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Latvia

Jānis Gavars, Reinis Sokolovs & Raimonds Slaidiņš

I NATIONAL BASICS AND NATIONAL LEGAL THEORIES OF DIRECTORS' LIABILITIES

[A] Two-Tiered or Unitary Company Structure

The Latvian legal system follows the two-tiered company structure theory characterized by: (1) a board of directors which performs the executive function for the company; and (2) a supervisory board which performs the supervisory function (hereinafter, if jointly – Directors). There are two types of companies in Latvia: (1) Sabiedrība ar ierobežotu atbildību (hereinafter – SIA) which is a limited liability company; and (2) Akciju sabiedrība (hereinafter – AS) which is a joint stock company. A board of directors is mandatory for both types of companies (SIA and AS) while a supervisory board is mandatory only for AS and the shareholders of SIA may choose whether a supervisory board would be necessary for their company by including such a provision in the articles of association of the company.

At the same time, according to the Commercial Law, the meeting of shareholders can also be considered an administrative institution of a Company which has the power to decide on specific matters (as well as, in specific conditions – to decide on matters which are within the competence of the Directors).

Commercial activities in Latvia (including Director's liability) are regulated by the Commercial law, by Civil Law and other laws, as well as by the norms of international law that are legally binding in Latvia. The provisions of the Civil Law are applied to commercial activities only insofar as the Commercial Law or other laws that regulate commercial activities do not specify otherwise.

[B] Chairman/CEO

If the board of directors consists of more than one member, a chairman of the board of directors is elected from among the members, who is responsible for organizing the activities of the board. If a SIA has established a supervisory board, the articles of association may provide that the chairman of the board of directors is appointed by the supervisory board, whereas with regard to an AS, the law provides that the chairman of the board of directors is appointed by the supervisory board. With regard to both types of company, the articles of association of the company may provide that the vote of the chairman prevails in case of a tied vote in the meeting of board of directors. The chairman of the board of directors is responsible of signing several procedural and corporate documents such as minutes of the meetings of the board of directors, compartments of the shareholders register of the company in case of share alienation etc.

Similarly, with regard to both – SIA and AS, a chairman and at least one deputy chairman of the supervisory board must be elected by the members of the supervisory board. The deputy chairman of the supervisory board performs the duties of the chairman only if the chairman is absent (due to illness, business trip, vacation and the like), or has assigned such a task to the deputy chairman. The chairman of the supervisory board convenes supervisory board meetings, but in his or her absence or by a specific assignment – it is the task of the deputy chairman. It may be provided in the articles of association of the company that the vote of the chairman shall prevail in the event of tied vote in supervisory board meetings.

Companies may introduce CEO level managers as employees who will be engaged in the management of a company's business activities. Such staff members will be employed on the basis of an employment agreement, a work-performance agreement or a respective power of attorney but not on the basis of the Commercial law. In practice, CEOs will also often be the members of the company's board of directors.

[C] Board Structures

With regard to all types of company, the board of directors may consist of one or more members who are natural persons with the capacity to act. Members of the board of directors may not be supervisory board members, the auditor of the company and members of the supervisory board of the dominant undertaking in a group of companies. Greater restrictions on members of the board of directors may be specified in the articles of association.

Also, with regard to both company types, the supervisory board shall also consist of natural persons with the capacity to act. The minimum number of supervisory members is three, but if the stock of the company is publically traded, then the supervisory board shall consist of a minimum of five members. The maximum number of supervisory board members is twenty. The following persons may not be members of the supervisory board: (1) members of the board of directors, the auditor, procura

holder or a commercial representative of the company; (2) members of the board of directors of any dependent company of the company or any person with the right to represent the dependent company. The articles of association may provide stricter restrictions that apply to supervisory board members.

[D] Directors' Elections/Staggering

Members of the board of directors of an AS are elected by the supervisory board of the company, while in a SIA the members of the board of directors are elected by the general meeting of shareholders even if the company has formed a supervisory board. A consent from the relevant person is required in order to elect him/her as a member of the board of directors.

With regard to both company types, members of the supervisory board are elected by simple majority of votes of the present shareholders in the shareholders meeting, if although the articles of association may provide that a larger number of votes is necessary for such election.

