LIABILITY OF MEMBERS FOR COMPANY OBLIGATIONS IN CASE ABUSES OF THE PRIVILEGE OF LIMITED LIABILITY

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Abstract: The principle of limited liability - limited liability for the company's obligations represents the fundamentals of the operations of modern capital companies. Nevertheless, in circumstances where globalization of the market of goods and services gets more and more important, there is room for the circumvention of the law, especially in the area of abuse of the principle of limited liability for company's obligations. The issue of piercing the corporate veil is an exception to the principle that the members of the company are not liable to the company's obligations, i.e. to respond only to the amount of the amount entered into the company. The purpose and goal of establishing this institute is primarily to prevent various forms of abuse in the business of companies. Piercing the corporate veil exists in all those cases when the limited partner, a member of a limited liability company and a shareholder, as well as the legal representative of that person if they are a legally incapable natural person, abuses the rule on limited liability for the company's obligations. The misuse of the right exists when the following persons: 1) use the company to achieve a goal that is otherwise prohibited to them; 2) use the company's property or dispose of it as if it were their personal property; 3) use the company or its property in order to harm the company's creditors and 4) in order to gain benefits for themselves or third parties reduce the company's property, even though they knew or had to know that the company will not be able to perform its obligations. The author will investigate the extent to which the institution of piercing the corporate veil and criminal liability of individual persons is normatively regulated within the national framework and the scope of case law.
Keywords: *piercing the corporate veil, company, responsibility of members, shareholder, misuse of the right, criminal liability of individual persons*

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INTRODUCTION

The expansive development of the capital market in the former SFRY, which was closed until the beginning of the 1990s (it was not familiar with modern business mechanisms), created conditions for performing a series of speculative transactions that were often on the verge of being illegitimate. The economy, which for the past twenty years has tried to some extent to present itself as transparent in terms of the rules of business, in practice has very often been contrary to the proclaimed principles of good business. Non-transparency of business, the need for quick earnings, underdeveloped control institutions, insufficiently developed legal regulations and case law created conditions for business malpractice. Having recognized the weaknesses of the legal system, the liable persons in a legal entity would undertake a range of frauds that would lead to abuse of rights. One of the common fraudulent behaviors is the abuse of the principle of limited liability of a company member – shareholders (liable only to the extent of capital that they invested in the company) for the company's liabilities. This type of fraudulent behavior is most present in a corporation, especially in a single form of business (single-member corporation), which is the most suitable form of disturbing the balance of gaining benefits.

DEVELOPMENT, ETYMOLOGY AND NOTION OF THE TERM PIERCING THE CORPORATE VEIL

Like most institutes of modern business, the institute of piercing the corporate veil originates from case law. The desire and need of the court to prevent: a) *fraud*, b) injustice, c) evasion of just responsibility, d) distortion or hiding of the truth or d) unjust raising of a defense, as actions in the company business, inevitably influenced the development of the institute of piercing the corporate veil (Barbić, 2008:292). Piercing the corporate veil evolution is experienced through case law in relation to the liability for obligations of a legal entity when its members abuse the fact that it is a company which is a separate legal entity (Barbić, 2008:292). The dominating understanding is that the origin of the institute of piercing the corporate veil is related to a precedent in the English law in the litigation *Salomon v Salomon & Co Ltd* [1896] UKHL 1 (16 November 1896), and one of the earliest cases of piercing the corporate veil in United States is *Booth v. Bunce* 33 N.Y. 139 (1865). Piercing the corporate veil refers to the judicially imposed exception to this principle by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's action as if it were the shareholder's own (Thompson, 1991:1036). The case law of the United States of America (*Berkey v. Third Avenue R. Co.*, 244 N.Y. 84, 155 N.E. 58 [1926], *Perpetual Real Estate Servs. Inc. v. Michaelson Props., Inc.* - 974 F.2d 545 [4th Cir. 1992] etc.) has gone the furthest in terms of elaborating the institute of piercing the corporate veil, for the reason of the relevant role that the corporate personality has played in the development of the infrastructure of the country (Micklethwait, & Wooldridge, 2003:57-78). In an empirical study about the piercing the corporate veil, Thompson, R., concluded that piercing of the corporate veil is one of the most litigated issues in Company law in the U.S. In his study, used a pool of 1,600 cases. He found that in 636 cases the veil had been pierced and that in 947 cases it had not. The 636 cases represent 40%, which can be considered a high figure if it is compared with other jurisdictions in which the veil is not frequently or never pierced (Thompson, 1991:1048-1050). Two decades after, Oh, P., refreshes this subject with a new study based on 2,908 cases and found that the veil had been pierced in 50% of the cases (Oh, 2010: 108). Dealing with the institute of piercing the corporate veil, the case law of the UK has greatly contributed to the development of: a) single economic unit theory;[2]

