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LEGAL STATUS OF THE INDEPENDENT DIRECTORS

Abstract

In the modern business environment characterized by processes of globalization, integration and transition, the independence of governing bodies becomes a key instrument for the implementation of reforms in the area of corporate law. The immense consequences which corporate scandals have caused influenced the adoption of the whole set of regulatory rules whose main goal is to improve the corporate governance framework, to set clear criteria for the selection of board members in companies and work on the independence of management entities themselves. For this purpose, one of the most important results of the reform of corporate governance becomes strengthening the independence of the board of directors, with controlled authorization over the work of executive directors. The author of the paper is focused on determining the legal status of independent directors in companies, as well as the analysis of the legal and economic institutes strengthening the position of independent directors, as well as the factors that in some cases may point to their ineffectiveness. Thought framework of the research includes the analysis of legal regulations in the legal system of the Republic of Serbia, as well as the most important European legal acts. The aim of the paper is to point to the existence of space and opportunities for creating new mechanisms for strengthening the position of independent directors, which helps prevent potential abuse by companies.

Key words: *corporate governance, the board of directors, executive director, non-executive director, independent director.*

1. INTRODUCTORY CONSIDERATIONS

Corporate scandals, flexible forms of management companies, the conditions of continuous advancement of information technology and the increasing complexity of business transactions, came up with the need to establish adequate corporate governance framework. In such business environment, the requirements for increased responsibility of individuals operating company are strengthening, and the need for disclosure of

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information on the financial position and operating performance of the company, is becoming more emphasized. With the aim of adapting to the specific economic conditions and increasing the efficiency of the existing models of corporate governance, there is a reform in the area of company law through which it is supposed to find ways for improving corporate governance. Globalization, integration and transition as contemporary economic processes have resulted in changing the status of board members in companies and opened the question of efficiency of the existing model of corporate governance, their convergence and adaptability to legal and economic environment. The changes go in the direction of efforts to define the legal and economic institutes on the corporate control market, which would reconcile the interests of owners and management of the company. The most important direction of reform is going towards the establishment of an optimal structure of membership in the management bodies and strengthening the position of independent board members.

The safest way to adapt corporate governance framework prevailing economic, political and social environment is through strengthening the legal and regulatory framework, and the improvement of existing regulations in the field of company law. The amended regulation should be based on the strengthening of corporate governance mechanisms through the modification of the structure of the board, as well as maintaining confidence in the capital market and protection of investors' positions. The most important result of the reform of corporate governance is linked to the strengthening of the independence of the board, which is achieved by introducing the membership of independent directors. Due to the growing interest and public concern about corporate social responsibility activities, the independence of the members of the board of directors becomes a key mechanism for solving the problem of monitoring the management of the joint stock company. Members of the board of directors of the companies are responsible for good corporate governance, and their responsibility in particular stands out in public joint stock companies.

Independent directors are considered one of the key mechanisms for effective corporate governance of the companies. By the inability of shareholders to oversee the executive directors, there is a request to the membership structure of the administrative board finds at least one director with the power and influence like the managing director of the company, who will not have operational authority. The main objective of the independent directors is to protect shareholders and board members from arbitrary and illegal operations of the executive board. The main task of independent directors is to make a tool of control over members of the

executive board, acting objectively, impartially, guided by exclusively professional criteria. The primary objective of the reform of company law becomes a search for mechanisms of corporate governance that can solve agency problems and provide effective instruments whose active use provides company's growth and development in the market.

2. THE PROBLEMS OF CORPORATE GOVERNANCE AND THE INDEPENDENCE OF THE BOARD OF DIRECTORS

Since the current models of corporate governance have not shown the expected efficiency, a modern business conditions characterized by privatization processes and frequent connecting companies have created an atmosphere that has not itself lead to the effective management of companies, need to change corporate rules becomes explicit. Insecure environment in which very fast, and it seems easy, the emergence of new economic actors occurs, but in which, up to that point, world's leading companies quickly disappear, initiated the improvement of corporate governance through reform of company law. Securing stricter, but also rational and efficient form of company management, indirectly should have strengthened the legal security of investors, as well as ensured trust in the financial markets. Successful reform could have become a guarantor of gradual economic development, but also the incentive mechanism to attract new investors, increase employment and productivity growth.

