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LEGAL RELATION BETWEEN THE SHAREHOLDERS AND THE MANAGERS IN SOUTH-EASTERN EUROPEAN COUNTRIES AS A COMPETITIVENESS CONDITIONS

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***Abstract**: Company laws in the Region of SEE do not have a long history, due to they all have been enacted after the fall of the Berlin Wall. The fact that almost all Central-Eastern European countries passed some sort of corporate governance codes doesn't change this reality. In Serbia the codification of commercial law started under difficult professional circumstances. Legal system had shown up contradictory trends of development despite the indisputably positive tendencies. Imperative for CEE countries definitely was to implement known company law principles in own acts. In that field the impact of European Union was very available. Corporate governance as the main part of company law plays very important role in management organization of every business association. There are a few legal acts which define some elements of corporate governance, especially regarding the role of main actors – shareholders and directors. Balance of power in a company based on three critical actors: shareholders, management and the board of directors. The negotiations about joining the EU determine, in fact, more or less established procedures, standards and other preconditions that a candidate country has to fulfill in order to join it, including all elements on company rule, as well as the companies' competitiveness.*

***Key words:** company, shareholder, director, liability, competition*

1. Introduction

In the 20th century the usually pattern of the company management was the broad notion that control of a company resides in the hands of the

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individual or group who have the power to select the board of directors. It is in 'management control' that the kernel of their thesis resided. There are also different theories about corporations' registration and the role of their stakeholders. Incorporation by registration was introduced in 1844. The corporate entity principle was firmly settled at the end of the 19th century in the Salomon case. Incorporation gives the company legal personality, separate from its members, with the result that a company may own property, sue and be sued in its own corporate name. However, it seems that almost exactly 100 years after Salomon was decided, the courts may have settled down to the idea that it has to be followed, unless the situation can be brought within the 'facade' test. It is likely that in future cases judges will find themselves focusing on what it is to mean.

Company laws in the Region of SEE do not have a long history, due to they all have been enacted after the fall of the Berlin Wall. The fact that almost all Central-Eastern European countries passed some sort of corporate governance codes doesn't change this reality.[1]

In Serbia the codification of commercial law started under difficult professional circumstances. Legal system had shown up contradictory trends of development despite the indisputably positive tendencies, like in all former socialist countries. In Serbia there was specific problem about social ownership and no clear answer even to the simple question of who was (and still is) the subject of that kind of ownership. The result of social ownership was the new way of enterprises' governing – self-governing.

Harmonization of law, particularly company law in mentioned countries is one of the competitiveness conditions. Defining the institute 'piercing the veil' definitely makes better position at the market for companies established in countries which laws recognize it.

2. Harmonization the laws of SEE countries in the relation with European Union rules

One of the goals set to the European Economic Community in the Treaties of Rome under which it was established, was the "harmonization of laws and regulations to the extent necessary for successful operation of the common market".[2] The establishment and operation of the common market largely depends on an adequate law, including contract and company law.

[1] The Region of SEE involves countries of West Balcan and Hungary, Romania, Bulgaria, Greece, Albania (in the author's focus are Srbian, Croatian, FYROM and Hungarian rules); on the other hand, CEE countries is wider concept

[2] Article 3.h. of the Treaty Establishing the European Economic Community

The provisions of which should provide for the equality of members of the community, free trade and free movement of people, services and capital, the harmonization of national legislations of the member states were set as a goal parallel to the economic ones. In that respect, the EEC and subsequently the European Community and the European Union, should be looked upon not only as an economic integration, which is certainly is, but also as an effort made towards creating a unified legal system.[11, pg. 260-263] In that system the community subjects are not only states, but also individuals as consumers increasingly.

The community law is created and applied in the framework of three communities: European (Economic) Community, European Coal and Steel Community and European Atomic Energy Community. The entity definitely created as a special organization. Also, it comprised for a long time mostly regulations of public law nature. Economic and political integration process was going on to the Community's/Union's goals, moving from a "union of states" into a "federal state", in a form of European Union. Europeanization of law, particular company law, means a process of unification or harmonization based on the acceptance and application of common standards by official institutions, first in the European Union member states and then in other European states. Harmonization should be based on adjustment of regulations to the extent necessary for achievement of the desired goal by applying them. Also according Hopt, unification is conducive to the achievement of full uniformity of regulations, which in turn leads to the creation of a unified legal system.[7, pg.34] The EC has pursued a wide-ranging programme of harmonization. The provisions of the EC Treaty on the freedom of establishment of companies have given rise to several important judgments by the ECJ. One of final steps was made after many years of negotiation through a European Company Statute in 2001. European Commission has shown very strong intend on improvement a field of Company law and modernize existing directives, as well as adopt of several measures that have been in the pipeline for some time. It has been noted the intends to take steps by European Commission to take steps to improve corporate governance in the EU promoting proposals of directives which will require greater disclosure and introduce communication with shareholders and institutional investors.[12, pg.19-26] The Commission intends to legislative to give all listed companies the choice between the one-tier and two-tier board system. There are also recommended some solutions on the role of non-executive directors and directors' remunerations.

Obviously, one of the fundamental objectives of the European Union is to enable the free movement of persons around the Single Market. This includes the right for nationals of a Member State to establish themselves in another Member State, as well as this right extended to companies (articles 43 and 48 EC).[3]

Generally speaking, companies formed in the EU entitled to move around the internal market in the same way as individuals. Mentioned activity could be done in two different ways – so-called primary, and secondary establishment. A primary establishment considers setting-up in another Member State by moving the company's registered office, but secondary establishment means setting-up of an agency, branch or a subsidiary formed under the laws of the host Member State.