2 Single economic unit theory is based on the decision *Salomon v. Salomon* (1897) when the principle of

b) piercing of the corporate veil under the fraud exception[3] and c) reverse piercing.[4] Of importance is judgement in 2013, *Prest v Petrodel* (*Prest v Petrodel Resources Ltd & Ors* [2013] UKSC 34) the English Supreme Court clarified the law of piercing the corporate veil, and that for the reason that it is a growing number of cases, attempts were made to circumvent the separate personality and limited liability of companies. The Supreme Court even went so far as to call the existence of the doctrine into question altogether in VTB Capital (*VTB Capital Plc v Nutritek International Corp and others* [2013] UKSC 5). (Schall, 2016:549-550). After *VTB Capital* case, however, *Prest* apparently confirmed the existence of the doctrine, and the court made an effort to deliver the long missing rationale for piercing the veil by spelling out the "evasion principle" as opposed to the "concealment principle". (Schall, 2016:550).

The etymology of the term piercing the corporate veil has its source in the American legal and court terminology. The term "piercing the veil" was first coined by Wormser I. M. (Wormser, 1912:497). Term "piercing the corporate veil" (Thompson, 1991:1036) is most often used, while the terms "disregard the corporate entity" (Clark, 1986:37) and "misuse of corporate form" are used less frequently (Hackney & Benson, 1982:850). Unlike the American terminology, the term "lifting the corporate veil" is dominant in English legal terminology, while the term "looking behind the company" is used to a lesser extent. Although considered synonymous, in legal theory there are opinions that there is the essential difference between the terms piercing the corporate veil and lifting the corporate veil. Piercing the corporate veil is focused exclusively on the member's liability for the company's obligations in case of abuse of the limited liability concept, while lifting the corporate veil should be viewed in a much broader context, because it can explain any situation in which it is necessary to, for the purpose of determination of the member's legal liability for company's liabilities, look behind the corporate entity (Ramsay & Noakes, 2001:253-255). In the Serbian legal literature, for the reason of ignorance institute piercing the corporate veil, the terms were used "illusion of economic identity" (Law on Amendment to Company Law, Official Gazette of SFRY, 40/89) and "abuse of legal subjectivity" (Company Law, Official Gazette of RS, 125/04). Underdeveloped case law and business ethics, which started from the position that there is no separation of obligations (company = member), influenced the development of the view that the company is the only entity that should be responsible for the obligations to creditors. Only with the development of the company law, and especially when a more comprehensive view was of the way of operation of the company obtained and the possible abuse of the principle of limited liability of company members for the company's liabilities, did the modern Serbian legal and regulatory terminology start using the term piercing the corporate veil (Васиљевић, 2011:68).

In legal theory, there is no single position on the notion of the institute of piercing the corporate veil, but its consideration in both broad and narrow sense comes to the fore. In a broader sense, piercing the corporate veil includes all cases in which the legal relationship between the company' s creditors and its members is caused by the liability of the company, regardless of the legal nature of that relationship (Brnabić, 2010:14). Based on the stated position, the institute of piercing the corporate veil could include any type of liability of a member of the company that arose in connection with the obligations of the company. Unlike the term in a broader sense, piercing the corporate veil in a narrow sense does not represent anything other than the individual and unlimited liability of a member of the company due to abuse of the rule on limited liability for the obligations of the company. By applying the stated attitude, a member of a corporation is unlimitedly liable with its personal assets for the liabilities that the company has assumed in its own name. In this case, a member of a corporation is compared to

separation of legal personality and its members was established.

3 Fraud exception is a theory that considers the piercing the corporate veil a situation when the existence of certain companies is a already a fraudulent business.

