5. Troicki on the original nature of the ecclesiastical law, its original place and its relationship with respect to the state law

In the opinion upheld by Troicki, the ecclesiastical law does not fall under any of the existing groups of the legal or ecclesiastical disciplines, but differs from all of them by its original nature. As a result, it establishes an original relationship of the co-ordination with the secular law, and not of the subordination. It brings to mind the social-pluralistic teachings of Leon Petrazycki, Georges Gurvitch and other followers of the social pluralism in legal science.

In support of his viewpoint Troicki mentions a number of important reasons. In the first place, the church in terms of its origin, nature, objective and resources has at its disposal a significant distinguishing feature which makes it distinct from all other societies. It came into existence independently of the will of the state. Christian church was founded by Jesus Christ and his disciples, completely independently of the state.[27] And not only did the church come into existence independently of the state, but also despite the will of the state. In the first three centuries the state considered the church an illicit collegium – *collegium illicitum*.[28] That historical fact is in agreement with the claims of the mentioned advocates of social pluralism, who in their teachings also point out that social organisations and the law have come into being before or independently of the state and its law. However, Troicki obviously differs from the advocates of social pluralism when he claims that the church has not been created by the will of its members, but, according to its doctrine, "from

[25] *Ibid.,* 42 43.

[26] See: R. Sohm, *Krchenrecht die geschichilichen Grundlagen*, 1892. See: S. V. Troicki, 35 40.

[27] See: S. V. Troicki, 49.

[28] *Ibid.,*42 43.

up there, by the will of God himself". The church reflects human nature itself, and not the will of individual persons or collective groups. The church is not only a society, but an institution. It cannot be abrogated by the will of its members or the will of the state. According to its doctrine, it must exist forever. And while all other associations may belong to the public or to the private law branch, this is not the case with the ecclesiastical law.[29]

Departing from the mentioned points, Troicki further claims that the ecclesiastical law besides being not secular is moreover completely independent of the state. The law precedes the state. The state does not create the law, but the law, i.e. "natural legal sense" creates the state. Before him, that claim was emphasised by Leon Petrazycki, according to whom the law is a product of conscience, an individual-psychological experience. It exists as a multitude of legal experiences, i.e. as a product of emotions and intuition. Petrazycki calls this law an "individual experience" or "intuitive law". It appears spontaneously, comes into being directly from the conscience of an individual and manifests itself outside the state in the minds of individuals and collective experience. Petrazycki was among the first who thus opposed the opinions which point out the unity of the law based on the state coercion. He emphasised spontaneity and intuition as the elements decisive for coming into existance, the explanation and the determination of the law.[30] Exactly the same also does Troicki when he claims that there is no state without the law, but that the law may exist and, in effect, it does exist outside the state (for example, when it has to do with children, families or indigenous peoples who are incognizant of state organisation).[31] If the law can exist without the state, it follows therefrom that the church too may create its law on its own and independently of the state.

Neither is the third reason, which suggests that the state sanctions are important in the law, defendable. According to Troicki, the law exists even when there are no state sanctions. Moreover, outside the church too, there is a whole series of sanctions which are not coercive in their character (e.g. public disgrace, *infamia* in the Roman law). This even more so being the reason for the church to have sanctions which do not have the character of coercive force, but are nevertheless more efficient than any other coercive force (e.g. ecclesiastical ex-communication).

Trocki therefrom concludes that the change in legal conscience, and not the external coercion, determines the fate of legal institutions. If that were true, the legal would be only those norms which are voluntarily

[29] *Ibid.,* 44 and 49.

[30] See: L. Petrazycki, *Law and Morality*, Cambridge 1955 [*Teorija prava i mora la*, Beograd, Podgorica, Sremski Karlovci 1999 (transl.)].

[31] See: S. Troicki, 41.

obeyed by the morally motivated individuals, while it would not be the case with the norms which are disobeyed by the unmotivated individuals. The afore-mentioned contradiction in which Troicki becomes entangled by overly expanding the concept of law can easily be removed by way of which the ecclesiastical norms, which are based on the probability of the imposition of the mental punishment upon the wrongdoer, will be considered a type of the "naked law" (*nudum ius*), whilst all the other ecclesiastical norms, which are based on the probability of the imposition of the coercive force upon the wrongdoer, will be considered the complete or incomplete legal norms. Such a solution is not incorrect since even without the mentioned expansion it is possible to reliably determine the concept of law in its expanded meaning, which will be hereinafter shown.

Finally, Troicki points out, one cannot accept as true even the reason referring to the territoriality according to which the church cannot have its own – of the state – independent law, for then it would be the state (*statu*), whilist the interrelationships between the church and the state would fall under the international law (*ius inter civitates*). Although the church is found in the same territory as the state is found, it is still not found within the state area, thus rendering the possibility of the conflict between the church and the state lesser than that between the states. The truth of the matter is that the sovereignty is essentially indivisible. On the other hand, it is divisible as to its jurisdictions. (*Kompetenz-Kompetenz theory*). This means that the jurisdiction of the church sovereignty differs from the jurisdiction of the state sovereignty. In view of this important difference, Troicki concludes that the church sovereignty and the state sovereignty can exist in the same territory.[32] And furthermore – it is possible to consider the subjects of the international law, without being contradictory though, all the churches which conclude international agreements. The most famous are the concordats, i.e. the international agreements which regulate the international relationships between the church and the state. For instance, by the concordats have long since been regulated the relationsips between the Roman Catholic Church and the states, which is also the case with the Protestant Church and the Orthodox Church.[33] The most recent example is the concordat concluded between the Vatican and Montenegro in June 2011.

Troicki supports the above-mentioned claim by referring to the fact that in the modern state law and the international law exist teachings on the individual rights of citizens which are, in principal, outside the area of the state jurisdiction. This claim is very similar to Jean-Jacques Rousseau's teaching on the inherent natural rights of the people which precede

[32] See: S. V. Troicki, "Međunarodna zaštita religijskih prava", *Ariv za pravne i društvene nauke*, February March 1926.

[33] See: S. Troicki, *Crkveno pravo*, 45.

the society and the state. It follows therefrom that the state depends on the people, and not the people on the state. Within these rights have long since been included the freedom of speech, the freedom of assembly, the freedom of association, and, above all, the freedom of religion and conscience. In this field, it is not the state that is sovereign, but an individual, i.e. sovereign are his/her religious and moral conscience and will. If an individual is sovereign in the area of the mentioned individual rights, the fuller is the exercise of the "sovereignty of assembly" right of individuals united by their common religious beliefs in the church which by its provisions and on its own regulates the areas of the freedom of religion and conscience. And exactly here lies the answer to the objection according to which there cannot exist "status in statu", i.e. the state within the state. It is true that the state within the state cannot exist, but the church is not the state but "the kingdom which is not of this world". As a result, it "is not in the area of the state, but has its separate area at its disposal".[34]

A few more important ideas characteristic for the teaching of S. V. Troicki should be pointed out. First of all, he defended the right of the science of the ecclesiastical law to exist independently. He regarded as unnecessary the "purity" stands of the ecclesiastical-legal writers, who contested the concept of the ecclesiastical law, considering it as a type of *contradictio in adiecto*. Of a stimulating effect is also his other idea – that the conflict between ethics and the law does not hold. This idea of his is based on the claim that the church is not only a spiritual society, but also a secular one since the ecclesiastical law exists wherever the church exists. Otherwise, the church "turns into and moves to either the anarchic sects or the part of the state apparatus".[35] Neither does the formal factor of the law "contradict the substance of the church since the external forms are required by religion too, and even by ethics. Hence, coercion and its force are not the choice of the law".[36] The choice is concerned with freedom and love. Their promotion should not be only the task of the church, but of the state, too. In their absence, we must content ourselves with its being at least "decent" (civilised), i.e. to contain at least a "minimum of morality".[37]

The controversies between the first four viewpoints and the fifth viewpoint of Sergey Viktorovitch Troicki on the place of the ecclesiastical law may be softened by showing the multiple layers of the concept of the ecclesiastical law, its different types, chracteristics and its contemporary relationship with the state law.

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[34] *Ibid.,* 40.

[35] *Ibid.*, 39 40.

[36] *Ibid.*, 37.

[37] See: L. Fuller, *Morality of Law*, ed. Yale Universiti Press, New Haven and Lon don 1964, and *Moralnost prava*, Belgrade 2003 (transl.).

2. THE MULTILAYERDNESS OF THE ECCLESIASTICAL LAW CONCEPT AND ITS PLACE IN THE SYSTEM OF LAW

2.1. Secular and sacral ecclesiastical law

In Roman law, Marcus Tullius Cicero and Marcus Fabius Quintilian made a clear distinction between the *ius publicum* and the *ius sacrum*.[38] The former at large related to the secular law, and the latter to the ecclesiastical law. Today, that distinction is softened in favour of the secular law. It looks like the ecclesiastical law is a somewhat "softened" derivative of the state law.

Something like that is only partially acceptable on condition that within the ecclesiastical law itself an additional distinction is made between its *secular part* (e.g. its *ius publicum* and *ius privatum*, which refer to the organisation and the functioning of the church, its relationship with the state and the society, how the decisions and other regulations are brought, property-related relationships, matrimonial relationships, etc.) and purely *sacral part* (*ius sacrum*) which contains the earliest religious norms. Such additional division, which suits better the contemporary relationship between the church and the state, deviates from the original Roman division, but not to the detriment of the independent existence of the ecclesiastical law. It also exists independently even today, when it is concerned with its other, purely sacral part, when one may really speak of the original ecclesiastical law, which is not even a softened derivative of the state law. Also, under certain conditions, one may speak of the original nature and the original place of the ecclesiastical law at large, based on the prior assessment as to what is more prevailing in it. One may only ask whether all the ecclesiastical norms are really the legal ones.

The answer to the question about the ecclesiastical law norms being legal depends on how the general concept of the law will have been determined in anticipation. Thus is at the same time solved the question referring to the determination of the derived concept of the ecclesiastical law. Only then is it possible to embark upon the determination of the areas over which the ecclesiastical law and the state law spread, which depends on the historically changeable relationship between the church and the state. Therefore, on the answer to this question depends what place the ecclesiastical law in the system of legal and ecclesiastical sciences will hold.

2.2. The concept and types of the ecclesiastical law: complete, incomplete and unfinished

When it has to do with the determination of the concept of law, it should be emphasised that this concept is not one-sided. In fact, the law

[38] See: Cicero, *Pro domo*, 49; Quintilianus, *Institutiones*, II, 4, 33.

at large is composed of a number of basic layers, i.e. types of the law of different degrees of being legal. Such understanding of the law – resembling "a series of coverings of an onion bulb",[39] renders possible the determination of the ecclesiastical law conventionally in the expanded and restricted meanings, and thereafter the determination of its relationship with the state law, too.

In determining the *expanded concept of the (ecclesiastical and state) law*, notice should be taken that the law at large has at its disposal a certain number of common characteristics. They are externality (corporality), heteronomy, social character, regularity (demarcation of interests), the object to be regulated (the three separate types of social relationship: property-related relationships, the relationship of the government and the organisation of society), measurability and precision, the existence of a dispute and the coming into existence of the court, special formalisation procedure, social (external) sanction, the realisation of the social and legal values: order, security, peace, justice, freedom and the enabling of the "co-existence" of the people in a society.[40] Only by having these characteristics do social rules acquire legal character. However, the mentioned legal characteristics are not present in the same amount in all legal norms. Some legal norms have at its disposal all the mentioned common characteristics, and others do not. The former are complete, and the latter are incomplete. On this basis, it is possible to determine different types of the ecclesiastical law and the state law.

The complete ecclesiastical law includes only the norms which have all the characteristics of the law. This is also the case with the *complete state law*. The most obvious difference between those two types of law exists in reference to the subjects which create them and the types of their "legal sense", while other differences need not be so clearly expressed.

There is also *the incomplete ecclesiastical law*. It contains the norms which do not have all those legal characteristics, but have a majority of them at least. That is why it necessitates the posing of the question whether the incomplete ecclesiastical law should have a state sanction. Since both these two situations may be encountered, i.e. that the norms of the ecclesiastical law have or do not have at their disposal the state sanction, it follows that there are *two types of the incomplete ecclesiastical law*. The first type comprises the ecclesiastical law which contains the majority of the common legal characteristics, among which is included the state sanction too, and the second type is the ecclesiastical law with the majority of the common legal characteristics, among which is not in-

[39] See: D. M. Mitrović, *Teorija države i prava*, Belgrade 2010, 205 209, and *Au tonomno pravo*, Belgrade 2010, 62 63.

[40] See: R. Lukić, "Pojam prava", *Zbornik za teoriju prava*, II, Belgrade 1982, 28.

cluded the state sanction. For the first type of the incomplete ecclesiastical law one may say that it is "less perfect" than the complete ecclesiastical law, while for the second type of the incomplete ecclesiastical law one may not say even that. Yet, the law knows of the norms without sanctions (*leges imperfectae*), which is the case with the constitutional principles on the right of the citizens to work, the right to inviolability of privacy, the right to the conclusion of contracts in good faith, the right to freedom of conscience, etc. In view of the fact that such norms do not contain provisions as to someone's obligation to legally support them through sanctions, nor the enforcement of the sanctions either, it has rather to do with an illusion of the law or at least with something like the "naked law" (*nudum ius*).

All the afore-said about the incomplete ecclesiastical law also applies to the *incomplete state law*, which also has at its disposal the majority of the common legal characteristics with or without the state sanction. On this basis, *two types of the incomplete state law* can also be determined: the "less perfect" or "incomplete" state law and the "unfinished" or "unrealised" (*nudum ius*) state law. In comparison with them, the complete state and ecclesiastical law should represent the "higher degree of development of one in many ways the same social phenomenon" – the law in its entirety and at large.[41]

The determination of the law in its expanded meaning enables the determination of at least three types of the ecclesiastical laws and three types of the state laws, respectively. Each type of the law in its expanded meaning can be classified into three layers. The first layer consists of the *complete* ecclesiastical or state law. The second layer consists of the so-called *incomplete*, "imperfect" laws (John Austin) or the laws of "decreased value" (Ronald M. Dworkin and John M. Finnis), which is exactly what the ecclesiastical law and the state law are. The third layer consists of the illusions of the law – the *unfinished* or unrealised ("naked") ecclesiastical or state law. Neither are such norms, as already mentioned, insignificant from the position of the political culture and social life. Besides, it may chance that they subsequently gain the support of the state sanction (for instance, by the enactment of a legal or an ecclesiastical provision on imposing the sanction upon them, or by the decision of the constitutional or some other state and ecclesiastical court), whereupon they subsequently (*ex post*) become complete or perfect (*leges perfectae*).

Obviously, the concept of law is not one-sided, nor is it monlithic, but complex, detailed and as a whole composed of layers of different degrees of being legal. This at large applies to both the ecclesiastical law and the state law. The most important and stringent are the complete ec-

[41] *Ibid.,* 29.

clesiastical law and the state law. Afterward follow the incomplete ecclesiastical law and the state law. In the end is found the incomplete ecclesiastical or state law. The norms of the ecclesiastical or the state law which do not have at its disposal the majority of the common legal characteristics do not come under the law at all, but under the social rules.

Also, within each of the mentioned layers can be determined the "sublayers" of the ecclesiastical and state law, and within the sublayers their "sub-sublayers". It reflects the reality for within each type of the ecclesiastical or the state law there exist its special subbranches, and within each one of them there exist numerous institutions, subinstitutions and sub-subinstitutions, etc., all the way up to the norms which belong to the precisely determined type of the ecclesiastical or state law.[42]

In addition to the parallel, there exist the interwoven subbranches, institutions, subinstitutions, etc., of the ecclesiastical law and the state law, which makes the whole picture an unprecedentedly much more complex than the one shown. Perhaps, it is to the best to talk about the *ecclesiastical law as the special sub-subsystem within the area of the autonomous subsystem of the law*. It exists concurrently with other subsubsystems of the autonomous law and the subsystem of the state law, and comprises the unique law of the involved state.

Such determination does not diminish the importance of the ecclesiastical law, but makes contemporary both its place and its relationship with the state law. In contrast to other similar autonomous sub-subsystems of the law (corporate, guild, employer, trade union law or the rules of other social subjects), it is only the ecclesiastical law that has, in an undoubtedly recognised way, at its disposal – though only in one of its parts – the independence from the state. This being due to the particular role of the ecclesiastical teaching and the mission of the church in a society, in contrast to all other social organisations.

The afore-mentioned multilayerdness of the ecclesiastical law and the state law cannot be ascribed to chance. As suggested, it is used to finely tune the order of the relationships between the different importance and the degree of conflict, and, which is also important, to adequately legally regulate also those social areas which would, in the absence of the ecclesiastical law, be regulated by the state law or with the social norms. It is thus shown how between the state law and the social norms there exists a vast social area which is occupied by the ecclesiastical law. Also, it is readily observeable that all types of the state law belong to the secular law, while it is not the case with the ecclesiastical law.

The restricted concept of law (ecclesiastical and state) may be determined when only one of its legal characteristics is chosen as the most important. This is the case when the law as "a substantial normative phe-

[42] See: D. M. Mitrović, *Teorija države i prava*, 545 551.

nomenon" is determined with respect to the state sanction as its most discerning external characteristic. According to this measure, the legal norms would be only the complete and only those incomplete ecclesiastical and state norms which have at their disposal the state sanction. Other incomplete ecclesiastical and state norms, which do not contain the state sanction, would fall under the social rules, independently of the degree to which they have at their disposal other common legal characteristics. This statist viewpoint clearly points out that the law is always based on the force. It is only the force that is to a varying extent applied in the ecclesiastical and the state law. By such approach is modified the way in which the relationship between the state and the ecclesiastical law is determined. In that case, the *ius sacrum* would also become a derivative of the state law.

3. THE RELATIONSHIP BETWEEN THE ECCLESIASTICAL LAW AND THE STATE LAW

3.1. Dependent and independent ecclesiastical law

By making the distinction between the secular and the sacral part of the ecclesiastical law, the *division of the ecclesiastical law into the state-dependant law and the state-independent law* is pointed out. It is even possible to create a whole typology of the ecclesiastical law based on the mutual influences the state law and the ecclesiastical law have on each other. In one such typology, in addition to purely state law on the church, i.e. "state-ecclesiastical law" (*ius inter civitates et ecclesias*),[43] there would also exist a few types of the autonomous ecclesiastical law. The first would be the *ecclesiastical law in a purely dependent relationship on the state*. It would be integrated within the framework of a given order and realised by relying on the state coercion. The second would be the *ecclesiastical law as a kind of an admixture – the decentralised public* or *associated droit social*. The third would be the *ecclesiastical law in a pure and independent relationship with respect to the state*. It would realise its integrative role without relying on the state, its coercion and the law. The first two types of the dependent ecclesiastical law would fall under the secular law and the third independent type under the sacral ecclesiastical law.

The *independent ecclesiastical law* is particularly interesting, which complete independence of the state is being unnecessarily disputed on different grounds. It exists whenever the commands and sanctions against

[43] See: S. Avramović, *Prilozi nastanku državno crkvenog prava u Srbiji*, Beograd 2007; M. Radulović, *Obnova srpskog državno crkvenog prava*, Konrad Adenaur Fund, the Christian Cultural Center, Belgrade 2009.

the wrongdoers may independently of the state be passed and enforced by the various church organs and bodies (e.g. Holy Synod of Bishops or the Holy Synod of Bishops of the Serbian Orthodox Church on the grounds of the legal or moral assessment whether there is a wrongdoing or a transgression). Some writers think that this type of the ecclesiastical law is a pure manifestation of the contemporary legal pluralism, but of a secular type. Such claim is not quite correct for it is through the independent ecclesiastical law that is simultaneously being regulated the relationships between man and the church, the church and the divinity or between the very ecclesiastical bodies within the church. It is even less correct if within the independent ecclesiastical law are listed purely religious norms, the particular characteristic of which is the focusing on the issues referring to moral and legal determination. They always contain the judgment as to whether something has or does not have a religious value, the judgment of approval or disapproval, and it is quite distant from the contemporary legal pluralism of the secular type.

3.2. A few more important things pertinent to the relationship between the ecclesiastical law and the state law

The division of the ecclesiastical law into the state-dependent law and the state-independent law enables the discernment of a number of important things pertinent to the relationship between the ecclesiastical law and the state law:

- Firstly, that the ecclesiastical law at the same time consists of one type of the state law and of the three types of the autonomous law to a varying degree independent with respect to the state law;
- Secondly, that the first of the three mentioned types of the autonomous ecclesiastical law at large falls under the dependent law, the second only partially, while the third type is independent, i.e. out of the reach of the state law;
- Thirdly, that it is rendered possible to include within the dependent ecclesiastical law all the types of the complete and incomplete ecclesiastical law which are under the influence of the state law, especially in terms of the possibility to impose the state sanction, and within the independent ecclesiastical law only those types of the unfinished ecclesiastical law which are not under the influence of the state law and do not rely on the imposition of the state sanction;
- Fourthly, that the independent ecclesiastical law is also composed of the secular and sacral parts, which thus makes its concept even more complex. Before all, under the secular part of the

independent ecclesiastical law may fall the decisions made by the supreme and all the other subordinated church bodies, as well as their activities in the area of social community work, and under the purely sacral part of the ecclesiastical law fall the decisions of a stringently religious character (for example, how to observe the Lent, when and how to perform liturgy, etc.);

– And fifthly, that not even the secular part of the independent ecclesiastical law can be a kind of the law "competitive" with the state law – especially not today for it is exactly the state with its law that determines ("apportions") it indirectly and informally. The normative independence of the church is, out of necessity, limited in this area too by the requirement that the involved ecclesiastical regulations, at least in general, be harmonised with the constitution, the law and other state provisions.

Such obvious – though not a full supremacy, enables the state itself to directly organise the ecclesiastical relationships which are otherwise already regulated by the norms of the sacral ecclesiastical law. In that case, there is an interweaving of the state part and the sacral part of the dependant and the independent ecclesiastical law. However, the interweaving is not to the full because there exists a purely sacral part of the independent ecclesiastical law, which belongs to the purely ecclesiastical area. Its existence on its own and independently of the state does not challenge the full supremacy of the state law over the ecclesiastical law since the church by its own law cannot organise the state relationships. It can seldom affect even the content and the way of their regulation. As a result, in the states with democratic constitutions the scope and the content of the ecclesiastical law are not determined quite precisely. Thus is left room for the regulation of the social relationships through the ecclesiastical legal provisions, though only within the framework determined by the state through its legislation.

The relationship between the state law and the ecclesiastical law may also be viewed quite differently. When the ecclesiastical law is considered in its entirety, it follows that the supremacy of the state law over the ecclesiastical law is only quantitative and illusionary: it looks like the ecclesiastical law is inundated by the state law. When those deposits are removed from the substance, and the concept of the ecclesiastical law is reduced to its purely sacral part – suddenly surfaces the brilliance of its original quality of independence which depicts it as a historically older and more original than the state law, normally, to the extent to which the human striving towards the high spiritual worth is separate from the similar endeavours of the state and its law. And, not even today is this a small enterprise as it has to do with the substance, and not with the quantity. Troicki was not wrong, but went too far when he expanded the substantial

characteristics of the church to the ecclesiastical law at large. It did not exist even at the time whose contemporary he was.

3.3. The influence of the state law on the ecclesiastical law and the ecclesiastical law on the state law

Although the church is an extraordinarily important factor in the life of a society and the state, the same does not always apply to the relationship between the ecclesiastical law and the state law.[44] Until recently, there have existed or exist still today societies (for example, at the time of the Roman Empire, the early European capitalism or real-socialism) in which the ecclesiastical law was significantly reduced or restricted due to the overly powerful legal statism. Such churches have on the various historical grounds become the state churches (the Christian Church following the Edict of Milan in the Roman Empire, the Anglican Church as of Henry VIII or the Protestant Church as of Martin Luther) or were abrogated (as in the USSR and the members states of the socialist block /in most cases today's members of the European Union/).[45] Also, there existed such societies in which statism was destroyed for the reason of which the church had to assume the role of the state: somewhere, the church became the state (papal state), and elsewhere, it only acted in the stead of the state (the Serbian Orthodox Church during the occupation by the Ottoman Empire). Today, there exist various types of permeation and complementing between the ecclesiastical law and the state law, parallel to the supremacy of the state law, the existence of which types is in a dynamic balance which provides the law at large with the necessary measure of viability.[46]

The influence of the state law on the ecclesiastical law is obvious in the area of the *creation* of regulations. Three characteristic situations should be distinguished. In reference to the first, the state authorities beforehand and in the ordinary legislative way through the constitution or the law *authorise* the ecclesiastical subjects to create their law. Upon the adoption of their acts on the basis of the authority vested by the state, the subsequent confirmation by the state is no more required (the case of the so-called "ascertained consent", when the church enjoys more freedom). In relation to the second, the state subsequently *confirms* any general ecclesiastical act, the adoption of which does not require its prior explicit legal approval (the case of the so-called "convalidated consent", when the church enjoys less freedom). In regard to the third, the combined situation, when the church enjoys least freedom, the state first vests authority in the ecclesiastical subjects through the general provision, and thereupon

[44] See: D. Perić, *Crkveno pravo*, 21.

[45] See: Ch. Taylor, *A Secular Age*, Cambridge 2007.

[46] W. C. Durham Jr., "The Rights of Religious Communities to Acquire Legal Entity: A Summary of Recent Developments", A paper presented at the Conference "Re ligion and Law", Belgrade, May 2011.

subsequently *confirms* their acts. Without that confirmation, the ecclesiastical regulations cannot be valid before the law. Having the possibility to exert such double influence, the state authority finds additional security in that that the most important ecclesiastical acts and regulations are going to be in compliance with the most significant acts and regulations of the state law.[47]

The influence of the state law is even more obvious in the area of the *application* of the regulations of the sacral ecclesiastical law, as mentioned while determining the concept and the layers of the ecclesiastical law. Yet, there still exists a part of the ecclesiastical law outside the influence of the state and its state-ecclesiastical law. It is the independent, i.e. the pure sacral ecclesiastical law, within which framework the church may and should independently regulate and exercise its relationships without the interference of the state. That area, in conformity with the theory of symphony, traditionally belongs to the pure ecclesiastical legal area.

The *influence of the ecclesiastical law on the state law* is comprised of the ties of integration, collaboration, co-operation, co-ordination, correlation, etc., short of the domination though. Only now and then can the church through its authority and the credibility of its arguments directly influence the content of the state regulations pertaining to the church. However, the credibility is a matter of choice, and not the basis of being legally binding.

Although the church cannot directly influence the creation and implementation of the state regulations pertaining to the church, it can sometimes achieve that goal by exerting influence on its body of the faithful, who are at the same time citizens of the involved state. And the more widely the church is spread over, the stronger is its influence on the state through its body of the faithful. Obviously, the contemporary influence of the ecclesiastical law is not the same in comparison with the influence it exerted when the undeveloped state law relied on the ecclesiastical law and overtook it directly, or when the medieval state authority was so weak that it was unable to provide for the coercive force of the ecclesiastical regulations which it explicitly issued or implicitly accepted.

4. CONCLUSION

It seems that closest to the truth is the fact that the contemporary ecclesiastical law cannot with complete reliability be classified into a separate branch or area of the law as it is in its one part public, in its sec-

[47] See: G. del Vecchio, *Philosophie du droit*, Paris 1953; L. Zucca, "Law v. Religion", *Law, State and Religion in the New Europe*, Cambridge University Press, Cambridge 2010.

ond part it is private, in its third part it is international, in its fourth part it is internal, in its fifth part it is objective, in its sixth part it is subjective, etc. Thus, it may be claimed that the ecclesiastical law is a separate subsubsystem of the law within the framework of the subsystem of the autonomous law.

Leaving aside the state law pertaining to the church, today it may be said with reliability that the sacral and secular parts of the ecclesiastical law are the unique parts of the ecclesiastical law as being one complex type of the autonomous law with the oldest living tradition. And while the sacral part of the ecclesiastical law has a rather staying power, it may not be said of its secular part which has been continually developing.

Also, the ecclesiastical law is not being spread over on its own within its secular part, while it is being spread over on its own within its sacral part, within which the influence of the state and its law is neither possible nor desirable as it has to do with the quite original and from the very start quite independent ecclesiastical law. It may be said that it is the only type of the law which indeed does not depend on the state law.

Although almost the entire ecclesiastical law is today concerned with the purely organisational regulation of the church matters, and primarily with the organisation of the authority-related relationships (church hierarchy and organisation) and religious activities, it may also refer to the regulation of the family, educational, social-humanitarian, health and other aspects of life. In that part, the ecclesiastical law is similar to the norms of other social organisations. However, that area of the ecclesiastical law is not one-sided either, for at the same time its one part falls under the secular (public and private), and its other part under the purely sacral ecclesiastical law. This area reminds one mostly of the ideas upheld by those speaking in favour of the ecclesiastical law as being a type of the *droit social*. However, it is still not so because charity and profit are not one and the same in terms of the motivation for carrying out social community work. If it were different, the overall secular activities of the church would have to come under exactly the same provisions by which are regulated the activities of all the profitable and other like social organisations.

It is characteristic of the ecclesiastical law that through it is primarily regulated the realisation of mutual interests. However, when a dispute arises, primarily in the area of the religious rules, the contending parties refer to the permanent Church Court which, according to the precisely prescribed procedure, decides the dispute and pronounces the sanctions which are executed in an organised way, etc.

In short, the place of the ecclesiastical law and its relationship with the state law does not genuinely reflect the contemporary influence of the

church on the state and society, which is much more powerful and more comprehensive than the influence of its ecclesiastical law.

Today in the world there exist at least three formal-legal regimes for the regulation of the relationship between the church and the state in a society. The oldest *regime of the state church* exists when only one church is proclaimed the state church. Other churches are not abrogated, though only the state church has privileges at its disposal. In a somewhat more contemporary *regime of the recognised churches*, all the churches enjoy freedom, but only some among them are recognised and as a result maintain a certain relationship with respect to the state. The state exercises control over such recognised churches, provides financial support to them in proportion to their needs, the number of their believers, etc. On the other hand, the churches are forbidden to put to use the religious feelings of their members for political purposes. In the latest *regime of the separation of state and church*, churches are considered the private institutions with the work of which the state does not interfere, but only regulates it through its legislation. At the same time, the churches are forbidden to interfere with the state affairs.[48] There also exist different classifications.[49] Such relationship of the state with respect to the church is eristically explained by the need to ensure the freedom of religion. Despite this simulacrum,[50] history shows that it is impossible to fully separate neither politics from the religion nor the state from the church.