But, a fundamental problem could be that a company formed and registered in a particular Member State will only be deemed to have legal capacity and be recognized as a separate legal entity in accordance with the laws of that State. One of the solutions for evidenced problems was an attempt made in 1968. Then six Member States tried to enable companies to move freely around the European Union as the community (Belgium, France, Germany, Italy, Luxembourg and the Netherlands).[4] The main goal is to provide mutual recognition of companies with a Convention on the Mutual Recognition of Companies. But, Mentioned Convention has never entered into force, due to the Netherlands didn't it ratify. European Union company law is an area where you can see serious steps in order to improve a process of harmonization. The companies as legal entities are significant for all member States and their habitants. Particular attempt made in 2001 with the adoption of the Statute on a European Company, as well as a proposal for a Fourteenth Directive on the cross-border transfer of a company's registered office in 2004.

Comparing two ways of setting-up the companies and applicable law in different states it could be noted two doctrines. Namely, there are the *incorporation doctrine* and the *real seat doctrine*. Definitely, the Member States don't follow the same principles in order to determine the law applicable to a company law.[5, pg.353] The incorporate doctrine is used, for

[3] Article 43 provides follows: Restrictions on freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. And Article 48: Companies formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall be treated in the same way as natural persons who are nationals of Member States

[4] Article 293 EC provides a legal basis for Member States to negotiate to secure the mutual recognition of companies and the retention of their legal personality in the event of a transfer of their seat from one Member State to another

example, in Denmark, Finland, Ireland, the Netherlands, Sweden, and UK. That doctrine could be determined as principle uses the registered office as the relevant criterion. It means that the company will be governed by the law of its country of incorporation. Thus, the company's legal personality would depend on the position as it obtains in the jurisdiction where its registered office is based, even if its head office was based in another Member State.

3. Development of the company laws in the CEE countries (including Region SEE)

Company laws in the region don't have a long history. All of them were adopted after the fall of the Berlin Wall. Almost all Central and Eastern European countries passed some sort of corporate governance codes. After more than couple decades of changes, a new process began. Privatization in all CEE countries was, undoubtedly, the biggest of its kind in the history. That process was one of the different significance comparing with the same in the other part of the world. The socialist regimes in CEE for around 45 years left deep traces in the legal and economic environment. This is one of the reasons why the way from plan to market appeared long. The fact is that there were no worthwhile historical models for privatization, but on the other side the managers of privatized economic entities lacked basic knowledge in modern management.

Privatization targeted different goals, for example, political, social, legal, and economic.[13, pg. 151] In different countries the goals had different priority: creating support for introduction of market economy in Russian Federation, cutting the links of companies from the state in Czech Republic, transformation the social ownership in the other forms in Serbia, raising government revenues in Hungary. The ways of privatization were differ from country to country. Sale of companies to outsiders was the most frequent model, but also insider buyouts, such as management or employees, as well as the privatization through vouchers have been used. Obviously, under these circumstances the corruption was not rare phenomena, perhaps in all CEE countries.

Imperative for CEE countries definitely was to implement known company law principles in own acts. In that field the impact of European Union was very available. CEE countries, including SEE countries, should follow the European way towards the market economy. Essentially, all named countries in the region must pay close attention to what goes in the realms of law in the EU. From the point of view of the role of the EU rules, the countries should transform own company laws in order to rise their harmonization with European law on the high level. It is particularly important in a field of responsibility the managers and shareholders as the main actors in corporations. Irrespective that not all CEE countries have become by now Member States of the EU, they must change reality regarding the liability of shareholders and managers.[6, pg.323] There are some questions where consensus is necessary, especially if the competitiveness of enterprises should be the main aim: payment by the corporation of individual obligations; absence of corporate records; fraudulent representation by corporate directors; use of the corporation to promote fraud, injustice, or illegalities, and where court must be active in order to indicate the piercing the corporate veil and provide security for all economic participants.

4. New elements in SEE countries company legislation (with focus on Serbia, Croatia, FYROM and Hungary)

Generally speaking, all SEE countries and their company laws had been influenced primarily by German and French law. The transition towards democracy policy and market economy, along aspiration for joining the EU, meant the beginning of the strong influence of European Union law. The result is the chose between one-tier and two-tier corporate governance system and employees' role in the company management, which should be done in all SEE countries. Also, it has been found some new institutes, such as *prokura* (a legal institute originating from German law, a form of agency agreement whereby the agent acquires the widest authorization for representation of a company).

All of company laws in SEE countries define modern business form. ***The Serbian*** Company Act of 2004 presents the primary source of company law today.[5] That Act has managed to totally abandon the regulation of socially-owned companies. It is also featured by its focus on the latest developments in the company laws of developed Western legal systems. The Serbian Act has opted for four forms of business associations: two partnerships (general and limited) and two companies (limited liability company and joint-stock company). It defines business associations according to the teleological criterion, i.e. *making of profits*, which makes a clear departure from the previous tradition of using the character of activities as the criterion. It also introduces the notion of *tripartition*, whereby the company presents the amalgamation of interests of the shareholders,

[5] Zakon o privrednim drustvima, enacted in 2004, published in the Official Gazette of the Republic of Serbia, No. 125/2004

employees and creditors. At last, it strengthens the notion of liability by upgrading the doctrine of piercing the corporate veil and by introducing concepts related to the liability of company directors, namely the duty of loyalty, prohibition of competition with the company, and avoidance of conflict of interests.