Historically, inadequate corporate governance is one of the most common and most important cause of serious crises both in developing and developed countries.¹ The reform began in the years after the collapse of giant companies, like Enron, which caused tremendous adverse consequences not only in the countries where the headquarters of the company were, but also in other parts of the world due to the fact that those were the multinational companies, which in the years before deterioration employed the huge number of people and exercised the profits in the amount of over hundreds of millions of dollars. Therefore, the beginning of the 21st century was marked by reforms in different jurisdictions, with the intention of establishing a system of good corporate governance.² Changes in corporate governance are related principally to legal regulation and the basic

¹ A. Trifunović, *Principi korporativnog upravljanja u bankama u svetlu pravno-regulatornog okvira u Srbiji*, Bankarstvo, br. 1-2/2009, 88.

² D. Danilović, *Nezavisni direktori u realnom i bankarskom sektoru*, Pravo i privreda, 4-6/2016, 201.

principles of business to the organization and competence of corporate governance.³ Since the environment continuously imposes additional requirements and creates some new problems, and since the existing problems are not completely eradicated, and the corporate scandals continue to occur, it seems that in the years after the collapse of Enron the concept of permanent improvement of corporate governance was introduced and continuous finding new solutions as well.

Certainly, one of the key moments in the company law reform was the restructuring of the administrative boards in companies and the introduction of independent directors. Until recently, the dominant principle that the regulation on the management of the companies must be based on self-regulation among the participants, and that because of the differences between legal areas and traditions should be dominated by secondary, subordinate legislation, embodied in the so-called "soft law" (codes, principles, reports and recommendations good corporate governance practices), underwent some changes.⁴ In fact, such a regulation was similar to manipulation and abuse by the executive directors, and this tendency is noted to turn into "hard law".⁵ The main problem and the cause of the outbreak of corporate scandals was inadequate structure of the administrative boards. The management board should exercise substantial control over their operations and make strategic decisions.⁶ Poor administration, which is not able to realize the objectives of the company, is counterproductive and threatens not only a particular company, but also the overall economic development.⁷ Bearing in mind the importance of work that is performed by the management board, the question of the composition of the administrative board becomes the most important and most complex question of formal and substantial reform of company law, whose addressing could also help reducing the problem of insider information. New business conditions, the constant effort to be one step ahead, the development of financial markets, which restricts the ever-growing greed in humans, lead to a situation that at the core of the execution of the largest

³ I. Grubešić, *Razvoj nadzornih organa dioničkih društava – divergencija ili konvergencija entitetskih propisa?*, *Anali Pravnog fakulteta Univerziteta u Zenici*, 6/2010, 38.

⁴ D. Radonjić, *Nezavisni direktori*, *Pravo i privreda*, 5-8/2005, 60.

⁵ *Ibid.*

⁶ M. Čupić, *Analiza stanja i mogućnosti za unapređenje korporativnog upravljanja u Srbiji*, *Ekonomika preduzeća*, 58 (3-4), 2010, 180.

⁷ A. Trifunović, *op. cit.*, 87.

number of jobs in the market is insider information.⁸ In order to prevent the abuses that can lead to making decisions based on insider information, the basic goal becomes the formation of strong board of directors that can control the work of the executive directors of the company and work on solving the agency problem. Through privileged information, which gives them privileges in the market in the first place, these individuals obtain benefit for themselves or a person with whom they are linked.⁹ Therefore, in the board of directors firstly non-executive directors were introduced, who are supposed to supervise the executive directors, and then in an effort to comply with the requirements for higher standards of independence in order to achieve the function, institute of independent directors is created. Independent directors are taking control over the work of the executive boards and becoming an instrument of management control by shareholders.¹⁰

The complex legal nature of joint-stock company requires the existence of more entities in the company responsible for adequate corporate governance.¹¹ Shareholders, as owners of the company, are often dispersed, poorly informed, without the will and knowledge for the management of the company, hence they engage competent and professional teams of experts composed of individuals elected on the basis of objectively determined criteria, capable and willing to manage the company taking into account the long-term success of the company and protect the legitimate interests of its owners.¹² Organized in supervisory, administrative and executive board, engaged directors are required to be in the conduct of operating the company managed by standard care of a good businessman, acting in the best interests of shareholders. As the executive directors have the opportunity to get the privileged information, often the realization of their goals is put in front of the goals of the company. Trying to act preventively and to prevent the occurrence of such a situation and the emergence of information asymmetry, for members of the administrative board the independent directors are chosen. The essential role of independent directors, and therefore the board

⁸ J. Brašić, *Zloupotreba i protivpravno širenje insajderskih informacija*, in: Zbornik radova, sa međunarodnog naučnog skupa „Pravna država i stručnost procesnih subjekata kao instrument suprotstavljanja kriminalitetu“, Kragujevac, 2015, 599, <http://www.jura.kg.ac.rs/index.php/sr/naslovi.htm>, date of visit: 15. Jun 2016.