4 Reverse piercing is characterized by a reverse conception, company liability for the obligations that, by nature of things, a member of the company should be liable for on the individual basis.

a member of a proprietorship and partnership that is liable for the company's liabilities with its entire assets, i.e. the creditor may collect receivables from a member of the company arising from the company. Following modern trends, maturing in the field of corporate law, the Serbian legislation has implemented the theory of piercing the corporate veil in a narrow sense (Company Law - CL, Official Gazette of RS, nos. 36/2011, 99/2011, 83/2014 – other law, 5/2015 and 44/2018).

BUSINESS PRINCIPLES OF CORPORATION AFFECTING IMPLEMENTATION OF THE INSTITUTE OF PIERCINGTHE CORPORATE VEIL

A company can be defined as a technique (legal form) of organizing a company by the founder (one or several) in order to make a profit (regularly) or achieve certain non-economic goals (exception), with some legal independence from the founders and subsequent members and shareholders and with some openness to the subsequent accession of other members and shareholders (Васиљевић, 2004:30). The common denominator, regardless of the form in which the company appears as a legal entity, is the existence of legal separation from the members of the company. Legal separation can have property and non-property effects (Васиљевић, 2011:67). Property effects of the legal personality of a legal entity are reflected primarily in the separation of the assets of the legal entity from its members (Armour & Hansmann & Kraakman, 2009:7-11). The company's liabilities are not liabilities of the members of the company as well (Васиљевић, 2004:30).

Companies can be classified into two large groups: a) proprietorship and partnership and b) corporation. Proprietorship and partnership are characterized by the dominant presence of a personal element - *intuiti personae* members of the company, which influences the fact that the company is founded on the basis of trust and acquaintance, and the members are liable with unlimited personal assets (unlimited liability) for the company's liabilities. Unlike proprietorship and partnership, corporation (company) is characterized by domination of interest of the capital (Васиљевић, 2004:30), rather than elements *intuiti personae* and therefore the company is liable for its commitments with its assets. The ability to form the personal substrate of the company (members of the company form the personal substrate), to make decisions in the name and on behalf of the company, the limited economic risk of members in the company's operations and the independence of the company, is one of the most important grounds for emergence of corporation (Bakst, 1996:323). The fact that the company members are not liable for the company's liabilities is counterbalanced by share capital as a guarantee that the company shall settle its liabilities to its creditors on its own. Creditors of corporation may request settlement of its receivables only from the company as its debtor (Davies, 2008:37-40).

The effect of dominance of capital interests is that operation of a corporation is based on two fundamental principles: a) legal independence and b) limited liability of company members. The principle of limited liability of company members is set out in the text below and also is important for this paper.

PRINCIPLE OF LIMITED LIABILITY OF COMPANY MEMBERS

The principle of non-liability or concept of limited liability of the company members originates from business practice and case law. Certain authors are of the opinion that the concept of limited liability of the company members first appeared in England, dating back to the 15th century, (Kempin, 1960:13) and being affirmed during the 17th century (Kessler, 1967:239). It became generally accepted only with the enactment of the Limited Liability Act (Limited Liability Act 1855 (18 & 19 Vict c 133). Unlike the English legal system, in continental Europe, the adoption of the *commercial code* established and proclaimed the concept of limited liability of members in the companies organized in the form of: French *Société Anonyme* (S.A),[5] the German *Gesellschaft mit beschränkter Haftung* (GMBH)[6] and the Spanish *Sociedad Anónima* (S.A)[7] (Navarro, 2013:25). Unlike Europe, the concept of limited liability of company members in the American law started developing as late as in the 19th century through the institute of double-liability (Macey & Miller:31).

However, it should be emphasized that the source of the concept of limited liability should not be sought primarily in law, but also in economics (Mendelson, 2002:1217-1219). The meaning of limited liability of members of a corporation is based on enabling the development of economic activities and economic growth, in order to legally encourage investors to participate in the market without being afraid for personal assets (Lattin, 1971:11-12).