There are some important aspects of company law that are covered by other pieces of legislation: the Act on Privatization, the Act on Classification of Activities and of Register of Units of Classification, the Act on the Market for Securities and other Financial Instruments, the Bankruptcy Act, the Act on Protection of Competition, the Act on Foreign Investments. Regarding the field of corporate governance, the Serbian Securities Exchange Commission has published a document entitled *The Principles of Corporate Governance*, which is clearly not meant to represent the Serbian Code of Corporate Governance (rather it is an educational material). But, the Company Act in 2004 has incorporated some of the OECD Principles of Corporate Governance.[14] This could be induced from the increased protection of creditors' and minority shareholders' interests, which is noticeable in the new Company Act. The Company Act in 2004 for the first time includes duty of care and loyalty towards the company, conflict of interests and promotion of competition, and various forms of transparency and information to be provided.

Hungarian law belongs to the European continental legal system. In May 2004, Hungary has been a member of the European Union. Due to, the body of the *acquis communautaire* become a part of Hungarian law. As one of the youngest members of EU, Hungary is still in the learning phase of making legislation. The new Company act entered into force in July 2006, replacing Act CXLIV of 1997. This is the third company act in the past twenty years. It was promulgated to improve the competitiveness of Hungarian legal environment for doing business. One of the main tasks, among others, was to improve the flexibility and plausibility of the available Hungarian company forms, first of all, by enhancing the mechanisms for protection of creditors' rights, by introducing legal remedies that could be more easily used by shareholders and introducing new flexible systems for communication with authorities.

Definitely, Hungarian company law follows mostly the German model.[5, pg.353]_The company forms available under mentioned act are as follows: partnership, silent partnership, limited liability company, and joint-stock company. The fact whether shares of the latter and publicly listed, or privately held, shall be referred to in the name of the share company (public joint-stock company and closely held share company). The most frequent company forms provide the members with the protection of limited liability.[6] Members and shareholders in economic entities may not be held personally liable for the debts of their companies.[7]

Two countries have a status of candidates to join the EU – Former Yugoslavia Republic of Macedonia (FYROM) and Republic of Croatia.[8] The legal system of the ***FYROM*** is based on the civil law tradition. Obviously, the company area was the completely idiosyncratic law of the former Yugoslavia. Nowadays, the Company Law follows a combined French-German model. As the European integration of the FYROM is moving ahead the influence of the European Union law increases. The first company act of FYROM was passed in 1996. But, that act was an attempt to reform the inherited Yugoslav system. In 2004 FYROM enacted its second transitory Company act. This act is trying to involve full process of harmonization Macedonian legal system with the EU law. For example, the Company act incorporates following EU directives: the First, Second, Third, Sixth, Eleventh, and Twelfth. It means that in the Macedonian legal system are involved the elements concerning: the requirements for publishing information about joint-stock and limited liability companies as well as partnerships limited by shares, undertaken on behalf of companies, maintaining and changing the registered capital, est. There are defined well-known forms of companies: limited partnership, general partnership, limited liability company, joint-stock company, as well as partnerships limited by shares, economic interest groupings, and silent partnership.[1, pg.127]

On the other side, corporate governance is developing on different way. Various codes of best practices and principles have been developed during the last decade around the world to improve the standards belong to this area. There is currently no code of corporate governance or similar set of best practice recommendations in FYROM. The Macedonian Stock Exchange has been very active in establishing corporate governance rules, but finally version is still missing. The National Bank of FYROM was the first institution that made a step forward so far. It gave detailed descriptions and guidance on the corporate governance of banks and explains in some

[6] Owners of the company are termed 'members' in Hungarian company law in connection with all the company forms other than in case of share companies, where the term 'shareholder' is used

[7] The other cases of different levels of liability will be discussed in the part of piercing the corporate veil

[8] FYROM and Croatia were the parts of Yugoslavia. FYROM is the south neighbor of Serbia, Croatia is on its west side, and Hungary is on north of Serbia. All named countries belong to south-east Europe; Serbia, FYROM and Croatia are the part of Balkan Peninsula

details the functions of board committees, their role and expected results from their activities. The corporate governance system should also be a combination of good company legislation, existence of an independent and professional court system, as well as a developed capital market.

Croatia, as FYROM, is the candidate country for joining to the EU. Croatia is a civil country. Its law of business associations is primarily regulated by the Law on Business Associations. It defines six different forms of business organizations: general partnership, silent (secret) partnership, limited partnership, stock companies, private limited liability companies, and economic interest groupings. By this Act are regulated also the groups, mergers and acquisitions, as well as splitting of companies. The majority of the business associations come into existence upon registration with the court register.

4.1. Shareholders – their rights in relation with the management

Corporate governance as the main part of company law plays very important role in management organization of every business association. There are a few legal acts which define some elements of corporate governance, especially regarding the role of main actors – shareholders and directors. The OECD Principles recommends the basic elements. They involve a set of relationship between management, following the principles such as: accountability, responsibility, transparency, and fairness. In order to focus on our topic it would be highlighted the responsibility of the stakeholders, first of all, the shareholders, and directors.

From the beginning corporate governance is characterized by the concept of 'the control' of the corporation. Berle and Means refer to a subgroup of shareholders who have the actual power of selecting the board of directors using the following ways: complete ownership of common stock, majority control, legal devices, minority control, and management control.[3, pg.xii] Actually, shareholders, management and the board of directors are three critical factors. They are the key of effective governance. Relations among these participants should be taken into account in order to be realized the concept of the corporate governance. According previous mentioned principles, they should work together as the system will be provided. Often, the relation between shareholders and the board could be in problems. Transparency and accountability are essentially missing in this relation. 'The exchange of information between these two players is poor, and shareholders, for various reasons, have failed to exert much influence over boards. In short, directors don't know what shareholders want, and shareholders don't know what directors are doing.'[18, pg.18]

The shareholders, as one of the main players in the corporate governance system, can provide own influence in managing the corporation. First of all, they do it through the board structure, for example to promote individuals as candidates for a board. The shareholders intend to ensure proper process leading to the selection of a candidate who meets the right sort of criteria rather than to undertake the selection themselves. Also, shareholders seek to satisfy themselves, due to make a balance of executive and non-executive directors. They are keen to see the appointment of senior independent directors who can be an additional point to turn to in trouble, especially when the concern is about the chairman. The other shareholders' role is in remuneration policy: first, a conflict of interest could arise when boards have the task of deciding the remuneration of directors who sit on these same boards, and shareholders as owners should help mitigate this conflict; second, remuneration is one f the incentives that will determine the approach taken by the management in driving the company ahead; and third, there is a general need to preserve the integrity of the system. Shareholders their own interest could have in a field of internal control, due to the obligations facing listed companies to confirm that boards have examined the effectiveness of their internal controls.