⁹ *Ibid*, 597.

¹⁰ P. Steven, "Do outside independent directors strengthen corporate boards?", *Corporate Governance: The international journal of business in society*, Vol. 5, Issue 1, 2005, 59.

¹¹ S. Đorđević, *Značaj i uloga mehanizama korporativnog upravljanja u podizanju nivoa efikasnosti menadžmenta*, Škola biznisa, br. 1/2012, 51.

¹² A. Trifunović, *op. cit.*, 85.

of directors, becomes overseeing the work of executive directors which improves standards of impartiality in the management of other people, not its capital, and until then a single governing board is divided into two sub-boards, the executive board and board of directors. The aim is to be able to limit its administration and control, which is the indispensable factor of the institute of independent directors.¹³

In order to have the efficient corporate governance, it is necessary to incorporate the company's strategic elements, such as exemplary administration, constructive and open corporate culture, effective governance structure and clear performance standards in the business.¹⁴ Through the structure of the body the independence affects the business reputation of the company affecting therefore its profitable performance and working not only to preserve a good reputation and business of the company, but also the integrity of the capital market. This confirms the fact that an independent administrative boards in terms of the global movement of capital ensure profitable business. Guided by these findings we come to the view that the performance of the functions of independent directors is a privilege and prestige, and if they do not lead to legal and ethical standards in their act, they would risk their reputation, ruin their professional reputation that they enjoyed until the moment of choice the function. With successful performance of their duties, the independent directors acquire a reputation that recommends them for other functions. The only thing left is for practice to confirm the theory, given the fact that the introduction of independent directors in the structure of administrative bodies opened some new problems regarding the efficiency of the functions of the independent directors in the company.

2.1. The independence of the members of the board of directors

The primary objective of the reform of corporate governance is to determine the optimal number of members of the board of directors in companies, as well as the introduction of innovation in terms of the structure of membership. The result of such needs that through the process of globalization have expanded from the Anglo-Saxon law area to the other parts of the world, is twofold status of board members. Namely, the tasks are

¹³ D. Danilović, *op. cit.*, 201.

¹⁴ D. Sređić, T. Serdar, *Model savremenog korporativnog upravljanja sa aspekta finansijskog upravljanja*, Naučni časopis za ekonomiju, br. 03/12, 35.

carried out by two corporate governance boards, an executive board and board of directors, which further developed division of the members of the executive and non-executive directors.

Executive directors are members of the board of directors hired to perform tasks of daily company management.¹⁵ The purpose of their function is to implement collective decisions passed by the board of directors and management of current operations of the company. Executive directors are people who have the greatest power in the company because they bring the most important decisions of interest to a joint stock company.¹⁶ The second category of members are non-executive directors, whose main function is the control of executive directors. Non-executive member of the board of directors or the supervisory board does not perform their job in an employed relationship, hence their work does not require a full professional engagement.¹⁷ Non-executive directors supervise the work of the executive directors, suggest company's business strategy and monitor its implementation.¹⁸ A special category of non-executive directors is independent directors. Independence and objectivity of the members of the supervisory or the non-executive directors are important elements for the field tests and determination of financial and non-financial statements, the review of related party transactions, appointment and dismissal of board members, definition of the salaries, benefits and awards to executive directors and other members of the management board of joint stock company.¹⁹ Independent member of the board of directors may offer the board breath of fresh air and experience, which executive directors don't have.²⁰

Since the company's greatest strength is concentrated in the hands of the executive board, and since general director as the first director and legal representative of the company is chosen from the members of the executive board, can often lead to abuses by the executive directors and the excessive use of allocated powers, as well as violations of fiduciary duties to the company. Therefore, of particular importance is the control function of the

¹⁵ V. Radović, *Put ka nezavisom upravnom odboru*, *Pravni život*, 12/2008, 74.