The principle of separation of subjectivity, emphasized in the corporation, originates from the fact that the company as a legal entity is separated from its members (Barbić, 2008:291). The importance of the corporation being legally independent and the non-liability of the members of the company for the obligations of the company, represents one, if not the most important feature and advantage of the corporation over other forms of business. Unlike a proprietorship and partnership where the members are liable for the obligations of the company independently or jointly and severally with their personal assets, the principle of non-liability of the members of the company for the obligations of the corporation comes to the fore. The limit function enables the members of the company to have limited liability, i.e. to bear business risk only up to the amount of the subscribed or paid or unpaid contribution in the company (Easterbrook & Fischel, 1985:90). This principle disables creditors of the company to collect their receivables from the company also from the company members, i.e. company creditors are not and cannot be creditors of the company members.

The basic characteristic of the concept of limited liability of company members is manifested in the form of creating a legal veil of the company in relation to its creditors. Although the members of the company have a privilege of non-liability, it should be pointed out that they are obliged to behave in a certain way. In accordance with the fiduciary liabilities they have to the company, the company members must not abuse the principle of non-liability. Limited liability is a suitable ground for numerous abuses aimed at achieving the personal benefit of a company member, to the detriment of the interests of creditors. The concept of non-liability of a company member for the company's obligations, i.e. liability for business risk only, affects the creation of a sense of security of personal assets. Security that

5 The French *Société Anonyme* was introduced in the French *Code of Commerce* enacted in 1807. However, the attributes of legal personality and limited liability in addition to capital requirements where establishes in the *loi de mai de* 1863 and the reforms in 1867.

6 The German *Gesellschaft mit beschränkter Haftung* or limited liability company was introduced in Germany in 1892.

7 The concept of corporate personality and limited liability became subject of interest in 1869 and 1885 when reforms to the *Spanish code* of commerce were made.

personal assets cannot serve as assets for settling the company's creditors, i.e. that it is exempt from the potential claim of the company's creditors, can create a feeling in the members of the corporation that the company uses it for personal purposes (it is hidden behind the legal individuality of the company). The security of personal assets and the use of the company for personal purposes, where the members of the company hide behind the legal independence of the company, creates a feeling of absence of fear and apprehension of personal responsibility for relations with third parties (Barbić, 2008:291).

However, it should be pointed out that though members of the company can be relaxed due to the illusion of being non-liable for the company's liabilities with their personal assets, the protection of the personal assets is not absolute. The company's creditors may direct their claim also against the company members, thus settling their receivables from the personal assets of the company members (Јовановић, 1997:865-890). Then and in such circumstances we are talking about piercing the corporate veil or lifting the corporate veil. Piercing the corporate veil should be considered an exception from the privilege of the company members not being liable for the company's liabilities. If the privilege of limited liability is abused, or the company uses it in order to achieve goals that are not adequate to the reasons and policy of its foundation (Wormser, 1927:8) it is legitimate to pierce the corporate veil. Based on the above, it can be concluded that implementation of the institute of piercing the corporate veil is justified in the situation when the limited liability rule is abused. The doctrine of the prohibition of abuse of rights in the Serbian law is the basic principle that justifies the existence of the institute of piercing the corporate veil (Company Law, Official Gazette of RS, nos. 36/2011, 99/2011, 83/2014 – other law, 5/2015 and 44/2018). It can be concluded that the purpose of the establishment of the institute of piercing the corporate veil primarily refers to the: a) prevention of various forms of fraudulent behavior of members of the company and b) security for the company's creditors.

LEGAL NORMS OF THE REPUBLIC OF SERBIA COMPANY LAW

Following the trends of modern legislation in the field of corporate law of the Republic of Serbia, and in order to unify the legal framework, legal transplants are created and transplanted (Вотсон, 2000:58). The Republic of Serbia is no exception to the rule of non-implementation of legal transplants in its legal system, in this case Company Law. The institute of piercing the corporate veil as a legal transplant is implemented in the Company Law (CL, Official Gazette of RS, nos. 36/2011, 99/2011, 83/2014 – other law, 5/2015 and 44/2018).

Pursuant to the provisions of the Company Law, a limited partner, a member of a limited liability company and a shareholder, as well as the legal representative of that person if it is a legally incapable natural person,[8] is liable for the company's liabilities with its assets if it abuses the limited liability rule (CL, Official Gazette of RS, nos. 36/2011, 99/2011, 83/2014 – other law, 5/2015 and 44/2018). Definition the abuse of the limited liability rule for the company's liabilities is defined as a general basis for the implementation of the institute of piercing the corporate veil. It should be noted from the above definition that only those persons whose liabilities towards the company are limited to the amount of their contributions to the company are liable, i.e. responsible for business risk.