As understanding the governance has grown over the years, the shareholders have sought to codify own best practice. That act should include set out clearly the shareholders' policy on how they will discharge responsibilities, monitor for performance of investee companies and establish a dialogue with them where necessary, intervene where appropriate, evaluate the impact of their engagement, and report back to their clients or to beneficial owners.

Having regarding the shareholders' status, ***Hungarian Company Law*** defines that in its equity structure, the company should apply the 'one share - one vote' principle. The Managing Body should ensure that shareholders receive access to information in time to enable them to exercise their rights. It is suggested that an investor relations department is established to ensure ongoing communication with shareholders in order to comply with the provisions regarding transparency and disclosure, as well as the company's disclosure guidelines. If a shareholder has provided all the information and documents necessary for dividend payment, it is suggested that the company pays the dividend within 10 days. It is suggested that the company discloses its policy regarding anti-takeover devices to assure shareholders that these devices will not hinder a merger or acquisition of the company, if this serves the strategic interest of the company.[2, pg.61]

The Serbian Company Act, applying the same principles, amended the following shareholders' rights: each ordinary share gives to its holder the same rights as are held by each other holder under this Law, the Articles of Association and by-laws of the company and which rights particularly include:

1. The right to access to legal and other documents and information pertaining to and in possession of the company;
2. The right to participate in the shareholders' assembly;
3. The right to vote at the shareholders' assembly based on the principle that one share gives the right to one vote;
4. The right to receive dividends after any dividends payable pursuant to preferential rights of preferred shares have been paid in full;
5. The right to receive a distribution on liquidation of the company after the claims of creditors and holders of any preferred shares has been satisfied;
6. Preemptive rights to acquire newly-issued shares and other securities of the company; and
7. The right to receive distributions on shares in accordance with law.

Ordinary shares of a company may not be converted into preferred shares or other securities of the company.

4.2. Role of management and the board of directors

Balance of power in a company based on three critical actors: shareholders, management and the board of directors. Definitely each of these has important responsibilities of his own, as well as the key to effective governance. When they work together they provide a company success. But, when pieces of management system are missing or not functioning well, the system can become dangerously unbalanced.[10, pg. 88] In business practice a great deal of attention had been paid to the relationship between management and shareholders, and between management and the board, due to improving the flow of information between them and in mutual understanding.

The balanced activities of boards and directors could be complicated by the pressure on companies to demonstrate their commitment to corporate social responsibility (CSR).[9] The board has to take a balance between the requirements coming from CSR activists and the stakeholders.

In most countries the boards of private equity-owned companies are fundamentally different from the public boards. Depends on structure and the board's size its role can be viewed as a marginal, but also it could add value to company. Marginal role should be observed in contexts of largely active the executive team. In positive way, a board adds value on the following ways: it acts as a check on the executive team; it provides advice; and it improves the overall quality of the company's decision-making. Well-managed board, made up of independent people who work as a team, can make a valuable contribution to company's image and market position.

Under the ***Hungarian Company Law***, the executive officers or a board made up of executive officers shall conduct the management of the business association pursuant to the provisions governing the specific forms of business associations. For the purposes of this Act, ***'management'*** shall mean the passing of decisions other than those conferred by the memorandum of association under the competence of the supreme body or other company organ, and which are necessary in connection with the company's operations. The management of (public or private) limited companies shall be conducted by the Management Board, except where the powers of the Management Board are conferred under articles of association of private limited companies upon a single executive officer (general director). The articles of association of public limited companies may also contain provisions to tender management and supervisory functions upon the board of directors (public or private limited companies operated by the one-tier system). Such a (public or private) limited company shall have no supervisory board, and the members of the board of directors shall be treated as executive officers.

Unless an exemption is made in mentioned Act, the administrative duties of private limited companies is handled by the management body, consisting of minimum three and maximum eleven members, all natural persons. The management body shall elect its chairman from among its members.

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[9] What is CSR? This term can be defined in several different ways. Some companies adopted so-called triple bottom line reporting, covering the economic, social and environmental aspects of activities. Others have gone to demonstrate their commitments to the highest standards of ethical behavior. By company's acts directors should promote the success of the company and to have regard for the interests of customers, suppliers, the community and the environment

The Management Board shall exercise its rights and perform its duties as an independent body. The rules of procedure approved by the Management Board shall provide for the division of tasks and competence among the members of the Management Board.

The board of directors shall consist of minimum five and maximum eleven members, all natural persons, unless the articles of association provides otherwise with a view to employee participation. The board of directors shall elect its chairman from among its members. The articles of association may prescribe that the chairman of the board of directors be elected directly by the general meeting.