¹⁶ *Ibid*, 75.

¹⁷ H. Horak, K. Dumančić, *Neovisnost i nagrađivanje članova nadzornih odbora i neizvršnih direktora*, *Zbornik radova Pravnog fakulteta u Splitu*, 1/2011, 37.

¹⁸ M. Mićović, *Privredno pravo*, Kragujevac, 2012, 94.

¹⁹ H. Horak, K. Dumančić, *op. cit.*, 44.

²⁰ M. Žugalj, *Upravni odbori u tržišnom gospodarstvu*, u: *Zbornik radova Fakulteta organizacije i informatike Varaždin*, 1992, 241.

board of directors and that the board of directors set up is hierarchically superior to the executive board in order to control function implemented on the principle of seniority. These situations are easier to solve in a bicameral system of corporate governance in which the function control is done by the supervisory board itself, whose members cannot simultaneously be members of the board of directors.²¹ In contrast to the bicameral system of corporate governance, in the unicameral system the ties between members of the board of directors and executive become are significantly tighter.²² The main goal is, to the extent possible, to separate the executive directors responsible for the operational management of the daily operations of the company from those in charge of exercising the control over the results of operations of the executive board, as well as to impact on increasing the independence of the board and the prevention of abuse and the realization of personal interests in the company to the detriment of the interests of shareholders. The largest contribution to this entire attempt is the introduction of higher standards of directors' independence.

Independent directors were supposed to reduce the problem that arose between management, auditors and shareholders.²³ Namely, all the business decisions important for the financial position of the company are contained in the financial statements that the management board prepares for shareholders' meeting. Before it comes to the agenda and is accepted, a financial report is audited by independent external auditor. Given the numerous present illogicalities in the position of independent external auditors, and the fact that their own shareholders decide on the distribution of their own profits, often inadequate performance of the functions ensues, as well as the inability to spot the problems in the liquidity of the company or its neglect. Hence, the entire set of corporate scandals which appear almost successively contain in itself the problem of inefficient work performed by an independent external auditor, appointed and defined the compensation by shareholder board itself. Negative findings of the auditor affect the performance of the company whose audit is performed, which can have as a result the termination of the contract with the auditor.²⁴ Accordingly, the auditor has an interest in promoting positive financial reports of his client, which brings him into conflict with the duty of independence and third-party

²¹ V. Radović, *op.cit*, 76.

²² *Ibid.*

²³ M. Vasiljević, *Korporativno upravljanje: pravni aspekti*, Beograd, 2007, 91.

²⁴ *Ibid*, 261.

liability, because their function requires full commitment to public interest.²⁵ Since the bicameral systems of corporate governance exist as a distinct body of the supervisory board, whose essential task is to control the operation of the executive committee, it should have been worked on strengthening the functions of the administrative committee of the unicameral management systems. The main objective was to set up higher standards of independence, to the supervisory board, and the board of directors as well, and to secure specially division within the membership of the board of the unicameral model of corporate governance that would ensure the efficient execution of daily tasks and control over these transactions. The improvement of corporate governance is required to strengthen the supervisory and regulatory bodies eliminating potential conflicts of interest, which are believed to be the main cause of all problems in companies.

3. LEGAL AND ECONOMIC INSTITUTES TO STRENGTHEN THE POSITION OF INDEPENDENT DIRECTORS

The mechanisms of corporate governance allow in terms of parliamentary relations between the management board of joint stock company and the company itself performing the adequate control over the work of the director in charge of managing the daily operations of the company. Board members are the holders of special interest in the company, which can often be different from the interests of employees, creditors and shareholders themselves. Since board members are in a special, fiduciary relationship with the company, their interests should not be opposed to the interests of others interested in business success of the company. In recognizing such, the new situation, which can be a source of problems in the company, crucial role is in hands of efficient boards of directors, who could through carefully monitoring the members of the executive board act to fix the problem. In terms of the introduction of independent directors, as a special category of membership on boards of directors, the practice in different countries is significantly different. Regulation in some countries stipulates that independent directors must be members of the board of directors only in public companies, while in some countries there is an economic necessity for the presence of independent directors in any joint stock company. However, common to all countries is the requirement that there is appropriate involvement of independent directors in the work of the

²⁵ *Ibid.*

board of directors, as well as all other entities that have been established in the company and who are assigned specific responsibilities.