That the connection between the church and the state, and the ecclesiastical law and the state law, has almost never been broken is also shown by the fact that, starting from the Middle Ages, jurists have been awarded the degree (and title) of the doctor of the ecclesiastical and secular law (*doctorus iuris utrisque*).

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[48] *Pravna enciklopedija*, Belgrade 1979, 562.

[49] G. Robbers, "Constitution and Religion", *Constitutions et religions*, Tunis 1994; N. Đurđević, *Ostvarivanje slobode veroispovesti i pravni položaj crkava i verskih zajed nica u Republici Srbiji*, Beograd 2008.

[50] J. Baudrillard, *Simulacra and simulation*, Novi Sad 1991 (transl.).

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KINSHIP AND SOCIAL STRUCTURE OF EARLY ROMAN SOCIETY: SUBSTITUTION IN FUNCTION THE FATHER AND THE SON

The king's family in Rome represents the model of social relations in the ear ly period of Roman history. Roman mythology and legends offer examples of kinship and the social interaction of persons which are not characteristic of Indo European societies. Early social structure, in the time of the seven kings, left vestiges in both the legends and the language. Parallel to that in existence in Rome and some other countries is the structure in primitive societies, which were investigated by L. H. Morgan, B. Malinowski, and other early anthropologists, who based their conclu sions on direct contact with communities in America and the Pacific in the nineteenth and early twentieth centuries, and anthropologists today who conducted their re search in Africa. The elementary family type, father mother children, character istic of the Indo European society from antiquity until to day, is not attested as a social entity in the legends concerning the Roman kings.

Key words: *Roman kings. Social structure in early Rome. Pater and filius. Epicleros. Vesta. Daughter heiress.*

In his study *Structure and Function in Primitive Society*, Radcliff-Brown formulates the relation of the kinship and the social system as follows: "The idea is that in a given society we can isolate consequentially, if not in reality, a certain set of actions and interactions amongst persons which are determined by the relationships of kinship or marriage, and that in a particular society these are interconnected in a such way that we can give a general analytical description of them as constituting a system".[1] What is of particular importance here is his further statement

[1] A. R. Radcliffe Brown, *Structure and Function in Primitive Society*, London 1965, 6 ff. especially 10 11.

that institutions, if such a term is used to refer to the ordering by society of the interactions of persons in social relationships, have this double connection with structure, with a group or class which can be said to be an institution and with those relationships within the structural system to which the norms apply. The conduct of persons in their interactions with each other is controlled by norms, rules and patterns**.** Along with that, he states that the basis of science is systematic classification.

This statement could be fully applied to early Rome. Roman society in historical times was, as were those of other Indo-European peoples, strictly patriarchally organized. The Roman family was monogamic and based on the father's power over his wife, his sons and their wives, his daughters until their marriage and his grandchildren. The schema of the family group in the Indo-European society with the classificatory system is reconstructed as follows: father, son, and grandfather with their families, all of the wives and children controlled by the *pater*. The grandfather in the father line could be a *pater*. His power extended to all members of the family; his wife, his sons with their family, wives and children, and all daughters before marriage. Daughters were excluded from the family after marriage[2].

Stories about mythical heroes and kings which are preserved in the works of Livy, Dionysius of Halicarnassus and Plutarch, and other Roman and Greek authors prove that social structures in early Rome differ from the later known ones. Mythology and legends offer examples of kinship and the social interaction of persons which are not characteristic of Indo-European societies. Early social structure, in the time of the seven kings, left vestiges in both the legends and the language. Parallel to that in existence in Rome and some other countries is the structure in primitive societies, which were investigated by Morgan, Malinowski, and other early anthropologists who based their conclusions on direct contact with communities in America and the Pacific in the nineteenth and early twentieth centuries and anthropologists today who conducted their research in Africa[3]. They could contribute essentially in understanding some of the social structures of early society in antiquity.

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[2] E. Risch, "Verwandschaftsnamen und Struktur der Familie", *Museum Helveti cum* 1, 1944, 115 122.

[3] H. L. Morgan, *Ancient Society*, New York 1879; J. G. Frazer, *Totemism and Exogamy*, *A Treatise on Certain Early Forms of Superstition and Society*, I IV London 1910; B. Malinowski, "Der Vater in der Psychologie der Primitiven", in: *Gesellschaft ohne Staat II, Genealogie und Solidarität* (ed. F. Kramer), Chr. Siegrist 1983, 31 61. Theoretical studies by P. Francisci and J. Franciosi also open the way to the new approach to the early Roman past and structure which are common to many peoples on the deter mined level of development when the only certain kinship was based on the blood rela tionship with the common mother (P. de Francisci, *Primordia civitatis*, Rome 1959; G. Franciosi, *Clan gentilizio e strutture monogamiche. Contributo alla storia della familia Romana.* Corso di diritto romano I II, Naples 1975 1976; "La formazione della comunita

1. KINSHIP AND SOCIAL FUNCTION: THE FATHER

The language reflects the social relationship, action and interaction as well as the structure of the society. In his *Vocabulaire des institutions indoeuropeen,* Benveniste made a clear distinction between the general term and those signifying the personal kinship relations in Indo-European languages. In the social structures and the classification process in ancient societies biological kinship was not always the decisive element; *pater* is not necessarily the biological father, *filius* is not always the real son. Even the mother could be replaced by another woman, as was Rea Silvia by Larentia.The primitive nuclear Indo-European family does not have a term for marriage, *pater* is not the biological father, *filius* did not originally designate the son, and the term for cousins is missing. *Pater* in the Indo-European language *(skr. pitar, arm bayr, gr. pater, lat. pater, got. fadar etc.)* does not mean the physical father.[4] Parallel terms existed signifying the classificatory and physical kinship, *pater – atta, mater– anna, frater* and *adelphos* and *frater germanus* lat. *Maritus* was a Latin word, unknown in the original Indo-European and in Greek, because there was no marriage at the beginning. Benveniste also noted that the vocabulary, Greek above all, denotes the different social structure which was probably not of Indo-European origin.[5]

The concept of paternity in the Indo-European social structure is not absolutely valid. In the primitive stage of development in many societies *pater* is not necessarily the biological father; he was not a blood relative but a social institution. *Pater* has a social value, and does not represent a sentimental connection. He is the institution which existed when the man accepted the child as his own or when marriage was instituted. In some societies in the ancient world this happened some months or even some years after the child was born.[6] *Pater* and *filius* existed if their mutual connection was established. *Filius* existed only in the rela-

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politica romana primitiva", *Conferenze romanistiche*, 1951, Milano 1960, 69 105; "Il pro cesso di Virginia", *Mnemeio Siro Solazzi,* Bibl. di *Labeo* I, 1964, 135 169; "La plebe senza genti e il problema della 'Rogatio Canuleia'", in: *Ricerche sulla organizzazione gen tilizia Romana* (a cura di Gennaio Franciosi) I, Roma 1984, 121 179; Esogamia gentilizia e regalita Latina. 'L'ecternus heres' e la successione obliqua", *Ricerche sulla organizza zione gentilizia Romana*, III, ed. G. Franciosi Roma 1995, 53 67; B. Linke, *Von der Ver wandschaft zum Staat*, *Die Entstehung politischer Organisationsformen in der frührömi schen Geschichte*, Leizig 1995.

[4] E. Benveniste, *Le vocabulaire des institutions Indo européennes,* Paris 1969, 209 ff.

[5] E. Benveniste, 217 etc. This conclusion is proved by examples such as Zeus Heraios and the couple Hera Herascles, as well as the Greek words for brother, *adelphos* and *casignetos* which could not be explained by the reference on the matrilineal filia tion.

[6] See n. 11.

tion to the father. Risch remarks the absence of special terms designating the mutual kinship between such blood relatives as brothers and sisters' children and for the grandparents. They were all called sisters and brothers because they all were subject not to their physical father but to the *pater familias,* most often to their grandfather.[7]

The king's family in Rome represents the model of the social relations in the early period of Roman history. The elementary family type, father – mother – children, characteristic of the Indo-European society from antiquity until to-day, is not attested as a social entity in the legends concerning the Roman kings. The father is not recognized as belonging to the family in the early society in Rome.[8] The king's father is mostly unknown, and there is no evidence concerning the king's relation to his descent. In the king's family in early Rome no son inherited the father's position. Linguistic data concerning kinship show that the structure was not necessarily patriarchal. In the legends about the Roman kings as they are preserved in the works of the classical authors who lived in a society which was strictly patriarchal in character, as the Roman one was in this historical period, the father is lacking. Romulus's father does not exist, the father of Servius Tullius was either *ignotus*, or illegitimate, and the fathers of the remaining Roman kings, except that of Tarquinius Priscus, are not recorded. As an adjustment to the patriarchal system the father appears in the later literature as an imaginative figure, as a god, Mars for Romulus, Vulcan for Servius Tullius, or as a disguised relative (Amulius) or even as a symbol, represented by a phallus in the hearth.[9] The king's son is seldom recorded, but never as heir and successor. The son of Numitor is mentioned by Dionysius from Halicarnassus, but he had to disappear from the story in time because he was unimportant as the heir or successor. He was killed while hunting.[10] The king's daughter on the other hand had an important duty, to procreate and produce a child as her father's future successor in the generation that was to follow. Between the king and his grandson the daughter's husband is sometimes attested as king, as was Aeneas between Latinus and Lavinia's son, or Servius Tullius between two Tarquinii. The pattern of the king's family, as it appears not only in Roman society, but also in Latium, can be seen as a very simple one: the king, who does not exercise any power over his children or his wife, has a daughter whose son could inherit the throne in the third generation. This pattern is shown in Latinus-Lavinia-Ascanius or Silvius

[7] E. Risch, 117

[8] E. S. Hartland, *The Primitive Paternity, the Myth of supernatural Birth in Rela tion to the History of the Family*, London 1909, with examples in societies in Europe, Asia and other countries from the Middle Ages until recent times. Many nations did not recog nize the problem of paternity.

[9] Livy, I 4, 1 2; Dionysius of Halicarnassus, I 77, 1; Plutarch, *Romulus*, II 5 6

[10] Dionysius of Halicarnassus, I 76, 2

and again Numitor – Rea Silvia – Romulus, Numa Pompilius – unnamed daughter– Ancus Marcius. Between the grandfather and grandson there is usually a stranger on the throne, the son-in-law, except in the case of Romulus. Between Numitor and him is his uncle Amulius. Institutions in function, the mother and her son and the mother's father, are crucial in the line of succession. That means that the daughter and her children had to stay in her father's clan and to follow this kinship line. It could be suggested that the son went to live in his wife's clan, the form which is known in primitive societies. Romulus, however, did not stay in his mother's clan; his destiny leads him outside the family of his grandfather Numitor and uncle Amulius. Even later, when the victory over Amulius enabled them to return, Romulus and Remus left Alba Longa. In all likelihood the son had to leave the original clan, as is the custom in some primitive communities to-day. The king's daughter appears in the tradition as the mother of the future king (Rea, Tarquinia II?), the son-in-law was the successor to the throne (Aeneas, Servius Tullius, Tarquinius Superbus). Roman society was divided into those who could declare who their father was – *qui patrem ciere possint* called patricii, and plebei who could not do so even later in the historical period, until the middle of the fourth century BC.[11]There were societies in the ancient world in which it was necessary to publicly recognize a child as belonging to a certain father some years after his birth. This custom is described by Nicolaus Damascenus in the tribe of Liburni in Dalmatia: Similar procedures are known in some other communities in the antiquity.[12]

The father and the relation father – son appears not as a biologically conditioned connection, but as a position defined by custom. In many societies the function of the father in raising children was performed by the mother's brother. In some primitive peoples the relationship mother's brother – sister's son is also present today as the most important kinship relation. An illuminating example of the relationship between an uncle and a nephew in the society of the Trobriands is described by B. Malinowski.[13] These indigenous people believe that the mother creates the child from her own flesh and blood and that there are no links connecting it to its father. The brother and the sister are also created from the same substance, as they descend from the same mother. This view has influenced the definition of descent and the order of succession in the ranks of leadership, inherited positions, magic and all the rules in transmission according to kinship. In all these cases, a person transmits his

[11] M. Mirković,:Der Vater und die Patrizier: *qui patrem ciere possent", Klio* 86/2004, 83 100.

[12] Jacoby, FrGrHist IIA 103d; Arist. Pol. II 1,13; J. Bachofen, *Das Mutterrect*, Basel, 1897[2], 27; M. Mirković, "Son in law, Mother's brother, and Father in Lycian In scriptions", *ZSS* RA, 128/2011, 352 365.

[13] B. Malinowski, 31 etc.

own social position in the mother's line to his sister's children. This conception exclusively of matrilineal kinship is of crucial importance for the regulation of marriage, taboos and the relationship between the sexes. The feeling of kinship is extremely intense in the case of the death of a group member. The social rules defining the burial and mourning ceremonies, as well as the relevant expenses, prescribe that only those who are connected by the mother's line constitute an indivisible group in the intensity of feeling and interests; all the rest, even if they are connected by marriage, such as the father or child, are strictly separate and, naturally, cannot take part in the loss. Although the institution of marriage is known to the people from the Trobriand Islands they do not recognize the husband's role in bringing up the child. The father is defined socially as the person who marries the mother, who lives in her house and is a member of the household. He does not exist as a father in the sense he has in our society.

There are some modern paralleles. In South Africa a good deal of importance is attached to the relationship of the mother's brother to his sister's son. Radcliffe-Brown considers the relation of a man to his relatives on the mother's side and to his mother's in the Friendly Islands in his own time. The peculiar relation between a sister's son and a mother's brother also exist between a daughter's son and his mother's father. The daughter's son must be honored by his grandfather. He is a "chief" to him. The mother's father and the mother's brother are the objects of a very similar behavioral pattern. The custom in some tribes in Africa today of calling the mother's brother *kokwana* (grandfather) is significant. According to the records that deal with the customs of the Ba-Tonga people, the sister's son has certain special rights over the property of the mother's brother. Anthropologists regard those customs as being connected with matriarchal institutions, and hold that their presence in a patrilineal people could be regarded as evidence that this people were at some time in the past matrilineal.[14]

The mother's brother was important in early Greek society as someone who could exercise power and make decisions in society instead of the king. A well known example is the case of Creont, the brother of the king's wife, Iokasta, in the myth of Oedipos. He was the uncle of Oedipos and the great-uncle of Eteocles and Polinyces, as well as of An-

[14] A. R. Radcliffe Brown, "The mother's brother in South Africa", in: *Structure and Function in Primitive Society*, 15 etc. He does not agree with the idea that the cus toms relating to the mother's brother can only be explained by supposing that at some past time these peoples had matrilineal institutions and that the children in South Africa be longed to the social group of the mother. He explains this as follows: "Where the clas sificatory system of kinship reaches a high degree of development or the elaboration of another tendency makes its appearance: the tendency to develop patterns by regarding the former as a sort of male mother and the latter as a sort of female father".

tigone and Ismene. After Oedipos' death, he became the supreme political authority in Thebes, who also made decisions on the cult and prohibited Antigone and Ismene from burying their dead brothers and was even able to punish them. This system in known in some other Indo-Europeean peoples. Tacitus reports that among the Germanic people the sister's son enjoyed the same honors from his uncle as from his own father. This blood connection was regarded as even more sacred and closer than that with the father. The German tribes preferred to have them because they trusted them more than those belonging to the extended family.[15]

The term *avunculus*, designating the mother's brother, is preserved in Latin. There is no doubt that the mother's brother once existed as an institution in Rome, but *avunculus* has no importance in the legend about the seven kings. However, the memory of him is preserved in the legends. Ancus Marcius' uncle[16] is mentioned; the mother's brother appears in the legend about the end of the kingdom in Rome. Lucretia's husband Tarquinius Collatinus, her father Lucretius Tricipitanus, and Iunius Brutus, her *propinqui* (relatives), were the main actors in revenging her death, Livy, I, 58–59. In Servius'commentary of *Aen*. VIII 646, Iunius Brutus appears as her *avunculus,* meaning her mother's brother. In reality, he represented the last remnant of the old system in which the *avunculus* was as important as the father was later. The memory of the mother's brother who protects his sister's daughter is preserved in the Virginia story, which is placed by Livy in the middle of the fifth century.[17] Livy, *Ab urbe condita* III 44, linked this with the plebeians' struggle for written laws. M. Bettini was one of the scholars who pointed out this case.[18] The *avunculus* appears as one of the main actors in the dramatic events in the story of the girl Virginia and Appius Claudius, one of the ten elected members of the commission chosen to bring the XII Tables laws in Rome, in the middle of the fifth century. The story reflects a social structure that was older than the patriarchal system. When Appius Claudius tried to abduct the plebeian girl Virginia under the pretext that she was his slave girl, it was her *avunculus* Numitorius who defended her. *Avunculus* might have represented the remnant of an old system before the classificatory father was established as an institution. The important element in the story is that Virginia, who was protected by her mother's brother, is of plebeian origin. As a plebeian girl, Virginia had no certain father and was considered a slave. In Livy's story the father who was absent all the time

[15] Tacitus, *Germania*, 20,5: So*rorum filiis idem apud avunculum qui apud patrem honor; quidam sanctiorem artioremque hunc nexum sanguinis arbitrantur et in accipien dis obsidibus magis exigent tanquam et animam firmius et domus latius teneant*)..

[16] Plutarch, *Numa*, V 2 4 and IX 4.

[17] Livy, III, 44 ff. Cf. R. M. Ogilvie, *A Commentary on Livy Books* 1 5, 476 ff.

[18] M. Bettini, *Antropologia e cultura Romana, parentella, tempo, imagine dell'ani ma*, Roma 1986.

appears at the end as a frightened Indo-European *pater*, who had the right to exact extremely harsh punishment and to kill his own child. This act of extreme cruelty seems more like revenge on Appius Claudius, who was a patrician, than the right of a plebeian biological father to the life and death of his children. One more element in the story could be recognized as the remnants of an older social system: Icilius, another plebeian in the story, was designated as Virginia's betrothed, but not her husband, which could be explained by the fact that plebeians had no right to *matrimonium iustum.* Thus, the story contains the elements of kinship in the mother's line (*avunculus*) and plebeian customs (betrother), and, at the same time, the patriarchal structure with the father, who had the right to the life and death of his children. The absence of the father from the story was, until the last moment, as Livy tells us, symbolic. He had to fight the enemy, but he had no right to defend his biological child because the plebeians still had no right to marry legally or to have legal posterity. The *avunculus*, as the mother's brother, was the next relative whose duty was to defend Virginia, and he appears in this role. The *avunculus* and the father appear successively in the story, because in reality they belonged to different stages of the social development.

It is no accident that Livy placed the story of Virginia in the time of the plebeians' struggle for their civil rights, above all, the right to *conubium*, which they were granted thereafter, in 444 BC. It symbolizes the transition from the matrilineal to the patriarchal system with the father at the head of the family. Virginia was a plebeian girl and plebeians retained the old system longer than the patricians, according to which kinship on the mother's side was more important than that on the father's. We can suppose that the father appears later, at the end of Virginia's story, not as a plebeian father but as a *pater familias* with the right of a dominant patrician father. This right came together with the *matrimonium iustum* when the plebeians accepted the patriarchal system and the *patria potestas*, which demonstrates its cruelest form in this story. With the *lex Canuleia* which gave them the right to marry legally, plebeians were included in the society whose members were entitled to name their fathers, *qui patrem ciere possent.*[19] The point about the story of Virginia is to show that in order to solve a problem in the family in one way or another, it was necessary to have a father, which meant belonging to the patrician class in which only the father could decide about the destiny of his children, property and inheritance.

The *avunculus* belonged to the mother's family and was part of the matrilineal system. He was the main figure in raising his sister's children in a social system that was based on the blood relationship: brothers and

[19] M. Mirković, "Der Vater und die Patrizier: *qui patrem ciere* possent"*, Klio* 86/2004, 108 ff.

sisters were children of the same mother, they were *homogalaktai*. The Latin term *avunculus*, the mother's brother, derived from *avus*[20] who was the common father of the mother and her brother. In some Indo-European languages *avus* denoted not the grandfather, but the uncle on the mother's side[21]. Both *avus* and *avunculus* derived from blood kinship.

The uncle – nephew relationship persisted in the classical period but it was more affective than formal, as opposed to the relationship with a strict and sometimes cruel father.[22] The succession of the uncle by the nephew was probably less exceptional, as supposed by M. Beekes, who discusses this question in terms of classical law. In the historical period, the uncle – nephew tie could have been more or less affective, as has been suggested by Beekes and others, but in the early stage of social development it represented a relationship that was closer than the link with the biological father.[23] There was a difference regarding the uncle in early Roman history; in the case of Iunius Brutus in the story of Lucretia and Numitorius and in the story about Virginia on the one hand, and his later position in Roman society in the time of Augustus. The former belonged to the social system in which the sister's brother was a socially recognized institution. In this early social structure, it was the uncle's duty to protect and raise his sister's children. This relationship was not based on affection but was regulated by the customs of the primitive community.

2. DAUGHTER HEIRESS IN THE PLACE OF THE MISSING SON: *EPICLEROS*

The substiution of the father by the mother's brother could be expected in the structure based on the blood relationship; the relationship father – son is fundamental in the patriarchal society. In the patriarchal family only the son of the family could organize the *sacra* in the proper

[20] Festus, 14 M states: *Avunculus matris meae frater*, traxit *appellationem ab eo quod aeque tertius a me, ut avus est, sed non eiusdem iuris: ideoque vocabuli facta demi nutio est* " The avunculus as my mother's brother is so named as the third in the line beginning from me, like the grandfather, but not of the same *ius* as he is".

[21] E. Benveniste, 223

[22] As characterized by M. Bettini and thereafter by J. Bremmer. Bremmer dis cussed the problem of the relationship between the nephew and uncle in his article Avun culate and posterage*, The Journal of Indo European Studies* 4, 1976, 65 ff. comparing cases taken from two different systems, the one prevailing probably under the kings in Rome and the other that only existed in classical times. An affective relationship was the most likely explanation for the example of Augustus and his nephew Marcellus. It was Augustus' personal choice, not expected duty, which would have been prescribed by the customs of the community.

[23] R. S. P. Beekes, "Uncle and nephew", *The Journal of Indo European Studies* 4/1976, 43 64.

way and only the male heir could continue the family cult. The ancestral cult could only be transmitted by the male descendants.[24] The problem arose when there was no son in the family. *Filia familiae suae finis.* Introducing the dispute regarding the epicleros as daughter heiress W. Westrup limited his arguements to the historical époque. The institution of the *epicleros* in Greece and the *putrica* in India, represent for him the crucial argument for the thesis that the daughter could not inherit except in those families without a son. Even in such cases the daughter could neither inherit nor dispose of property as long as the father was alive. The daughter's son became the heir when he grew up. Westrup describes the daughter as the main heir as follows: In the sonless family *epikleros* and *putrika* serve to perpetuate the family and its cult. By giving birth to the heir *epikleros* and *putrika* transmit the inheritance and the paternal sacra. But they themselves do not inherit, they are merely the intermediate link between the grandfather and the grandson, between the bequeathed and the heir. The inheritance does not pass on to the daughter, it passes on together with the daughter for temporary management, to the nearest male relative, whose right and duty it is to marry her in order to fall definitively to the son who may be born of this marriage, i.e. the heir, when he comes of age.[25]

The phenomenon of the daughter taking over the position of the son in a sonless family is widespread in different countries in the Balkans in the nineteenth and twentieth centuries and in some remote regions even today. They could be paralleled with the Greek *epikleros* as suggested by S. Avramović.[26] In northern Albania in the nineteenth and twentieth centuries this social model is called *virginesa* or *virgina, tobelias* in Montenegro, *ostajnica* in Serbia and *blagarica* or *blagastica* in Croatia. This status is often assumed after the father's death. The metamorphosis of the daughter into the missing son is followed by changes to the name in the masculine form and her appearance is accommodated to that of men: she dresses like a man and her behaviour is masculine; she may be equipped with arms and practice hunting. There are different kinds of virginese: some of them changed their status as children because the father or the community, akin to the phratria, decided so. These types of heir usually vowed to remain unmarried and could continue the gens only as long as they lived. However, some of them produced children outside marriage and thus continued the gens. The adoption of the closest male relative's children is another way of preventing the extinguishing of the family. A

[24] See W. Westrup, *Introduction to Early Roman Law. Joint Family and Family Property*, Copenhagen London 1934, II 102 ff.

[25] W. Westrup, 110. See Theilheim, *Epikleros* in *RE* VI A, 1907, 114 etc.

[26] S. Avramović, "Response to Monique Bilé", *Symposion 1993, Vorträge zur griechichen und hellenistischen Rechtsgeschichte* (ed. G. Thür), Wien 1994, 58 ff.

blagarica in Croatia is allowed to marry a relative in order to prevent the property from being transferred outside the gens.[27]

These examples could help in understanding not only the *epicleros* in Greece, but also the phenomenon of the daughter heiress in Rome. Legends concerning early Rome know of two daughters heiresses, Lavinia and Rea Silvia. Lavinia was betrothed to her relative, the son of her *amita*. However, she did not marry him, but the extraneus Aeneas: thus the principle of exogamy prevailed. Rea Silvia in Rome is a daughter heiress and must have been close to the *epikleros* in the Greek world. As the king's daughter and his only child she had to choose between two possibilities: to marry a close relative as *epicleros* in Greece or to stay unmarried and to become a Vestal Virgin. The first possibility could be connected with her uncle Amulius, the closest male relative who appears in one version of the story as the possible father of her children Romulus and Remus. As she did not accept him, Amulius proclamed her a Vestal Virgin in order to prevent her from having children. Vesta's priestesses had to remain virgins. Rea chose neither of the two possibilities but opted for the third and produced children with somebody outside the clan. The father was also identified as a suitor or the god Mars himself, in both cases somebody outside her own gens. Rea was punished not because she produced children out of wedlock, but because she broke the family rule and gave birth to children outside her gens. That is why she was punished and the childred had to be killed.

The fact that Rea was proclamed a Vestal Virgin is crucial in explaining the position of the daughter heiress who broke the rules of the gens. That leads us to the question of the real nature of this institution. Modern research on the possible original position of the Vestal in the king's house in Rome starts with the question: was she in reality the king's wife or daughter? There are elements in the cult (maintaining the fire in the Vestal temple, preparing the *mola salsa*) which could be equally used as proof that Vestals performed the duties of a matrona or of the daughter of the house. Hommel, like M. Beard after him sees Vestals as the wives of the early kings.[28]

[27] The examples are recorded by V. Bogišić, *Zbornik sadašnjih pravnih običaja u južnih Slovena* I, Zagreb 1874; Fr. S. Krauss, *Sitte und Brauch der Südslaven, nach hei mischen*, Wien 1885. A short notice is consecrated to the problem by T. Djordjević, "Do mazetstvo", *Naš narodni život*, 1984, 466 470. See also small contributions by M. Barjaktarević, "Prilog proučavanju tobelija (zavetovanih devojaka)", *Zbornik Filozofskog fakulteta Beograd* 1, 1948, 843 852; P. Šarčević, "Sex and Gender Identity of 'Sworn Virgins' in South Eastern Europe: Historical Perspectives", in: *Womenhood and Manhood in XIX and XX Century* (eds. M. Jovanović, S. Naumović), Belgrade Graz 2002, 125 143.

[28] See H. Hommel, "Vesta und die frührömische Religion", *ANRW* I, 2/1992, 397 420. M. Beard, "The Sexual Status of Vestal Virgins", *JRS* 70/1980, 13, cites five major

It is not possible, on the one hand, on the level of real life to take any of these home duties as specific either for *matrona* or for daughters, and on the other, the earliest known examples of Vestal Virgins suggest that Vestal Virgins must have originally been the daughters of the family: Rea Silvia was the daughter of the king or the king's brother, and the Vestal Virgin Tarpeia who gave the name to the rock on Capitol Hill in Rome was also known as the daughter of King Titus Tatius and his only child. Although it is true that Rea Silvia gave birth to children, she could not have been a matron because she was not married. Rea's original position was that of the daughter heiress and that allows us to compare her with epikleros in Greece. The daughter as the only heiress in Greek law was forbidden to marry, except to the next male relative, her father's brother or his son.[29]

The daughter heiress could take over the role of the male heir in two main duties: first of all she had to take care of the property and prevent its transfer outside of the gens. This meant either to marry a relative, an uncle or his son, or to remain unmarried. The former solution meant the continuation of the gens; the son born from this union could inherit the gens' property and cult. The latter represented the way of the Vestals: as the last in the family she had to take care of the home and hearth, meaning the common cult as if she were a son.

Discussing the sexual status of the Vesta priestesses M.Beard emphasizes the male aspect as a very important element in the nature of Vestal Virgins. She suggests that the priestesses of Vesta were regarded as playing a male role and were, in part, classified as masculine. Certain of their privileges are, she concludes, almost exclusively associated with men so that it is at least arguable that the priestesses were regarded as playing a male role and were in part, classified as masculine.[30] Vestals enjoyed the services of a lictor in Rome, a right with a particularly male association. Even later in the historical times the occasional granting of this privilege to the wives of emperors must have been connected with their role as the priestesses of *divi* and hence the imitation of vestal privileges. Since this privilege could only be enjoyed by men in Rome it

factors as proof that Vestals represented the wives of the early Roman kings. Several of the ritual tasks are closely relate to those of the early Roman *mater familias*, primarily the guarding of the hearth, and the preparation of *mola salsa*, the annual cleaning of the *aedes vestae*. None of these duties could be qualified as characteristic of the wife, and not of the daughter. As M. Beard argued, virginity would not mean total abstinence from sexual in tercourse, but rather chastity (*pudicitia).* As one of her direct arguments she cites the data that in the year A.D. 9 Augustus granted Vestals all the rights of women who had borne children, thus legally assimilating their status to that of Roman matrons.

[29] *Epikleros* in *RE* VI A, 1907, 114 etc (Theilheim).