[E] Directors' Term of Appointment

A member of the board of directors (of SIA and/or AS) is elected for an indefinite period of time, if not otherwise specified in the articles of association.

The supervisory board (of SIA and/or AS) cannot be elected for a period which is longer than five years. The articles of association may provide for a shorter term.

[F] Delegation

In everyday business activities, it is common for members of the board of directors to delegate their tasks to employees of the company. The delegation of such tasks does not exclude the liability of the members of the board of directors as such but the culpability of members of the board will be reviewed in each respective case.

Companies may issue two types of authorizations for third parties to act on behalf of the company – a procura and/or an ordinary commercial power of attorney.

A procura is a commercial power of attorney which is registered with the commercial register and grants the procura holder the right to conclude transactions and to perform other legal activities associated with commercial activities on behalf of the company, including all procedural activities in the course of legal proceedings (bringing an action, settlement, appeal of a court judgment and the like).

If the company does not issue a procura (and register it within the commercial register), but authorizes a person to conduct commercial activities in its name, to conclude specific types of transactions related to the commercial activities performed by the company or also to conclude separate transactions related to the commercial activities performed by the company this may be accomplished by means of an ordinary commercial power of attorney. Such a power of attorney may relate to all

lawful activities related to the performance of such commercial activities or the conclusion of such transactions. An ordinary commercial power of attorney cannot be registered with the commercial register.

[G] Removal of Directors

A member of the board of directors in a SIA may be recalled anytime by a decision of the shareholders. If the company has a supervisory board, it may suspend any member of the board of directors from his or her position until the meeting of shareholders but for period which is not longer than two months. The articles of association may provide that a member of the board of directors may be recalled only if there is an important reason. Such reasons shall be considered to be gross violations of authority, failure to perform or to appropriately perform his or her duties, an inability to manage the company, or causing harm to the interests of the company, as well as loss of confidence from the shareholders. With regard to an AS, the members of the board of directors may be recalled only if there is an important reason. Members of the board of directors may leave their position, by submitting a notification thereof to the company anytime.

With regard to both – SIA and AS, members of the supervisory board may be recalled from their office at any time by a decision of a meeting of the shareholders. Similarly to the board of directors, a member of the supervisory board may relinquish his or her office at any time, by submitting a notice to the company. If a supervisory board member leaves or is recalled from the board before the expiration of the supervisory board's term, then the election of a new supervisory board member requires a new election of the entire supervisory board.

The fact that a person relinquishes their position as a company Director does not automatically terminate an employment and/or work-performance agreement, if such has been concluded between him/her and the company. The agreement that is the basis for the Director holding the respective position must be terminated separately from any employment agreement, after the decision regarding the removal of Director has been made.

II RECENT CASES DEALING WITH DIRECTORS' LIABILITY

[A] Judgment of 15 January 2014 in Case No. SKC-101/2014 of the Civil Case Department of the Supreme Court of Republic of Latvia[1]

In this case the Supreme Court indicated that the Article 169 of the Commercial Law of the Republic of Latvia provides for the liability of the members of the board of directors for losses suffered by the company. The Supreme Court ruled that the rebuttal of this principle is the task for the members of the board of directors in each respective case. At the same time, before a board member has the obligation to prove that he has acted

1. Judgment of 15 January 2014 in case No. SKC-101/2014 of the Civil Case department of the Supreme Court of Republic of Latvia, para. 8, (AT, 2014).

as an honest and prudent manager, the plaintiff has the obligation to prove the existence of losses according to the contest principle enshrined in the Civil Procedure Law of Republic of Latvia.

[B] Judgment of 27 May 2014 in Case No. SKC-102/2014 of the Civil Case Department of the Supreme Court of Republic of Latvia[2]

In this case, the Supreme Court reviewed the understanding of the term 'honest and prudent manager'. The Supreme Court noted that this term is a general clause which must be determined in the context of each specific case depending on the facts of the matter. In this case the Court ruled that the chairman of the board of directors cannot be exempt from liability for loss expected to be suffered by the Company in the future by means of a decision of the shareholders meeting as this would be contrary to the objective of the provisions of law providing the possibility of shareholders to release the members of the board from their liability for loss already caused to the company.