Defining the independence of member of the board of directors is not an easy task, because in trying to define the independence, there are numerous criteria, as well as the issue relating to which stakeholder the independency should be measured.²⁶ Independent membership should ensure objectivity and impartiality in their work in relation to the company in which they are engaged, to majority shareholders and board members.²⁷ The control function of independent directors should solve agency problems, prevent potential abuse of executive directors based on present informational asymmetry between executives and shareholders, and to get them to focus on strategic goals of the company. In determining independence, special attention is directed to the examination of the existence of personal interests of a member of the board of directors of the company, and then the possibility of harm or damage that may arise from the tight integration of non-executive director with a competitor company.²⁸

An independent director is a person who is not connected to directors and who has not been in the past two years executive director of the company or employed in the company, owner of more than 20% of the share capital of the company or a person connected with the company, received from the company or the person connected with the company, or claim the amounts which total value was more than 20% of its annual revenues in that period or was engaged in performing audits of financial statements of the company.²⁹ Criteria used to assess the independence of directors adopted in the Law on Business Companies have been harmonised with the recommendations of the European Union³⁰. Number of executive directors, due to the control of functions they perform, should be greater than the number of executive directors. Public shareholding company has at least one

²⁶ V. Radović, *op.cit.*, 84.

²⁷ D. Jurić, *Nezavisnost članova nadzornog odbora i neizvršnih direktora upravnog odbora i njihove komisije u dioničkom društvu*, izlaganje na Međunarodnom znanstvenom skupu „Socijalno odgovorno gospodarenje“, Pravni fakultet Sveučilišta u Rijeci, Rijeka 5-6. oktobra, 2007, 13.

²⁸ H. Horak, K. Dumančić, *op. cit.*, 34.

²⁹ Law on Companies (Zakon o privrednim društvima), *Official Gazette of the Republic of Serbia (Službeni glasnik RS)*, No. 36/2011, 99/2011, 83/2014- i dr. zakon 5/2015, čl. 392.

³⁰ See: Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, *Official Journal L 52/53* from 25.2.2005., <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32005H0162>, date of visit: 23 June 2016.

non-executive director who is also independent from the company.³¹ However, the total number of directors, as well as their internal distribution depends on the size of the company. Companies are able to adapt the structure of its board of directors to their own needs.³² Presence of independent directors should be sufficient, and they genuinely should be independent from operating the business and the company management. The number of non-executive and independent members of the board of directors depends on the actual independence of the board as a whole.³³ Especially significant role of independent directors is in addressing the issue of conflict of interest of executive directors, and prevention of problems which may result from conflict of interests. Independent directors are the individuals who will be able to speak, inside and outside the meeting rooms, about the abuses in the work of executive directors in order to protect the interests of shareholders.³⁴ In terms of the mandate for which independent director is called, it is important to take into account the need for continued work of board of directors, as well as the need to ensure innovation and motivation in the work. Therefore, it is necessary to establish a balance between the indefinite mandate, which allows directors to focus on the long-term interests of the company and the mandate for a limited time, which meets the need for periodic change of membership and faster achievement of good results.³⁵ In order to gain access to the exercise of control functions and evaluations of the work of the executive board, independent directors must be timely and duly informed of all the facts necessary for the fulfilment of their tasks, as well as to be introduced to the job appropriately. The monitoring function consists in monitoring the process of accounting, financial reporting, auditing and disclosure.³⁶

The introduction of independent directors strengthens the position of non-executive directors. An independent director is always non-executive director, but non-executive director does not have to fulfil the conditions

³¹ Art. 392 of the Law on Companies.

³² V. Radović, *op. cit.*, 92.

³³ D. Danilović, *op. cit.*, 204.

³⁴ D. Clarke, *Three concept of the independent director*, Delaware Journal of Corporate Law Vol. 32, No.1, GWU Legal Studies Research Paper No. 256, GWU Law School Public Law Research Paper No. 256, 2007, 84, <http://ssrn.com/abstract=975111>, date of visit: 6 June 2016.

³⁵ Kodeks korporativnog upravljanja Privredne komore Srbije (Code of Corporate Governance of Serbian Chamber of Commerce), *Službeni glasnik RS*, br. 99/2012, principle 6, recommendation 8.