[30] M. Beard, *JRS* 70, 1980, 17 ff. Her further dispute about the sexual status of Vestal Virgins see the paper Re reading (Vestal) virginity, *Women in antiquity, New as sessment*, (ed. R. Hawley, B. Levick), London New York 1995, 167 177.

seems that the lictor accorded the virgins certain elements of masculine status. Furthermore, Vestals were granted some rights in the court that were generally associated with men only. As Aulus Gellius and Plutarch imply they alone among all women were *testabilis*, i.e. capable of giving evidence. That would have been appropriate for the time preceding classical law. This privilege, considered very male, was subsequently granted occasionally to other categories of women in Rome. Vestals could bequeath property in their own right and unlike other categories of women, without undergoing the process of *capitis deminutio* and without the need for the tutor's permission as they came out of tutela when they entered the order. Their testamentary powers were defined in male terms. The privileges enjoyed by Vestals testify more to their legal independence than to the sexual ambiguity of their nature. In the classical period they are connected with men in Roman society.

This statement is significant when debating the origin and primary nature of this order. It is clear to M. Beard that these Vestal privileges in this respect are treated as something particularly un-female, and thus most naturally, male. Her explanation is covered by the suggestion that the Vesta priesthood was originally held not by virgins but by men. The male aspect might have had a social meaning in the developmental stage which left no traces in the written tradition. The debate about the male aspect of the Vestals in the very early stage of religious development could contribute to an understanding of the origin of the institution of the virgin order in a society where the accentuated idea of fertility in their nature was a sign of prosperity and the continuity of the clan.

The male elements characteristic of Vestals could be explained by the fact that they had to be the substitute for the son in the family. The male rights characteristic of Vestal Virgins could have meant that they had to take the place of the missing son. Rea was proclaimed a Vestal Virgin by her uncle Amulius, her next relative. If she was the daughter and the only heiress she united two of these characteristics in one person: i.e. she was not allowed to marry. The position of Rea Silvia is that of the Vestal who has born sons outside of her gens. By producing children she violated both the vow of chastity and the custom of the only heiress remaining unmarried.

If we bear in mind the fact that the legend has two versions: one in which the father of her children was the god Mars, that means extraneus, and the second which presents the possibility of the father being her uncle Amulius disguised as the god Mars, Rea's crime could be explained in two different ways, either in terms of the customs of an early society as a violation of the rules provided for Vestals or as an infringement of family law in the classical era. She might have transgressed as a Vestal Virgin who broke the vow of chastity (the version with Mars as the father) and

gave birth to twin sons, or because of engaging in sexual intercourse with her uncle (the second version with Amulius as the father) in a society which was exogamic. By proclaiming Rea a Vestal, Amulius's intention was to prevent the only daughter of his brother Numitor from marrying outside the gens. By declaring her a Vestal Virgin, Amulius intended to prevent her from giving birth to her father's future successor. This could have brought about the transition of the property and power outside the family, which is what happened when Rea's children were saved: with Romulus Silvii ceased to be kings. The center moved from Alba Longa to newly founded Rome.

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"KILLING A TYRANT" REMARKS ON CICERO'S MILONIANA*

Pro Milone represents an exception in two aspects both among the speeches left to us as Cicero's life work. On the one hand, this is the oratio whose original was delivered by the orator in a lost lawsuit, however, later on, guided by political con siderations, he published its revised version. On the other hand, Pro Milone is the speech of which we exactly know that the version published by Cicero and left to us is different from the oration given before the court of justice not only in style and structure but in its essence. Pro Milone is an essential constituent part and source of Cicero's philosophy of the state that produced hardly overestimatable impact on Eu ropean thinking, that is, in them Cicero as an orator and a politician, trying in vain to get back to the summit of his former influence, formulates his concept on the the ory of the state pointing far beyond the handling of the facts of the case and the rhetorical tactics as well as the rhetorical situation, which later on crystallised and constituted the subject matter in his theoretical works.

Key words: *Cicero. Pro Milone. Court speeches. Discrepancy between deliv ered and published speech. Rhetoric. Asconius.*

On 18 January 52, in Bovillae two emblematic figures of the *optimates* and the *populares*, Milo and Clodius clashed, and members of Milo's followers killed Clodius. Milo's defence was undertaken by Cicero; the final hearing was held on 8 April. Perhaps the weakest performance in Cicero's career took place in this lawsuit: both the *Clodiana multitudo* and Pompey's soldiers embarrassed him, clamours and shouting in stopped

* The paper is based upon the lecture given by the author at the *Forum Roma num*, University of Belgrade School of Law on April 18, 2011.

him short, made him irresolute, what is more, frightened him; he could not deliver the prepared speech with the planned *constantia*, he spoke flustered unable to collect his thoughts.[1] His delivered speech was taken down in shorthand as usual; and Asconius could still read the minutes that contained the speech and shouting in; it is, therefore, an indisputable fact that *Pro Milone* published later – as a matter of fact, apart from certain overlapping thoughts – is not fully identical with the *oratio* made on 8 April 52.[2] Afterwards, Cicero recalled this unsuccessful performance with indifference – whether pretended or real indifference it cannot be decided.[3] According to Dio Cassius's narrative, it was on this day that Milo tried to persuade Cicero to get out of his *lectica* only after the court of justice had appeared so that the soldiers and the heckled crowd should not increase his tension since he usually struggled with strong stage fright when he started his speeches as it is generally known.[4] Shops were closed on the day of the trial, the Forum was secured by Pompey's army; first, the accusers, Appius Claudius, M. Antonius and P. Valerius Nepos spoke, then, as the only defender, Cicero. Milo was convicted at a rate of thirty-eight/thirteen.[5] Approximately on 13 April, Milo went into exile to Massilia.[6]

In this paper, first, we outline the structure and legal background of Cicero's argument of defence. Then, we sum up the elements of philosophy of the state that appear in *Pro Milone*, and place them in the entirety of Cicero's state concept, paying special regard to the fact that *Pro Milone* is the first Ciceronian work in which the motif of killing the tyrant, which afterwards returns as a fully developed thought in *De re publica* and *De officiis*, appears as a right and obligation a responsibly thinking Roman citizen is entitled to and bound by.

1. HANDLING OF FACTS OF THE CASE IN *PRO MILONE*

M. Iunius Brutus – one of Caesar's later assassins, addressee of Cicero's history of eloquence entitled *Brutus* – voicing the conviction of several people, represented the view in his fictitious speech written in defence of Milo and published later that the assassination of Clodius constituted huge gain for the State.[7] According to Asconius, in his delivered

1 Plut. *Cic.* 35, 2 5.

2 Asc. 31.

3 Cic. *opt. gen.* 10.

4 Dio Cass. 40, 54, 2; 46, 7, 2. ff.

5 Asc. 29 32.

6 *Ibid.,* 33.

7 *Ibid.,* 30.

speech Cicero took up the position that though a person might be convicted for the sake of the public but in the absence of lawful judgment or other statutory authorisation nobody should be killed by referring to the interest of the state.[8] So, it is unambiguously clear that it was only the version of the speech left to us, i.e., the not only extensively re-edited but re-written version representing a completely new argument at certain points (which was published for legitimisation purposes and was in circulation as a political pamphlet), into which Cicero built the train of thoughts that acknowledgement rather than punishment would be due to Milo for killing Clodius as thereby he had done immense service to *res publica*.[9] At the same time, it is possible to accept Lintott's view that, compared to Asconius's account, the rest of the arguments of the published speech and the delivered oration might have mostly overlapped.[10]

Obviously, Cicero could not argue differently – as it was an undeniable fact that Milo's slaves had killed Clodius – than by claiming that they acted in a situation of lawful defence as decent slaves ought to, that is, they protected their master.[11] As a key legal argument he uses the *"vim vi"* and *"arma armis repellere cuique licet"* principle.[12] Right at the beginning of his speech he makes it clear that he would base his argument on it as follows. The end of the *prooemium/exordium* contains the description of the legal question of the case *(stasis, status, quaestio, constitutio)*. The possible forms of handling the case in accordance with Antique rhetorical theory are as follows: in the case of *status coniecturalis* it had to be clarified whether the suspect had committed the act, i.e., the question is aimed at the person of the perpetrator; *status definitivus* applied to the legal classification of the admitted act; in the case of *status generalis* or *qualitativus* they investigated if the committed act was subject to the scope of the given punitive statute; and in the case of *status translativus* they examined which law was to be applied and which court of justice was competent in the case. *Status generalis* can be taken more or less as the equivalent of the present-day reasons for excluding unlawfulness – for example, lawful defence, state of emergency, etc. Others argued that the case should be judged in terms of *status generalis*; more specifically, that killing of Clodius was not a crime because it served the interest of the state, thus, it occurred completely rightly. Cicero did not choose this path since he did not want to use either the tool of *deprecatio* (by which the accused admits his

[8] *Ibid.*

[9] Cic. *Mil.* 72 83. See also A. W. Lintott: "Cicero and Milo". Journal of Roman Studies 64 (1974) 62 78., 74.

[10] A. W. Lintott (1974) 74

[11] Cic. *Mil.* 8 11. 29 31.

[12] Vö. Ulp. D. 43, 16, 1, 27.; J. Zlinszky: *Római büntetőjog. (Roman Criminal Law.)* Budapest 1991. 114. f. See also J. E. Gaughan: *Murder Was Not a Crime: Homicide and Power in the Roman Republic.* Austin 2010.

guilt and asks for pardon referring to his earlier merits) or the opportunity of *comparatio*, which presents the act as a deed performed for the sake of the state. In his argument he used the tool of *relatio criminis*[13] and wanted to prove that Clodius had intended to murder Milo, and Milo had acted in self-defence only. At the same time, it can be established that setting out from the stable legal and political grounds of reference to the situation of lawful defence he does not lay smaller emphasis on emotional impact and uses the tool of *comparatio*, that is, he presents Milo's act committed in self-defence as a deed beneficial to the State – the latter assessment was most probably not voiced in the delivered speech and was inserted in the published version only.[14]

The argument of the prosecution somewhat helped Cicero as the Appii Claudii argued that Milo set a trap for Clodius with premeditated malice to be able to murder him, which Cicero could easily refute.[15] The primary aim of the court of justice set up by Pompey must have been to punish the abettors – in this case Milo, who did not kill Clodius with his own hands – rather than the slaves and freemen belonging to the people of the house of Milo and Clodius who clashed on Via Appia. In accordance with that, the phrase *"dolo malo"* well-known from the *praetor*'s edict[16] was in several cases adopted in the usage of *quaestiones de vi* too.[17] On the other hand, to distinguish voluntary homicide from involuntary homicide, the phrase *"dolo"* was used already in the *par(r)icida* definition attributed to Numa.[18] *Lex Cornelia de sicariis et veneficis* ordered to punish bearing of arms suitable for manslaughter and bearing of arms with intent to kill.[19] Taking all this into consideration, there are good chances for presuming that *lex Pompeia de vi* providing grounds for the proceedings against Milo also contained the phrase *"dolo (malo)"* and, accordingly, the accusers might have also wanted to prove that the act had been premeditated, prepared, which Cicero could easily refute.[20]

Accordingly, Cicero, responding to the usage of the prosecution, uses the phrases *"insidiae"* and *"insidiator"* several times;[21] however, he

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[13] Cf. Cic. *inv.* 2, 78. ff.

[14] A. W. Lintott: *Violence in Republican Rome.* Oxford 1968. 23.

[15] Cic. *Mil.* 46. ff.

[16] Cf. Cic. *Tull.* 7. 24.

[17] Ulp. D. 48, 6. 10 pr. 1.

[18] Fest. 247. *si qui hominem liberum sciens morti duit, paricidas esto.*

[19] Cf. D. J. Cloud: *Parricidium: from the lex Numae to the lex Pompeia de par ricidiis.* Zeitschrift der Savigny Stiftung für Rechtsgeschichte, Romanistische Abteilung 88 (1971) 1 66; W. Kunkel: *Untersuchungen zur Entwicklung des römischen Krimi nalverfahrens in vorsullanischer Zeit.* München 1962. 65. ff.

[20] A. W. Lintott (1974.) 75. See also M. C. Alexander: *The Case for the Prosecu tion in the Ciceronean Era.* Ann Arbor 2003. 263. f.

[21] Cic. *Mil.* 10. 11. 14. 23. 28. 30. 31.

strives to refute that the point would have been that both Milo and Clodius had planned in advance to kill the other, and emphasises that the plan of the murder was formulated and became determination unilaterally in Clodius.[22] He convincingly refers to the opportunity provided by *ius naturale* that killing of the aggressor *insidiator* does not qualify an unlawful act.[23] Cicero endeavours to turn it to his and his defendant's advantage that the senate qualified the events taken place on Via Appia treason when he tries to prove regarding the clash that it was seemingly condemned but practically approved by the senate.[24] In the *narratio* the orator touches on lawful defence as well as stresses that the slaves killed Clodius not upon Milos's instructions.[25] Presentation of the situation of lawful defence bears a clear resemblance to the relevant locus in *Pro Sestio* where the orator describes Sestius's act as the only possible form of defence against Clodius.[26] Cicero, at least in the version of the speech left to us, elegantly disregards the point of the case most critical to Milo: the attacking of the inn, that is, the circumstance that even the most brilliant orator could not have presented as direct outcome or manifestation of lawful defence.

After the speeches had been delivered, both the prosecution and the defence repudiated and demanded expulsion of five senators, five knights and five *tribuni aerarii* from the members of the *quaestio*; so, a total of fifty-one jurors voted. According to Asconius, twelve senators, thirteen knights and thirteen *tribune aerarii* voted for Milo's guilt, and six senators, four knights and three *tribune aerarii* voted for his innocence; furthermore, Asconius describes that according to certain people Marcus Porcius Cato most certainly took a stand for acquitting the accused as he declared several times that Clodius's death was a great relief to *res publica*.[27] During the following days Milo went into voluntary exile to Massilia.

2. THE MOTIF OF KILLING THE TYRANT AS FURTHER DEVELOPMENT OF LAWFUL DEFENCE

Below it is worth investigating how the motif of killing the tyrant appears in the speech delivered in defence of Milo, more precisely, in the published speech left to us, and how it is reflected and more elaborately worked out in Cicero's later philosophical works. As a starting point it

22 *Ibid.,* 23. 31. ff.

23 *Ibid.,* 7 11.

24 *Ibid.,* 12 14.

25 *Ibid.,* 28 29.

26 *Ibid.,* 88. ff.

27 Asc. 32.

must be made clear that harmonisation of the defence of *dignitas* and legitimised application of *vis* – i.e., killing the tyrant as a category of public law/philosophy of the state –was integrated in Cicero's philosophy only after Milo's unsuccessful defence and publication of the re-written/re-edited version of the speech.[28]

There is a completely striking connection between the portrait of the tyrant in *De re publica*[29] and the formulation of the demand to eliminate the tyrant from public life[30] and the image of "Milo as *tyrannoktonos*".[31] Accordingly, tyranny is created not through filling some office, position or dignity; the tyrant carries the core of tyranny in his personality, being, which is aimed at a single goal: *dominatio* over his fellow-citizens, and, eventually, at seizing *regnum*.[32] Thus, the *civis* who frees the State from the plague of tyranny is nothing else than *tutor et procurator rei publicae*, that is, healer of the community. In *Pro Milone* the contrast becomes sharp and clear: Clodius appears as *tyrannus*,[33] his death as killing the tyrant,[34] Milo as *conservator populi*, and through killing Clodius as *tutor et procurator rei publicae*.[35] As a historical example for *tyrannus* Cicero very often mentions Tarquinius Superbus, Sp. Maelius and Ti. Gracchus,[36] and refers to Verres from the recent past.[37] Cicero himself was several times called *tyrannus* by his political opponents and enemies.[38]

Cicero's theory of killing the tyrant is primarily based on stoic philosophy;[39] at the same time, it is important to underline that this theory is not a direct philosophical transformation of the *"vim vi repellere licet"* principle that serves the legal postulate of defence in *Pro Sestio* and *Pro Milone*.[40] The stoic element of the motif of killing the tyrant can be

[28] M. E. Clark, J. S. Ruebel: *Philosophy and Rhetoric in Cicero's Pro Milone.* Rheinisches Museum 128 (1985) 57 72., 72; A. Melchior: "Twinned Fortunes and the Publication of Cicero's Pro Milone" Classical Philology 103 3/2008. 282 297., 283.

[29] Cic. *rep.* 2, 47. See also A. Lintott: *Cicero as Evidence. A Historian's Compan ion.* Oxford New York 2008. 226. ff.

[30] *Ibid.,* 2, 51.

[31] In detail see K. Büchner: *Der Tyrann und sein Gegenbild in Ciceros 'Staat'.* In: *Studien zur römischen Literatur, II.* Wiesbaden 1962. 116 147; R. Heinze: *Ciceros 'Staat' als politische Tendenzschrift.* Hermes 59 (1924) 73 94.

[32] K. Büchner 121; E. Meyer: *Römischer Staat und Staatsgedanke.* Zürich 1964. 345.

[33] Cic. *Mil.* 35.

[34] *Ibid.,* 80. 83. 89.

[35] *Ibid.,* 80. Cf. Büchner 1962. 138. f.

[36] Cf. M. E. Clark, J. S. Ruebel 59; A. W. Lintott (1968) 55. ff.

[37] Cic. *Verr.* 2, 3, 20.

[38] Cic. *Vat.* 23; *Sest.* 109.

[39] M. Pohlenz: *Die Stoa, I.* Göttingen 1964. 139. 185. 313.

[40] M. E. Clark, J. S. Ruebel59.

demonstrated most clearly, what is more, in a form uttered by Cicero, in the third book of *De officiis* written in 44.[41] He declares that the element of killing the tyrant[42] is fully in harmony with stoic philosophy,[43] which also complies with *naturalis ratio*,[44] i.e., it is the ultimate conclusion of ethical consideration.[45] In view of the fact that the *tyrannus* ruins human community and places himself outside the rules of coexistence,[46] accordingly, these rules are not binding him either.[47] Cicero extends this principle to a wider scope, more specifically, he harmonises it with the norms of *ius naturale*, *ius gentium*, *ius divinum* and *ius humanum*.[48] The stoic sage acts in harmony with the laws of nature when he eliminates the tyrant from society, imitates the efforts of Hercules made for the sake of mankind.[49]

Cicero transforms the thesis of stoic moral philosophy into the legal thinking and concepts of the Romans.[50] His reasoning culminates in turning the right of killing the tyrant into the ethical/legal command of killing the tyrant: making common cause with the tyrant is excluded, he must be barred and removed from human community since he is nothing else than a beast having assumed human form.[51] Phalaris's case is Cicero's most favourite example, and by that he demonstrates that assassination is not only ethically fair but it is definitely a moral obligation *(honestum necare),* elimination of the tyrant from the community *(feritas et immanitas beluae segreganda est)*. This again is in line with the identification of the *tyrannus* with *belua* also present in stoic philosophy, which is clearly formulated in *De re publica* too[52] in such form that the *tyrannus* is the most harmful species of animals, which is the most hateful subhuman being both to gods and humans, that is, it lives merely *in figura hominis*.[53] Thus, the key attributes of the tyrant can be described by the following concepts: *nulla societas, belua, genus pestiferum, exul, contra leges, contra naturam*; i.e., a being close to a subhuman form of exist-

41 Cic. *off.* 3, 19 32.

42 *Ibid.,* 3, 32.

43 *Ibid.,* 3, 20.

44 *Ibid.,* 3, 23.

45 *Ibid.,* 3, 14. 19.

46 *Ibid.,* 3, 21.

47 *Ibid.,* 3, 32.

48 *Ibid.,* 3, 23.

49 *Ibid.,* 3, 23. 25.

50 M. E. Clark, J. S. Ruebel61.

51 Cic. *off.* 3, 32.

52 Cic. *rep.* 2, 48.

53 M. E. Clark, J. S. Ruebel 61.

ence, whose assassination cannot constitute moral offence just as killing any harmful beast.[54]

In *Pro Milone* this train of thoughts and images can be clearly followed. Cicero devotes two paragraphs to Clodius's sexual debaucheries,[55] three to his religious offences,[56] and underlines his crimes committed against natural law and positive law.[57] All this properly substantiates the image depicted of Clodius's beastly nature: the net of laws, which served to catch Clodius, the beast, who wants to seize *regnum*,[58] and of which he slipped out several times, and the representation of the wild beast hiding in darkness creates the image of beastly existence.[59] The wild animal *topos* occurs several times in Cicero's *corpus* in the characterisation of both Clodius[60] and Antonius.[61] So, Clodius was nothing else than a *belua* upsetting the order of Roman *societas*, terrorising decent citizens, among others Cicero and Pompey,[62] who tried to carry through the seizing of *dominatio* by undermining laws *(legibus Clodianis)* too, as it is an immanent feature of every tyrant,[63] and in 58 Cicero himself almost fell victim to this legislation crushing the law, more precisely *lex Clodia de capite civium*.

When Cicero refers to the circumstance of the situation of lawful defence excluding unlawfulness with regard to Milo's defence,[64] on the one hand, he supports his argument by the terminology of the relevant passage of *lex Cornelia de sicariis*,[65] on the other hand, he does not refer to written law but to man's innate right derived from nature in order to prove Milo's act, for if an assassin, aggressor, robber or enemy attacks somebody by arms, then he can use every means to protect his life.[66] Consequently, in killing the *insidiator*, that is, Clodius, Milo followed the law of nature as the force of positive law does not prevail in such cases,

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[54] *Ibid.,* 62.

[55] Cic. *Mil.* 55 56.

[56] *Ibid.,* 85 87.

[57] *Ibid.,* 44. 73. sk.

[58] *Ibid.,* 43. 76 78.

[59] *Ibid.,* 40 41.

[60] Cic. *Sest.* 16; *Mil.* 40. 85; *har. resp.* 5.

[61] Cic. *Phil.* 3, 28; 4, 12; 7, 27.

[62] Cic. *Mil.* 37 39.

[63] *Ibid.,* 89. Cf. Cic. *dom.* 43. ff.; *Pis.* 58.

[64] Cic. *Mil.* 10 11.

[65] R. Cahen: "Examen de quelques passages du Pro Milone". Revue des Etudes Anciennes 25 (1923) 119 138., 122. ff.

[66] Cic. *Mil.* 10. *haec ... non scripta, sed nata lex, quam ... ex natura ipsa adripui mus*

for in war law is silent, and the assassin can be killed rightly.[67] With the aid of the basic principles of stoic philosophy, among others, Cicero extends the scope of lawful defence to a wide domain: educated persons were allowed by common sense, barbaric tribes by necessity, peoples by unwritten law and wild beasts by nature to drive back every attack of violence every time by every means.[68]

The orator, however, does not confine himself to prove lawfulness of Milo's act: it is not punishment at all but praise that he would deserve for killing Clodius since he did a great service to *res publica* so to say unselfishly because all of his acts were motivated – as Cicero asserts – by his commitment to public good.[69] It is in this spirit that he makes Milo speak: he makes him wish citizens and the State tranquil and undisturbed life even at the expense of his own exile.[70] He raises this train of thoughts and greatness of Milo's act to a divine-cosmic sphere and strikes a tone that he uses later in *Somnium Scipionis* when praising the merits of men who work for the public.[71] By that he opens a new dimension for the interpretation of the *"vim vi repellere"* principle as he distinguishes between two kinds of *vis*: baleful violence used by Clodius and the force that guarantees survival of Rome by which providence, i.e., *providentia* itself intervened as saviour through Milo in the fate of the State.[72] Therefore, in this sense, his defendant is no longer an independent doer but an agent who fulfils the prediction made by Cicero in 57 that Milo would kill Clodius,[73] that is, a means of *providentia* because divine providence, destiny had let Clodius stay alive so that it could fulfil his punishment at a given place, given time and under given circumstances by Milo's hands.[74]

All this is unambiguously reverberated in the relevant paragraphs of *De officiis*. *Providentia*, which is the form of appearance of stoic *fatum*,[75] that is, *heimarmenē*, is manifested through the *sapiens*, who is, on the basis of *naturae ratio*, not only entitled but obliged to kill the *tyrannus* that annihilates *coniunctio civium*.[76] So, in this respect, Milo is

[67] *Ibid.,* 11. *silent enim leges inter arma*; cf. Cic. *Sest.* 86; *leg.* 1, 19; 2, 8. 11; *fin.* 4, 25.

[68] Cic. *Mil.* 30.

[69] *Ibid.,* 6.

[70] *Ibid.,* 93.

[71] Cic. *rep.* 6, 13. ff.

[72] Cic. *Mil.* 83 84. Cf. K. Büchner 276; M. E. Clark, J. S. Ruebel 67.

[73] Cic. *Att.* 4, 5.

[74] Cic. *Mil.* 86.

[75] On the other aspects of *fatum* see W. Pötscher: *Das römische fatum Begriff und Verwendung.* In: H. Temporini W. Haase (Hrsg.): Aufstieg und Niedergang der römischen Welt, II. 16. 1. Berlin New York 1978. 393 424.

[76] Cic. *off.* 3, 23.

nothing else than a manifestation of the archetype of stoic *sapiens*, who, having realised *naturae ratio*, fulfilled the order of *heimarmenē* and freed the State from the contagion poisoning the community. Law and statutes, i.e., state authority was not and would not have been able to bring the peril embodied by Clodius under control,[77] law and order of the State could not put proper tools into Milo's hands to act as avenger.[78]

It is known from Asconius that there are significant differences between the speech delivered in defence of Milo and the speech published, and before delivering the speech Cicero had rejected Brutus's proposal to refer to lawfulness of killing the tyrant in Milo's defence.[79] The fact that he did not achieve his goal, that is, he did not attain Milo's acquittal most probably made the orator change his tactics of argument in the re-written *Pro Milone* disseminated also as a political pamphlet.[80] Presumably, before making the speech, it was not for theoretical reasons that Cicero refused to accept Brutus's argument as in 63 he himself had several conspirators executed without judgment and undertook the defence of Rabirius charged with *perduellio* – the difference between these cases and Milo's case was that the latter was not backed by *senatus consultum ultimum*.[81] In 57, Cicero cherished hopes regarding Clodius's assassination by recalling the example of Scipio Nasica who killed Ti. Gracchus as *tyrannus*, but at that time he had not placed himself beyond the limits of positive law yet.[82] In the speech delivered he endeavoured to use the system of argument of positive law and was reluctant to resort to the tools of legitimisation of stoic philosophy – his efforts were not crowned by success. Afterwards, in the published version he used the system of argument of stoa, which he later on shaped into a structure of profound thoughts with respect to the idea of killing the tyrant in *De re publica*, *De finibus bonorum et malorum*, *Tusculanae disputationes* – in which he defined the time of the dialogue as the period of Milo's lawsuit – and in *De officiis*. He might have meant the oral pleadings, stylised into a paper on the philosophy of the state, which highlights Milo's unselfishness and self-sacrifice and which sets Milo as an example of the stoic sage, to provide *consolatio* for Milo.[83]

In what follows it is worth following Aislinn Melchior's train of thoughts that convincingly proves that in the version of *Pro Milone* left to

[77] Cic. *Mil.* 77.

[78] *Ibid.,* 88.

[79] Asc. 30.

[80] M. E. Clark, J. S. Ruebel 69.

[81] Cf. J. Ungern Sternberg v. Pükel: *Spätrepublikanisches Notstandsrecht.* München 1970. 12. ff.

[82] Cic. *dom.* 91; *Att.* 4, 3.

[83] M. E. Clark, J. S. Ruebel72.

us Cicero consequently enforces the tendency in Milo's representation that he compares his defendant and his acts performed for the sake of *res publica* to his own merits obtained during suppression of Catilina's plot and identifies him with himself. All this might have primarily served a given political goal: as his own fate exemplifies the opportunity of returning/being called back from unlawful exile, he is hoping that Milo will be called back too, and that is what he wanted to advance by publishing the *oratio*.[84]

The key points of identifying the two persons, Cicero and Milo are as follows. Both did noble service to the State as they freed the community of the tyrant, however, the ungrateful crowd forced both of them into exile. These similarities should bring along the following as logical consequences: if Cicero was able to return home from exile triumphantly, then Milo should return home too. The enemies of Cicero and Milo embody an identical principium: in the identification Cicero represents Clodius as second Catilina, however, it is not *Pro Milone* where this image occurs for the first time. This identification emerges several times after his return from exile; for example, in *De domo sua* Clodius appears as *felix Catilina*.[85] In *Pro Milone*, identification of Clodius with Catilina is carried out by applying certain *appositiones* rather than by name. In this respect it is worth comparing the usage of *Pro Milone* with that of the speeches against Catilina. The key characteristics of both Catilina and the conspirators are *furor*[86] and *audacia*;[87] they appear as *latro*,[88] *insidiator*[89] and *parricida*.[90] Clodius and his adherents are also characterised by *furor*[91] and *audacia*[92] just as by the classifications *latro*,[93] *insidiator*[94] and *parricida*.[95] The identification of Catilina with Clodius develops most clearly at the point where the orator speaks about the causes of his own exile,[96] and in relation to it characterises Clodius as it were as the "legal successor" of Catilina who undermined the State.

84 A. Melchior. 285. f.

85 Cic. *dom.* 72.

86 Cic. *Cat.* 1, 1. 2. 15. 23. 31; 2, 19. 25; 3, 4; 4, 12.

87 *Ibid.,* 1, 1. 4. 7; 2, 3. 10. 27.

88 *Ibid.,* 1, 23. 31. 33; 2, 7. 16. 22.

89 *Ibid.,* 1, 11. 32; 2, 6. 10.

90 *Ibid.,* 1, 17. 29. 33; 2, 7. 22.

91 Cic. *Mil.* 3. 27. 32. 34. 35. 77.

92 *Ibid.,* 6. 30. 32.

93 *Ibid.,* 17. 18. 55.

94 *Ibid.,* 6. 10. 11. 14. 19. 27. 30. 54.

95 *Ibid.,* 18. 86.

96 *Ibid.,* 36 37.

