

Board member's risks and liability 3/9/23



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A board member's liability covers many activities and may have various consequences, such as financial compensation, cash recovery, a ban on the conduct of business, and even a criminal penalty. This article explores areas where the board member may be held liable and looks at ways to mitigate this risk.

The Commerce Act includes a wide range of rules, as this is essentially based on a general clause stating that the board member must act as a decent and caring steward, i.e. he must make reasonable decisions in the company's best interests. And the presumption of innocence is replaced by the presumption of the board member's guilt, i.e. he must prove that he has acted as a decent and caring steward.

If the board member acts in good faith according to a decision approved by the company's council or shareholder, then no liability arises. However, such appropriate conduct does not necessarily mean the board member will not be held liable. Claims against the board member expire within five years after a loss arose.

The Commerce Act also imposes competition restrictions on the board that prevent any of its members from taking the following steps without the council's or shareholder's permission:

1. Becoming a personally liable partner without limited liability in a partnership
2. Becoming a shareholder with additional liability in another company
3. Entering into transactions in the company's line of business in their own or a third party's name
4. Sitting on the board of another company in the same line of business, as any loss caused to the company may then be claimed from the board member personally

After passing the Digitalisation Directive, Latvia changed its rules that make the board responsible for registering the company's legal address. The board member is responsible for registering the company at an address where it has a legal basis to be registered, subject to the board member's confirmation of the right to be based at that address. The board member is also responsible for the company being reachable at the address. If the board member breaches any of these rules, he may be held liable for giving false particulars to a government agency under section 272 of the Criminal Code.

So the board member's liability is regulated in rather abstract and very specific ways, but we should bear in mind that liability is applied in practice for a breach of general clauses as well. For example, on 18 April 2019 the courts ruled on the joint and several liability of a bank's board members and recovery of EUR 15 million from them¹ because they were found in breach of section 169 of the Commerce Act, having failed to act as decent and caring stewards. The bank's insolvency administrator sued the board to maximise the recovery of funds for its creditors. The administrator claimed that mismanagement by the board resulted in bank loans being approved without verifying that the borrowers were able to repay them, which brought the bank to insolvency. The board filed an appeal, which was dismissed.

Insolvency rules provide for several forms of liability the board member faces personally if a breach is discovered.

Board members may be held jointly and severally liable for failure to transfer the debtor's documents at the insolvency administrator's request during insolvency proceedings. Liability arises also if the documentation is in such a bad shape that it's impossible to obtain a clear view of the debtor's transactions and financial position for the last three years. This supports the requirement that board members must be aware of and regularly monitor the company's financial position because they are treated as interested parties against the debtor or the insolvent company.

These rules also permit the insolvency administrator to assess and cancel any transactions made within three years before insolvency was announced and to recover funds from the board member personally if those transactions caused the company to become insolvent. So the board member may be held liable directly with his own assets for any wrong decisions he has made.

If the board member's actions have brought the company to insolvency, then section 213 of the Criminal Code may be applied – bringing to insolvency. This is divided into lighter liability for negligence and heavier liability for deliberate bringing to insolvency. So the board member faces not only the obligation to repay losses but even a real prison sentence in certain situations.

The Taxes and Duties Act, too, prescribes wide liability of the board. This includes the State Revenue Service's power to take legal action seeking repayment of the company's overdue taxes to the Treasury from the board member personally, subject to the following criteria being met:

- Overdue taxes exceed the sum of 50 monthly minimum wages set in Latvia (the monthly minimum wage is EUR 620 from January 2023).
- The decision to recover overdue taxes has been notified to the company.
- It has been established that the company disposed of its assets and failed to pay its overdue taxes in full by statutory deadlines as a result of the board member's act or omission after the decision on a tax audit was made, after a statement was sent of discrepancies found during a data compliance review between the information filed by the taxpayer and the information held by the tax authority, after a thematic review memo was drawn up if that review found substantial breaches suggesting tax evasion, and after overdue taxes arose.
- A statement has been issued confirming that recovery is impossible.
- The company has defaulted on its obligation to file a corporate insolvency petition under the Insolvency Act.

Also, criminal liability may arise for evasion of taxes and equivalent charges under section 218 of the Criminal Code, applicable in the event of a large-scale evasion (exceeding 50 monthly minimum wages).

Attention should also be paid to the prevention of money laundering and terrorism financing. If the board member is responsible for this area, the supervisory authority may issue a warning, charge a fine, or remove him from this function of board liability.

The board member's protection

The board member's liability covers many areas, so each transaction deserves a careful assessment. The board member's liability insurance can be chosen for the following purposes:

- Covering risks where the board member is liable with his own personal assets
- Providing a guarantee to the company that the board member will have funds to repay to the company because the claim against him may substantially exceed his personal finances

- Providing a guarantee of security in board decision-making, helping the company to grow

When it comes to choosing insurance, you should become familiar with its restrictions, be aware of risks the insurer will or will not cover, and assess whether the policy covers risks relevant to your company. For example, no insurer will undertake to insure a deliberately unlawful act or fraud, a dispute begun before the insurance was bought, or an activity aimed at gaining a personal benefit.

¹ Riga Regional Court ruling No. C30601515 of 18 April 2019 (archive No. CA-0081-19)