Exempli causa the legislator itemizes the cases of abuse of the limited liability rule by the company members, specifically when they: 1) use the company to achieve a goal that is otherwise prohibited; 2)

8 It should be noted that it is not considered that every legal representative is liable, but only the one who represents a legally incapable natural person who appears in the role of some of the mentioned persons.

use the company's assets or dispose of it as if it were their personal assets; 3) use the company or its assets in order to damage the company's creditors and 4) in order to gain benefits for themselves or third parties reduce the company's assets, even though they knew or had to know that the company will not be able to settle its liabilities (CL, Official Gazette of RS, nos. 36/2011, 99/2011, 83/2014 – other law, 5/2015 and 44/2018). In order to protect the interests of the creditor, and for the sake of legal certainty, the legislator stipulates a subjective and objective deadline within which the company's creditor can file a lawsuit to the competent court for piercing and abuse by the responsible person (persons liable for the company's liabilities to the amount of their contribution). Stipulation of the subjective deadline determines the creditor's interest in their receivables and their intention to collect them, i.e. the company's creditor may file a lawsuit against the responsible persons within six months from the moment of learning about the abuse (CL, Official Gazette of RS, nos. 36/2011, 99/2011, 83/2014 – other law, 5/2015 and 44/2018). It is important for the protection of the creditors' rights that they are given the opportunity to protect their interests also in the circumstances the claim against the company is not due. If the claim is not due at the moment of learning of the abuse, the creditor has the right to file a lawsuit for piercing the corporate veil and to prevent abuse, provided that the period of six months begins to run from the date of maturity of the claim (CL, Official Gazette of the RS, nos. 36/2011, 99/2011, 83/2014 – other law, 5/2015 and 44/2018). However, it should be emphasized that the possibility to protect the interests, although the claim is not due, is provided only under the condition that at the time of the abuse of the limited liability rule, the plaintiff had the status of a creditor to the company (Decision of the Commercial Appellate Court 5753/12 dated 03 April 2013). In addition to stipulating the subjective deadline, the legislator also stipulates the objective deadline in which the creditor exercises its rights. By stipulating the objective deadline, the creditors of the company are protected, may file a lawsuit no later than five years from the date of the abuse (CL, Official Gazette of the RS, nos. 36/2011, 99/2011, 83/2014 – other law, 5/2015 and 44/2018). Finally, by specifying the subject matter jurisdiction of commercial courts only conditions have been created for better implementation of the law in case of abuse of rights limited liability.

CRIMINAL LIABILITY

In addition to the liability of a company member with its personal assets in connection with piercing the corporate veil pursuant to the provisions of the Company Law, we can point out that the liability of a member for abuse of limited liability right may be criminal. Until the adoption of the Law on the Liability of Legal Entities for Criminal Offences - LLLECO (Law on the Liability of Legal Entities for Criminal Offences, Official Gazette of the RS, 97/2008), the criminal law regulations on the liability of legal entities (primarily companies) did not exist in the Republic of Serbia, and the only liability of a legal entity that existed primarily related to misdemeanors (Law on Misdemenaours, Official Gazette of the RS, nos. 65/2013 and 13/2016)[9] and economic offences that are a legal entity or the responsi-

9 A legal person shall be liable for a misdemeanour committed by an action or omission of due supervision of the management body or a responsible person or by an action of another person that, at the time when the misdemeanour was committed, was authorized to act in the name of the legal person. A legal person shall additionally be liable for a misdemeanour when: 1) the management body passes an unlawful decision or an order whereby committing misdemeanour is enabled or when the responsible person orders a person to commit a misdemeanour; 2) a natural person shall commit a misdemeanour due to an omission by the responsible person to supervise or control him/her. Under conditions referred to in paragraph 2 of this Article, a legal person may additionally be liable for a misdemeanour when: 1) the misdemeanour proceeding against the responsible person has been discontinued or when such person has been relieved from liability in compliance with the provisions of Article 250 of this Law; 2) there are legal or actual obstacles for determining liability of the responsible person with the legal person or where it cannot be determined who the responsible person is. LAW