Accordingly, Cicero identifies Milo's role with his own, representing both of them as archetypal manifestations of real patriotism, who qualified the State for this role by undertaking the sublime task of killing the tyrant, that is, Clodius – in the case of Milo – and chasing away Catilina and having the conspirators executed – in the case of Cicero. Just as the great and the good of past times, C. Servilius Ahala who killed Spurius Maelius, Publius Scipio Nasica who did away with Tiberius Gracchus, Lucius Opimius who used the opportunities provided by *senatus consultum ultimum* and did away with Caius Gracchus, and Caius Marius who rendered L. Saturninus harmless.[97] In the first speech against Catilina the orator calls the example of exactly the same men to his audience's mind when he urges that Catilina should be rendered harmless.[98] In view of the fact that at the time of publishing *Pro Milone* the speeches against Catilina constituted *exempla* of Roman rhetorical training to be learned by heart, Cicero could certainly expect the readers of the oral pleadings to recognise the reminiscences implied by the enumeration without doubt and draw necessary conclusions from them with respect to the parallels between the roles of Milo and Cicero.[99]

The characters of Spurius Maelius and Tiberius Gracchus return in the second *sermocinatio* of *Pro Milone*, i.e., in the passage where the orator calls Milo as it were as a fictitious speaker,[100] which can be considered as a kind of reminiscence of the given locus of the fourth *Catilinaria* again where Cicero expounds that Catilina represents a danger to the State greater than any of the former subversive elements, the Gracchi and L. Saturninus.[101] Thereby the orator clearly demonstrates that Clodius, rendered harmless by Milo, also carried danger to *res publica* greater than former subversive elements, measurable only to the peril caused by Catilina. Just as Cicero mentions himself as *conservator civium*,[102] Milo also becomes *conservator populi*.[103] When he puts the statement into Milo's mouth that he fended off Clodius's dagger that he drove at citizens' throat,[104] it is a clear *allusio* to the passage of the third *Catilinaria* where Cicero tells the same about himself regarding Catilina's weapons.[105] It appears also as a parallel between Cicero and Milo that both of them

[97] *Ibid.,* 82.

[98] Cic. *Cat.* 1, 3 4.

[99] A. Melchior. 290.

[100] Cic. *Mil.* 72 73.

[101] Cic. *Cat.* 4, 4.

[102] On this topic see J. Paterson: *Self Reference in Cicero's Forensic Speeches.* In: J. Powell J. Paterson (eds.): Oxford 2004. 79 95.

[103] Cic. *Mil.* 73. 80.

[104] *Ibid.,* 77.

[105] Cic. *Cat.* 3, 2.

saved the State and peace of citizens at the expense of risking their own life and safety.[106] (At the same time, the orator makes use of the identification properly in other respects too: he opposes Milo's courage to his own fear,[107] and Milo's face and glance turned rigid as marble to his own tears[108]).

The identification of Milo with himself has further tempting opportunities in store: in the person of Milo who kills Clodius he can triumph over the dead primordial enemy.[109] In spite of the fact that no direct evidence is available to us that by publishing the speech Cicero wanted to attain that Milo should be called home from exile, all these parallels and identifications give us a good chance of presuming it.[110]

When Cicero forwarded a copy of the published speech – which is one of the masterpieces of both rhetoric and political pamphlets indeed – to Milo too, allegedly he made the only remark that if earlier Cicero had spoken before court like that too, then now he could not eat the superb fish that can be caught solely in Massilia.[111] Cicero was not wrong – this statement makes us discern: in a certain sense Milo was a stoic sage indeed.

[106] Cic. *Mil.* 30. Cf. Cic. *Cat.* 4, 18.

[107] Cic. *Mil.* 1.

[108] *Ibid.,* 101. 105.

[109] A. Melchior. 293.

[110] *Ibid.,* 295.

[111] Dio Cass. 40, 54, 2.

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AFTER THE ICJ'S ADVISORY OPINION ON KOSOVO: THE FUTURE OF SELF-DETERMINATION CONFLICTS*

Despite the expectation that the ICJ's Advisory Opinion on Kosovo will pro foundly contribute to the clarification of international law on self determination, the Court, nevertheless, confined itself to a rather narrow reading of the submitted ques tion. Yet, I will argue that some of its findings are of general nature. Such are the following conclusions: 1. that "general international law contains no applicable pro hibition of declarations of independence", except in cases where they are in connec tion with a violation of general international legal norms of jus cogens; 2. that "the scope of the principle of territorial integrity is confined to the sphere of relations between States" and, hence, does not concern non state actors, including secession ist groups; and 3. that "persons who acted together in their capacity as representa tives of the people" of some territory under the UN interim regime of governance are not bound to act within the framework of powers and responsibilities established to govern the conduct of provisional institutions. I will argue, furthermore, that these findings might have disastrous consequences for the future of self determination con flicts. First, by being excluded from the duty to respect the jus cogens norm of territo rial integrity, secessionist groups, as non state actors, might be inclined to use all possible means, including the violent ones, to seize as much power as possible over delineated piece of territory of the recognized state. Second, secessionists may now even more relentlessly resort to the issuing of UDIs, while simultaneously searching for some patron(s) among Great Powers, which would at the critical moment back up their strive for statehood, by formally recognizing the new entity as a state. This, in turn, may even affect the role of 'recognition theory' in international law. Finally, states drawn into prolonged self determination conflicts with their rebellion minori ties will be dissuaded from entering into provisional UN mandated conflict settlement

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arrangements, because no guarantee will exist that 'representatives of a self deter mining people' would not unilaterally dissolve them.

Key words: *International Court of Justice. Self determination conflicts. Uni lateral declaration of independence. Non state actors. Territorial integrity .*

1. INTRODUCTION

All those who tried to enter the International Court of Justice's (ICJ) web site in the late afternoon of July 22, 2010 were denied access for several hours, because the system simply could not manage to utilize such a large number of potential visitors. This unprecedented interest of the global public opinion in the ICJ's Advisory Opinion on the accordance of Kosovo's unilateral declaration of independence (UDI) with international law[1] was triggered by the expectation that the rendered opinion will profoundly contribute to the clarification of one of the most obfuscated areas of international law, that of self-determination. This process has drawn attention of both academia and various state and non-state actors, which eagerly waited for a decision that would, preferably, advance their own political interests.[2] Having this huge expectation in mind, it came as no surprise that the ICJ's opinion[3] was eventually met with an open disgruntlement. This particularly holds for international legal scholars, who almost unanimously criticized the ICJ for its overtly narrow interpretation of the posed question, which eventually led it to hardly illuminating conclusions.[4] Hence, one may come across various downgrading qualifications of the ICJ's final product, such as "die Kunst des Nich-

[1] The UN General Assembly submitted the following question to the ICJ: "Is the unilateral declaration of independence by the Provisional Institutions of Self Government of Kosovo in accordance with international law?" UNGA A/63/L. 2.

[2] This was the first Advisory Opinion case in which all the permanent Security Council's members have participated in the oral proceeding and submitted their written statements.

[3] International Court of Justice, Accordance with international law of the unilat eral declaration of independence in respect of Kosovo, Advisory Opinion, No. 2010/25, 22 July 2010. (Advisory Opinion)

[4] A notable exception, in that respect, is Szewczyk's characterization of the ICJ's Advisory Opinion as "a groundbreaking decision". (B. M. Szewczyk, Lawfulness of Ko sovo's Declaration of Independence, *ASIL Insight* 14/2010, 26, at *http://www.asil.org/ files/insight100817pdf.pdf*, acc. 5 Feb. 2012) On the other hand, d'Aspremont says that "the astonishment expressed by some commentators is baffling. How could one have seri ously believed that the Court would come with a grand opinion about statehood and self determination by re interpreting broadly the very narrow question submitted to it?" J. d'Aspremont, The Creation of States before the International Court of Justice: Which (Il) legality?, 2 at *http://www.haguejusticeportal.net/Docs/Commentaries%20PDF/DAspre mont Kosovo EN.pdf*, acc. 5. Feb. 2012

tssagens" (the art of saying nothing)[5], "an exercise in the art of silence",[6] or "the sounds of silence and missing links".[7] This overall scholarly dissatisfaction is probably most eloquently summarized in the following observation – "the present Advisory Opinion might not enter into the judicial history of the Court for its answer to this question, but rather for what it did not say",[8]

Without discussing what would presumably be the most adequate course of action for the ICJ,[9] this paper will focus on those findings of the Advisory Opinion, which are of a rather general nature and, as such, might potentially affect various self-determination conflicts. Since the ICJ deliberately refrained from a more direct elaboration of international law of self-determination,[10] these findings are the following ones: 1. that

[5] A. Peters, "Das Kosovogutachten und die Kunst des Nichtssagens", *Jusletter* 25. Oktober 2010, at *http://papers.ssrn.com/sol3/papers.cfm?abstract id 1701093*, acc. 5. Feb. 2012.

[6] C. Pippan, "The International Court of Justice's Opinion on Kosovo's Declara tion of Independence", *Europäisches Journal für Minderheitenfragen* 3 4/2010, 145 166.

[7] T. Burri, "The Kosovo Opinion and Secession: The Sounds of Silence and Missing Links", *German Law Journal* 8/2010, 881 889.

[8] B. Arp, "The ICJ Advisory Opinion on the Accordance with International Law of the Unilateral Declaration of Independence in Respect of Kosovo and International Protection of Minorities", *German Law Journal* 8/2010, 847.

[9] Opinions on this matter largely differ. While some commentators bluntly speak of the ICJ's "cowardice" (see, M. C. Mineiro, The Cowardice of the Restrictive Advisory Opinion Approach: A Failure of the ICJ to exercise its judicial prerogative in the applica tion of General Principles of International Law in fulfillment of International Peace and Security, Memo Prepared for the Hague Academy of International Law Summer Public International Law Directed Studies Program (4 August 2010), at *http://papers.ssrn.com/ sol3/papers.cfm?abstract id 1654265, acc. 5 Feb. 2012)*, others argue that "it would have been more appropriate for the Court to decline jurisdiction in this case." P. Hilpold, The ICJ Advisory Opinion on Kosovo: Different Perspectives of a Delicate Question (3 January 2011), 48, at *http://papers.ssrn.com/sol3/papers.cfm?abstract id 1734443*, acc. 5 Feb. 2012. There are commentators, on the other hand, who argue that the ICJ posi tioned itself more as a means of dispute settlement than as a legal advisory body. Judged by this standard, "[t]he Court succeeded, in the sense that it created a favorable climate for talks between Belgrade and Pristina, though at the cost of a lost opportunity for the development of international law and some confusion of its contentious and advisory functions." D. Richemond Barak, The International Court of Justice on Kosovo: Missed Opportunity or Dispute "Settlement"?, 3, at *http://papers.ssrn.com/sol3/papers. cfm?abstract id 1723034*, acc. 5. Feb. 2012

[10] The Court explicitly states at a number of places what it was not required to address in its opinion. More particularly, it specifies that the submitted question "does not ask about the legal consequences" of the UDI, just as it "does not ask whether or not Kosovo has achieved statehood. Nor does it ask about the validity or legal effects of the recognition of Kosovo by those States which have recognized it as an independent State." (Advisory Opinion, par. 51) Consequently, "[t]he Court is not required by the question it has been asked to take a position on whether international law conferred a positive entitle

"general international law contains no applicable prohibition of declarations of independence"[11], except in cases where they are in connection with a violation of general international legal norms of *jus cogens*;[12] 2. that "the scope of the principle of territorial integrity is confined to the sphere of relations between States" and, hence, does not concern non-state actors, including secessionist groups;[13] and 3. that "persons who acted together in their capacity as representatives of the people" of some territory under the UN interim regime of governance are not bound to act within the framework of powers and responsibilities established to govern the conduct of provisional institutions.[14]

After scrutinizing these findings of the ICJ, in the remainder of the paper I will embark upon their plausible consequences for other self-determination conflicts around the globe. At first glance, this might appear a thankless role, because it seems akin to making a political prognosis. Not so, however. Although, in legal terms, the Advisory Opinion clearly does not set any kind of precedent rule, which might be directly applicable in analogous disputes,[15] it will be argued that the concerned actors elsewhere might, nonetheless, infer some straightforward legal conclusions from the aforementioned general findings of the ICJ. These legal conclusions, in turn, might significantly shape political options and preferences of relevant parties to self-determination conflicts.[16] When taken

ment on Kosovo unilaterally to declare its independence or, *a fortiori*, on whether international law generally confers an entitlement on entities situated within a State unilaterally to break away from it." Moreover, "it is entirely possible for a particular act – such as a unilateral declaration of independence – not to be in violation of international law without necessarily constituting the exercise of a right conferred by it. The Court has been asked for an opinion on the first point, not the second." (par. 56) Finally, the Court specifically underlines that the questions, as to whether Kosovo has the right to separate statehood in accordance with international law on self determination or as a form of 'remedial secession', go "beyond the scope of the question posed by the General Assembly." (par. 83)

[11] *Ibid*., par. 84.

[12] *Ibid*., par. 81.

[13] *Ibid*., par. 80.

[14] *Ibid*., paras. 109, 121.

[15] On the other hand, the ICJ did not employ 'the unique case' thesis of the pro-Kosovo independence camp. On non-sustainability of this thesis, see, M. Jovanović, "Is Kosovo and Metohija Indeed a 'Unique Case'?", *The* Kosovo *Precedent: Implications for Statehood, Self-determination and Minority Rights* (ed. *J. Summers*), Martinus Nijhoff Publishers, Leiden – Boston, 2011, 345–374.

[16] One can here draw a parallel with the situation created after the Badinter Commission's opinions, which legally qualified the case of Yugoslavia as the one of state disintegration. Federal scholars have promptly criticized this ruling, arguing that it "in effect declassifies federal states internationally into 'second class unitary states'." (T. Fleiner, H. Schneider and R. L. Watts, *Report of the Expert Group on Proposals for the Constitutional Reorganization of the Federal Republic of Yugoslavia*, Institute for Liberal Democratic Studies, Belgrade, 2001, 17.) Moreover, they argued that this ruling might be

in conjunction, three ICJ's findings might trigger the following patterns of political behavior. First, by being excluded from the duty to respect the *jus cogens* norm of territorial integrity, secessionist groups, as non-state actors, might be inclined to use all possible means, including the violent ones, to seize as much power as possible over delineated piece of territory of the recognized state. Second, secessionists may now even more relentlessly resort to the issuing of UDIs, while simultaneously searching for some patron(s) among Great Powers, which would at the critical moment back up their strive for statehood, by formally recognizing the new entity as a state. This, in turn, may even affect the role of 'recognition theory' in international law. Finally, states drawn into prolonged self-determination conflicts with their rebellion minorities will be dissuaded from entering into provisional UN-mandated conflict-settlement arrangements, because no guarantee will exist that 'representatives of a self-determining people' would not unilaterally dissolve them.

2. THE STATUS OF UDI UNDER INTERNATIONAL LAW

In the proceeding before the ICJ, some states expressed the view that a UDI is a fact that cannot be subjected to legal assessment, and, thus, it cannot be considered either valid or invalid. For the purposes of this paper, I will single out the statements of two prominent authorities in the field, James Crawford, representing Great Britain, and Martti Koskenniemi, representing Finland. In order to make his point more vivid, the former at some point solemnly declared the independence of South Australia. This utterance was followed with two rhetorical questions. Crawford, first, asked if, by unilaterally declaring independence, he committed

another nail in the coffin of the very idea of federalism, because it will most likely dis suade governments "either from entrusting minorities with a broad measure of local au tonomy or from entering into federal arrangements as a method of regulating interethnic relations. In the event of a severe crisis, in which it is judged by an outside authority that the state is in the process of dissolution, the sub state units of government so created may be considered as vested with a right to separate statehood." (M. Rady, "Self Determina tion and Dissolution of Yugoslavia", *Ethnic and Racial Studies* 2/1996, 387) This predic tion turned accurate, particularly in post communist Europe, where no state opted for the model of ethno cultural territorial autonomy, despite frequent requests of minority com munities for such a status. The only post communist federal states are Russia and Bosnia and Herzegovina, which rather reluctantly entered into this arrangement (see more gen eral in, M. Jovanović, *Transition and Federalism East European Record*, in M. Jovanović and S. Samardzić, *Federalism and Decentralisation in Eastern Europe: Between Transi tion and Secession*, Institut du Fédéralisme, LIT Verlag, Fribourg Vienna, 2007, 1 167). The third post communist federal state was the State Community of Serbia and Montene gro, which eventually dissolved after the Montenegro's constitutionally mandated referen dum for independence. See, M. Jovanović, "Consensual Secession of Montenegro To wards a Good Practice?", *On the Way to Statehood: Secession and Globalization* (eds. A. Pavković and P. Radan), Ashgate, Aldershot, 2008, 133 148.

any internationally wrongful act in the Court's presence. Secondly, he asked whether the committed act was effective. Since the answer to both questions was clearly negative – in the first case, because he had no representative capacity, and in the second, because no one would rally to his call – he asked if it, then, made more sense to treat as illegal only those UDIs, which had been issued by representative bodies and which were likely to be effective? The answer to this question was all the more obvious and it was negative again. Crawford said that the reason for such an answer was quite simple "A declaration issued by persons within a State is a collection of words writ in water; it is the sound of one hand clapping. What matters is what is done subsequently, especially the reaction of the international community".[17]

Koskenniemi expressed a similar standpoint. He noticed that the question submitted to the ICJ implied that there were precise international legal rules regulating the making of independence declarations. However, "there are no such rules. No treaty, no custom regulates the matter ... A declaration is simply a fact, or the endpoint of an accumulation of facts. Just like possession of territory, population or government are facts".[18]

The ICJ, nevertheless, "did not agree with the argument that UDIs are not legally accessible at all."[19] It entered into the discussion regarding legality of the UDI in the case of Kosovo. However, in doing so, the ICJ proceeded from a revised formulation of the question. Whereas it was asked to assess whether the Kosovo UDI was "in accordance with international law", the ICJ somewhat laconically concluded that "[t]he answer to that question turns on whether or not the applicable international law prohibited the declaration of independence".[20] Putting aside the issue of whether the ICJ is generally legally authorized to change the advisory request[21], particularly when proceeding from the statement that the one it deals with "is clearly formulated",[22] many commentators argued that, with this specific reformulation in mind, the ICJ resurrected the outdated Lotus principle.[23] As put by Judge Simma, in his separate Declaration,

[17] CR 2009/32, p. 47.

[18] CR 2009/30, p. 57.

[19] M. Vashakmadze and M. Lippold, "'Nothing But a Road Towards Secession?' The International Court of Justice's Advisory Opinion on Accordance with International Law of the Unilateral Declaration of Independence in Respect of Kosovo", *Goettingen Journal of International Law* 2/2010, 631.

[20] Advisory Opinion, par. 56.

[21] Kammerhofer is, for instance, of the opinion that the ICJ is not legally entitled to such an act. J. Kammerhofer, Begging the Question? The Kosovo Opinion and the Reformulation of Advisory Requests, at *http://papers.ssrn.com/sol3/papers.cfm?abstract id 1684539*, acc. 5 Feb. 2012

[22] Advisory Opinion, par. 51.

[23] "Lotus", Judgment No. 9, 1927, P.C.I.J., Series A, No. 10, p. 18.

"[t]he underlying rationale of the Court's approach reflects an old, tired view of international law, which takes the adage, famously expressed in the *'Lotus'* Judgment, according to which restrictions on the independence of States cannot be presumed because of the consensual nature of the international legal order." In other words, "it is not necessary to demonstrate a permissive rule so long as there is no prohibition".[24] By using this approach, not only did the ICJ fail "to seize a chance to move beyond this anachronistic, extremely consensualist vision of international law",[25] but, curiously enough, it also helped the secessionists' cause, despite the fact that the Lotus was originally intended to protect sovereignty of states.[26] Consequently, this reinterpretation of the question decisively affected the scope of the ICJ's advisory role[27], thereby seriously damaging the integrity of its judicial function.[28]

Once it decided to narrow down the question as to investigate the existence of a general prohibitive rule of international law[29], the ICJ swiftly concluded that the state practice throughout eighteenth and nineteenth century "points clearly to the conclusion that international law contained no prohibition of declarations of independence." Many new states came to existence in the second half of twentieth century, by way of exercising the right to self-determination. Moreover, unilateral declarations were issued on a numerous occasions outside of the context of de-

[24] Declaration of Judge Bruno Simma, par. 2

[25] *Ibid*., par. 3

[26] A. Peters, 2.

[27] In a pre Advisory Opinion analysis of potential courses of action of the ICJ, Milanović argued that much would depend on how the Court will deal with 'The Question Question'. M. Milanović, Kosovo Advisory Opinion Preview, at *www.ejiltalk.org/kosovo advisory opinion preview/*, acc. 5 Feb. 2012

[28] In Hilpold's view, the ICJ's decision to avoid highly contentious issues of the right to self determination, statehood and the legality of the acts of recognition "might have been a good choice", but "[t]he advisory role of the ICJ as such and the integrity of the judicial function, however, have suffered further reputational damage." P. Hilpold, 28. Similarly, Judge Simma closes his Declaration with the following conclusion: "To not even enquire into whether a declaration of independence might be 'tolerated' or even ex pressly permitted under international law does not do justice to the General Assembly's request and, in my eyes, significantly reduces the *advisory* quality of this Opinion." Dec laration of Judge Bruno Simma, par. 10.

[29] With regard to this issue, Koskenniemi's position seems to be more nuanced than Crawford's, insofar as he claims that even when no explicit rule in international law regulates certain behavior, it still does not follow that it cannot be judged as valid or in valid on the basis of some more general legal principle. In that respect, Koskenniemi ex plicitly refers to the wording of the ICJ's decision in the 1951 *Fisheries* case. After draw ing a parallel with this case, he concludes that "the fact that there are no mechanical rules on declarations of independence may not make it impossible to judge what their effect should be. Such judgment must only be based on a balanced assessment of the relevant facts, including as the Court then stated the needs of the communities as can be de tected from their histories." CR 2009/30, p. 58.

colonization, and yet "[t]he practice of States in these latter cases does not point to the emergence in international law of a new rule prohibiting the making of a declaration of independence in such cases".[30]

This assertion implies two further separate conclusions. The first one concerns several cases in which the Security Council did condemn UDIs, which were brought up by some participants in the oral proceedings. With regard to these cases, the ICJ stated that the illegality attached to those declarations of independence "stemmed not from the unilateral character of these declarations as such, but from the fact that they were, or would have been, connected with the unlawful use of force or other egregious violations of norms of general international law, in particular those of a peremptory character (jus cogens)".[31] In other words, it is a particular legal context, within which the fact of issuing a unilateral declaration of independence may subsequently trigger its illegality.

The second conclusion concerns a potential source of legal prohibition of a UDI under international law. While there is no general prohibitive rule against UDIs, such a prohibition may still be envisaged by some special rule of an international legal instrument. Such a special rule would outweigh the general non-prohibitive one, according to the well-established legal principle *lex specialis derogat legi generali*. It was exactly for this reason that the ICJ found it necessary to determine whether the Kosovo UDI was in accordance with a special legal regime, established in the SC Resolution 1244.[32]

It can be, thus, argued, contra Crawford, that it very much made sense for the ICJ to determine the legality/illegality of the Kosovo UDI. This was so, because the question before the Court was not merely whether the Kosovo UDI was in accordance with *general* international law, which was largely in the focus of Crawford's attention, but whether it was in accordance with *applicable* international law.[33] This implies that the Kosovo UDI would be deemed illegal either if it were issued in connection with some violation of general international legal norms of *jus co-*

[30] Advisory Opinion, par. 79.

[31] *Ibid*., par. 81.

[32] The ICJ went a step further and investigated whether the UDI contravened the Kosovo Constitutional Framework, arguing that "[t]he Constitutional Framework derives its binding force from the binding character of resolution 1244 (1999) and thus from in ternational law. In that sense it therefore possesses an international legal character." Advi sory Opinion, par. 88. For an interesting challenge of this ICJ's view, *see*, D. Jacobs, The *Kosovo* Advisory Opinion: A Voyage by the ICJ into the Twilight Zone of International Law, at *http://www.haguejusticeportal.net/Docs/Commentaries%20PDF/Jacobs Kosovo Note EN.pdf*, acc. 5 Feb. 2012

[33] Crawford did assert that not only "international law does not regulate declara tions of independence as such", but also that there was "nothing in the surrounding cir cumstances, including resolution 1244, to impose any contrary obligation." However, he did not bother much to justify this statement. CR 2009/32, p. 52.

gens, or if it were as such prohibited by the special legal regime of the SC Resolution 1244. The first form of illegality would exist if the authors of the Kosovo UDI were in violation of the principle of territorial integrity, as argued by some participants in the proceedings. The second form of illegality would exist if the SC Resolution 1244 did exclude such an option for determining the final status of the province.

3. NON-STATE ACTORS AND THE PRINCIPLE OF TERRITORIAL INTEGRITY

The first aforementioned form of the prohibitive use of a UDI implies that the peremptory norm of general international law regarding the duty to respect the principle of territorial integrity binds not only states, but non-state actors as well. This position is on the behalf of Serbia elaborated by another expert in the field, Malcolm Shaw. He offered several arguments for such a claim. First, the concept of international relations is now widely acknowledged as to include civil wars, violations of humanitarian law, terrorism and the internal seizure of power. Secondly, international law tends nowadays to directly address non-state entities, and even the authors of the Kosovo UDI reluctantly admit that that is the case. They particularly mention the Colonial Declaration, which, in their own words, "may perhaps be read as broadening the beneficiaries of the principle of territorial integrity so as to include not just the State but the people of the State". Shaw, thus, concludes that "[t]he classical structure of international law has changed and no State or other entity may seek now to cling to it in the face of established evolution. The clock may not be turned back".[34] That this is so is, furthermore, evidenced in the recent practice, which demonstrates that non-state entities within existing states are directly addressed in the context of internal conflict and with regard to territorial integrity. Examples include SC Resolution 787 (1992), calling "all parties and others concerned to respect strictly the territorial integrity" of Bosnia and Herzegovina, as well as resolutions relating to the Democratic Republic of Congo, Somalia and Sudan, which also strongly reaffirmed the importance of the sovereignty and territorial integrity of those states faced with internal secessionist conflicts. It can be, thus, concluded that "the international community now accepts that non-State entities and groups within sovereign States may be directly required to respect the territorial integrity of that State".[35]

Finally, numerous international and regional instruments concerning the protection of minorities and indigenous peoples explicitly stipulate that nothing in the instrument in question may be construed as per-

[34] CR 2009/24, p. 66.

[35] *Ibid*., p. 67.

mitting any activity contrary to, *inter alia*, the sovereignty and the territorial integrity of states. This formulation can be found in the 1992 UN *Declaration* on the Rights of *Persons Belonging* to National or Ethnic, Religious and Linguistic Minorities, as well as in the specific regional instruments, such as the European Charter on Regional or Minority Languages and Framework Convention for the Protection of National Minorities. Moreover, the recent UN Declaration on the Rights of Indigenous Peoples refers in this context to both states and peoples. Shaw, thus, concludes that it is

> simply incorrect to maintain that international law does not apply directly to non-State entities nor that the norm of territorial integrity is today limited to third States alone. Practice makes it very clear that such norm is now recognized as applying to non-consensual situations of internal conflict and secessionist attempts. This has been most recently recognized in the Report on the Conflict in Georgia of the Mission established by the Council of the European Union.[36]

A number of countries that supported the Kosovo UDI challenged this reasoning.[37] I will here focus again on Koskenniemi's argumentation. He notices that the principle of territorial integrity "does not at all concern the relation between a State and an entity seeking self-determination". This is testified by the explicit wording, as well as *raison d'être* of instruments, such as the 1970 Friendly Relations Declaration and the 1975 Helsinki Final Act. Both of them "deal with *inter-State relations* and in particular the *duty of other States not to intervene* in internal political processes".[38] To say this, however, is not to argue that the present day international law does not contain rules concerning individuals. To the contrary, there are such rules in the areas of human rights, economic relations and the environment. However, "rules about sovereignty or territorial integrity are not among those — and we understand well why. It would be absurd to claim that international law takes any position beyond respect of human rights and non-violence in respect of the agendas of domestic groups or federalist movements, for example".[39]

Koskenniemi, thus, concludes that, although territorial integrity lays out a general value of unharmed statehood, which international law seeks to protect, "it should be weighed against countervailing values, among them the right of oppressed people to seek self-determination in-

[36] *Ibid*., p. 67. This position was advanced by representatives of several other states in the oral proceedings: Argentina, CR 2009/26, p. 38, Brazil, CR 2009/28, p. 17, China, CR 2009/29, p. 33, Spain, CR 2009/30, p. 15, Romania, CR 2009/32, p. 20, Ven ezuela, CR 2009/33, p. 6, Vietnam CR 2009/33, p. 20.

[37] See, Austria CR 2009/27, p. 9, Bulgaria CR 2009/28, p. 25, United States CR 2009/30, p. 30, France CR 2009/31, p. 12, United Kingdom CR 2009/32, p. 53.

[38] CR 2009/30, p. 59.

[39] *Ibid*., pp. 59 60. (emphasis in the original)

cluding by way of independence." In such a conflict, "it is the factual context that should decide which value should weigh heaviest".[40] This reading of external self-determination, as a last resort right of oppressed groups, which is applicable outside the colonization context, is not only today favored by "a broad body of scholarship", but it may be said to constitute a "part of the traditional law of self-determination that was always to be balanced against territorial integrity". As the *Aaland Islands* case demonstrates, this balancing is principally always opened for the application of the external form of self-determination, that is, independent statehood.[41] Having in mind a specific historical context of the Kosovo case, which was determined by the violent break-up of the SFRY and, particularly, by "the ethnic cleansing undertaken by or with the consent of Serbian authorities, as well as the deadlock in the international status negotiations thereafter, the people of Kosovo were entitled to constitute themselves as a State. This was", in Koskennimi's words, "achieved by the facts of history and symbolized by the Declaration of Independence of 17 February 2008".[42]

Eventually, the ICJ did accept the reasoning of the pro-Kosovo independence camp with respect to the circle of subjects bound by the *jus cogens* principle of territorial integrity, but as noticed by some commentators, "it remains regrettable that the Court offers no further line of argumentation." Having particularly in mind the growing importance of non-state actors in international relations, the ICJ could more thoroughly investigate "whether non-State actors, which have a certain degree of structure or organization, are bound by the principle of territorial integrity".[43] Instead, the ICJ resorted to |a textual interpretation of the selected number of provisions on territorial integration, assuming, alongside with Koskenniemi, that "[t]he will of the drafters *is* the language of the instrument." Any other interpretative technique that might have searched for the purpose of the relevant body of law beyond the plain text would amount to "speculation about what might be a good (acceptable, workable, realistic, or fair) way to apply it".[44] For Koskenniemi, this would imply abandoning *formalism*, which he tends to endorse generally,[45]

[40] *Ibid*., p. 60.

[41] *Ibid*., p. 62.

[42] *Ibid*., p. 64.

[43] M. Vashakmadze and M. Lippold, 632.

[44] M. Koskenniemi, "What is International Law For?", *International Law* (ed. M. D. Evans), Oxford University Press, Oxford, 2003, 99.