[C] Judgment of 13 June 2014 in Case No. 2014-02-01 of the Constitutional Court of Republic of Latvia 'On the Compliance of Para 4 of Section 17 of Deposit Guarantee Law with the First Sentence of Article 91 of the Constitution of the Republic of Latvia'.[3]

The Constitutional Court reviewed (*inter alia*) the aspects of the Article 169 of Commercial law providing for the liability of Directors. The Constitutional Court determined that the term 'honest and prudent manager' incorporates objective obligations such as being loyal to the company, avoiding the adoption of a decision in case of a conflict of interest, to act according to law, articles of association and the decisions of shareholders meetings as well as the obligation to adopt economically reasonable decisions. According to the Constitutional Court, as essential criteria to determine that one acted as an honest and prudent manager is the conformity of his/hers conduct with the purpose of the economic activity of the company.

III JUDICIAL REVIEW (FOR EXAMPLE, TIGHTENING OF STANDARDS?)

Several amendments have lately been made in Latvian laws regulating the liability of Directors including imposing personal liability for delaying the time for filing documents with the commercial register, non-performance of company's tax obligations and delayed filing for insolvency in case the company has not settled its debts for more than two months.

2. Judgment of 27 May 2014 in case No. SKC-102/2014 of the Civil Case department of the Supreme Court of Republic of Latvia, para. 10, (AT, 2014).
3. On the Compliance of para. 4 of s. 17 of the Deposit Guarantee Law with the first sentence of Art. 91 of the Constitution of the Republic of Latvia, 117 (5177), LV, para. 14.2.2., (ST, 2014).

As of 1 January 2013, the Register of Enterprises has the authority to review administrative violation matters involving the non-submission of documents with the commercial register. According to the Administrative Violation Code of Latvia, the Register of Enterprises may send a warning for this violation or impose a penalty of EUR 70 to EUR 430.

As of 1 January 2015, the State Revenue Service (tax authority) of Republic of Latvia can bring a personal recovery claim against members of the board of directors for the non-performance of tax obligations of a company. Liability will apply to those persons who were board members when the tax debt arose, whether they continue to perform the tasks of the members of the board or not. This specific type of tax liability of board members arises if all of the following criteria are met:

- The unpaid tax amount exceeds fifty minimum salaries (currently – EUR 18,000).
- The company has been notified about the enforcement of the tax debt.
- The company has disposed of all assets to a party related to a board member (e.g., spouse, controlled companies, etc.) after the tax debt is discovered.
- Recovery of the tax debt from the company is impossible.
- The company has failed to apply for insolvency proceedings.

It is important to note that on 29 December 2015, the Constitutional Court of Republic of Latvia has initiated a case regarding the above-mentioned law that provides for the liability of members of the board of directors for the non-performance of company's tax obligations.[4]

A similar personal liability clause can be applied as of 1 January 2015 regarding the insolvency obligations of the members of the board of directors. If the documents reflecting accounting information are not transferred from the company to the insolvency administrator (or if a substantial part of the accountancy information is missing) the members of the board of directors can be held personally liable for all of the company's debts. Such a claim against members of the board of directors may be brought either by the insolvency administrator or the creditors of the insolvent company.

IV TYPICAL SCHEMES/BEHAVIOUR TO AVOID DIRECTORS' LIABILITY

The Commercial Law does not allow for the possibility to limit the liability of Directors in the articles of association of the company. However, there are certain actions that can be taken to protect Directors from such liability.

4. Decision of the Constitutional Court of Republic of Latvia of 29 December 2015 regarding the initiation of a case 'On the compliance of Section 60, 61 and 62 of the law "On Taxes and Fees" with the first sentence of Article 91, Article 92 and Article 105 of the Constitution of the Republic of Latvia'.