ble person of a legal entity may be liable for an economic offence (Economic Offences Act, Official Gazette of SFRY nos. 4/77, 36/77 - cor., 14/85, 10/86 (edited text), 74/87, 57/89 and 3/90 and Official Gazette of FRY, nos. 27/92, 16/93, 31/93, 41/93, 50/93, 24/94, 28/96 and 64/2001 and Official Gazette of RS, 101/2005 – other law). The economic offence as one of the more complete and stricter types of liability in relation to misdemeanors committed by a legal entity is to sanction a violation of the legality of business in the field of economic and financial business. The legal regulation of the liability of legal entities for committed criminal offenses has made a significant step forward to more complete, thorough and comprehensive legal regulations. Although the adoption of the LLLECO can be seen as a success of the domestic legislator, it should be noted that the adoption of this law is not a voluntary legal regulation, but the result of obligations undertaken by concluding and ratifying international conventions (Recommendation No. R (88) 18, of the Committee of Ministers to Member States, Concerning Liability of Enterprises having Legal Personality for Offences Committed in the Exercise of their Activities) by the Republic of Serbia. The importance of LLLECO lies in the fact that it stipulates that a liable person (natural person) legally or de facto entrusted with a certain circle of tasks within a legal entity is considered liable, i.e. person that can be considered authorized to act on behalf of the legal entity (LLLECO, Official Gazette of the RS, 97/2008). Although the provisions of the law emphasize the liability of a legal entity, as a person having business ability and therefore a criminal offence can be attribute to it, natural persons who are the personal substrate of the company and who are in the category of authorized persons by law or internal documents (directors, management, proxy, legal representative...) whose decisions affect the creation of business policy may be subject to criminal liability for abuse. When determining which natural persons are to be considered liable, it is proclaimed that the liable person is considered to be a natural person legally or de facto entrusted with a certain circle of tasks in a legal entity, as well as a person who is authorized or can be considered authorized to act on behalf of the legal entity (LLLECO, Official Gazette of the RS, no. 97/2008). Any natural person in a legal entity who is de facto or legally assigned to perform certain tasks can be considered responsible. It should be noted that this is a *question facti* that is assessed in each case, whereby the internal regulations of the legal entity must be taken into account, and especially the fact that the liable persons authorized to act on behalf of the legal entity have entrusted them with certain tasks (Ilić, 2010:249). However, a special type of liability which has made a significant step forward in the field of liability of a natural person is: a) when a person within a legal entity (employee) without a legal basis is entrusted with performance of a certain task that he/she is not competent for, or b) when a person who does not have the status of an employed person is entrusted with the performance of certain tasks without a contractual relationship (Stojanović). Finally, it should be noted that the regulation of this type of liability of natural persons by the legislator has significantly expanded the basis of liability of legal entities for criminal offenses (Đurđević, 2005:45).

CONCLUSION

Striving to regulate the capital market, which was characterized by non-transparency of operations, the need for quick earnings, underdeveloped control institutions, insufficiently developed legal regulations and case law, the Republic of Serbia adopts and implements modern institutes in its legislation. One of the institutes that represents the acquis of modern corporate law and which regulates the liability of a member of the company in case of abuse of the rules on limited liability is piercing the

ON MISDEMEANOURS ' 9 The liability of a natural or responsible person with a legal person for a misdemeanour committed, for a criminal offence or for an economic offence shall not preclude the liability for misdemeanour of the legal person. – Art. 27, Law on Misdemenaours.

corporate veil. The institute piercing the corporate veil a legal transplant is implemented in the Companies Law, and the legislator exemplifies the cases when there is an abuse of the limited liability rules by a member of the company. In addition to the liability of a member of the company with personal property in connection with the breach of legal personality based on the provisions of the Companies Law, we can point out that the liability of a member for abuse of limited liability may be criminal. The significance of the criminal liability regulation is that it stipulates that the responsible person (natural person) who is legally or de facto entrusted with a certain range of activities in the legal entity, as well as the person who is authorized, or who can be considered authorized to acts on behalf of the legal entity, and has abused the tasks entrusted to it concerning the business of the company. It can be concluded that regardless of the fact that there was a good will to place and regulate the abuse of the rights of a member of company in order to meet modern standards of corporate business, in business and court practice it remained only at the level of good wishes of the legislator.

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