[45] Koskenniemi is aware that formalism in its pure form is today hardly possible, especially with the disappearance of the bipolar world, which is marked with "the turn to ethics in international law". Nonetheless, Koskenniemi says that "against the particularity of the ethical decision, I would like to invoke formalism as a horizon of universality,

for the sake of *instrumentalism*, which is never devoid of a political choice.[46]

However, precisely Koskenniemi's argumentation goes beyond mere textual interpretation and 'formalism', when asserting the right of an oppressed people to remedial secession. Koskenniemi is, naturally, aware of the fact that the stipulated objectives of international law, like 'peace' or 'justice', just as well as general concepts, like '*jus cogens*' or '*erga omnes* obligations', are so broad as to inevitably raise complex interpretative disputes. Hence, he notices that 'self-determination' "may be constructed analytically to mean anything one wants it to mean, and many studies have invoked its extreme flexibility".[47] This is, actually, what he does when interpreting international law on self-determination as to encompass the 'remedial right to external self-determination'. Unlike in the case of territorial integrity, Koskenniemi does not offer any formal source of international law for such a claim, but instead refers to "a broad body of scholarship" and to a single case, which predated international law on self-determination of the UN era. This has led him to a rather strong conclusion that 'remedial right to self-determination' should not be considered as some newly invented rule, but as a composite "part of the traditional law of self-determination".[48]

In its written statement to the ICJ, Germany elaborated this stance in more details,[49] but apparently, both authors of this submission and Koskenniemi failed "to furnish a convincing basis in positive international law for such an assumption." Actually, as pointed out by Hilpold, "no such basis exists".[50] It seems that the most that supporters of this argu-

embedded in a *culture* of restraint, a *commitment* to listening to others' claims and seeking to take them into account." What would such a culture and commitment, or lack thereof, imply, he illustrates on the case of the NATO bombing of Serbia. "The reference to 'mor al duty' in the justification of the bombing of Serbia was objectionable because it signified a retreat from such commitment into the private life of the conscience, casting the Serbs as immoral 'criminals' with whom no political community could exist and against whom no measures were excessive. By contrast, a commitment to formalism would construct the West and Serbia as political antagonists in a larger community, whose antagonism can only be set aside by reference what exceeds their particular interests and claims." M. Koskenniemi, "The Turn to Ethics in International Law", *Thesaurus Acroasiarum*, 33/2010, 394.

46 "A legal technique that reaches directly to law's purposes is either compelled to think that it can access the right purpose in some politics independent fashion in which case it would stand to defend its implicit moral naturalism or it transforms itself to a licence for those powers in position to realise their own purposes to do precisely that." M. Koskenniemi (2003), 98.

47 *Ibid*., 106.

48 CR 2009/30, p. 62.

49 Written Statement of Germany of April 15, 2009, p. 35.

50 P. Hilpold, 43.

ment could convincingly claim is that the offered interpretation represents a "new" and an "emerging normative trend" in international law of self-determination. This is how Cassese, for instance, perceives it in the closing chapter of his thoroughly analytical treatise on self-determination.[51] Accordingly, if Koskenniemi's argument in favor of the right of oppressed people to external form of self-determination has any support in international law, it can only be found in some form of 'instrumentalism', whereby the specific objectives of this field of international law would be interpreted differently outside the decolonization context.

In that case, however, the employed instrumental interpretative technique would have to be extended to the countervailing principle of territorial integrity as well. It is a well-established fact of the international legal system of the UN era that the introduction of the principle of territorial integration served one of the main objectives of this legal system, that of world peace. If anything received such a universal acceptance as a lesson of two World Wars was the belief that peace would be impossible in the absence of explicit provisions forbidding aggressive war and the violation of territorial integrity of states. For a long period, state actors were justifiably held to be the key menace to world peace. No wonder, thus, that the aforementioned international legal instruments from 1970s addressed explicitly only states as bearers of the duty to refrain from harming territorial integrity. One may, nonetheless, reasonably challenge a mechanical application of these provisions on the circumstances of the current-day world.[52] As Marshall and Gurr persuasively demonstrated in several consecutive global reports on armed conflicts and self-determination movements, "ethnonational wars for independence" be-

[51] Cassese argues that in "exceptional cases where factual conditions render inter nal self determination impracticable", international law should be open for the possibility of external self determination of ethnocultural minorities. This exit option should be re considered if, "in a multinational State, armed conflict breaks out and one or more groups fight for secession", or "when the central authorities of a multinational State are irremedi ably oppressive and despotic, persistently violate the basic rights of minorities and no peaceful and constructive solution can be envisaged". Antonio Cassese, *Self determina tion of Peoples: A Legal Reappraisal*, Cambridge University Press, Cambridge 1995, 359.

[52] That is what actually Koskenniemi himself suggested in a 1994 article dealing with the issue of self determination. While arguing that the 1975 Helsinki Final Act rec ognized that self determination is applicable beyond the colonial context, he, nonetheless, notices that "it is doubtful whether that statement of principle was intended to be taken literally (however much Eastern European populations now aim to take the West at its word). Its revolutionary potential was tempered by the Final Act's strong emphasis on territorial integrity and the preservation of existing boundaries." Yet, "then came the events of 1989 and suddenly geopolitics and nationalism existed everywhere." In dra matically changed circumstances, a simple recourse to "doctrinal purity" was hardly an option for international lawyers. M. Koskenniemi, "National Self determination Today: Problems of Legal Theory and Practice", *International and Comparative Law Quarterly* 2/1994, 242 243.

came in the post-Cold War period "the main threat to civil peace and regional security".[53] Even Koskenniemi in one of his articles illustrates the so-called "paradox of objectives" in international law, by pointing out that "[t]o say that international law aims at peace *between States* is perhaps already to have narrowed down its scope unacceptably".[54] Among non-state actors, one can hardly find a better candidate than rebellion secessionist groups for the status of bearer of duties aimed at preserving international peace.[55] If those duties include forbearance from violence, as asserted by Koskenniemi himself when referring to "domestic groups", than it seems reasonable to argue that they also encompass the duty to respect territorial integrity, particularly when violent means are employed in the secessionist struggle and when the non-state actor in question is partially recognized as an international subject, that being the case with Kosovo Albanians.[56]

The duty of a rebellion secessionist group to respect territorial integrity of the host state would be, in this respect, a logical corollary of the state right to unharmed statehood, which, on the other hand, is not absolute and should be counterweighted with the right of an oppressed people to external self-determination. Had the ICJ come to this conclusion and resorted to the balancing of countervailing claims, it would have decided the case, as suggested by Koskenniemi, on the merits of "the factual context" and on its considerations "which value should weigh heaviest." Instead, the ICJ simply refrained from entering into this problem area. It acknowledged that 'remedial secession' is "a subject on which radically different views were expressed by those taking part in the proceedings and expressing a position on the question", which led it to eventually conclude, "that it is not necessary to resolve these questions in the present

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[53] M. G. Marshall & T. R. Gurr, *Peace and Conflict 2003: A Global Survey of Armed Conflicts, Self Determination Movements, and Democracy*, MD: CIDCM, College Park, 2003, 1, at *http://www.systemicpeace.org/PC2003.pdf*, acc. 5 Feb. 2012

[54] M. Koskenniemi (2003), 90. (emphasis in the original)

[55] Vashakmadze and Lippold rightly stress that one should differentiate between various types of non state actors, as well as various areas of international law, because "the concept of international legal personality does not necessarily encompass the same range of rights and duties for all subjects of law." M. Vashakmadze and M. Lippold, 633.

[56] This opinion is shared by Milano, who argues that the right to territorial integ rity is, first, "opposable, externally, to third states against actions aimed at changing the territorial configuration of the state". However, it is also opposable "internally, to interna tional subjects, such as peoples, insurgents, de facto independent entities that may acquire international legal personality due to effective control or international recognition in bind ing instruments (that being the case for Kosovo's provisional authorities) and may seek to disrupt the territorial unity of a state." E. Milano, "The Independence of Kosovo Under International Law", *Kosovo Staatsschulden Notstand EU Reformvertrag Human itätsrecht* (*Beiträge zum 33. Österreichischen Völkerrechtstag 2008 in Conegliano*) (eds. S. Wittich, A. Reinisch and A. Gattini), Peter Lang, Frankfurt, 2009, 24.

case".[57] As for the principle of territorial integrity, the ICJ merely asserted that non-state actors are not generally bound by the duty to respect it.[58]

While it is arguable whether the ICJ could simply circumvent the issue of 'remedial secession' by narrowing down the scope of the submitted question[59], it is clear that it should have provided far more stronger arguments that the non-state actor in this particular case was not bound with the *jus cogens* duty of territorial integrity.[60] This is so in light of the fact that several UN resolutions explicitly addressed "Kosovo Albanian community" as being obliged to comply fully with the established duties, including the one of respecting territorial integrity of the host state. Hence, the Resolution 1203 (1998), while reaffirming the territorial integrity of the Federal Republic of Yugoslavia (to be succeeded by Serbia), also demanded that "the Kosovo Albanian leadership and all other elements of the Kosovo Albanian community comply fully and swiftly with resolutions 1160 (1998) and 1199 (1998)." Both of these resolutions reaffirmed that a political solution to the Kosovo problem had to be based on the territorial integrity of the FRY. Finally, the SC Resolution 1244 (1999), as the key legal instrument to this conflict, commences by recalling previous resolutions, including the mentioned ones. According to the Serbian side: "In this way, the Security Council underlined the earlier resolutions that had called for a political solution based on the territorial integrity of the Federal Republic of Yugoslavia and autonomy for Kosovo and had also demanded that the Kosovo Albanian leadership and community accept this".[61] If the ICJ endorsed this argument, it would then also have to conclude that the Kosovo UDI was unlawful, because it violated the principle of territorial integrity. The ICJ, however, argued that the omission of an explicit mention of the "Kosovo Albanian community" from the SC Res-

[57] Advisory Opinion, paras. 82, 83.

[58] *Ibid*., par. 80.

[59] In Burri's opinion, "one cannot credibly avoid dealing with the legality of se cession, when asked to assess the legality of a declaration of independence in the circum stances of this case ... It is not persuasive to rely on the wording of the question asked to avoid the true issue behind the question. The ICJ should have addressed the real issue whether Kosovo's remedial secession from Serbia was lawful or, applying discretion, have declined to give an opinion altogether." T. Burri, 886.

[60] After reminding that the ICJ did acknowledge unlawfulness of UDIs that are connected to blatant violations of *jus cogens* norms, Howse and Teitel ask "how could the Court be so sure that the Kosovo declaration was *not* or *would not* be connected to such violations of other norms?" They subsequently demonstrate that the Court's approach, which relied on the method of "reducing the declaration to a statement of hopes and wishes, mere words without obvious effects" is not sustainable. R. Howse and R. Teitel, "Delphic Dictum: How Has the ICJ Contributed to the Global Rule of Law by Its Ruling on Kosovo?", *German Law Journal* 8/2010, 842.

[61] Written Statement of Serbia, p. 182.

olution 1244, "notwithstanding the somewhat general reference to 'all concerned'", could be interpreted as excluding this non-state actor from the circle of subjects, which are under stipulated duties.[62]

4. UN-MONITORED INTERIM INSTITUTIONS AND 'REPRESENTATIVES OF THE PEOPLE'

I have earlier indicated that the second form of illegality of the Kosovo UDI would exist if the SC Resolution 1244 did exclude such an option for determining the final status of the province. Accordingly, in order to refute such a claim, one would need to demonstrate either that the UDI is in accordance/does not violate the Resolution 1244 or that the authors of the UDI are not those bound by the Resolution 1244. It was already clear after the submitted written statements and oral proceedings before the ICJ, that the issue of "how to characterize the authors of the UDI", which at first glance "might seem to be quite marginal or even peculiar",[63] could turn to be crucial for the final decision of the Court.

Although the question submitted to the ICJ by the UN General Assembly referred to "the unilateral declaration of independence *by the Provisional Institutions of Self-Government of Kosovo*", the Court, nonetheless, argued that, because the authorship was contested in the oral proceedings, it had to address this question separately. The ICJ argued that "[t]he identity of the authors of the declaration of independence ... is a matter which is capable of affecting the answer to the question whether that declaration was in accordance with international law."[64] This investigation focused on determining whether the UDI was an act of the "Assembly of Kosovo", which is one of the Provisional Institutions of Self-Government, or "whether those who adopted the declaration were acting in a different capacity".[65] The ICJ undertook not only a detailed linguistic analysis of the adopted UDI, but it also tried to grasp into intentions of its authors. This led the ICJ to conclude:

> This language indicates that the authors of the declaration did not seek to act within the standard framework of interim self-administration of Kosovo, but aimed at establishing Kosovo "as an independent and sovereign state" (para. 1). The declaration of independence, therefore, was not intended by those who adopted it to take effect within the legal order created for the interim phase, nor was it capable of doing so. On the contrary,

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[62] This interpretation is, however, not related to the ICJ's discussion concerning the principle of territorial integrity, but to its determination of whether the authors of the UDI acted in violation of the SC Resolution 1244. Advisory Opinion, par. 118.

[63] M. Milanović, at www.ejiltalk.org/kosovo advisory opinion preview/

[64] Advisory Opinion, par. 52.

[65] *Ibid*., par. 102.

> the Court considers that the authors of that declaration did not act, or intend to act, in the capacity of an institution created by and empowered to act within that legal order but, rather, set out to adopt a measure the significance and effects of which would lie outside that order.[66]

In the Court's opinion, this conclusion is evidenced by the fact that the original text of the UDI has no reference of the authorship to the "Assembly of Kosovo", but instead the self-reference of the persons adopting the declaration as "the democratically-elected leaders of our people".[67] Moreover, the silence of the Special Representative of the Secretary General indicates that he did not consider the UDI to be the act of the Provisional Institutions, for otherwise he would have been obliged to take action against it, as an act *ultra vires*.[68] For all the stated reasons, the ICJ concluded that the authors of the UDI did not act as one of the Provisional Institutions, "but rather as persons who acted together in their capacity as representatives of the people of Kosovo outside the framework of the interim administration".[69] After having made this initial step, the ICJ more easily inferred the conclusion that the SC Resolution 1244 did not bar the authors from issuing a UDI and that, accordingly, this act did not violate the resolution in question. While the objective and purpose of the Resolution 1244 was the establishment of an interim administration, the authors of the UDI tried to determine the final status for Kosovo. The fact that the Resolution 1244 stipulates that such a status shall come as a result of "political settlement" does not, in the ICJ's opinion, make a unilateral declaration an illegal act.[70]

In his separate declaration, the ICJ's Vice-President Tomka discards the Court's majority opinion regarding the authorship as "nothing more than a *post hoc* intellectual construct." Such a stance of the ICJ assumes "that all relevant actors did not know correctly who adopted the declaration on 17 February 2008 in Pristina" – neither Serbia, when proposed the question; nor other States that adopted the Resolution 63/3; nor the Secretary-General and his Special Representative; nor even the Prime Minister of Kosovo, when introducing the text of declaration at the special session of the Assembly of Kosovo.[71] As Judge Tomka persuasively demonstrates, however, all the mentioned actors, including the representatives of the major powers that backed Kosovo's independence, such as the UK, USA, and France, referred in their official statements to "provisional institutions" and/or "Kosovo Assembly" as the author of the UDI.[72] That

[66] *Ibid*., par. 105.

[67] *Ibid*., par. 107.

[68] *Ibid*., par. 108.

[69] *Ibid*., par. 109.

[70] *Ibid*., paras. 118, 119. Using the same reasoning, the ICJ concluded that the UDI was not in violation of the Constitutional Framework as well. (par. 121)

[71] Declaration of Vice President Tomka, par. 12.

[72] *Ibid*., paras. 13 18.

this is so becomes particularly obvious from the solemn introductory statement of the Kosovo Prime Minister, who stressed that the "invitation for a *special session* is extended *in accordance with the Kosovo Constitutional Framework*" (Judge Tomka's emphasis), whereby one of the items on the agenda was declaration of independence for Kosovo. Accordingly, the authors "wished to act in accordance with that framework and not outside of it, as the majority asserts".[73] Finally, in addition to the President of Kosovo, its Prime Minister and the President of its Assembly, all those who added their signatures below the declaration did so as members of the Kosovo Assembly "as *verbis expressis* confirmed on the original papyrus version of the declaration, in the Albanian language." The Court's majority conclusion "that '[n]owhere in the original Albanian text of the declaration (which is the sole authentic text) is any reference made to the declaration being the work of the Assembly of Kosovo' (paragraph 107) is thus plainly incorrect, not enhancing the credibility of the majority's intellectual construct."[74]

This 'intellectual construct' appears, thus, as a necessary logical premise for the conclusion that the UDI was not in violation of the SC Resolution 1244 and the Constitutional Framework. If the declaration were attributable to the Kosovo Assembly, it would have to be declared illegal. This stems, for instance, from the 2001 UNMIK expert opinion on legal nature of the Constitutional Framework, in which a special part is devoted to the constraints imposed by the SC Resolution 1244. One of them concerns the determination of the final status by provisional institutions. It is particularly stated that the Kosovo Assembly is not authorized "to reverse the position as reflected in the Constitutional Framework. Should it try, the SRSG will be obliged under SCR 1244 to block it."[75] And indeed, the Special Representative did exercise this power on several occasions from 2002 to 2005.[76] In its Advisory Opinion, however, the ICJ largely relied on "[t]he silence of the Special Representative of the Secretary-General" in the aftermath of the February 2008 UDI, interpreting it as the sign that he did not consider this declaration as an act of the Provisional Institutions "designed to take effect within the legal order for the supervision of which he was responsible".[77] Judge Tomka rightly notices that, even if this was so,

> the Advisory Opinion provides no explanation why acts which were considered as going beyond the competencies of the Provisional Institutions in the period 2002–2005, would no longer have any such character in

[73] *Ibid*., par. 19.

[74] *Ibid*., par. 20.

[75] A. Borg Olivier, Behind the Framework, 25 May 2001, UNMIK/FR/0040/01, available at *http://www.unmikonline.org/pub/features/fr040.html*, acc. 5 Feb. 2012

[76] See, Declaration of Vice President Tomka, par. 32.

[77] Advisory Opinion, par. 108.

> 2008, despite the fact that provisions of the Constitutional Framework on the competencies of these institutions have not been amended and remained the same in February 2008 as they were in 2005.[78]

This leads Ker-Lindsay to draw an even more far-reaching conclusion. He says that the problem stems from the fact that "the Special Representative in question openly supported independence." Moreover, even if this was not the case, "there is a good argument to be made that if he had decided to do try to annul the declaration, it would have led to violent incidents that would almost certainly have placed UN officials in Kosovo in extreme danger." Put differently, one could argue that in the given circumstances "the UN was acting under duress".[79]

Be that as it may, the ICJ's entire argumentative construct hinges upon a dubious assumption that "the representatives of the Self-Government Institutions and the authors of the UDI are partially the same persons, meeting in the official building of the Self-Government, but acting in a different capacity".[80] This subsequently led the ICJ to a "circular and tautological" line of reasoning, according to which "[t]hose who violated the law (the members of the Kosovo Assembly) set themselves outside the law and as a consequence no more violation was given (as Res. 1244/1999 did not cover this situation)".[81] In other words, "since the PISG were not empowered to declare independence, they could not have been acting in the capacity of the PISG when they did so." This argument, however, obviously runs counter the general legal principle, equally applicable in international law, "that an organ my commit *ultra vires* conduct while still acting in official capacity".[82]

As a consequence, one may reasonably ask whether any legal order governed "democratically elected representatives of the people" at the moment of their adoption of the Kosovo UDI.[83] The ICJ's reasoning makes us believe that the answer is: "None".[84] From the purely legal point of view, this situation is unsustainable. As noticed by Vidmar, the

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[78] Declaration of Vice President Tomka, par. 33. Judge Tomka, thus, concludes: "The legal régime governing the international territorial administration of Kosovo by the United Nations remained, on 17 February 2008, unchanged. What certainly evolved were the political situation and realities in Kosovo. The majority deemed preferable to take into account these political developments and realities, rather than the strict requirement of respect for such rules, thus trespassing the limits of judicial restraint." par. 35.

[79] J. Ker Lindsay, "Not Such a '*Sui Generis'* Case After All: Assessing the ICJ Opinion on Kosovo", *Nationalities Papers* 1/2011, 6.

[80] M. Vashakmadze and M. Lippold, 639.

[81] P. Hilpold, 33.

[82] J. Cerone, "The Kosovo Advisory Opinion of the International Court of Justice", *Annals of the Faculty of Law in Belgrade Belgrade Law Review* 3/2010, 212.

[83] Cf. Dissenting Opinion of Judge Bennouna, par. 64.

[84] Cf. C. Pippan, 164.

ICJ "here tries to ride on two horses. If the individuals acted outside of the framework of self-governing institutions, they did not have the capacity to act. If they had the capacity to act, they acted within the framework of these institutions. There is no third way".[85] Consequently, the ICJ's legal conclusion could be justified only within the constitutional law theory of '*pouvoir constituant*'. This theory would imply that secession is a revolutionary act, which tends to establish the normative discontinuity with the preceding legal order. Such an argumentative strategy is, however, "very risky, because with the reference to 'extra-legality', all possible violations could be treated as seemingly legitimate".[86] Moreover, the notion of '*pouvoir constituant*', "if translated into the language of international law – is inherently linked to the very issue the ICJ was determined not to address in its opinion on Kosovo (self-determination)".[87]

5. THE FUTURE OF SELF-DETERMINATION CONFLICTS

As soon as one comes to the issue of plausible effects of the Advisory Opinion for the future of similar self-determination conflicts, one finds out that opinions range from the statement that the ICJ's ruling provides "a guide and instruction manual for secessionist groups the world over"[88], to the statement that "the Opinion itself remains unique and limited to the circumstances of the concrete case".[89] The latter stance is accurate to the extent that the ICJ deliberately avoided discussing some open and general issues pertaining to self-determination, statehood and recognition, and instead focused, as much as possible, to the case in question. On the other hand, I already said that once the Advisory Opinion is carefully unpacked, it becomes clear that there is much of accuracy in the former statement as well. Three previously discussed conclusions of the ICJ, which are also of general nature, have the potential of seriously affecting developments of other self-determination conflicts.

Let me first start with the ICJ's coarse statement that non-state actors, including rebellion secessionists, are not bound by the *jus cogens* norm of territorial integrity. Previous analysis demonstrates that this con-

[85] J. Vidmar, The *Kosovo* Opinion and General International Law: How Far reaching and Controversial is the ICJ's Reasoning?, 5, at *http://www.haguejusticeportal.net/Docs/Commentaries%20PDF/Vidmar Kosovo Note EN.pdf*, acc. 5 Feb. 2012.

[86] A. Peters, 3.

[87] C. Pippan, 164. For an interesting theoretical exposition of the subject matter, see, Z. Oklopčić, "*Populus Interruptus*: Self Determination, the Independence of Kosovo, and the Vocabulary of Peoplehood", *Leiden Journal of International Law* 4/2009, 677 702.

[88] Dissenting Opinion of Judge Koroma, par. 4.

[89] M. Vashakmadze and M. Lippold, 647.

clusion might be challenged from the standpoint of purposive interpretation of relevant international legal instruments. Even more specifically, Gazzini argues that the ICJ's finding "is both unnecessary for the purpose of this advisory opinion and possibly misleading as a matter of general international law." It is unnecessary, because it is obvious that any secessionist's declaration of independence is aimed at affecting territorial integrity of the host state. It is, on the other hand, misleading "as it conveys the idea that entities other than States are not bound by the general prohibition on the use of force." Gazzini notices that there is "a legal paradox" behind the question of applicability of the general prohibition on the use of force to secessionist groups. He notices that every process of gaining independence is, by a rule, an incremental one and it usually goes through several phases. In the first one, internal turbulences are normally subjected to domestic rules, as well as to some rules of humanitarian law. However, in the course of conflict, insurgents may acquire the status of a subject of international law. Gazzini notices that to determine when this has effectively happened, "may be particularly problematic as it requires an assessment of the independence and effectiveness." Once this is determined, however, the relationship between the parties turns into one governed by rules of international law. In such a situation, it remains open as to "whether these rules include the prohibition on the use of force in spite of the ongoing armed conflict and whether such a prohibition would apply also to the State concerned". In any way, the ICJ's cursory finding is "superficial and ultimately unconvincing".[90]

The aforementioned argument becomes more plausible if one takes into account a highly instructive case of the Kosovo Liberation Army. This organization quickly passed the way from a US State Department listed terrorist group to the one of liberation movement that closely and actively cooperated with NATO.[91] The absence of a clear international legal rule, which would differentiate between terrorists and freedom fighters, coupled with the ICJ's reasoning that non-state actors are exempted from the duty to respect territorial integrity, seems to reward secessionists, more openly than ever, with a wide range of tactics for the achievement of their ultimate goal. These by no means exclude the resort to violence in order to trigger reprisals, which would in turn change the nature of the conflict into international one and, perhaps, force the international community to intervene on the side of secessionists. As pointed out by Ignatieff, "The KLA's success between 1997 and 1999 was a vintage demonstration of how to exploit the human rights conscience of the West

[90] T. Gazzini, The Kosovo Advisory Opinion from the Standpoint of General In ternational Law, 3. at *http://www.haguejusticeportal.net/Docs/Commentaries%20PDF/Gazzini Kosovo Note EN.pdf*, acc. 5 Feb. 2012.

[91] See, The KLA Terrorists or Freedom Fighters?, BBC, June 28, 1998, at *http://news.bbc.co.uk/2/hi/europe/121818.stm*, acc. 5 Feb. 2012.

in order to incite an intervention that resulted eventually in guerilla victory".[92]

This leads me to the second plausible effect of the Advisory Opinion, which concerns the status of UDI in international law. The ICJ's overall argumentative strategy was to separate the fact of issuance of the declaration of independence from the purported legal effects of that act. It supposedly focused only on the former issue, while leaving aside the letter. However, one can reasonably ask: "Can it be that an entity declares independence without violating international law but then violates international law, when it effects independence by seceding and creating a new state?" Since this reasoning would hardly be consequential, one can still infer an implicit ICJ's conclusion regarding unilateral acts of secession. It is that "[g]eneral international law, and especially the principle of effectiveness, would determine if a declaration of independence has resulted in the creation of a new state".[93] Many hoped that the ICJ would fill the lacuna in this area of law, by providing some more firm guidelines for the legality of secessionist politics. This has not happened, partly because "a legal framework of any kind for secession would risk bolstering secessionist movements and as such endanger national and international stability." However, one can easily attach the same consequences to the Advisory Opinion as it was finally handed down:

> It almost certainly does not discourage groups intent on secession to hold that the legality of declarations of independence is in no way linked to the legality of secession. On the contrary, it probably encourages them to assert their identity symbolically and declare themselves independent, as general international law according to the ICJ's opinion establishes no obstacles in this regard. Whether a wave of 'irrelevant' declarations of independence serves international and national stability better than some guidance provided by a legal framework, even if limited, remains to be seen, but it is doubtful to say the least.[94]

This ICJ's stance raises another interesting question that is of general nature. It concerns the status of the act of recognition. Gazzini, for instance, argues that the "crux of the matter" is not whether a UDI of a would-be State is as such prohibited by international law, "but whether international law imposes upon other States any obligations in relation to a declaration of independence." These obligations may vary, as to include the duty not to recognize the new entity, or not to support it, etc. In any way, international law seems to be "more concerned with the consequences of declaration of independence for other States, rather than on the law-

[92] M. Ignatieff, *Human Rights as Politics and Idolatry*, Princeton University Press, Princeton and Oxford, 2001, 45.

[93] R. Muharremi, "A Note on the ICJ Advisory Opinion on Kosovo", *German Law Journal* 8/2010, 880.

[94] T. Burri, 888.

fulness of such a declaration".[95] Generally, it is assumed that international law has not much to say about the legality of other states' recognition of newly independent states. This means that there is neither a duty to recognize, nor a duty to refrain from recognizing a state. Accordingly, "recognition of newly independent states is generally lawful, so long as that new state has effectively established its independence in fact." In the context of an attempted secession, however, the act of recognition of a claimant to statehood that did not fulfill the Montevideo criteria of statehood would constitute an unlawful intervention in the internal affairs of the host state. The unlawfulness of recognition equally exists when effective control over territory was acquired through a violation of some peremptory norm of international law. Finally, the unlawfulness of recognition can stem from an explicit ban of the Security Council on recognizing a particular entity, as it was the case with Southern Rhodesia. It is within these specific contexts "that the otherwise separate questions of the existence of a state and recognition of that state may intersect".[96]

The ICJ did not address the legal situation of third-party states, especially those that already recognized Kosovo. However, the answer to this question "is important for the future." As the previous paragraph demonstrates, a premature recognition of not yet effectively established state is unlawful. In the case of Kosovo, one may argue there is more to it, insofar as "the Security Council has created a legal regime binding all States by which it has reserved the final word on the Kosovo status for itself, and by which it has excluded the unilateral termination of the territorial integrity of Yugoslavia (now Serbia)".[97] The ICJ essentially dismissed this line of reasoning by claiming, first, that the UDI was merely "an attempt to determine finally the status of Kosovo",[98] and not an act of secession itself, and second, that the authors of the UDI were not provisional institutions. This argumentation, however, takes us back again to the legal situation of countries that already recognized Kosovo – "If the declaration is what the majority says it is, can it be on its own an adequate basis for recognition of statehood?"[99]

Consequently, the fact that the ICJ did not explicitly address the legality of third-states' acts of recognition of Kosovo might lead many

[95] T. Gazzini, 2.

[96] J. Cerone, "The Legality and Legal Effect of Kosovo's Purported Secession and Ensuing Acts of Recognition", *Annals of the Faculty of Law in Belgrade Belgrade Law Review* 3/2008, 65.

[97] Moreover, since "[t]he Court says that this regime is still valid", one may con clude that "negotiations must continue." M. Bothe, "Kosovo So What? The Holding of the International Court of Justice is not the Last Word on Kosovo's Independence", *Ger man Law Journal* 8/2010, 839.

[98] Hence, the UDI and the SC Resolution 1244 are two instruments that "operate on a different level". Advisory Opinion, par. 114.