The majority of the board of directors shall be made up of independent persons, unless the articles of association prescribe a higher percentage. A board member shall not be considered independent, in particular, if:

a) An employee of the public limited company, or if a former employee for five years following the termination of such employment;
b) Providing services to the public limited company or its executive officers for consideration as an expert or other similar services;
c) A shareholder of the public limited company controlling at least thirty per cent of the votes, whether directly or indirectly, or is a close relative or a domestic spouse of such person;
d) A close relative of any - non-independent - executive officer or executive employee of the public limited company;
e) Entitled to receive financial benefits based on his board membership if the public limited company operates profitably, or receives any other form of remuneration from the company apart from the salary for his board membership, or from a company that is affiliated to the public limited company;
f) Engaged in a partnership with a non-independent member of the public limited company in another business association on the strength of which the non-independent members attains control;
g) An independent auditor of the public limited company, or an employee or partner of such auditor, for three years following the termination of such relationship;
h) An executive officer or executive employee of a business association, whose independent board member also holds an executive office in the public limited company.

The requirement for the majority of the board of directors to be made up of independent persons shall not apply if the public limited company is a controlled company belonging to a recognized group.

What are about the solutions offered by ***Serbian Company Law***? Closed joint stock company must have a single director or a board of directors. On the other side, an open joint stock company must have a board of directors.

The number of members of the ***board of directors*** of an open company shall be stated in the company's Articles of Association. The board of an open company shall have not less than three members and not more than 15 members.

All of the members of a company's board of directors:

1. shall be elected by the shareholders at each annual shareholders' assembly; and
2. may be elected by the shareholders at any extraordinary shareholder assembly which has been convened for that purpose.

In a listed open joint stock company a majority of the members of the board of directors shall be non-executive directors and, of them, at least two members shall be independent directors.

Nominators referred previously shall nominate at least three candidates for non-executive board positions. For purposes of the Law, "independent director" of a company means, as of any point in time, a director of a company who or whose family members either separately or together with him or each other, during the two preceding years:

- Was or were not an employee or employees of the company;
- Did not make to or receive from the company payments of more than 10,000 Euro or equivalent;
- Did not own more than a 10% stock or other ownership interest, directly or indirectly, in an entity that made to or received from the company payments of more than such amount;
- Did not act as a director or manager of an entity that made to or received from the company payments of more than such amount;
- Did not own directly or indirectly (including for this purpose ownership by any family member or related person) stock of the company representing more than 10% of the company's capital; and
- Was not an auditor for the company?

"Non-executive director" means a person who is not a member of the management body of the company.

What about the management body of a company under the Article 322 of Serbian Company Act?

An open joint stock company shall have a management body. A closed joint stock company may have a management body. A company's board of directors shall elect the members of the management body. The members of a management body may be called managing directors. A person may be both a member of the board of directors and the management body, but in an open company no more than half of the board of directors may be management body members.[13, pg.159]

The competence of the management body shall include implementation of decisions of the board of directors and all matters associated with management and operation of the current activities of the company except matters within the exclusive competence of the board of directors or the shareholders' assembly. The board of directors shall report to the shareholders on the following matters:

- Not less than once each year, on the intended business policy and other general matters regarding the future conduct of the company's business, including any deviations from previously-set goals and the reasons for such deviations;
- At each annual shareholders' assembly, on the profitability, economic condition and solvency of the company;
- Not less than every six months, on the state of the business, in particular revenues, and the condition of the company; and
- Promptly, on business transactions that may have a material impact on the company's profitability and solvency, so that the shareholders may be aware of such matters.

4.3. Legal Relation between the Shareholders and the Managers (Duties of directors and liability of the shareholders)

Modern company law is based on the premise of the separation of assets and liability between shareholders and the company. This means that the company is only liable for its own debts and that its assets are the basis of that liability. However, all legal systems are familiar with some exception to the principle of the limited liability of companies. There is the case of *in concreto* liability, such as guarantees, which is of contractual nature and it does not pose too many legal dilemmas. In case of groups of companies, sometimes is possible to establish *in abstracto* liability among the members of the group on a contractual basis. Modern company law also recognizes the concept of mandatory *in abstracto* liability.[15, pg. 85-89] This situation understands several possibilities: the cases of transformation the companies, such as mergers, divisions, and consolidations; all partnerships and limited partnerships, where some of the partners are always personally and severally liable for the debts of their partnership; cases of corporate veil piercing, where shareholders attempt to abuse the principle of distinct liability of the company to the detriment of the company and/or its creditors.

The crucial point of understanding the concept of limited liability and corporate veil piercing is the notion of legal personality and separation of assets. The legal personality of various business entities is the cornerstone of company law. The concept started gaining importance only in the colonial period, when the first joint-stock companies emerged. This period developed the postulate of limited liability: distinct juridical personality of companies from the shareholders and separation of assets. But, what could be the problem? People who had money didn't want to run the business on their own, invested into a company, due to company is separate legal entity. On the other side, they got a share profit. The company is the one that runs the business; it is responsible for the success or failure of the business, not the investors. The investors have only one obligation – to pay their contribution to the company. The company has its own assets, which is totally separated from the investors' assets.

5. Legal institute 'piercing the veil' under SEE rules as a competitive advantage

Translation law, where the legal system of SEE countries belong, is often 'fluid' and it is simply impossible to state with desirable specificity what is exactly the law?[9, pg. 20] This is the logical consequence of two opposing circumstances: the undeniably considerable gaps existing in SEE countries legal systems and, on the other side, the pressure imposed on local courts. The legal institute called 'piercing the corporate veil' and potential liability of directors and shareholders should be in the focus of the process of solving more traditional dilemmas.

It became obvious that the concept of limited liability could be abused by the shareholders and the managers of the company. This is the reason why the theories accept the solution that there is the better way of escaping liability than hiding behind the juridical personality of a corporation. But, in that purpose, company would be liable even its shareholders fraudulently used the corporation in order to gain benefit for themselves or to deceit creditors. The practice gave us the dilemma what is the way of preserving all the benefits of legal personality, and at the same time, protecting creditors from fraudulent behavior.