³⁶ F. Shu-Acquaye, *The Independent Board of Directors and Governance in the United States: Where is This Heading?*, Whittier Law Review, No. 27/2006, 732.

required for independent director.³⁷ An independent director is a non-executive director who can be expected to objectively and impartially judge when making decisions.³⁸ Therefore, individuals appointed as independent directors of the company must meet all the conditions required for the effective performance of the duties of non-executive directors, as well as some additional requirements, which will strengthen their independence. The function of independent directors in the long run should result in greater independence of the entire board of directors, as well as more regular and more effective supervision over their operations.³⁹

Criteria for the selection of independent members must be clearly established and strictly defined, and in the selection of independent directors, individuals responsible for the appointment of the company shall be guided by them. Personal independence provides the members by prescribing clear criteria for the selection and dismissal, precisely delimited and established the authority of these persons.⁴⁰ It is especially important to choose people who have an objective and professional willingness to perform control functions. Improving functions of the independent directors and taking a leading role in the company is particularly important in order to preserve the confidence not only in the financial stability of the company, its reputation, but also in maintaining confidence in the financial markets, due to which abuse and frequent breakdowns company suffered major disruption in the market, which can have negative effect on attracting investors. Therefore, as a particularly important feature of independent directors the integrity of the work and independence from the influence of any organ of the company during the monitoring of the work of executive directors are emphasized. It is especially important that individuals appointed as independent directors have the willingness to carry out these tasks, the energy to devote to the performance of their duties in the company, as well as the understanding of the company's business. In performing their supervisory functions they should act with thorough examination and independently, and judge with the ability to offer new and different perspectives and constructive suggestions. Since there is dominant lack of suitably qualified human resources, the question is which individuals are potential candidates for independent directors, and from whose ranks to elect. The lack of objective

³⁷ M. Vasiljević, *op. cit.*, 96.

³⁸ V. Radović, *Put ka nezavisnom...*, 86.

³⁹ I. Grubešić, *op. cit.*, 50.

⁴⁰ J. Brašić, *Pravni položaj i pitanje samostalnosti Komisije za hartije od vrednosti RS*, Zbornik Pravnog fakulteta u Nišu, br. 72/2016, 350.

criteria pose new problems in the position of independent directors, and in particular must take into account the setting of clear criteria for the selection of independent members of the company. Each company is obliged to accept and comply with the criteria under the general legal acts, but it is free in prescribing additional criteria related to the selection of independent directors in them. For the position of independent director in the company it is important to organize training programs by the same company, as well as to enable the presence of continuous improvement programs organized by other bodies. In this way, they strengthen the position of independent directors, who are trained to follow trends in corporate law in order to respond properly and perform their function. Investing in professional training of independent directors, at the same time is investing in the development of the company in which they are engaged, due to the fact that professional criteria enhance their reputation, strengthen the company's reputation, and non-profit objectives are put in the function of profitable goals.

To the independence of members of the board of directors significantly contribute the amount, type and structure of fees which they are paid with respect to providing special services to the company and the exercise of supervisory powers. Also, in order to protect the interests of investors and shareholders, the important issue is the transparency of fees and rewards members of the management board receive. Publication of data on the structure and amount of compensation varies from country to country, and it is notable that the countries have adopted the minimum requirements in terms of transparency of fees. In situations where management of the company is not able to develop a system of fees itself, it is necessary to engage external consultants in order to avoid conflict of interest.⁴¹ Namely, the compensation for executive directors consists of fixed and variable parts, while compensation for non-executive directors consists solely of a fixed part.⁴² As the executive directors are involved in the company on the basis of an employment contract, since they are holders of the highest workload in the company for they lead current affairs of the company, their compensation is always greater than the compensation of company's non-executive directors. Compensation of executive directors in the variable part is linked to the business success of both the company and their individual contribution

⁴¹ I. Vukasanović, V. Kuč, *Kako unaprediti korporativno upravljanje*, Tranzicija, god. 14, br. 29, 2012, 8.