[99] R. Howse and R. Teitel, 843.

secessionists to conclude that the easiest way for solving intricate legal situations and gaining statehood would be to safeguard recognition of as many states as possible, and preferably the most powerful ones.[100] This would not only fundamentally reverse the abovementioned doctrinal stance that the existence of a state is one thing, its recognition or non-recognition another[101], but it would open the room for a world of the increasing number of 'Selfistans'[102], which would in international arena dwell as half-recognized 'pet states' of the Great Powers.[103] It is, in this respect, interesting to remind of Crawford's statement in the oral proceedings before the Court, which to a certain extent strengthen the 'constitutive' theory of recognition. He said,

> international law *has* an institution with the function of determining claims to statehood. That institution is recognition by other States, leading in due course to diplomatic relations and admission to international organizations. A substantial measure of recognition is strong evidence of statehood, just as its absence is virtually conclusive the other way. In this context, general recognition can also have a curative effect as regards deficiencies in the manner in which a new State came into existence.[104]

Again, it seems that the ICJ implicitly endorsed this reasoning, by leaving to the discretion of individual states to determine the ultimate status of Kosovo in international law. One may reasonably ask, "whether this state of affairs serves the purpose of strengthening the rule of law in international relations or whether it contravenes such a purpose".[105]

A final potential effect of the Advisory Opinion to be mentioned here concerns the fate of provisional UN-mandated conflict-settlement

[100] Conversely "As for other territories that seek independence, but do not have the support of influential parts of the international community, their hopes for achieving statehood remain as remote as they ever were." J. Ker Lindsay, 8.

[101] Sterio's analysis suggests that this is already a situation in international law. She says: "Statehood in practice seems to hinge on recognition: in other words, an entity seems to be treated as a state only if the outside world, and specifically, the most powerful states (the Great Powers), wishes to recognize it as such." M. Sterio, "On the Right to Self Determination: "Selfistans", Secession, and the Great Powers' Rule", *Minnesota Journal of International Law* 1/2010, 149.

[102] Sterio borrowed this term from Rushdie's novel 'Shalimar the Clown', in which the author at one place says sarcastically: "Why not just stand still and draw a circle round your feet and name that Sefistan?" *Ibid*., 137, n. 1.

[103] Cf. C. J. Borgen, "The Language of Law and the Practice of Politics: Great Powers and the Rhetoric of Self Determination in the Cases of Kosovo and South Osse tia", *Chicago Journal of International Law* 1/2009, 1 33.

[104] CR 2009/32, pp. 47 48. Contrast this statement with the one from his much celebrated book on the creation of states. There, he says that "[t]he conclusion must be that the status of an entity as a State is, in principle, independent of recognition", even though recognition "can resolve uncertainties as to status and allow for new situations to be regularized." J. Crawford, *The Creation of States in International Law* (2nd ed.), Ox ford University Press, Oxford, 2006, 28, 27.

[105] M. Vashakmadze and M. Lippold, 634.

arrangements, which eventually may be dissolved by a unilateral act of one party to the conflict. This point was already in the oral proceedings raised by the Serbian representative, Zimmerman. He asked, "whether both, the relevant members of the Security Council, as well as the individual States concerned, would in the future accept such solutions, were the Court to tolerate that such United Nations-led administration is nothing but a road towards secession".[106] A number of commentators of the Advisory Opinion share his worry, that the adopted ICJ's stance could seriously jeopardize this role of the world organization. Peters notices that this is one plausible legal-political outcome of the Opinion, because states will have legitimate fear that an internationally governed part of their territory may end up independent without their consent.[107] After demonstrating that it would be "totally illogical" to assume that the special legal regime of 1244 is construed as to open the room for unilateral declaration of independence,[108] Hilpold also stresses potential far-reaching consequences of the Court's reasoning. He says that a unique experiment of international administration of Kosovo

> that avoided a further deterioration of the situation in this region was based on trust and associated with legitimate expectations not only on the side of Serbia but also on that of many other allied nations. It could be the case that in future similar experiments, though necessary they may be from a humanitarian perspective, will have a hard time to find the necessary approval as these expectations were, at the end, totally ignored.[109]

6. A CONCLUDING NOTE

The purpose of this paper was to show that even narrowly construed, the ICJ's Advisory Opinion on Kosovo offers several important general legal conclusions, which might significantly affect patterns of political behavior of the interested political actors in similar existing or future self-determination conflicts. To state potential effects, however, is not to predict future events. In fact, no one can really tell what will be the future of the Kosovo case itself. At first, it appeared as if the ICJ's ruling,

[106] CR 2009/24, p. 60

[107] A. Peters, 4.

[108] Hilpold also points out that the reference to "settlement" in the SC Resolution 1244 "can only be understood as a consensual solution to be found or at least accepted by the Security Council." Finally, "It can hardly be assumed that this resolution should allow for the evolving of a situation where the institutions created by the Council can take over the reins and at the same time not acting illegally just because they had acted *ultra vires*." Consequently, to explain the developments as the Court eventually did is for him "tanta mount to ridicule Serbia (and its friends and allies) for having believed in the solemn and peremptory language of Res. 1244/1999." P. Hilpold, 34.

[109] *Ibid*., 45.

despite its alleged silence on the issue, would consolidate Kosovo's claim to statehood. As put by Kammerhofer, the Advisory Opinion "has led to the popular conception that the Court in *Kosovo* has confirmed that Kosovo has validly seceded from Serbia and is now a state." He says that, although his colleagues "will know not to interpret this outcome into the Court's silence, the political effect is the same as if it had pronounced itself in favour of an independent Kosovo".[110] Yet, the expected new wave of recognitions of Kosovo did not occur.[111] Thus, it remains open whether the Kosovo Advisory Opinion indeed provides a first-help tool kit for various secessionists around the globe,[112] or its effects will be far more modest. What is, however, clear is that the ICJ's Opinion can hardly advance the cause of international rule of law in self-determination conflicts.[113]

[110] J. Kammerhofer, 10.

[111] As Ker Lindsay notes, "a number of countries have analyzed the decision and come to the conclusion that it has not provided a firm justification for Kosovo's indepen dence, and has not therefore opened the way for widespread recognition." J. Ker Lindsay, 8.

[112] The immediate impact of this sort cannot be underestimated. For instance, the foreign ministry in Transdniester welcomed the "landmark" decision, perceiving it as a plausible "model" for political behavior (Quoted from J. Ker Lindsay, 6.) Similarly, pro independence commentators in Catalonia emphasize the ICJ's conclusion that "general international law contains no applicable prohibition of declarations of independence". More particularly, they take notice of the fact that "[t]he plural in 'declarations' gives an indication that this doesn't only apply to the matter of Kosovo, but that it is understood to be a general principle." From this, they readily infer the conclusion that "a State cannot declare itself indivisible under international law." Finally, "since a popular referendum on self government along the lines of those envisaged for Scotland or Quebec is unthinkable given the political realities of Spain, Catalonia might well find in a unilateral declaration of independence the only means to start a peaceful process of separation."

At *http://www.catalonianewstate.com/2010 07 01 archive.html*, acc. 5 Feb. 2012. For potential effects of the Opinion in Africa, which "currently has more conflicts or civil wars within its geographical area than any other continent in the world", see, O. Oladele Osinuga, ICJ Advisory Opinion on Kosovo: An African Perspective, at *http:// www.modernghana.com/news/286020/50/icj advisory opinion on kosovo an african per spect.html*, acc. 5. Feb. 2012

[113] As pointed out by Trifunovska, "a Kosovo argument" will be in the future "used by various subjects, states supporting independence, states opposing independence and entities claiming the independence. What will be the strength of this argument in each particular case will depend on their particular circumstances and prevailing interests." S. Trifunovska, "The Impact of the 'Kosovo Precedent' on Self Determination Struggles", *Kosovo: A Precedent*, (ed. J. Summers), 393.

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PUBLIC INTEREST AND THE QUESTION OF LOCUS STANDI

An era of rapid industrial progress, scientific development, globalization, i.e. of phenomena whose consequences transcend national boundaries, increasingly raise questions about the eligibility to participate in proceedings, not only of those that are directly, but also of those that are indirectly affected; in many cases it happens that an entire community suffers because of misdeeds caused by public authorities. This paper is based on the assumption that a distinction should be made in the approach to private and public law because they protect different goods. If parties in the process may only be the ones that have an individual, personal, and concrete interest, who then may represent groups or individuals that for various reasons cannot do it by themselves? How can we determine the substance of the public interest, how do we preserve it? The paper will attempt to answer these and similar questions by highlighting the very na ture of the public interest, the comparative legal arrangements, and the dividing line between the procedural and substantive content of individual cases.

Key words: *Standing. Public law. Public interest. Nature of things.*

1. INTRODUCTION

Legal protection means the right to demand protection from public authorities in case of any breach of compromise or right. The fundamental human right to justice is apparent in several international documents as well as in constitutions of states. Public law contains rules that are established by state authorities with the use of power (*ius imperium*), which is applied to a broader range of people than in legal relations in civil law. It essentially deals with the public interest, which is *per se* a very vague legal concept that needs concrete substance. Since concern for the public interest is in the hands of public authorities, a question arises

whether the right to protect or promote the public interest in the public (as well as civil) domain depends on a substantive right, or whether there may also exist separate procedural rights that may be exercised by persons that do not represent the public authorities.

It cannot be overlooked that 'the right to effective judicial protection is one of the cornerstones of societies governed by the rule of law and judicial access is a key aspect of that right'.[1] An era of rapid industrial progress, scientific development, globalization, i.e. of phenomena whose consequences transcend national boundaries, increasingly raise questions about the eligibility to participate in proceedings, not only of those that are directly, but also of those that are indirectly affected; in many cases it happens that an entire community suffers because of misdeeds caused by public authorities. Who will protect a community (when the state refuses to admit its mistakes) if not the community itself? Have political terms of office become too long for people who can have their say only every four years at the elections? Public and private law have their own subjects to safeguard. This paper is based on the assumption that a distinction should be made in the approach to private and public law because they protect different goods. If parties in the process may only be the ones that have an individual, personal, and concrete interest, who then may represent groups or individuals that for various reasons cannot do it by themselves? How can we determine the substance of the public interest, how do we preserve it? The paper will attempt to answer these and similar questions by highlighting the very nature of the public interest, the comparative legal arrangements, and the dividing line between the procedural and substantive content of individual cases. Can we really answer the question of *qui bono* with the same answer in the private as well as the public sphere? What measures are available to people if authorities pursue the common good in an unsatisfactory manner, due to lack of resources, people, a too broad scope of competences, lack of information, improper or even illegal behavior? Is it primarily a question of continuity of administrative law in its controlling function as the safeguard (only) in the interest of the parties in the procedure (resulting from the historic fight against abuse of power in the 18th century) or should it also follow the recent doctrines that try to go beyond a mere controlling function to the governing of society? This is the perspective of *Governing (Steuerung*)[2] which should provide new resources for an effective application of rules that are not applied at the expense of the parties in the proceeding, but to the benefit of society as a whole.

[1] E. Delaney, *Right to an Effective Remedy: Judicial Protection and European Citizenship* (Great Britain: Federal Trust for Education and Research, 2004).

[2] See M. Ruffert (ed.), *The Transformation of Administrative Law in Europe*, Sellier European Law Publishers GmbH, München 2007, 11.

2. PARTICIPATION IN THE PUBLIC INTEREST A PLATFORM

Most constitutions are based on the principle of sovereignty of the people, which has emerged from monarchic sovereignty. Althusius, Locke and Rousseau mainly influenced this path where the last in his Social Contract (*Contrat Social*) defined the real and undisputed sovereignty of the people using his version of contractual theory. For our reading it is important that he has introduced the concept of general will (*volonté générale*), which differs from the common will (*volonté de tous*) since the former results from the latter; it is a will that is geared toward a greater good and consists of what remains from the common will when all oppositions of the particular good are excluded from it. 'Sovereignty is only the implementation of universal will, which is prone to equality'.[3] 'The will can be only the will of all people or just of one part. In the first case the expressed will is the act of sovereignty and it is the law, [while] the second case represents only the special will or an act of administration, therefore it is only decree'.[4] The power is therefore in the hands of the people that have delegated it (*potestas delegare*) to representative bodies, which must implement it for the common good. Thus the general will becomes a synonym for the public interest, and the public interest for the common good.

In the field of public law public authorities have a broad standing (within the jurisdiction) while subjects (whose rights have been violated or threatened, on whom obligations have been imposed, or who only protect their legal interest) have a narrower one. Given that the state should take care of the public interest through delegation of authority from the people to their representatives, there arises a question of the exclusivity of that legitimacy. Can a represented person act as an agent and *vice versa*? While in the first case this is always true, in the second case (in the relationship between the people and the state) it never is. Public authorities can only perform operations that are in the public interest. Who else than people will look after the public interest if the state does not take care of it (in a neutral way) satisfactorily?

Despite the fact that the state has a monopoly power, it is not omnipotent. It is only the strongest legal entity within its legal and state borders. It is plagued by the lack of resources, people, and sometimes will. The state should strive for good governance of society, rational use of resources, and efficiency. It depends on political parties, interest groups, and other centers of power. A good is never good enough, so the state's conduct could always be better. Subjective circumstances left aside, the objective ones in which states operate in themselves prevent the effectiveness of the public interest.

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[3] J. J. Rousseau, *Družbena pogodba*, Krtina, Ljubljana 2001, 31.

[4] J. J. Rousseau, 32.

3. ADMINISTRATIVE LAW IN RELATION TO CIVIL LAW

The relation of administrative law to civil law, of the public interest to the right, obligation, or to the individual's legal interest, could be described as a "strong family tie"; in the period of transition from absolutism to constitutionalism, it derived from the assumption that the state cannot be governed by different rules than other entities (the doctrine of equality of law for the state and its citizens was defended mainly by Dicey[5]); however, almost at the same time, at least in France, emerged the idea that in order to protect and promote the public interest the state must have a "stronger" will through laws in relation to individuals. For a long time this prevailing division between those two ideas was related to the character of legal norms and dealings with power: while in civil law dispositive norms should prevail, in administrative law imperative norms should. The former is dominated by the relationship of equality and the freedom of negotiation between the participants, while the latter is dominated by subordination and authority. Such division is suitable only as a starting point for our study because there are exceptions in both cases. They are somehow inversely proportional: norms of imperative nature are also present in civil law, but to a lesser extent than the dispositive ones; in administrative law or parallel to it, there are also dispositive norms, but to a lesser degree (e.g. liability in tort law, personal name) then the imperative ones.[6] Limits that could be resistant against effects from either side cannot be clearly and unambiguously set. Many property relations are placed in administrative rather than civil law.[7] The legal regime of the public good (*res in publico usu*) is barely mentioned by property codes, although it is the *in rem* institute and refers to a specific regulation in other laws. In the case of works on private land, the law may allow the status of public good, through which the state or local government pursues the public interest,[8] or it may enter into a special administrative arrangement (an administrative contract or a concession partnership) which establishes the rights and duties between private investors and a public entity concerning the building, maintenance and management of infrastructure and other facilities in the public interest; after a certain period,

[5] A. V. Dicey, *Introduction to the Study of the Law of the Constitution* [1885], Elibron Classics, 2005.

[6] Imperative norms are sometimes exercised when the objective cannot be achieved through dispositive norms (e.g. expropriation of land because of the failure to reach an agreement on the purchase of land).

[7] E.g. obtaining the locational information for a specific area as a confirmation from official records under administrative law, registration of property in the land register through material (land registry) law, obtaining operating permits for the use of the facility through administrative law.

[8] See Article 21 in the Slovenian Construction Act (conditions for obtaining the status of the built public good).

the public entity gets the right of use or the right to the legal title (depending on various models of property rights and concession contracts). The boundary between administrative and civil law is determined by the method of formation (termination) of the legal relationship and the applicable jurisdiction related to that.

Substantive and procedural arrangements of standing in administrative law are taken from civil law and as such (with the same content) are still largely (*conservatively*) used. Administrative law has very little to say in other people's standings in the administrative processes that are not already covered by civil law. Comparison with civil law shows that other state authorities (usually that of the public prosecutor or the state attorney), which are not directly involved in the decision-making in administrative cases, in protecting the public interest (paradoxically) perform a better role than in administrative law. With regard to procedural and substantive legitimacy we may find that the rules of civil law at large offer a broader right of standing than those of administrative law, which is *per se* responsible for enforcing the (wider) public interest. The transfer of standing in administrative law into other state bodies is very rare. Reasons for limited and exceptional cases of standing in public law outside the explicit public authorities are based on the concept that all entitlements and obligations are imposed almost exclusively on those authorities. And from them the people expect good execution of their tasks.

4. THE PRINCIPLE OF LEGITIMATE EXPECTATIONS

People expect that an opposing party will not violate an agreement (*pacta sunt servanda*). Even in the principle of legitimate expectations, which has its origin in administrative law (it respects the principles of fairness and reasonableness in cases where people have expectations or an interest that public bodies will retain the present practice and keep their promises), we can clearly see that it is derived from civil law,[9] which

[9] The British development of the concept of legitimate expectations doctrine owes its establishment to estoppel developed by Lord Denning. In the case Reprotech (R *v the East Sussex County Council, ex p Reprotech (Pebsham) Ltd; Reprotech (Pebsham) Ltd v East Sussex County Council* [2002] UKHL 8)) Lord Hoffman pointed out that though estoppel and legitimate expectations are cousins, they have different personalities: 'Of course there is an analogy between the private law estoppel and legitimate expecta tions generated by a public authority, which rejection would imply an abuse of power /.../ but it is merely an analogy, since the legal remedies against public authorities must also take into account the interests of the general public'. More in: R. Thomas, *Legitimate Expectations and Proportionality in Administrative Law,* Hart Publishing 2000, 50–52. There is also a direct link with the civil law concept of legal entitlement, which is the 'absolute right (usually cash) to benefits, such as social security and is approved as soon

protects mainly the interests of individuals and organizations, and also indirectly the wider public interest (i.e. that the state would not arbitrarily alter its practices in civil cases without the compelling public interest). The principle of legitimate expectations may be found in most legal systems (e.g. British legitimate expectations, German *Vertrauensschutz*, French *protection de la confiance legitime*) at the crossroads of civil and administrative law – if the former protects the interests of individuals in relation to the already established expectations, the latter may change them if such action is in the public interest (a quasi-retroactivity). The principle has been shaped as a general principle which is usually associated with a broader legal state. However, while protecting the rights of individuals, there still remains the unresolved question of who will protect the public interest if the state does not do this in an efficient way? This is a similar issue to that of the protection of supervisors; if the answer is supervisors themselves, then in the case of the public interest the answer is the people themselves.

The principle of legitimate expectations is closely linked to rights and duties: with regard to rights it refers to our request that the state will not change our position in the future if there is no legitimate reason; with regard to duties it refers to the state complying with our demands. Rights and duties do not have equal importance in civil and administrative law; while the case in civil law is primarily in its specific, concrete enforceability, in administrative (constitutional) law it is also in the abstract non-enforcement. In civil law we do not expect or demand from the opposite side to respect our human rights (if we cannot find a concrete right in law[10]), but our mutual agreed expectations (human rights are not the subject in an agreement). In administrative law we expect from the state to respect human rights, meet the public interest, earn our respect, and to be legitimate. Human rights are directly applicable which means that the state must respect them even if they belong to some individual that is in this country for the first time.[11] This is clearly reflected in the terms of human rights which go beyond concrete, contractual relationship of the parties involved.[12]

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as legal requirements are met'. B. A. Garner (ed.), *Black's Law Dictionary*, 8th ed., Thom son & West 2004, 573.

[10] In a contractual relationship we do not care about what others think about our freedom of conscience, religion, family life, etc.

[11] While in administrative law each state is obliged to respect the human right to freedom of conscience, even if the individual has never been or will never be in the coun try, in civil law this is unthinkable.

[12] The right may be 'something that is correct under the law, morality or ethics <to know right from wrong>; something which is attributed to a person only after its fair re quest, the legal guarantee, or moral principle <the right to freedom>; power, privilege or immunity, which is allowed to person under the law, legally enforceable requirement that

We usually understand the right as a legitimate request which obliges the other person to proceed in a certain way, or to omit an action. Since a right has its corollary in duty, it is expected from the state to apply public rights to our lives as part of its duty to protect and promote the public interest. Just as it is understood in civil law that sometimes we have to intervene in a particular situation in advance to protect our legal rights (i.e. we have a legal entitlement) because an act of another person will over time be resulting in the non-enforceability of our rights (in other words, when breach will finally be recognized, there will be nothing more to claim, that is why we want a temporary injunction), similarly, legitimate expectations in administrative law justify our demand for the state to take a specific action or to make an omission because over time there would be nothing left to enforce, or a restoration to the previous condition would be (almost) impossible.

5. THE BASIS FOR DETERMINING THE CONTENT OF THE PUBLIC INTEREST

How can criteria be determined for issues that we would like to exercise in the public interest cases? The Slovenian legal system derives from a conservative (administrative-legal pre-WW2 Austrian) understanding of standing, and correlated to that, administrative matters that are dealing with rights, obligations, or legal benefits[13] of natural or legal persons or other clients in the field of administrative law. A case is considered an administrative one if regulations provide that an authority is obliged to use the administrative procedure in some matters, make a decision in an administrative proceeding, promulgate an administrative decision, or if the protection of the public interest derives from "the nature of things". Therefore, if some other enactment does not clearly provide that the disputed matter in a particular area is an administrative matter, it is considered an administrative one when it protects the public interest. However, by such circular reasoning we are proving one and the same thing: that only public institutions can determine the content of the public interest, that they are the only ones that know what is best for society. But what is best when it comes to global warming with rising sea levels, changes in ocean currents and other weather phenomena, to scarcity and

someone will do or not do in their behavior; recognized and protected interest, in which the intervention is a violation'. B. A. Garner, *supra* n 9, 1374.

[13] The person who proves the legal interest by claiming that he enters into the process to protect his legal interests (a side participant) also has the right to attend the proceedings. The legal benefit is direct and determined in law or under other regulation that underpins personal gain. A person who requests participation in the process must specify his legal interest in his application (Article 43 of the Slovenian Administrative Procedure Act).

waste of natural resources, pollution, public health and (incurable or massive) diseases of populations, growing inequality between people, migration, unemployment, aging of population, and to other risks of bigger proportions? With the passing of time everything becomes much more complex in areas that are not yet „mature enough„ for an individual legal protection (e.g. micro parts of pesticides that are or could be harmful to human health in connection with other causes) on the basis of the legal interest. Harlow and Rawlings describe the today's process of transforming judicial review from a "drainpipe", formalist model into a funnel model (the limitation of the ambit of adjudication associated with the establishment of significant judicial 'no-go areas' put in issue the real accountability of political actors) where courts have abandoned some of the strict procedural certainties. They have put aside the prevailing private-interest rationale and gave explicit recognition to the role of pressure groups as the 'public interest advocates'. Reflecting and reinforcing the rise of a rights-based approach to judicial review, there has emerged a third ideal type, the '(American) freeway' where, participative and pluralist in orientation, this 'interest-representation' model ultimately stands for judicial review as a surrogate political process.[14] 'There is a general judicial consensus that the law related to standing has become increasingly relaxed. /.../ The cases therefore evidence a judicial tendency to liberalise the standing rules governing both traditional and modern remedies'.[15] Douglas speaks about the sufficient interest where standing is based 'on the importance of the interest, where the interest is consistent with relevant legislative purposes, or with fundamental legal policy'.[16] It seems that judges allow the sufficiency of interest by looking at the purpose, object and subject matter of the Act as a whole. This base is used also as a failure to take into account relevant considerations, which represents one part (the other is taking an irrelevant consideration into account in the exercise of power) of improper exercise of discretion. This standard is accomplished when the facts for it outweigh those against it; it could be paired with the civil judicial standard of the balance of probabilities (i.e. as "more likely than not"). This standard of proof leads us back to "the nature of things" (*de rerum natura*), to the nature of the public interest. There are many descriptions of the public interest, probably as many as there are authors who regard this notion from their respective points of view, so it is perhaps more appropriate if we consider it from the perspective of its core elements.

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[14] See C. Harlow, R. Rawlings, *Law and Administration,* 3rd ed, Cambridge Uni versity Press 2009, 672 674.

[15] R. Douglas, 'Standing'. In H. P. Lee, M. Growes (Eds.), *Australian Administra tive Law. Fundamentals, Principles and Doctrines,* Cambridge University Press 2007, 164.

[16] Ibid, 166 168.

By doing so, we can still use the work of Aristotle for determining the nature of things because he provides essential elements for the description of all things. Aristotle deals with things and their external motion in *Physics* (*Physica*).[17] He insists on a clear separation between the core material and shape, which if they are combined represent the nature of individual things. He has emphasized the difference between things as they are and with respect to their final intent. In the third section of the second book of *Physics* he states that it is necessary to use four different explanatory principles as regards the question of the cause of existence of certain things. Each thing (animal, plant, etc.) should have four causes: the material cause (the contents – *causa materialis*), the formal cause (the form – *causa formalis*), the moving cause (a force that causes the merging of content and form – *causa efficiens*), and the final cause (the goal – *causa finalis*). The reasons for all four properties are essential elements of each case of existence and nature of things. Aristotle believes that any absence or modification of any of these elements leads to the existence of different types. Explanation of all four causes is of overall importance and captures the reality of the things themselves (it shows us the nature of things).

Aristotle‘s view on the nature of things should be sufficient for our treatment of causes and modes of their interaction in the public interest. When can the (sufficient) public interest derive from the nature of things? It should contain the above-mentioned four reasons. It should appear with a real or potential content and form (both matter and form will depend on circumstances and areas as well as on the possibility of their interaction – how the form affects the content and *vice versa*), which should be coupled with a common connecting element (operations of public authorities) and with the final goal (the good of society as a whole, the common benefit). It turns out that (contrary to our expectations) there must always be operations of public authorities for the common good, but this is not the whole nature of things (in the functioning of public authorities the combination of shape and appearance of that functioning is present – the content and form of government action is affected by the underlying motion that is the reason that in turn affects the original content and format on which it operates – that is, how and by what means the public authority acts on the original form and its matter to derive the common good from these activities), there must also be a connection to the scope and substance of the matter we want to have influence on.

In conjunction with the standing of subjects outside the public authorities, the protection of the public interest should be (according to the nature of the public interest) present if the scope of the public interest is so important that we can talk about benefits for society as a whole, when

[17] Available at: *http://classics.mit.edu/Aristotle/physics.2.ii.html#187* (6.12.2010)

an area is sufficiently regulated, when the incidence in an area is such that it can be understood by an individual or an organization in all dimensions of that area (he/it must have sufficient information; there must exist his/its past efforts or experiences in the area), if the operation of public authorities is not satisfactory or effective, when the society as a whole will benefit from a particular operation of the state [18] (if a person has a benefit or detriment, the law already gives him standing *ex lege*).

6. *LOCUS STANDI* IN FRANCE AND GREAT BRITAIN

After providing the platform for identifying areas where the nature of the public interest should be located, let us take a look at the arrangements of the right of standing in individual countries. By doing that we will be able to compare theoretical reasoning with practical legal arrangements. A legal system is designed to safeguard and protect the rights of concrete natural and legal persons. A court must pay special attention to assessing whether there is a legal interest; the request should be carefully reviewed, moreover, it should be assessed what might happen if the court rejects it. Up to our times, standing or *locus standi* has been mostly synonymous with the legal interest, but as we will see, it is changing into something more dynamic, flexible, or deliberative, into something that also constitutes one of the elements of representative democracy.

6.1 France

In France, an individual cannot challenge the legislature‘s rules because of the separation between regulations and administrative acts in Articles 34 and 37 of the Constitution. In the context of administrative law (*droit administratif*) an individual must prove his legal interest, the interest for operation (*l‘intérêt à agir*). In France as in other states, the right to subjective process is divided from substantive law. The admissibility of the action depends on the presence of the legal interest (if there is no interest, there is no action – *pas d‘intérêt, pas d’action*), arising from Article 31 of the Law on Civil Procedure.[19] The Article recognizes the right to sue persons who can demonstrate an interest and the ability

[18] So distant neighbors could not invest remedies or participate in the proceedings concerning the area of influence on the other two neighbors if the area of influence does not extend to the plot of this neighbor; society as a whole does not benefit from such an intervention.

[19] The right of action is available to all those who have the legitimate interest in the success or dismissal of a claim, without prejudice to those cases where the law confers the right of action solely upon persons whom it authorizes to raise or oppose a claim, or to defend a particular interest.

for interest (*intérêt pour agir* or *la qualité pour agir*). Participation depends on the legal existence of a legal or natural person, within which also the heirs of a deceased person and groups without legal personality (a community of individuals, companies in the startup phase) may be involved in the process. The titular must show that the interest protected by law is a personal and direct interest (nobody can act as an agent – *nul ne plaide par procureur*). In addition to the individual participation in the frame of the legal interest, common actions are possible within the capacity for the interest, i.e. the eligibility for operation (*la qualité pour agir*). Such qualification results from the application and enables the submission and treatment of action. The property of such qualification is a result recognized by law or is present in the activities that are open to the interested parties who can justify a cause of action. The law gives rise to certain groups, which represent a real collective interest of the group, without being required to demonstrate the personal interest for the action: e.g. workers unions,[20] and associations that prevent racism,[21] sexual or family violence,[22] protect or help children at risk and victims of harassment,[23] address crime against humanity or war crimes,[24] discrimination based on sex or customs, living habits,[25] the defense of nature and the environment[26], or protect consumers.[27] 'If an individual wishes to gain his favor, he must demonstrate the personal interest for his personal right. For all other cases, especially in cases of claims for abuse of power (*recours pour exces de pouvoir*), there is a more liberal interpretation, through which courts uphold the interests that are not too vague or too indirect'.[28] In France then a liberal[29] concept of the legal interest dominates where the criterion is sufficient connection with an individual case.

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[20] Article L2131 1 du Code du travail.

[21] Article 2 1 du Code de procédure pénale.

[22] Article 2 2 du Code de procédure pénale.

[23] Article 2 3 du Code de procédure pénale.

[24] Article 2 4 du Code de procédure pénale

[25] Article 2 6 du Code de procédure pénale.

[26] Article L142 1 du Code de l'environnement.

[27] Article L421 1 du Code de la consommation.

[28] R. Chapus, *Droit administratif general*, 10[E] ed., Montchrestien 1996, 723.