The real answer on previous question offers the institute of piercing the corporate veil. Its roots it can be found in the Salomon v A.Salomon & Co. Ltd. Case (HL 1896) which introduced the piercing the corporate veil in England. Although the case upheld the notion of separate legal entity, it became the landmark decision of modern corporate law. Besides different old opinions, the new notions are based on the presumption of upholding the juridical personality, which is rebuttable in case of serious abuse. The concept of serious abuse was developed through the time and legislative developing, but today involves various institutes: whether the corporation was used as the alter ego of the shareholder, whether the corporation was inadequately capitalized, or whether the corporation was used to perpetrate a fraud or a wrong.[18, pg.698]

The contemporary company law in the Region of SEE doesn't have a long history. Actually, all company laws have been amended after the fall of the Berlin Wall.[10] Among the others implemented institutes, the forms of business organizations, the managing, bankruptcy, role of stakeholders, own significantly place has the issue of piercing the corporate veil. The basic question of most importance is whether the shareholders may be hold liable for the obligations of a corporation. This question could be dominant exactly in the region of SEE countries where privately held companies are numerous.[11] [6, pg.323] Actually, relationship between the limited liability and the piercing the veil produces the most confusing meaning in corporate law. When does the piercing the veil exactly exists? It could not be found the final end precise answer. But, almost all national legislation of SEE countries (and the others countries) amended the following cases: payment by the corporation of individual obligations; use of the corporation to promote fraud, injustice or illegalities; fraudulent representation by corporate directors, or failure to observe corporate formalities.

Note once more: the fact that shareholders are not personally liable for obligations of the companies may lead to a variety of abuses. During the privatization process in transition countries, due to the lack of marker

[10] But, for example, Serbia in a period of the end of XIX century had a very modern Joint-stock company act, 1896

[11] The study has been done a few years ago among the 1600 reported cases, with special point to the piercing the veil

economy culture and complete legal framework, companies might have been acquired through transactions that remotely resembled leveraged buyouts. Often it could be seen the situation that an important individual uses own political influence to force on the corporation's director to get the money out of the company in lawful and less lawful ways. But, piercing the veil is not specific of the countries in transition procedure. This legal institute is very well known in the countries with market economies. In Germany, the members of the board of management conclude generally a service contract with the company represented by the supervisory board. They may only be revoked for cause. In United Kingdom a member of the board of directors possesses a dual character – he is agent of, and trustee for the company, and as thus liable to the company for, inter alia, ultra vires acts, mala fides acts, and losses caused by culpable negligence. Also, director has no right to be paid for his trustee services, cannon pay to other director-agent, or make presents to each other out of the company's assets, unless authorized by company (its general meeting).

In ***Croatia*** the status of business organization is regulated by Company Act (basic text 1993, changes 1999, and 2003). By mentioned act the corporate veil and legal aspects of piercing the corporate veil is defined, also. The central notion of the piercing the veil doctrine is ***abuse***.[8, pg.35] Liability of otherwise not liable shareholders of a company to the creditors of that company may only occur if such a shareholder abuses the circumstance that it is not liable for the obligations of the company. The definition of abuse in a corporate veil is specified in comparing the same in the other area. The abuse is a specific sub-type of the general prohibition of abuse of rights as a general principle of civil and commercial law. According the article 10 of Company law, paragraph 4, it is currently 'presumed that the prerequisite of liability of a member of a business association is fulfilled, such as the piercing doctrine applies to members of business associations who are not personally liable for obligations of the business association due to the limited liability principle of law. They should be liable particular:

- If he uses the business associations to attain goal that would otherwise be prohibited to such a member, or
- If he uses the business association to cause damage to its creditors, or
- If, contrary to law, operates the assets of the business association as if they were his own, or,
- If he – for his benefit of some other person – diminishes the assets of the business association, even though he knew or ought to have

known that the business association would not be able to settle its obligations.

Who is exactly member of business association? This word doesn't limit the personal scope of its applicability merely to natural or legal person. It means that both, natural and legal persons are capable of being liable under the piercing doctrine. Under the Croatian Company law, definition of member includes any partner in a partnership or shareholder in joint-stock company or limited liability company. It could be concluded that this meaning of word 'member' is broader that the term 'shareholder'. Furthermore, the piercing doctrine is not limited only to shareholders having a 100% shareholding in the company. It means that members would be involved all they have in the given business association – 1% or 100% shareholding. Generally, the piercing doctrine is applicable solely to the shareholders of companies (joint-stock and closely-held limited liability companies) and limited partners in limited partnerships.

Then, all mentioned kinds of liability shareholders are direct shareholders, the persons that directly share in a company, as opposed to indirect shareholders who controls direct shareholders. Direct shareholders are personally liable for obligations of the company under the piercing the veil. The situation could be considered if there is a group of companies, for example the company-mother, company-daughter or company-sister. [4, pg.56] Consequently, the piercing doctrine cannot be directly applicable to such companies, but the provision of the Company Law should be modified to enable such piercing, if any abuse is proved.

On the end, what could be conclusion regarding the solutions needed by Croatian Company Law? Who are responsible for the company's obligation? Definitely, it is possible to argue that the shareholder's liability is of the same nature as the liability of the company itself. The reason for this view lies in the very nature of the piercing the corporate veil doctrine, due to it puts the shareholder into the same position as if there would be no corporate veil.[12]

The legal system of the ***FYROM*** is based on the civil law tradition. The Company Law follows a combined French-German model and it amended in 2004. At the moment FYROM is in position of country candidate for EU membership. It has the same status as Croatia. As this country accepts the modern principle of corporate governance, the

[12] On the other side, it is possible to argue that shareholder's liability is tortuous, because of arising only in case there is some culpability on the side of the shareholder involved in abuse

usefulness and the obvious advantages of the juridical entity, especially corporate, status and limited liability of juridical entities are unquestionable. The principle of the legal personality means that the company once incorporated, becomes a legal entity that is separate from its founders. This concept considers that the company is capable of holding rights and of being subject to obligations and liabilities which are not the same as those borne by its members. As it is previous mentioned, this statement means that the company as separate legal entity has its own assets and liabilities and it own creditors, while the shareholders or members are not liable for the obligations of the company.