⁴² Kodeks korporativnog upravljanja Privredne komore Srbije, principle 9, recommendation 1, recommendation 2.

to the work, while non-executive directors do not receive stimulation because they are not carriers of the operational duties of the company. The difference in fees should be based on contributions to the work, and be proportional to the scale, complexity of tasks and responsibilities. Specific legal position of independent directors and specific objectives of corporate governance placed before them, impose the need to pay particular attention to their compensation, taking into account the fact that certain types and amounts of fees can have a negative effect on their independence.⁴³ On the one hand the fee can motivate independent directors in exercising their duties, or if they are not satisfied with it, it can open a whole range of problems, which are again returning to those issues whose resolution was the reason of introducing such a special group of members of independent directors. The appropriate fee for the work is the foundation for the independence with regard to the fact that individuals who are adequately rewarded for their work in this way achieve their independence, hence the adequate compensation guarantees the independence and objectivity of the work for the company.⁴⁴ Fee, above all, should be sufficient to attract and retain highly qualified individuals in positions of independent members of the board.⁴⁵

With the growth of the company and its business success, business transaction become more complicated which requires a more complex corporate governance structure. As companies hire in individuals of various business and professional profiles and as they operate with different business partners, it was necessary for companies to form several different management entities. Those entities are commissions formed of individuals specialized in the field of their interest, where the nomination commission, remuneration commission and the audit and other commissions in accordance with the needs of the company are required, if it is permitted by statute.⁴⁶ The importance of these commissions for the legal position of independent directors is that in each of these commissions particularly there is significant presence of independent directors, with the same function they have in boards of directors.

⁴³ V. Radović, *Naknada članovima uprave akcionarskog društva*, Beograd, 2011, 56.

⁴⁴ H. Horak, K. Dumančić, *op. cit.*, 48.

⁴⁵ V. Radović, *Naknada članovima...*, 245.

⁴⁶ M. Mićović, *op. cit.*, 96.

4. LIMITATIONS OF EFFICIENCY IN THE WORK OF INDEPENDENT DIRECTORS

The majority independent boards of directors are considered to be best practice of corporate governance. But despite that, independent directors themselves cannot guarantee a long-term business success of the company.⁴⁷ In addition to all the benefits that institute of independent directors brings, there is a certain number of limitations in their legal position, which is manifested through certain deficiencies in their work and performance of control functions in the company.

Too busy working schedule. The confidence given and the important role of independent directors require that they have sufficient time to fulfil their duties on the board.⁴⁸ However, most often, independent directors do not perform control function which they were hired for in the company as their sole task, but are also engaged in other companies with which they have an employment contract. Therefore, the activities of the independent directors are addition to the core business operations, which they do. It often happens even in the more companies that are not related to each other, they perform the function of independent directors, so they cannot always be present at meetings of the board of directors, which reduces the importance of the work of the organs of the company, preventing them from performing their basic duties. Overload of other duties makes them passive members of the board of directors.⁴⁹ In order to prevent too busy working schedule of independent directors a larger number of rules was developed, such as the drafting of the needed available time, limiting the number of membership, required information in the proposal for the appointment, signing a declaration on the existence of time available, as well as informing the board of directors of any subsequent amendments, notifying shareholders, compiling reports on attending the sessions, the assessment report of independent members, reports on completed tasks.⁵⁰ The work of independent directors should equally contribute to the company, regardless of whether they are members of other supervisory board, or the board of directors.⁵¹

Incompetence. Despite the clearly defined criteria for the selection of independent directors, it often happens that for the independent director of

⁴⁷ D. Clarke, *op. cit.*, 75.

⁴⁸ D. Radonjić, *op. cit.*, 67.

⁴⁹ V. Radović, *Tri razloga neefikasnosti nezavisnih direktora*, *Pravni život*, 11/2011, 102.

⁵⁰ *Ibid.*, 102-108.

⁵¹ H. Horak, K. Dumančić, *op. cit.*, 48.

the company is appointed an individual who does not have sufficient knowledge, expertise and experience necessary for efficient work. As they do not have enough knowledge about matter they need to decide, they are unable to critically examine the proposals of executive directors or to propose their own different content of decisions, so they vote mechanically for the proposals, by which all the benefits of their involvement in the company are lost.⁵² For independent members are often appointed individuals from the world of politics, culture, show business, sports, education and other fields whose work does not necessarily have anything in common with the activities of the company, and they are not expected to exercise control functions, but to ensure the company's name and reputation, at the expense of professional quality. The problem is solved by prescribing competency requirements for the appointment of independent directors, pre and post publication of information on competence, introduction into the work program of independent directors, continuous professional development.⁵³

Uninformed. To be able to make decisions during the operation, independent directors in the exercise of their functions must have full, timely and clear information necessary to perform their tasks. Independent directors have significantly less information from the executive directors, who are as operating the company's decision the most important information source. The problem of insider information arises because the source of information for independent directors are executive directors, whose work should be controlled, hence, it often leads to abuse and covering of information. It is therefore important to constantly work on reducing information asymmetry that exists on this relation, deepening the agency problems and hindering effective performance of the duties of independent directors.