[29] The interest can be invoked not only for material, but also for moral reasons (CE 8 Februar 1908 *abbe Deliard*, Rec. 127); although the interest is personal this does not mean that it must be exclusive; it is connected also to the quality of the public service (CE 21 December 1906, *Syndicat du quartier Croix de Seguey Tivoli*, GAJA, n. 16), to the inhabitants in a specific community (CE 29 March 1901, *Casanova*, GAJA, n. 8), to tho se who have the sufficient interest for annulation of decisions, relative to the functioning of service in the community (CE 10. februar 1950, *Gicquel*, Rec. 100); the interest cannot only be personal, but also a public one (CE 7. junij 1902, *Maire de Neris les Bains*,

6.2 Great Britain

In British administrative law, an applicant must have a sufficiently large (sufficient) interest for the issues to which the application relates.[30] The requirement of „sufficient interest„ was created by the interpretation of the American courts[31] and later transferred to Britain: Lord Diplock in the case of *Inland Revenue Commissioners Appellants in the National Federation of Self-employed and Small Businesses Ltd.* [1981] 2 W. L. R. 722 said that

> 'it would, in my view, be a grave lacuna in our system of public law if a pressure group, like the federation, or even a single public-spirited taxpayer, were prevented by outdated technical rules of locus standi from bringing the matter to the attention of the court to vindicate the rule of law and get the unlawful conduct stopped.'

Lord Scarman in the above-mentioned case gave his perception of the adequacy of the interest:

> '[t]he sufficiency of the interest is a mixed question of law and fact. The legal element in the mixture is less than the matters of fact and degree: but it is important, as setting the limits within which, and the principles by which, the discretion is to be exercised ... The one legal principle, which is implicit in the case law and accurately, reflected in the rule of court, is that in determining the sufficiency of an applicant's interest it is necessary to consider the matter to which the application relates. It is wrong in law, as I understand the cases, for the court to attempt an assessment of the sufficiency of an applicant's interest without regard to the matter of his complaint. If he fails to show, when he applies for leave, a prima facie case, or reasonable grounds for believing that there has been a failure of public duty, the court would be in error if it granted leave. The curb represented by the need for an applicant to show, when he seeks leave to apply, that he has such a case is an essential protection against abuse of legal process. But, that being said, the discretion belongs to the court: and, as my noble and learned friend Lord Diplock has already made clear, it is the function of the judges to determine the way in which it is to be exercised'.

It looks that the House of Lords has developed a two-step test from that case:

GAJA, n. 9), where it is important enough (CE 13. februar 1930, *Dufour*, Rec. 176). J. Waline, *Droit administratif,* Dalloz 2010, 618.

[30] When AJR procedure was introduced in 1978, an American style test of 'suffi cient interest' was included on the advice of the Law Commission (Law Commission's Report on Remedies in Administrative Law [1976, Law Com. No. 73, Cmnd. 6407]). Set out in s. 31(3) of the Supreme Court Act 1981, the test is mandatory: the court 'shall not grant leave /.../ unless it considers that the applicant has a sufficient interest in the matter to which the application relates'.

[31] See *Sierra Club v Morton* 405 US 727 (1972) or *Lujan v Defenders of Wildlife* 504 US 555 (1992).

1) Standing is not a preliminary question, which would be independent of the merits of a claim. The question of sufficient interest cannot be audited only in the abstract, but together with the legal and factual context in relation to all the various factors to which the parties point. 2) After examining the facts, the court considers whether the public authority breached its powers. If it turns out that there is a fairly large violation, court proceedings are initiated.

The British system much like the French one has a more and more liberal standing in public law. 'Prerogative legal remedies have always been more liberal than the standing of civil law remedies'.[32] The British system is moving away[33] from classic standing towards the assessment of the merits of the claim.

It looks that in the countries which do not have public participation in areas of preparation and adoption of general or secondary legislation, it is desirable that the system of standing is applied also for the cases of the public interest, i.e. in the sufficiently-important state's decisions (France[34], Great Britain). The dates of above-mentioned cases also show that the sufficiency of interest was accepted before the notions of NPM, Governance, Global Government and the like although they are similar in that they represent attempts to achieve a more effective government or to broaden the space or scope of operations. The sufficiency of interest has been established mainly because of the specific needs in a community's life.

7. CONCLUSION

In private law the direct beneficiaries of certain rights have an interest, while in public law all share the interest. *Locus standi* cannot be the same in both areas – the infringement of private rights should be

[32] H.W.R. Wade and C.F. Forsyth, *Administrative Law*, 9th ed., Oxford University Press 2004, 684.

[33] In recent years, the Parliament has passed Acts relaxing the strictness of the application of the rule by defining classes of persons who may commence proceedings. The Trade Marks Act 1994 allows "any person" to bring proceedings to recover loss su ffered by them as a result of an unjustified threat of trademark infringement. In the face of such provisions, courts maintain a jurisdiction to control their audiences. In such cases, a claimant will be required to show that he has been aggrieved by the threat of infringe ment in case that he was not a direct receiver of the threat. The Contracts (Rights of Third Parties) Act 1999 also defines classes of persons that may bring actions under a contract and thus have been granted locus standi where it otherwise would not exist due to the doctrine of privity of contract.

[34] Although France is under consideration to adopt public participation also: see 'Rapport public 2011: Consulter autrement, participer effectivement'. (Conseil d'État, Pa ris 2011).

treated in private law while abuse of public power in administrative law. *Locus standi* has been created in civil law, and therefore cannot be directly transferred to public law. Such immediacy neglects the dimension of the public interest that can still be described using the Aristotelian nature of things. The most recent additions to the modernization toward economic efficiency, privatization, and deregulation are citizens– and transparency-oriented. This paper confirms that the judicial protection in France and Britain, not only in the recent government documents in this field (e.g. the French statute concerning the rights of individuals against the administration – *Loi n. 2000–321 du 12 avril 2000 relative aux droits des citoyens dans leurs relations avec les Administrations*[35] – DCRA and the British concept of „Modernizing Government„[36]), allows a broader right of standing than the classic Germanic approach.[37] The responsibilities of public authorities are growing and consequences could be far reaching. If we advocate classic *locus standi* by granting more and more powers to public authorities, the public responsibility and accountability is smaller with every new assignment (the responsibility of government is a corollary of its powers). *Locus standi* can cause dismissal of even the most reasonable action against even an absurd abuse of power because „an individual has no legal interest.„ Regime of standing in public law should move from the sphere of interest into the merits of the case. The public interest in issues that are interesting for the people in the state and wider community (the environment, human health, rights, good governance of state or transnational communities) cannot be based on the demonstration of a specific state's intervention in the rights or interests of a particular individual, just like the public interest *per se* is not constituted only from the sum of individuals' wills. It is much more: by the strict standing even a large sum of petitioners (who can be counted in thousands) cannot provide sufficient ground for the commencement of proceedings. It turns out that the initiation of the case depends significantly on the substance which is behind the person's claim.

The rules of *locus standi* have been traditionally used with strictness in private law, but have often been relaxed in certain conditions in the presence of elements of public law, particularly where the individual freedom has been threatened. Issues relating to the protection of life, liberty, or physical integrity can be traced all the way back to the Roman times when in special cases it was considered that the procedure was nec-

[35] Available at: *http://www.legifrance.gouv.fr/affichTexte.do?cidTexte LEGITEXT 000005629288&dateTexte 20101217* (17.12.2010)

[36] Available at: *http://www.archive.official documents.co.uk/document/cm43/4310/4310.htm* (17.12.2010)

[37] Similarly, for transparency see R. Mathias, *The Transformation of Administra tive Law in Europe*, Sellier, European Law Publishers, 2007, 35. Beyond the academic concept called "*Steuerung*" (governing) Germany did not evolve. Id, 18.

essary because it was in the public interest.[38] A critical question touches on the issue of protection of areas and enforcement in areas that concern us all, where *locus standi* has become an opponent of the protection – opposing what it should protect. It is only a means, not a goal; the state has been repeatedly shown as an organization without the necessary resources to be able to play the role of the sole protector of natural resources (this is also evident on the international level), making it necessary to open the public interest to civil society organizations and individuals who have the resources, time, and sufficient interest to litigate. In places where the state shows weakness[39] or even abuses its power, it is unlikely that anyone else can step in but the people themselves.[40] Despite more modern forms of standing in environmental cases, we should keep evaluating the possibilities of a broader right of standing in other areas. Since human rights are our birthright, and since the human being is Aristotelian *homo politicos*, our public interest should be similar. Errors in the implementation of the public interest can be found in the nature of the state's practices which fall short of expectations. It should be only natural that there would be an effective way of pointing out errors, not only at the time of elections, but also in the time between them. Sometimes the consequences are difficult to repair or which is worse, an irreparable harm to the community as a whole can be caused.

Orthodox standing has been developed in accordance with the views of a bygone era. These became obsolete a century ago. The doctrine should be aligned with current guidelines. The theoretical debate on the nature of the public interest in the first part of the paper is similar to the outcome of British and French legislation and case law. The two countries have been far apart in creation of administrative law, but the similarities in standing (and other issues) bring them closer together. The British and French approach with judicial determination of the *sufficiency or quality of the interest* is a good compromise between law and facts. An alleged breach of duty or illegality of state's actions could be related to

[38] The so-called *actio popularis* – although it is used only for special cases that meet the stringent requirements: see R. W. Lee, *Elements of Roman Law*, 4th ed., Sweet and Maxwell 1956. Lee explains that these measures were 'in the public interest, which has been allowed to any member of the public to sue for the imposition of a sentence, which he kept to himself or to share with the country' and points out that the *actio popularis* was additional due to the lack of criminal law. Id, 708.

[39] Given the limited space I can only mention the so called Peltzman effect where the regulation itself creates the opposite effect.

[40] Even a politician who decides major community issues has no *locus standi*, but his mandate to intervene in the public interest is based on elections. Sometimes the citi zens should have the possibility to enforce the public interest through the courts if they consider that the state does not exercise it sufficiently.

the position of the claimant which must have a sufficient, qualitative individual (not merely legal) interest to pursue and protect the public interest. Administrative law has been developed primarily to protect the rights of the people against abuse of power. Let it also have the appropriate tools against abuse now and in the future.

Dr. Dragica Vujadinović*

Ronald Dworkin, *Justice for Hedgehogs, Cambridge*, London: Harvard University Press, 2011, 506.

Ronald Dworkin – one of the greatest contemporary political and legal philosophers – has pursued his comprehensive liberal theory for nearly four decades, beginning with the field of philosophy of law in his books *Taking Rights Seriously*[1], *A Matter of Principle*[2], and *Law's Empire*[3], followed roughly two decades later by his book *Justice in Robes*[4]. Along the way, Dworkin developed a liberal political theory of justice based on an "equality of resources" account of justice, set out in the book *Sovereign Virtue – The Theory and Practice of Equality*.[5] These works were supplemented by other books and articles that attempted to clarify the philosophical foundations of his theory of justice. In his latest work, *Justice for Hedgehogs*[6], Dworkin intends to solidify the philosophical foundations of his theory, and especially to illustrate the unity of ethical and moral values as well as more fully develop his conception of the integrity of law, politics and morality.

Dworkin has already partly explained in *Sovereign Virtue* and in several related articles the philosophical foundations of his political and legal theory. In *Sovereign Virtue*, the author accentuates political morality,

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1 Dworkin, Ronald, *Taking Rights Seriously*, London: Gerald Duckworth &Co Ltd, 1977.

2 Dworkin, R., *A Matter of Principle,* Cambridge, Massachusetts: Harvard Uni versity Press, 1985.

3 Dworkin, R., *Law's Empire*, Cambridge, Massachusetts: Harvard University Press, 1986.

4 Dworkin, R., *Justice in Robes*, Cambridge, Massachusetts: Harvard University Press, 2006.

5 Dworkin, R., *Sovereign Virtue Theory and Practice of Equality*, Cambridge, Massachusetts, London, England: Harvard University Press, 2000.

6 Dworkin, R., *Justice for Hedgehogs*, Cambridge, Massachusetts, London, Eng land: Harvard University Press, 2011.

whereas in *Justice for Hedgehogs*, he focuses more on individual ethics and personal morality. Nevertheless, the point in both is that there is continuity between individual ethics and political morality despite multitudinous individual moral positions and that justice is a parameter of individual ethics.

Dworkin uses the term "ethics" both in a narrow sense, i.e., as personal ethics (which is the study of how to live well)**,** and on occasion in a broader sense, i.e., as personal morality (which is the study of how we must treat other people). However, the author uses the term "morality" primarily to mean political morality regarding how a sovereign power should treat its citizens.

Dworkin elaborated two fundamental principles of his moral and political philosophy in *Sovereign Virtue*. The first fundamental principle is that of "equal importance" of each individual/ "equal concern". The second concerns a form of "special responsibility" of each individual for his/her own destiny and life achievements. His interpretation of these principles in *Sovereign Virtue* centers mostly upon an "equal concern" of the sovereign power for its citizens and is linked to his political theory of justice, called "equality of resources" account of justice.

The first principle, equal concern, requires a government to adopt laws and policies which ensure that its citizens` fates are not linked to their economic and social background, gender, race, individual skills and handicaps. The second principle, special responsibility, requires that a government works to connect the individual fates of its citizens to the choices that they have made.

In accordance with the "equality of resources" account of justice, the sovereign power or coercive political government must secure the just distribution of resources, which is both "endowment insensitive," or separated from any differences of the individual with regard to social status, as well as to natural talents and handicaps on the one hand, and "ambition-sensitive" to personal choices on the other.

In *Justice for Hedgehogs*, Dworkin also considers two fundamental principles of humanity, but this time he formulates them as two ethical principles (principles of individual ethics): the principles of self-respect and of authenticity. The author transfers political principles into their ethical analogues. In doing so, he emphasizes that we have an ethical responsibility to create something of positive value out of our lives, and that this ethical responsibility is an objective one. In addition, he argues that our various responsibilities and obligations to others flow from the above mentioned personal responsibility for our own lives.

These two principles together offer a conception of human dignity. Dignity requires self-respect and authenticity, and dignity helps in identi-

fying the content of personal morality**.** As Dworkin says, acts are wrongful if they insult the dignity of others. The principle of dignity demands that we should be responsible not only for the success of our lives but also to accept relational responsibility.

After elaborating two fundamental principles from the point of individual ethics and individual morality, Dworkin returns to the linkage between an individual perspective and that of political morality and legitimacy. This helps to clarify the interconnection of individual well-being and living well in the political community on one side, and explaining political legitimacy starting from personal dignity on the other. When Dworkin addresses ethics and personal morality, he studies them through the concepts of responsibility, i.e., duties, obligations. From self-respect as the central concept of individual ethics, he turns toward the central concept of personal morality – our duties to aid others and not to harm them, as well as to our special duties as individuals toward friends and relatives and the promises that we make to them. Thereafter, Dworkin turns to political morality and political obligations, as a distinct department of value, where impartiality is necessary and where certain individuals have special roles and powers to act on behalf of the community as a whole.

According to *Sovereign Virtue,* the legitimacy of a government deriving from the political community depends both on how a purported government has acquired its power and how that power is exercised. Justice is a matter of sovereign responsibility to treat each person with equal concern and respect.

When Dworkin comes back to political morality and political legitimacy in his new book *Justice for Hedgehogs*, he deepens his analysis of the same topic as compared to *Sovereign Virtue.* The author puts the main focus on human rights and on obligations of the sovereign to secure that rights of citizens be fully respected: rights plainly provide a better focus in the field of political morality, whereas duties and obligations are a better point of reference in the field of personal responsibility, because individuals have political rights, and some of these rights, at least, are matched only by collective duties of the community as a whole rather than of particular individuals. There is a deep connection between the pivotal idea of political legitimacy (based on fundamental principles of humanity – "equal concern" and "special responisibility") and the two principles of human dignity – principles of "self-respect" and "authenticity", i.e. between his conception of political legitimacy and his conception of "basic" human rights.

According to Dworkin, the principle of legitimacy is the most abstract source of political rights. He summs up the right based and morally

founded conception of legitimacy: "Government has no moral authority to coerce anyone, even to improve the welfare or well-being or goodness of the community as a whole, unless it respects those two requirements (D.V. of human dignity) person by person. The principles of dignity therefore state very abastract political rights: they trump government`s collective policies. We form this hypothesis: All political rights are derivative from that fundamental one. We fix and defend particular rights by asking in much more detail, what equal concern and respect require."[7]

Political rights which are basic for human dignity are "basic" human rights and they are trumps for legitimacy. Other political rights are trumps/relevant standards for other political ideal, like for justice. Principles of dignity have been directly expressed in specific "basic" human rights. The first principle of dignity – principle of self-respect – is supported by paradigmatic human rights: not to be tortured, discriminated and exposed to blatant prejudices, not to be punished innocent, and by the right to due process. These human rights are derivatives of the principle of self-respect. The second principle of dignity – principle of authenticity and personal responsibility – is supported by the right of free speech and expression, right to conscience, political participation, due process, religious belief.

Dworkin closes the circle, so to speak, between *Sovereign Virtue* and *Justice for Hedgehogs*, in the latter of which he deepens and diversifies his analysis of fundamental principles of humanity. He also comes back to the issue of the sovereign, justice and political legitimacy from the perspective of human rights.

Dworkin also considers the concept of interpretative integrity of morality, politics, and law, i.e. of the concepts of liberty, equality, democracy, and justice, by integrating all of them through human rights conceived as both the derivations of two fundamental principles of human dignity and trumps of political legitimacy.

In accordance with his theory of an objective truth in the field of values, Dworkin claims absolute truth for the theory of human rights. Basic human rights do not depend on the cultural features. Rather, they are universal rights according to an abstract standard of human dignity; this does not mean, however, that these principles are universally endorsed. Basic human rights are given, substantive, they have a quality of objective truth, they are taken as axiomatic; they are not true by definition, nor do they follow from some immutable laws of human nature, or Divine law. They should be accepted without any need for justification, even though many people disregard them as substantive and true ones. The point is that we must accept them because what makes them true for

[7] Dworkin, R., *Justice for Hedgehogs*, 330.

us is our humanity, the fact that we have life to live and to live well, and death to face.[8]

Justice for Hedgehogs was expected to systematically present the author's philosophical foundations, especially and most importantly the ethical foundations of his political theory of justice. As a criticism, it would be fair to say that this last book does not offer the promised systematical overview. Instead, *Justice for Hedgehogs* focused on certain dimensions of philosophical ethics, primarily on individual ethics and on the way that individual ethics and political morality have been essentially interconnected. Great attention was paid in this book (perhaps a bit too extensively) to the epistemological dimension, i.e. an issue of the truth in morals, and on giving a priority to the so-called internal skepticism over an external one.

It is possible to systematically reconstruct the philosophical foundations of Dworkin`s theory of justice by taking into account *Justice for Hedgehogs* together with *Sovereign Virtue* and the above-mentioned preparatory articles. Therefore, the presentation of *Justice for Hedgehogs* necessarily includes relevant elements and concepts from Dworkin`s previous works. This last book, however, offers analysis and conceptual dimensions which essentially deepen, enrich, complete, and finalize Dworkin`s political theory of justice and political philosophy.

The importance of this book and of the entirety of Dworkin's works is supported by the fact that the *Boston University Law Review* organized a massive symposium on the near-final draft of *Justice for Hedgehogs* in September 2009. This review published a special volume in April 2010 which contained numerous critical essays and thirty-eight pages of Dworkin`s own critical response to his critics. In addition, Dworkin also took into consideration relevant critical remarks by addressing them in the final version of this great book.

[8] Dworkin, R. Keynote Address, Boston University School of Law Symposium, *Justice for Hedgehogs*: A Conference on Ronald dworkin`s Forthcoming Book, Septem ber 2009, *Boston University Law Review*, 476.

Dr. Goran Dajović*

Miodrag Jovanović, *Collective Rights. A Legal Theory*, Cambridge University Press, Cambridge 2012, p. 230.

Early this year, Cambridge University Press published the new book of Miodrag Jovanović, a professor of the Belgrade University, Faculty of Law. It concerns the topic that he has started to research almost ten years ago in his PhD thesis.[1] Although the thesis developed some of the core ideas only in a nutshell, it served as a starting point for this book which can be regarded as his final statement regarding the problem of collective rights.

The book is divided into four chapters. The first one (*What it means for a theory of collective rights to be legal – reflections on methodology*) is, in a deeper sense, introductory. It is, so to speak, a separate essay about the methodology of jurisprudence. Jovanović lays down the methodological foundation of his enterprise and he contemplates about the purpose of jurisprudential efforts in general. After the first, "foundational" chapter, the reader is faced with two pivotal parts of the book. The second chapter (*Theories of rights and collectives as right-holders*) is, on the one hand, an extended and scrupulous analysis of the existing and dominant theories of rights and, on the other hand, an analytical preparation for the next chapter. This is so in virtue of the fact that Jovanović takes the very possibility of the right holding capacity of groups to be the crucial condition for the existence of collective rights. In the third, and essential chapter for the book's topic (*Collective rights as a distinctive legal concept*), the author exposes several important conceptual clarifications (and I would add, classifications). Finally, the book ends with a chapter dedicated to the problem of the alleged universality of collective rights (*Are there universal collective rights?*)

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1 M. Jovanović: *Kolektivna prava u multikulturnim zajednicama* [Collective Rights in Multicultural Communities], Beograd 2004.

What is the main achievement of this book? Let us mention and describe only two, in my opinion, the most important ones. The first one is substantial and it concerns the conclusions which Jovanović developed in the pivotal parts of the book. The second chief accomplishment is, strictly speaking, of methodological significance.

Let us begin with the substantial achievement. Jovanović claims that a theory of rights has to tackle four different issues:

(1) what does a claim of right consist of (e.g. protection of choice or interest),

(2) what is the form and extent of that protection

(3) what is the nature of the right-holder and

(4) what is the nature of the good which the right is claimed to (p. 86).

Jovanović looks for the answer to the first and the most important question in Raz's interest theory of rights. Namely, he dismisses the alternative, so-called "choice" theory of rights as empirically incorrect, because this theory insists on autonomy and will as preconditions for the right-holding capacity, and due to this insistence it excludes children and mentally ill persons as right-holders. As Jovanović says "in that respect, this theory seems to be in stark contrast with a number of the existing general and regional international legal instruments that stipulate the right of everyone to recognition of his/her legal personality"(p.74). Therefore, the author turns to the rival theory of Joseph Raz. This theory attempts to ground *subjective rights of individuals* as follows: "X has a right if and only if X can have rights and... an aspect of X's well-being (his interest) is a sufficient reason for holding other person(s) to be under a duty". The second part of the definition concerns the 'capacity for possessing rights': "An individual is capable of having rights if and only if ... his well-being is of ultimate value". The cited "definition" solves the first and the third question and implies answer to the fourth. However, does the definition pertain to the concept of *collective* rights? Are there collective rights, after all? Are there "collective interests" protected by these rights? In addition, what kind of goods can generate collective interests? Finally, who is the subject of such kind of interest? All of these questions must be answered if one wants to construct a theory of collective rights. And Miodrag Jovanović has done it.

Groups can be conceived to hold rights only to "participatory goods" or precisely – it is one correction which Jovanović attaches to the concept of "shared" or "communal" or "participatory" goods – only to "socially irreducible goods". If one community *perceives* good in a way that it can be enjoyed only "by the group and that this enjoyment is not

reducible to the sum of the enjoyments of individuals",[2] we can say that such good is "communal" (like language, culture or national heritage) and *it can generate collective interest.*

Nevertheless, although the existence of such collective interest is a necessary condition for the existence of collective rights, it is not a sufficient condition. Actually, it is not accepted (neither in theory nor in legal practice) that any set of individuals who possess a joint interest can have group rights. For instance, speakers of Esperanto can have an interest in using this language in the communication with local officials, but that interest could not give rise to their legal right to communicate with them in Esperanto. It transpires that the problem of *right-holder* comes to the fore of the debates about collective rights. In that respect, the main task of Jovanović's theory is exactly to provide some characteristics of groups which would qualify them for the status of right-holders.[3]

First of all, it must be noted here that there is a crucial difference between "a *category* of persons, understood to mean all those people who fit a particular description" (such as being minors or voters), and "*group* proper, understood to mean a set of people who by their shared characteristics think of themselves as forming a distinct group".[4] First set of persons is a creation of law, as it is the case, for instance, with voters or workers. Contrary to this, some entities (for example, national minorities) already exist as such, based on 'objective criteria' (p. 125). The law does not create such kind of groups.[5] They are not legal creation, but "*de* facto, pre-legally existing *non-reducible* collectivities" (p. 58). As such, they must be clearly differentiated from juristic persons as a separate type of right-holders.

However, it should be stressed that what is important for these groups being potential right-holders *is not only* their independent, social existence, but *their moral distinctiveness* as well. At this point, Jovanović brings into play and defends the moral standpoint, which a Canadian scholar Michael Hartney labeled as "value collectivism". According to this view, cultural identity and distinctivness of a group are not instrumental, but intrinsic values. Therefore, the existence of *some* collectives or communities (e.g., indigenous peoples, national or religious minorities) is one moral good that can not be reduced to moral worthiness of

[2] J. Waldron, *Liberal Rights*, Cambridge 1993, 355.

[3] As Jovanović rightly observes, "the whole mess with 'collective rights'... is exactly about whether the status of a separate legal personality could be extended to groups qua groups", 44.

[4] D. Miller, "Group Rights, Human Rights and Citizenship", *European Journal of Philosophy* 2/2002, 178.

[5] M. McDonald, "Should Communities Have Rights? Reflections on Liberal In dividualism", *Canadian Journal of Law and Jurisprudence* 2/1991, 218 19.

individuals, i.e. members of these collectives, and this is the reason why moral rights of groups are not reducible to the moral rights of its members. Following some other authors[6], Jovanović holds that only by keeping in mind this property of collectives, it is possible to construct their legal subjectivity. And exactly this moral worthiness, coupled with the pre-legal existence of a collective, is the reason and justification for the existence of collective rights which protect collective interests of such collectives.

Finally, Jovanović steadily demystifies the truism that collective rights are rights which "shall be exercised in community with others". Collective rights can be exercised individually – for instance, exemption from compulsory wearing of crash helmets for Sikhs, as in the British law.[7] On the other hand, some individual rights can be exercised only collectively, for instance the right to assemble, to strike or to associate freely. A single person cannot enjoy these rights, and yet they are fundamental *individual* rights. Accordingly, *definiens* for a collective right cannot be determined by the way of its exercise (i.e. rights exercised collectively), but it must be found, as previously indicated, in the collective interest which is protected by these rights and in the nature of the right-holder. Eventually, Jovanović summarizes his theoretical account as follows: "Ultimate beneficiary of collective rights is the collective entity *as such* and the protected good is the one from the category of 'socially irreducible goods'" (p. 119).

This is short and, as in any other case of the book review, inevitably uncompleted elucidation of the main substantive conclusions of this book. Let us now turn to the second achievement of this book, i.e. its methodological "message". In this respect, one can, first, notice that the title of the book itself determines its "genre". Namely, it is the work of *legal theory* or, in terms of the Anglo-American legal philosophy, it belongs to the province of *jurisprudence*. It is well-known that, as a general and philosophical legal discipline, jurisprudence is inclined to self-reflection. Put differently, jurisprudents are prone to investigate and contemplate about the boundaries and scope of jurisprudence, as well as about its methods. Questions like, "What is jurisprudence?", "What are the basic methods of jurisprudence"?, are the most important questions raised by jurisprudence. And jurisprudents have to answer them before they can

[6] "Someone or something can hold rights only if it is the sort of thing to which duties can be owed and which is capable of being wronged. In other words, moral stand ing is a precondition of right holding", P. Jones, "Group Rights and Group Oppression", *Journal of Political Philosophy* 4/1999, 361 2.

[7] Of course, collective rights can be exercised collectively as well and there is also the third way of exercising a collective right, i.e. via some representative body or agent, 115 116.

turn to other tasks. Consequently, proper theorizing about law cannot begin in any other way.

And it is exactly the way that Jovanović follows. How does he do it? The one of purposes of jurisprudence is to produce concepts and theories which participants will be able to recognize as correct when they face them. Therefore, jurisprudence does not only record actual conceptual framework of law, but it scrutinizes and reconsiders this framework. Jovanović explicitly refers to this task in numerous places, most notably in the opening chapter of the book. He is permanently concerned with the role and the very meaning of jurisprudence, generally, and with the purpose and usefulness of his own task of establishing a theory about one general legal concept, particularly. It is important to emphasize that this is a theory about a practical (not theoretical concept) and, as Jovanović claims (for instance, at p. 3), an "emerging" concept as well. He is undertaking this theoretical endeavor by using all the panoply of the modern conceptual analysis. He sets out to prove his points from the truisms about collective rights; then, he analyses ruling theories about rights in general; finally, he focuses on collective rights, putting them in the grid of all other kinds of rights, trying to conceptualize and make theoretical use of them and, by analyzing the relationships of this and other similar concepts. Although it should be noted that this book is a true piece of art in conceptual analysis, we would get a wrong impression if we neglect avowed interdisciplinary approach on which Jovanović constantly insists. He is convinced (it seems rightly) that without helping hand of empirical and axiological methods, his task would never be accomplished so extensively and thoroughly.

Finally, one can certainly find a few misinterpretations, mistakes and overstatements in this book. For instance, Jovanović sometimes, in my opinion mistakenly, identifies conceptual analysis with Hart's early method of paraphrasing, whereas paraphrasing is only one among a few of its possible means (40, 73). He also sometimes confuses ontological and axiological questions (45). Finally, he stresses too much the practical justification of his enterprise (41–2, 64), and while I find this useful, it is not so pressing, because if jurisprudence *can* take part in creation of legal concepts, than I do not see any argument why it *should not* do so. Nonetheless, Jovanović constantly offers contra arguments against one such elusive argument. However, it seems to me that it would be hairsplitting to insist further on the quibbles while talking about this, in all other ways, excellent book.

Let me sum up this review with a short observation on its relevance and potential influence. This book is, in several ways, important for Serbian academic jurists and for domestic legal culture in general. First of all, its subject is very well connected to domestic legal practice. Serbian

society is multicultural and multinational, and different kinds of collectives (national and religious minorities) are recognized and established as legal entities. Consequently, his analysis could be of pragmatic use. As Jovanović says, "the undertaken clarificatory work of jurisprudence... (can) significantly affect legal-drafting practice..."(65).

Secondly, when jurisprudence deals with its own methods and nature, it makes a good deal of useful job for other legal disciplines, especially for practically oriented legal science. When studying, for instance, methodological questions, jurisprudence instructs academic jurists who study practical legal concepts. One of the greatest virtues of this book is that its author puts forward this insight so clearly. Moreover, this book is an exceptional example of well performed theoretical analysis of a relevant legal concept and, as such, it can serve as a standard for other authors willing to undertake this kind of analysis of a legal concept, be that theoretical or practical in nature.

Last but not the least, it seems that this book puts a luminary of the Serbian legal theory back on the European jurisprudential sky. It would be more than welcome that some of its stardust falls on other Serbian legal theorists as well and prompts them to maintain the shine of that star alive.