The exceptions could be present in a case of prevention abuse in the practice. In that cases the courts have own role in sense that they may negate the principle of separate legal entity and limited liability of the company and pierce or lift the corporate veil. The liability would be affixed to the persons responsible for or benefiting from the operations of the company. Mentioned persons could be the shareholders or managers. Of course, as in Croatia or the other countries (we will see later), this situation is known as lifting the corporate veil. In FYROM, according the Company Law, it could be applied in following cases:

- Where a relation of agency is found to exist;
- Where the company is being used as a mechanism to avoid legal obligations;
- In the case of a group of companies, where the justice of the case requires that the companies within that group should be regarded as a single economic entity; and
- Where the corporate veil is lifted to ensure compliance with a court order.

Historical aspect of the piercing the corporate veil is the same as in other former Yugoslav republics. The changes after independence were necessary. The country had to develop modern legal system, including the area of company law, in order to attract foreign direct investments and promote the private business. These goals were followed by the Company Act 2004. According this Act, a company shall be liable for its debts with its entire property. Also, as the article 27(2) of the mentioned Act defines, partners in a general partnership and general partners in a limited partnership and a limited partnership by shares shall be jointly and severally liable for the company's debts with their entire property. On the other side, members in a limited liability company, shareholders in a joint-stock company, and limited partners in a limited partnership as well as limited partnership by shares, not be able for the debts of the company, unless otherwise determined by Law (article 27(3) Company Act, 2004).

Directly, the principle of piercing the veil in FYROM legislation was embedded in the provisions which regulate the special liability of members or shareholders in exactly defined situations. In these situations members and shareholders can be liable for the obligations of the company to which they belong. The examples of the piercing of the corporate veil should be precisely defined. FYROM's Company Act has done on the following way, it means that members or shareholders of the company shall be jointly and severally liable if they:

- Abuse the company's status as a legal person in order to carry out transactions and pursue objectives prohibited to them as individuals;
- Abused the company's status as a legal person in order to cause damage to its creditors;
- Used the company's assets as if they were their own, contrary to the law; or
- Decreased the company's assets for their own benefit or for the benefit of a third party when they were aware or should have been aware that the company was not capable of setting its liabilities to third parties.

Generally speaking, the Company act 2004 has a more detailed provision concerning the personal liability of the partners than the previous. The same could be said for the liability of the members of a limited liability company. These facts could be crucial to ensure investors to have a trust in FYROM legal system.

Hungary as a member of the EU developed legal system which is known as the European continental legal system. The newest Company act amended in 2006. It was promulgated to improve the 'competitiveness' of the Hungarian legal environment for doing business. It's the main characteristics are improving the flexibility and plausibility of the available company forms, first of all by enhancing the mechanisms for protection of creditors' rights, by introducing legal remedies that could be more easily used by shareholders and introducing new flexible system for communication with authorities.

Hungarian Company law follows mostly the German model. Well known company forms provide the members with the protection of limited liability. It means that members or shareholders of company as a legal entity may not be held personally liable for the debts of their companies. The Company act governs three situation of the piercing the corporate veil:

- First of them is applicable after the termination of the company, if the members liquidate their company in bad faith, leaving the creditors' claim unsatisfied;
- The second – may arise during the liquidation procedure, when the creditors may claim piercing of corporate veil during liquidation in bankruptcy. The necessary condition is that the controlling member or shareholder pursued a business policy that is detrimental to the controlled company;
- At last, the piercing the veil could be the administrative measure. The party acquiring shares in a company has a duty to report to the court of registration about the acquisition of control within thirty days. In case of delay in complying with mentioned obligation, the acquiring party is liable for the debts of the controlled company in case of liquidation of the controlled company.

The so-called third company act, Act IV of 2006 on the following way introduces the provisions regarding piercing the corporate veil:

- Members of unlimited companies are liable for creditors' claims without limitation;
- In case of winding up or liquidation of a company with limited liability, the members may be liable for claims of unsatisfied creditors of the company for a period of five years, up to the amount they received in the course of winding up the company;
- According the section 50 of Act IV of 2006, no protection of limited liability is due to a member/shareholder who abused it;
- Piercing of corporate veil provisions regarding abuse the limited liability apply to all individuals and legal entities irrespective of company forms.[13]

Definitely, the act from 2006, besides maintaining the piercing the veil provisions, introduces a series of new provisions regarding groups of companies, also serving the interests of creditors. The fact alone clearly indicates that major efforts are made in Hungary to ensure adequate protection of creditors.

[13] Section 52-64 Act IV of 2006 introduced the series of new provisions regarding control and consolidation, the principle, however remains the same: the limited member/shareholder looses the privilege of limited liability once he abuse it

What it could be said regarding the case of **Serbia and management loyalty?**

Modern company law is based on the premise of the separation of the assets and liability between the shareholders and the company. All defined forms of the business associations under Serbian Company Act have a main goal to provide a profit. But, it means that all participants have to be responsible for their activities. On the first place it should be the directors and shareholders duties. And the company has to be liable for its acts. In that case the institutes of duty of loyalty, as well as the piercing the corporate veil, are very important for the business realization, as well as for competitive market position.