The lack of adequate work compensation. The biggest incentives in the work of both the executive as well as non-executive, as well as independent directors in the company, are just compensations or incentives for their work. In performing everyday tasks the company's executive directors receive bonuses related to the profitability of the company itself which significantly affects their motivation to work. On the other hand, the independent directors of the company usually receive a fixed amount of charges proportionate to field of operations conducted in the company. Without incentives for work, it comes to the reduction of the effectiveness of their decision making, which is transmitted to the efficiency of the board of directors, and bearing in mind that the board of directors supervises the

⁵² V. Radović, *Tri razloga...*, 108.

⁵³ *Ibid*, 109.

executive directors and that he is hierarchically higher authority than him, and therefore to reduction of the efficiency of the entire administration. Inconsistency of rewarding with the successfully done work stands out as the main problem of poor performance of independent directors.

Direct and indirect impact of executive directors. The process of selection and appointment of independent directors of the company must be based on professional and objective criteria in order to ensure their independence in the future work. A key feature of the legal position of independent directors is precisely their independence from any other body and individual of the company. However, in certain situations, even independent directors cannot be successful if they do not have the personal greatness or confidence to resist executives.⁵⁴ It is unacceptable that in the exercise of their supervisory duties over the work of the executive directors, independent directors of company to be subjected to impacts and abuses by the individual whom they shall supervise. It often happens that the executive directors abuse their position in the company preventing the independent directors in carrying out their duties, hiding information using numerous other instruments that could influence their independence. A special influence of executive directors on independent ones can be seen in a situation when they are left to determine the fees to independent directors of the company.

5. CONCLUSION

The agency problems inherent in constant conflict of interest between shareholders and the company's management, as well as in their different target functions, created the need for finding an instrument to ensure the reliability of the company's business, its reputation and social standard. The concept of permanent formation of the regulatory framework of corporate governance and coordination of the basic principles on which corporate governance is based, was imposed by corporate scandals, as well as by the processes of globalization and financial liberalization. Aiming at prevention and protection of shareholders and investors, the most important direction of the reform of corporate governance is going to strengthen the board of directors, ensuring effective management structures and setting clear standards for the selection of independent members of the board of directors, which become a key mechanism for evaluating the work of the management board. Therefore, the most important instrument of improving corporate governance and strengthening the independence of the administrative board

⁵⁴ D. Radonjić, *op. cit.*, 65.

becomes the institute of independent directors, which would through their supervisory powers, objective, independent and impartial work, ensure proper operation of the executive board.

Raising awareness about the importance of the company's management in recent years has resulted in dynamic changes in the legislation, which was reflected in the implementation of the reform of corporate governance even in the Republic of Serbia. Legal status of independent directors based on secure foundations in the Law on Business Companies and Code of Corporate Governance, which are taking into account the process of European integration are in comply with the OECD Principles of Corporate Governance, as well as the regulations of the European Union. The specific position of independent directors in the company is caused by the fact that they precisely represent a link between the board of directors and executive board, which defined them as irreplaceable entities of the effective implementation of protection of shareholders through a comprehensive monitoring of the legality of work of executive directors. In that way the company's internal business control mechanisms and risk management are strengthened. The Law on Business Companies and the Code of Corporate Governance clearly set out the criteria for the selection of independent members of the Board of Directors, determined by their competence, and detailed guidelines for the preservation of their independence were made. However, despite this, in practice certain deficiencies in their legal position, which may reduce their effectiveness, still occur. Such a situation indicates that independent directors still cannot be a guarantee of business success of the company, and although the steps to strengthen the independence of the administrative boards are determining mechanisms of corporate governance reform, the ideal solution is not found, and the trend of continuous adjustment of regulations in terms of corporate governance practices continues.

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