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CONTRACTS, TREATIES AND UMBRELLA CLAUSES: SOME JURISDICTIONAL ISSUES IN INTERNATIONAL INVESTMENT ARBITRATION

Investor State contracts are an important instrument for realising foreign in vestments. The mixture of public and private law present in these contracts raises a number of interesting legal questions. This article focuses on certain jurisdictional issues which are of high importance for both investors and host States in interna tional investment arbitration.

Two main issues are discussed. The first is the relationship between the breaches of investor State contract as opposed to the breaches of the bilateral invest ment treaty, and the impact this has on establishing arbitral jurisdiction. The second issue discussed are the "umbrella" clauses and the proper understanding of their content. Both topics are mainly analyzed in the context of ICSID, but conclusions drawn can be applied to other forms of investment dispute settlement.

The article concludes with proposed guidelines on how to overcome the exist ing divergence in jurisprudence which is detrimental to legal certainty in this area of law.

Key words: *Investor State contracts. Investment arbitration. ICSID. Um brella clauses*

1. INTRODUCTION

Contracts between the host State and the foreign investor, aimed at realising a foreign economic investment, have a long history. They range from early concession contracts dealing with exploitation of mineral resources to contemporary contractual arrangements such as service agree-

ments.[1] Respecting investor-State contracts, especially in times of turmoil, was seen as one of the cornerstones in relations between the host State and foreign investors. What is important to note is that these contracts have actually lost nothing of their importance in the modern business world of foreign investment. Investor-state contracts, in one form or another, are still very often used to enter a foreign market and make an investment. The entrance into certain sectors of the host State economy (such as oil exploitation) is often possible solely through such contracts, as governments deem it necessary to retain certain control over some crucial and sensitive areas.[2] All this has prompted one International Centre for Settlement of Investment Disputes (hereinafter ICSID) tribunal to state that foreign investments are actually *characteristically* made with the contractual involvement of the host State.[3]

It is, thus, understandable that legal issues surrounding investor-State contracts deserve special attention. It has been established that interference with the contractual rights of the foreign investor in these contracts (mostly in cases of expropriation) often engages international responsibility of the host State.[4] However, for the host State to be responsible, it is necessary for a foreign investor to obtain a judgement or an arbitral award.

In that regard, investment arbitration is an especially important method of dispute resolution. There is no doubt that the possibility of resolving disputes with a sovereign State through arbitration is an important development in favour of foreign investors, chiefly in the terms of getting an unbiased and more predictable outcome. Readiness of States to accept being on equal footing with a foreign *private* entity can be seen as a part of a grand bargain to attract foreign investments as much as possible. It can also be seen as an aspect of the gradual restriction of State immunity, which has, as a trend, received general acceptance in the international community.

However, despite these developments, it would be wrong to think that establishing jurisdiction over a State is a problem-free area. Regarding the topic of this article, a number of jurisdictional issues can only

[1] For a historical overview, see M. Sornarajah, *The International Law on Foreign Investment*, Cambridge University Press, Cambridge 2010[3], 19 28.

[2] UNCTAD, *State Contracts*, New York Geneva 2004, 2 3.

[3] *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, IC SID Case No. ARB/02/6, Decision on Objections to Jurisdiction (January 29, 2004), 132(d), 8 ICSID Reports 518 (2005).

[4] S. Alexandrov, "Breach of Treaty Claims and Breach of Contract Claims: Is It Still Unknown Territory?", *Arbitration Under International Investment Agreements: A Guide to the Key Issues* (ed. K. Yannaca Small), Oxford University Press, Oxford 2010, 324 325. *See also* R. Leal Arcas, "The Multilateralization of International Investment Law"*, North Carolina Journal of International Law and Commercial Regulation* 35/2009 2010, 53 54.

arise in relation to investor-State contracts, as opposed to a situation where the host State is not a contractual party. Two main issues which are occupying the attention of academics and practitioners in this area are the distinction between contractual and bilateral investment treaty (BIT) claims and the proper interpretation of so-called "umbrella" clauses. These two topics will be examined in parts 2 and 3, respectively, followed by a conclusion in part 4.

It should be noted that the following text is primarily focused on ICSID jurisprudence. This is warranted as ICSID has positioned itself, in terms of case volume dealt with,[5] as a primary forum for resolution of investment disputes in the world. However, most of the deliberations can be relevant for other means of investment arbitration, such as under UNCITRAL Arbitration Rules and conclusions reached can be applied *mutatis mutandis*.

2. CONTRACTUAL AND BIT CLAIMS

Regarding the relationship between the claims of a foreign investor stemming from a contract with the state and the ones from a BIT, the basic idea is clear. A host State guarantees certain standards of protection to a foreign investor in accordance with a BIT (or a domestic law, but for simplicity sake we will refer to BITs)[6] it has concluded with that investor's home State. If it fails to fulfil these standards, this constitutes a breach of the treaty and the foreign investor is entitled to pursue (in most cases) investment arbitration before an international institution as stipulated in the dispute resolution clause of the BIT itself. Previous steps along the way can exist (such as the need to exhaust domestic remedies first)[7], but ultimately in most cases the dispute can be expected to end up before an arbitral tribunal. If the State has a contract with a particular foreign investor, breaches of contract are to be (like in ordinary commercial contracts) examined and sanctioned before the institution (international commercial arbitration/domestic court) designated in the dispute resolution provisions of that particular contract. These two types of disputes, BIT and contractual ones, remain analytically distinct.[8]

[5] J.P. Sasse, *An Economic Analysis of Bilateral Investment Treaties*, Gabler Ver lag, Hamburg 2011, 59.

[6] This is also warranted as arbitration based on domestic legislation is now rela tively rare. See A.K. Bjorklund, "The Emerging Civilization of Investment Arbitration", *Penn State Law Review* 113/2008 2009, 1270.

[7] C. Schreuer, "Calvo's Grandchildren: The Return of Local Remedies in Invest ment Arbitration"*, The Law and Practice of International Courts and Tribunals* 4/2005, 1 3.

[8] G. Van Harten, "The Public Private Distinction in the International Arbitration of Individual Claims Against the State", *International and Comparative Law Quarterly*

This distinction holds true even if the breach of the BIT stems from the breach of a contract. It is quite possible that the host State's breach of a particular contract is such as to trigger the breach of the BIT standards as well and, consequently, engage the BIT dispute resolution mechanism.[9] Despite the fact that in determining whether or not there has been a breach of the BIT the tribunal must usually interpret the particular contract and examine its performance (as stated, for example, in the *Vivendi* case)[10] this does not mean that it has jurisdiction to decide upon the contractual breach itself. It simply means that it so happened that the host State infringed its treaty obligations by breaching a contract, and not, for example, by outright seizing of corporate premises of the foreign investor. The same distinction applies even if breaches of contract and BIT exist concurrently, as is often the case. Each of the breaches is to be resolved in its own forum. It is not always easy to distinguish between these breaches in practice, but theoretically there should be no dilemma about the proper solution.

The legal situation becomes more complicated when, in one way or another, the BIT dispute mechanism becomes entangled with "purely" contractual breaches. The least problematic scenario is where the BIT explicitly states in its jurisdiction clause that it can be used to resolve "any dispute" between the State and the foreign investor.[11] This simply opens up a possible dispute settlement mechanism to be pursued by the foreign investor in additions to the one(s) existing in the contract(s). The key here is for the wording of the BIT to be explicit and all inclusive, such as including "all" disputes in this extension of the BIT jurisdiction.[12] As soon as the wording becomes more qualified predictability of the result seems to diminish rapidly, as is well illustrated by the *SGS* cases discussed later.

A more controversial scenario is the situation which can be described as "disguising" contractual claims into treaty-based ones. A foreign investor faced with the host State's contractual breach might be inclined to qualify this as a BIT breach in order to avoid the contractual dispute resolution mechanism (which can entail, for example, litigating

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56/2007, 372; s*ee also* C. McLachlan, L. Shore, M. Weiniger, *International Investment Arbitration: Substantive Principles*, Oxford University Press, Oxford 2007, 103.

[9] *See* G. Van Harten, 387; *see also* A. Reinisch, "Expropriation", *The Oxford Handbook of International Investment Law* (eds. P. Muchlinski, F. Ortino, C. Schreuer), Oxford University Press, Oxford 2008, 417 420.

[10] *Compañía de Aguas del Aconquija S.A. and Vivendi Universal S.A. v. Argentine Republic,* ICSID Case No. ARB/97/3, Decision on Annulment (July 3, 2002), 105, 110 111, *International Legal Materials* 41/2002, 1135 *et seq*.

[11] *See* S. Alexandrov, 329 330.

[12] C. Schreuer, "Investment Treaty Arbitration and the Jurisdiction over Contract Claims The Vivendi Case Considered"*, International Investment Law and Arbitration: Leading Cases From the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (ed. T. Weiler), Cameron May, London 2005, 296.

only in the domestic courts). Based on the theoretical model explained above, the conclusion is that the foreign investor's claims are to be rejected in the jurisdictional phase of an investment dispute. The problem, however, arises on the factual level. What needs to be distinguished is whether the State really acted as a contractual party, and thus committed a contractual breach, or its actions fall within a public/BIT sphere. There is no generally accepted method for distinguishing these two spheres, but some guidelines can be suggested.

It is submitted that in order for an act of State to cause breach of the BIT and engage international responsibility, it must be one done by the State in its capacity as a sovereign. Pragmatically speaking, it should be of such nature that the ordinary contractual party would not be in a position to perform such an act.[13] Thus, a tribunal faced with the issue should, in accordance with well established practice,[14] determine jurisdiction by establishing whether or not the alleged breaching act is in any case capable of being characterised as falling within a BIT scope. As was clearly explained by the *Vivendi* ad hoc Committee, "[a] treaty cause of action is not the same as a contractual cause of action; it requires a clear showing of conduct which is in the circumstances contrary to the relevant treaty standard."[15] The *Impregilo v. Pakistan* tribunal, which fully endorsed such approach, also set out the rationale for it: "(...) to ensure that, in considering issues of jurisdiction, courts and tribunals do not go into the merits of cases without sufficient prior debate."[16]

However, some ICSID tribunals disagreed with such approach. In *Joy Mining v. Egypt* it was concluded that, under certain circumstances, "it might be considered to be a dispute where it is virtually impossible to separate the contract issues from the treaty issues and to draw any jurisdictional conclusions from a distinction between them." [17] Other tribunals suggested that examination whether sovereign powers have been employed requires establishing the nature, or even the motive and intent of the alleged breach, which can only be done in the merits stage of the dispute.[18]

Such arguments can be said to indicate a real issue in some cases. Indeed, sometimes the factual matrix of the case at hand simply cannot

[13] *See* UNCTAD, 9 10; *See also* G. Van Harten, 373 374.

[14] M. Feit, "Responsibility of the State under International Law for the Breach of Contract Committed by a State Owned Entity", *Berkeley Journal of International Law* 28/2010, 145.

[15] *Vivendi v. Argentina*, 113.

[16] *Impregilo S.p.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/03/3, Decision on Jurisdiction (April 22, 2005), 254, *available at* http://icsid.worldbank.org, accessed 23 September 2011.

[17] *Joy Mining Machinery Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/03/11, Award (August 6, 2004), 75, *ICSID Review* 19/2004, 486.

[18] *See* S. Alexandrov, 340.

allow for dealing with a distinction between contractual and treaty breaches at the jurisdictional level. In such situations leaving the final decision for the merits phase, of course, remains warranted.

Still, in the author's opinion, it is advisable to fully examine these issues in the jurisdictional phase whenever it is possible. It is for the tribunal to exert careful evaluation in order to distinguish the issues present and, if prompted, end the proceedings. Leaving essentially jurisdictional questions to be answered in the merits phase should in any case be *ultima ratio*. Three reasons, at least, can be put forward.

Firstly, not allowing for a case to go to the merits phase without convincing reasons should be strived for as much as possible because loosening of scrutiny in the jurisdictional phase might encourage proliferation of dubious claims to the (already rather overflowed) ICSID dispute resolution mechanism. The *Impregilo* decision on jurisdiction took note of this danger.[19] If it appears that it is relatively easy to advance the case to the merits phase, foreign investors might be inclined to attempt to do so without sufficient ground and by that also ignore contractual jurisdiction clauses. This is harmful to the balance of the whole dispute settlement system. In the author's opinion, lack of scrutiny in the jurisdictional phase is somewhat reminiscent of the (in)famous quote uttered during the Albigensian crusade "*Caedite eos! Novit enim Dominus qui sunt eius*"[20] in the sense that the sorting out of the issues is left to the latter stage, but with very unwelcome consequences.

Secondly, it should be borne in mind that prolongation of arbitral proceedings means more expenses for the parties involved. Investors (which are practically always in the position of the claimant in ICSID proceedings) might be faced with the unnecessary costs associated with proceeding to the merits phase (while having a rather weak claim) just because the tribunal wanted to give itself additional time and "breathing space" to deal with certain issues. Strictness in the jurisdictional phase also prevents possible delay tactics by host States, aimed at financially wearing out claimant (if the said claimant is not, of course, a strong multinational company). On the other hand, States in dire financial straits (example of Argentina after the 1999–2002 financial collapse comes to mind) would also be interested in ending the proceedings as soon as possible, preferably in the jurisdictional phase.[21]

Thirdly, the undue prolongation of proceedings can have an adverse impact on the host State's reputation as an investment-friendly destination. The launching of proceedings could already be seen as tarnish-

[19] *Impregilo v. Pakistan*, 254.

[20] "Kill them [all]! Surely the Lord discerns which [ones] are his" according to historical reports, this was the answer given by the papal legate Arnaud Amaury when asked how the crusaders were to distinguish Catholics and heretical Cathars in the be sieged city of Béziers.

[21] A.K. Bjorklund, 1275.

ing the reputation of the host State, and the decision that the dispute is to proceed to the merits phase can send an additional negative signal to other potential investors. *Fama est* principle can be quite harmful, especially regarding countries not known for their good investment climate in the first place.

Thus, it can be said that an arbitral tribunal should cautiously approach any situation that is reminiscent of an attempt to "disguise" a contractual claim into a BIT garb. But this must not go against the need to carefully evaluate if the host State itself is attempting to mask its sovereign acts into a contractual shell. The actual careful weighing of arguments has to be done in each and every case, which, unfortunately, must leave any attempt to provide guidelines at a rather general level.

3. UMBRELLA CLAUSES

The proper understanding and application of the so-called "umbrella clauses" has been deemed as of the most contentious questions in investment arbitration.[22] Generally speaking, it is a provision in the BIT by which the host State guarantees that it will respect all obligations assumed in regards to investments. However, the wording of the umbrella clauses is far from uniform. Lack of uniformity is also present regarding their occurrence – they are present in one form or another in around 40% of the 2700 BITs worldwide.[23]

It is not possible within the scope of this article to go into all the interesting factual or theoretical subtleties of particular ICSID cases. The focus is on the two cases which were the progenitors of two main branches of ICSID jurisprudence. Umbrella clauses came under the spotlight after the well known *SGS v. Pakistan*[24] and *SGS v. Philippines*[25] cases. Two arbitral tribunals reached divergent conclusions whether an umbrella clause extended the jurisdiction of the investment tribunal to pure contractual breaches. The tribunal in *SGS v. Pakistan* took a restrictive approach. It interpreted the clause worded "either Contracting Party shall constantly guarantee the observance of commitments it has entered into with respect to the investments of the investors of the other Contracting Party" of the Switzerland-Pakistan BIT as not extending its jurisdiction to purely contractual breaches. In short, the tribunal was of the opinion that

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[22] K. Yannaca Small, "What About This 'Umbrella Clause'?", *Arbitration Under International Investment Agreements: A Guide to the Key Issues* (ed. K. Yannaca Small), Oxford University Press, Oxford 2010, 480; *See also* UNCTAD, 19.

[23] *See* K. Yannaca Small, 483.

[24] *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan,* IC SID Case No. ARB/01/13, Decision on Objections to Jurisdiction (August 6, 2003), *Inter national Legal Materials* 42/2003, 1290 *et seq*.

[25] *SGS v. Philippines*, *supra* note 3.

the consequences of such a broad interpretation would be to allow for establishing jurisdiction against Contracting States in a largely unpredictable (theoretically unlimited) number of cases and that this could not have been the parties' intentions. This opinion was further backed by the systematic interpretation, indicating that the position of the clause within the BIT does not suggest such a broad content and importance of the clause.[26] This reasoning was followed in a number of cases, including *Joy Mining v. Egypt*,[27] *Salini v. Jordan*,[28] *El Paso v. Argentina*,[29] and *Pan American v Argentina/BP Energy Joint Decision*.[30]

However, the tribunal in *SGS v. Philippines* reached a different conclusion. The BIT clause here stated "each Contracting Party shall observe any obligation it has assumed with regard to specific investments in its territory by investors of the other Contracting Party." The Tribunal concluded, basically, that the clause "is what it says" and that the tribunal has jurisdiction over contractual disputes. Eventually, however, it did not exercise its jurisdiction and suspended the proceedings indefinitely until the domestic courts in Philippines (which had jurisdiction according to the contract) deal with the dispute.[31] *SGS v. Philippines* reasoning was also followed in a number of cases, such as *Sempra v. Argentina*, [32] *Noble Ventures v. Romania*,[33] *LG v. Argentina*,[34] and *Continental Casualty v. Argentina*.[35]

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[26] *See* K. Yannaca Small, 485.

[27] *Joy Mining v. Egypt, supra* note 17.

[28] *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Hashemite Kingdom of Jordan,* ICSID Case No. ARB/02/13, Decision on Jurisdiction (November 29, 2004), *Internation al Legal Materials* 44/2005, 569 *et seq.*

[29] *El Paso Energy International Company v. Argentine Republic,* ICSID Case No. ARB/03/15, Decision on Jurisdiction (April 27, 2006), *ICSID Review* 21/2006, 488 *et seq.*

[30] *Pan American Energy LLC and BP Argentina Exploration Company v. Argen tine Republic,* ICSID Case No. ARB/03/13 and *BP America Production Company and others v. Argentine Republic,* ICSID Case No. ARB/04/8, Joint Decision on Preliminary Objections (July 27, 2006), *available at* http://italaw.com, accessed 23 September 2011.

[31] For the distinction between jurisdiction and admissibility of disputes see G. Zeiler, "Jurisdiction, Competence, and Admissibility of Claims in ICSID Arbitration Pro ceedings"*, International Investment Law for the 21st Century: Essays in Honour of Chris toph Schreuer* (eds. August Reinisch et al.), Oxford University Press, Oxford 2009.

[32] *Sempra Energy International v. Argentine Republic,* ICSID Case No. ARB/02/16, Decision on Jurisdiction (May 11, 2005), *available at* http://icsid.worldbank.org, accessed 23 September 2011.

[33] *Noble Ventures, Inc. v. Romania,* ICSID Case No. ARB/01/11, Award (October 12, 2005), *available at* http://italaw.com, accessed 23 September 2011.

[34] *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic,* ICSID Case No. ARB/02/1, Decision on Liability (October 3, 2006) ICSID Review 21/2006, 203 *et seq*.

[35] *Continental Casualty Company v. Argentine Republic*, ICSID Case No. ARB/03/9, Award (September 5, 2008), *available at* http://italaw.com, accessed 23 Sep tember 2011.

In consequence, this led to two branches of divergent jurisprudence, which can be characterized as taking a "narrow" and a "wide" approach.[36] Both approaches warrant a closer look. Those in favour of a narrow approach emphasize the need to be very careful in widening the scope of treaty jurisdiction based on another clause and not the jurisdiction clause itself. Umbrella clauses can put a host State in a very precarious position in addition to introducing a grey area into a public-private dispute distinction.[37] In dealing with these clauses, tribunals should, as has been already observed in jurisprudence, exert restraint and careful balancing. In the words of *El Paso* tribunal, "(...)far-reaching consequences of a broad interpretation of the so-called umbrella clauses, quite destructive of the distinction between national legal orders and the international legal order, have been well understood and clearly explained(...)".[38]

In addition, it can be said that the situation could be complicated by the interplay with a Most-Favoured-Nation (MFN) clause, possibly transposing the umbrella clause to all BITs containing the MFN clause despite not having the umbrella clause themselves. This multiplies the number of contracts in which a foreign investor could assert treaty jurisdiction for contractual breaches.[39] It cannot be automatically assumed that this would be the typical intention of a host State. In the author's opinion, the opposite presumption (narrowing of the jurisdiction) is what seems as a more plausible typical intention.

However, the arguments for a wide approach are quite strong too. Most importantly, it is not clear what would be the purpose of umbrella clauses if not exactly to extend the jurisdiction. Granting a wide consent to arbitration by a State is not something unheard of or starkly unusual.[40] If offering wider protection to a foreign investor is seen as a primary goal, then a wider approach can be seen as better in achieving it. As the *Sempra* tribunal observed, "[t]he fact that the Treaty also includes the specific guarantee of a general 'umbrella clause' (...) creates an even closer link between the contract, the context of the investment and the Treaty."[41] Generally, it does seem that the wide approach is currently the preferred one in scholarly writings.[42]

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[36] *See* K. Yannaca Small, 488, 490.

[37] *See* G. Van Harten, 388.

[38] *El Paso Energy v. Argentina*, 82.

[39] More on this subject: S.W. Schill, "International Investment Law: Emergence of a Multilateral System of Investment Protection on Bilateral Grounds", *Trade, Law and Development* 2/2010, 71 73.

[40] For example, domestic legislation can also allow for such jurisdiction. See S. Alexandrov, 331 332.

[41] *Sempra Energy v. Argentina,* 101.

[42] J. Wong, "Umbrella Clauses in Bilateral Investment Treaties: Of Breaches of Contract, Treaty Violations, and the Divide between Developing and Developed Countries

What is the right approach? As is so often the case, there is no straightforward answer or hard and fast rule. It must be understood that "the" umbrella clause does not exist, as the wording of different clauses varies significantly.[43] Accordingly, interpretation of a particular clause on a case by case basis is of the utmost importance. The host State is, of course, free to widen the scope of treaty jurisdiction as much as it wants. What is highly preferable is that such widening is unambiguously clear from the BIT. Thus, tribunals should be careful when interpreting broad and rather ambiguous clauses which require, for example, maintaining of an "adequate legal framework" for the protection of investments.[44] Such general and broad wording might indicate something akin to a standard of treatment, instead of indicating consent to arbitration. Also, despite widespread opposing opinions, there might be persuasive alternative explanations for the meaning of the umbrella clause even if its wording might seem to indicate extension of treaty jurisdiction to contractual breaches.

For instance, it has been suggested that an umbrella clause might have a substantive aspect in the sense that it is a modified version of a stabilization clause.[45] Furthermore, the wording of a clause calling for observance of obligations towards an investment might actually mean that the State is simply extending the treaty dispute resolution to any obligation it has acquired *alongside* the BIT, but not contractually with a particular foreign investor. This could include any provision of national legislation, or even a proclamation of the host State that would seem to imply a certain obligation towards investors.[46] Although the doctrine suggests that this expansion of jurisdiction to obligations assumed outside the BIT is an additional function of the umbrella clause (in addition to expansion of jurisdiction to contractual disputes), in the author's opinion there is no reason why this function could not actually be the sole one.

Of course, the main aim of the tribunal should always be the discovery of what the contracting States really intended. The tribunal should primarily remain committed to the discovery of that intent, including recourse to the history of the particular BIT provision and preceding negotiations.[47] However, if faced with a hard case that can legitimately go either way, the tribunal should, in the author's opinion, decline treaty jurisdiction. It should be borne in mind that the issue of interpretation of um-

in Foreign Investment Disputes", *George Mason Law Review* 14/2006, 164. *See also* C. McLachlan, L. Shore, M. Weiniger, 115.

[43] J. Crawford, "Treaty and Contract in Investment Arbitration", *Arbitration International* 24/2008, 355.

[44] *See Salini v. Jordan*, 66.

[45] *See* C. McLachlan, L. Shore, M. Weiniger, 116 117.

[46] *See* K. Yannaca Small, 497.

[47] Vienna Convention on the Law of Treaties, May 22, 1969, 1155 U.N.T.S. 331 (entered into force Jan. 27, 1980) art. 32.

brella clauses is actually one more aspect of the long standing conflict between the interests of developed and developing countries.[48] Some authors even deem investment law as a whole to be a relic of imperialistic policies of great powers.[49]

In general, maintaining the balance of interests of investors and host States through sensible interpretation is thus of key importance. Overprotection of investors could seriously impede the whole investment disputes settlement system by causing a backlash against it by the host States. Such potential consequences seem to suggest that when a State opposes the wide approach and there is no persuasive evidence to the contrary, the old Roman law maxim *in dubio pro reo* offers the right solution.

4. CONCLUSION

It is not difficult to notice that in matters of large importance for establishing a jurisdiction of an arbitral tribunal in investment arbitration there is no unified stance either in jurisprudence or in doctrine. This divergence, especially in ICSID jurisprudence, is a reason for serious concern.

Currently, the decision on jurisdiction of an ICSID tribunal is more likely to be predicted by the analysis of the composition of the arbitral tribunal (and by looking to which strand of jurisprudence particular arbitrators adhere to) than by the analysis of legal principles. This, of course, calls for reform aimed at achieving convergence.

One should be aware, however, that the lack of formal stare decisis doctrine in ICSID arbitration might be an obstacle to ever achieving a totally unified approach. However, with the attitude that was exhibited, for example, by the *Bayindir* and *Saba Fakes* tribunals, the homogeneity of case law can be largely achieved. As stated in *Saba Fakes*, "(...)unless there are compelling reasons to the contrary, it [tribunal] ought to follow solutions established in a series of consistent cases that are comparable to the case at hand, subject to the specificity of the treaty under consideration and the circumstances of the case."[50]

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[48] *See* P.M. Blyschak, "State Consent, Investor Interests and the Future of Invest ment Arbitration: Reanalyzing the Jurisdiction of Investor State Tribunals in Hard Cases"*, Asper Review of International Business and Trade Law* 9/2009, 99 101 *et seq*.

[49] For example, K. Miles, "International Investment Law: Origins, Imperialism and Conceptualizing the Environment"*, Colorado Journal of International Environmental Law and Policy* 21/2010, 1.

[50] *Saba Fakes v. Turkey*, ICSID Case No. ARB/07/20, Award (July 14, 2009), 96, *available at* http://italaw.com, accessed 23 September 2011.

While achieving uniformity of practice through introducing binding precedents is hardly practically feasible, or even desirable, ICSID tribunals should be aware of their role in remedying the current situation of divergence. Similar thoughts have been expressed elsewhere in doctrinal writings.[51]

In that regard, it is the author's opinion that when dealing with investor-State contracts some solutions can be distilled from the previous discussion and that these general guiding principles can be of assistance for the tribunals, both ICSID and non-ICSID ones.

Firstly, breaches of contract and breaches of a BIT should be kept distinct as much as possible as to prevent uncertainty and/or unwelcome overflow of litigation. The tribunals should be quick to sanction any attempt to confuse these two in order to obtain BIT jurisdiction.

Secondly, States are free to widen their consent to investment arbitration to all situations they want, but should aim to express this in a BIT as unambiguously as possible. Another point of interest for a host State would be how to limit a potential default expansion of consent to arbitrate through MFN clauses.

Thirdly, there can be no uniform interpretation of "umbrella" clauses, as they differ in wording and each clause necessarily deserves its own interpretation. In a seemingly irresolvable case of doubt whether the clause grants jurisdiction to deal with contractual breaches, the tribunal should decline it as this is more justified from a legal viewpoint and is important for keeping the balance of the investment law system.

It is, of course, not easy to achieve the observance of these guidelines in practice. But it is something to be aimed for. It is the author's opinion that application of the above guidelines would promote fair, balanced and reasonably predictable outcomes in deciding various issues that come before investment arbitration tribunals. And such outcomes would increase the protection of both legal and economic interests of investors and host States.

[51] See, for example, T.H. Cheng, "Precedent and Control in Investment Treaty Arbitration", *Fordham International Law Journal* 30/2006 2007, 1016.

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If there are more than three authors, only the first name should be cited, followed by abbreviation *et alia* (*et al.*) in verso.

Example: L. Favoreu *et al*., *Droit constitutionnel*, Dalloz, Paris 1999.

4. Repeated citations to the same author should include only the first letter of his or her name, last name and the number of the page.

Example: J. Raz, 65.

4.1. If two or more references to the same author are cited, the year of publication should be provided in brackets. If two or more references to the same author published in the same year are cited, these should be distinguished by adding a,b,c, etc. after the year:

Example: W. Kymlicka, (1988a), 182.

5. If more than one page is cited from a text and they are specified, they should be separated by a dash, followed by a period. If more than one page is cited from a text, but they are not specifically stated, after the number which notes the first page and should be specified "etc." with a period at the end.

Example: H.L.A. Hart, 238–276.

Example: H.L.A. Hart, 244 etc.

6. If the same page of the same source was cited in the preceding footnote, the Latin abbreviation for *Ibidem* should be used, in verso, followed by a period.

Example: *Ibid.*

6.1. If the same source (but *not* the same page) was cited in the preceding footnote, the Latin abbreviation for *Ibidem* should be used, in verso, followed by the page number and a period.

Example: *Ibid.*, 69.

7. Statutes and other regulations should be provided with a complete title in recto, followed by the name of the official publication (e.g. official gazette) in verso, and then the number (volume) and year of publication in recto. In case of repeated citations, an acronym should be provided on the first mention of a given statute or other regulation.

Example: Personal Data Protection Act, *Official Gazette of the Republic of Serbia*, No. 97/08.

7.1. If the statute has been changed and supplemented, numbers and years should be given in a successive order of publishing changes and additions.

Example: Criminal Procedure Act, *Official Gazette of the Republic of Ser bia*, No. 58/04, 85/05 and 115/05.

8. Articles of the cited statutes and regulations should be denoted as follows:

Example: Article 5 (1) (3); Article 4–12.

9. Citation of court decisions should contain the most complete information possible (category and number of decision, date of decision, the publication in which it was published).

10. Latin and other foreign words and phrases as well as Internet addresses should be written in verso.

11. Citations of the web pages, websites or e-books should include the title of the text, source address (URL) and the date most recently accessed.

Example: European Commission for Democracy through Law, Opinion on the Constitution of Serbia, *http://www.venice.coe.int/docs/2007/CDL AD(2007)004 e.asp,* last visited 24 May 2007.

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