[A] Compliance with the Principle of an Honest and Prudent Manager

In order to prove that a Director is not liable for loss caused to the company, the Director must prove that he has acted as an honest and prudent manager. This means avoiding even ordinary negligence. However, in any case – an accidental loss (caused by an accidental event or force majeure) is not required to be compensated by anyone. Acting in accordance with the duties of an honest and prudent manager would be, e.g., voting against and non-execution of a decision which has caused losses to the company etc.[5]

[B] Release from Liability by Means of a Decision of the Shareholders' Meeting

The general meeting of shareholders has the right to release Directors from their civil liability after a loss has been detected. It is the prerogative of the general meeting of shareholders to decide to release a Director from liability. Similarly, a settlement can be made with Directors if decided by the shareholders' meeting.

[C] Good Faith Compliance with Shareholders' Decisions

Directors cannot be held liable if they act in good faith according to a lawful decision of the shareholders' meeting. For this exemption to be valid, the decision of the shareholders' meeting must have been adopted according to the provisions of law and articles of association.

V LIABILITY ISSUES

[A] Who Can Sue?

Directors can be civilly (private liability), administratively and/or even criminally liable (public liability).

[1] Private Liability

In case of civil liability which is within the scope of private law, Directors can be held liable as against the company, the shareholders, or any third party for the loss caused to that person. That means that each of the subjects mentioned has standing to make a civil claim against members of the board of directors.

In order to make such a claim against a Director the claimant must prove unlawful action or failure to act by a Director, loss in a specific amount and causality between the unlawful action (failure to act) and the loss.

5. Aigars Strupišs. Komercikuma komentāri III. 150, (A. Strupiša juridiskais birojs, 2003).

With regard to both company types, in situations when the company is making a claim against the board of directors, the company is represented by the supervisory board. On the contrary – if the company is making a claim against the supervisory board, the company is represented by the board of directors.

If the company (SIA) has not formed a supervisory board, a special representative may be elected by a decision of the shareholders meeting to initiate the claim against a member of the board of directors. The shareholders' meeting may also authorize a special representative to represent the company in cases against the supervisory board.

If the shareholders' meeting does not resolve on electing the special representative, the claim will be brought by the shareholders of the company. Generally, it is the prerogative of the shareholders meeting to adopt a decision regarding a claim against a member of the board of directors by a simple majority of the votes. But this does not deprive the rights of minority shareholders – shareholders representing at least one-twentieth of the company's share capital or at least EUR 71,100 of the share capital may request that a claim be brought by the company. Such request by minority shareholders shall be submitted to the institution of the company which has the right to bring the claim (board of directors, supervisory board or the shareholders' meeting), but if the respective institution does not bring the claim within one month, the minority shareholders may bring the claim to court without the intermediation of such institution.

Additionally, it is possible that a creditor may bring a claim in its own name but for the benefit of the company. In cases where a creditor cannot obtain satisfaction of his claim from the company, this creditor may bring a claim against Directors if they have caused loss to the company and haven't compensated such loss. The creditor must prove that it is not possible to satisfy his claim from the company.

[2] Public Liability

The Directors may be held liable according to the Administrative Violations Code (for less serious infringements) or Criminal Law (for serious infringements) on various grounds. The Administrative Violations Code provides for the administrative liability of Directors for breaches such as: (1) failure to comply with accounting regulations; (2) non-submission of insolvency application; (3) the performance of commercial activities without proper registration or without a special permit, etc. More serious sanctions are provided by the Criminal law for breaches such as: (1) causing the company to become insolvent; (2) causing substantial harm to the company or another person's rights and interests; (3) violation of employment regulations, etc.

[B] Who Can Be Sued?

The Commercial Law provides that the company may initiate claims against the founders, Directors, or auditor of the company. Additionally, a claim can also be brought against the person who has exercised influence in bad faith over members of

the board of directors or supervisory board, a procura holder or a holder of a simple commercial proxy as a result of which the company has suffered losses.

[C] 'De Facto' Director

Latvian law does not specifically provide for the concept of 'de facto' Directors of companies but there are a few similar concepts. The role of a 'de facto' Director could be exercised by managing employees of the company who are not the registered members of the board of directors or the supervisory board but have a wide area of competence in the company. The company may also authorize third parties to perform specific operations on behalf of the company by means of a general power of attorney, or register a procura for a person who will have all rights to represent the company.