By the Company Act, article 31, there are basic principles about the duties to a company. The persons owing duties to a company are:

1. General partners and limited partners in a general or limited partnership;
2. Persons who under this Law are controlling members of a limited liability company or controlling shareholders of a joint stock company;
3. Authorized representatives of a company;
4. Members of a board of directors, members of an management body, members of a supervisory board, members of an audit committee, and internal auditors of a limited liability company or a joint stock company;
5. Persons who are authorized by contract to exercise management authority in a company; and
6. Liquidators of a company.

All of mentioned persons are obligated to act in the interest of the company.

Directly, term ***'duty of loyalty'*** could be defined as a duty to act fairly and loyally to the company. Wider, it means that all persons who have this obligation and who have a personal interest in a matter, have a duty particularly not to use property of the company for their own needs, not to use confidential information of the company for the purpose of gaining personal profit, not to abuse their position in the company for the purpose of personal enrichment to the damage of the company, and not to take business opportunities of the company for personal purposes (hereinafter called the "duty of loyalty", as it is defined by article 33 of Serbian Company Act).

The duty involves the obligation for named persons to perform their functions in the named capacity good faith, with the care of a good businessman, and in the reasonable belief that they are acting in the company's best interests.[14]

Obviously, all modern national legislations pay attention on liability for company debts. In that context the company's status and its relationship with external partners is in direct connection with its liability for debts. On the other side, the shareholders and the members should liable for company debts, but only in cases defined by Law. Actually, modern company law, including Serbian Law, is characterized by the principle of the separation of assets between the shareholders and the company. This is imperative for the implementation of institute *duty of loyalty* and *piercing the corporate veil*. Basic principle is that the company is only liable for its own debts and its assets are the basis of that liability. Without this principle companies could not be competitive, particularly on the international market. But, there are the cases when it should be necessary to make some exceptions to the limited liability of company. For example, mentioned situation is possible when is of contractual nature and it does not pose too many legal dilemmas. Or, in a case of group of companies sometimes it could be set up liability among the members of the group on a contractual basis. Finally, the case of piercing the corporate veil is one of these cases, when the shareholders attempt to abuse the principle of distinct liability of the company to the detriment of the company and its creditors.[15]

The Serbian legislature made decision to rely on the corporate veil piercing solution from the successor countries of the former Yugoslavia.

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[14] A person who has acted in accordance with defined duties in making a business judgment will not be liable for damages to the company which may arise from such judgment

[15] The Salomon & Salomon Co. Ltd. case was the case which introduced the piercing the corporate veil in England, at the end of the 19th century. Aron Salomon, the owner of a boot and leather business, sold it to a company he formed in return for fully paid-up shares in it, allotted to him and members of his family. Salomon also received an acknowledgement of the company's indebtedness to him, in the form of secured debentures. These were later mortgaged to an outsider. Soon after formation, the company went into liquidation at the behest of unpaid trade creditors. The debentures, being secured by a charge on the company's assets ranked in priority to the trade creditors and so the mortgage to the outsider was paid off. About £1000 remained and Aron Salomon, now as unencumbered owner of the debentures, claimed this in priority to the trade creditors. He succeeded and also defeated their claim that he should be made to indemnify the company in respect of its debts. The House of Lords affirmed the principle that the company was a separate legal person from the controlling shareholder, and that it was not to be regarded as his agent

Slovenia was the first one which decided that.[16] As for the institute of veil piercing, the Serbian drafters have chosen a peculiar solution – enumeration of the situations that may lead to veil piercing.[17] The new Company Act 2004 in its article 15, under title *'Abuse of the Legal Entity'* stipulates that:

1. A limited partner of a limited partnership, a member of a limited liability company, and a shareholder of a joint stock company may be held personally liable for obligations of the company if he wrongfully abuses the company form for illegal or fraudulent purposes or treats the assets of the company as though they were his personal assets and as though the company did not exist.
2. In cases referred to in paragraph (1) of this Article, such person shall be jointly and severally liable with the company.
3. Liability referred to in paragraphs (1) and (2) of this Article shall be determined by a competent court taking into consideration of all the circumstances related to the wrongful abuse and particularly considering that the general principle of limited liability shall not apply in cases referred to in paragraph (1) of this Article.'

The new law has opted for a general definition of veil piercing in lieu of a detailed perspective-type of drafting. It remains to be seen whether this approach will bear more fruits than earlier one. The new general definition may extend even to some novel situations that may well emerge in practice. Obviously, the new Act's piercing rules do not extend to managers anymore (but, it couldn't be forgotten that the Act regulates institute 'duty of loyalty' in order to make obligation for managers). Also, this Act specifically stresses that the postulate of juridical personality is not

[16] The lack of experience with the institutions of market economy in all SEE countries after the World War II followed by no one model of the piercing the corporate veil doctrine. In Serbia there were so-called socially-owned enterprises – definitely the Yugoslav experiment. Even Serbia had modern legislation in XIX century: 1844 enacted Civil Code, 1860 Commercial Code, 1896 Code on joint-stock company; the period after the World War II was completely different. But, Serbia was the first country which started with economical reforms – 1989 and 1996 two version of Company Law, Law on foreign direct investments, Law on privatization, Law on free zones, est.

[17] The 1996 Company Act, article 54: 'Founders, shareholders, members of the management board and members of director's executive board are liable with all of their property for the debts of the company: 1) if the company was abused in order to achieve a goal which was prohibited for them as individuals; 2) if they abused the company to the detriment of their creditors; 3) if they, contrary to the law, used company property as their own; 4) if they knew or should have known that as the results of their acts, on one hand, the value of the property of the company will be diminished to their or somebody else's benefit and, on the other hand, that the company will not be able to fulfill its obligations towards third parties.'