The Commercial Law also provides for a specific type of liability for a person who has exercised influence in bad faith over Directors, a procura holder or a person who has been authorized with a simple commercial power of attorney (by persuading him/her to act against the interests of the company or its shareholders) as a result of which the company has suffered loss. Such liability shall not apply if the influence was exerted: (1) by the use of one's voting rights at a meeting of shareholders; or (2) by the lawful use of one's decisive influence in accordance with the Groups of Companies Law.

[D] Thresholds and Limitations/Caps of Liabilities

The shareholders meeting is competent to release the Directors from liability on behalf of the company. The law states that Directors cannot be released from liability before such liability becomes known (e.g., under a contract). According to law, the shareholders' meeting may take such a decision only in respect to particular actions which result in company losses, disclosed during the meeting of shareholders. Even in the event the shareholders meeting releases a Director from liability this does not deprive the minority shareholders of the right to bring an action against the respective Director. Provisions of a contract between the Directors and the company may not deprive the third parties (creditors) of the right to bring an action against them.

[E] Joint Liability/Solidarity

The general principle provided by the Commercial law is that the Directors are jointly liable for losses that they have caused the company. At the same time, as mentioned before, Directors are not held liable if they prove that they have acted, as an honest and prudent manager, therefore individual liability is also possible towards the company and any third parties.

[F] Derivative Actions

When losses have been suffered by the company a claim must be brought in the company's name by its legal representatives. But this does not deprive the rights of the minority shareholders. The minority shareholders representing at least one-twentieth of the company's share capital or at least EUR 71,100 of the share capital may demand that a claim be brought by the company. Such a request by a minority shareholders must be submitted to the company's institution which has the right to bring an action (board of directors or supervisory board), but if this institution does not bring the action in a court within one month, the minority shareholders may bring an action in court without the intermediation of this institution.

[G] Class Actions

A claim for recovery of losses is a civil claim and therefore this claim can be filed by each person whose civil rights or interests which are protected by law are infringed. Generally, class actions are only recognized by Latvian law in specific cases regarding employment disputes and consumer protection disputes.

[H] Relevance of Bankruptcy of Corporation

If the company's business activities meet the insolvency criteria it is the duty of the board of directors to file for an insolvency procedure. The Directors of the company may be held criminally liable for causing the insolvency of the company.

If the documents reflecting accounting information are not transferred from the company to the insolvency administrator (or if a substantial part of the accountancy information is missing) the members of the board of directors may be held personally liable for all of the company's debts.

VI INDEMNIFICATION

If found to be liable, the Directors will be required to compensate losses inflicted on the company.

Directors among themselves may conclude agreements dividing specific areas of responsibility; therefore in their contractual relationship some of the jointly liable Directors may be entitled to indemnification.

VII DIRECTORS' AND OFFICERS' INSURANCE

Directors' and Officers' insurance is available to limit the civil liability of the Directors. Directors at the major national enterprises commonly insure their liability in Latvia. Insurance terms usually depend on the financial performance of the company and other factors evaluated by the insurer on a case-to-case basis. Most often these

insurance policies are governed by English law. Most commonly the policy covers the risk of 'ordinary and gross negligence', whereas 'malicious intent' is not covered.

VIII OTHER METHODS OF PROTECTION

See sections IV and VI above.

IX LAWYER DIRECTORSHIP

Generally there are no restrictions for lawyers to become members of the board of directors and members of the supervisory board in Latvian companies. At the same time, the Latvian Council of Sworn Advocates has indicated that acting as a member of the board of directors or supervisory board can be harmful for the professional independence of sworn advocates (Latvian – zvērināti advokāti) therefore sworn attorneys who combine their sworn advocate profession with a position of a member of the board of directors or supervisory board has the obligation to inform the Latvian Council of Sword Advocates.

X FORECAST ON FUTURE LEGISLATION DEVELOPMENT

Legislation regulating the liability of Directors is being constantly amended. Many of the issues indicated in the so-called European Action Plan regulating the liability of the Directors have already been introduced in Latvian law. Currently, there is no public information about any planned amendments regarding the liability of the Directors.

At the same time, the government is constantly working to fully introduce the recommendations of OECD regarding the development of good corporate governance principles.