

# Recovering lost profit from board member 2/50/23

Company board members should carry out their duties as honest and diligent stewards at all times.<sup>1</sup> The content of the phrase “as an honest and diligent steward” has been deliberately left undefined in the law, and so this should always be tailored to find a fair solution to each dispute.<sup>2</sup>

The standard of honest and diligent stewardship might be violated by a board member who has entered into a transaction in the company’s name that causes a loss to the company, but the case law shows that civil liability does not arise automatically in this case. While any board member’s task is to enter into profitable transactions in the company’s name, this is not always possible or even desirable. For example, it will not be possible to enter into a transaction that brings the usual level of profit if the company’s goods or services are not in demand on the market at the moment, and a deal could be struck for a deliberately lower price to attract new customers, etc.<sup>3</sup>

This means that what matters is the context of the transaction. For example, particular contractual terms under certain circumstances (the market price, the company’s financial position, other alternatives, etc.) may cause a loss to the company without the board member being held liable, while the same terms agreed under different circumstances could be grounds for considering the board member’s liability. Of course, there are business principles the board member must follow at all times. Any transaction made in the company’s name should first be carefully evaluated from all possible aspects, he needs to predict the consequences, study the terms and conditions, make sure the transaction complies with the law, check that the business partner’s representative is authorised to enter into the transaction, etc.<sup>4</sup>

If the company’s general meeting of shareholders believes the board member has failed to act as an honest and diligent steward in any of these aspects and his conduct has caused a loss to the company, the general meeting may resolve to sue him for damages.<sup>5</sup> Assuming that the court goes with the general meeting’s claim that the board member’s particular action (or inaction) means he was not acting as an honest and diligent steward, he may be held liable for losses caused to the company.

Under the Latvian legal framework, the term “loss” means not only a reduction in existing assets, such as impairment of an asset owned by the company, but also a loss of anticipated profit,<sup>6</sup> i.e. income the company missed because of the board member’s action (or inaction). The purpose of recovering lost profit is to receive a compensation for what the company would have received if the board member’s unlawful conduct had not taken place, or to prevent the harmful effects his unlawful conduct would definitely have on the company’s assets in the future.<sup>7</sup>

Recovering lost profit makes sense, because any company is an economic operator set up to make a profit, not only to preserve its existing assets.<sup>8</sup> However, we should bear in mind that the company is interested in growing the business and making a profit in the long term, not only short term, so the board member has the right to enter into transactions that might not maximise profits at once but which, for instance, award bonuses to workers, improve the workplace or the company’s reputation, attract new customers, etc.<sup>9</sup>

To win a lawsuit for damages (including lost profits), the general meeting needs to demonstrate that all the preconditions for paying damages are present:

1. The board member’s inexcusable action or inaction
2. The amount of loss caused to the company
3. A causal connection between the board member’s inexcusable action and the loss

However, even if all of these preconditions for seeking damages are proved, the court will not satisfy the general meeting's claim if the board member (defendant) afterwards demonstrates that his action (or inaction) does not contain even the slightest negligence, meaning he acted as an honest and diligent steward. So the company as plaintiff should first prove the existence of all three preconditions and the burden of proof then passes to the defendant – the board member, who can be excused if he demonstrates that he acted as an honest and diligent steward.<sup>10</sup>

It might not be easy to provide grounds for a lawsuit seeking recovery of lost profits from the board member. The claim should include not only evidence and calculations showing that profit was lost through the board member's acts<sup>11</sup> but also a statement that those acts fall short of the standard of honest and diligent stewardship.<sup>12</sup> The claim should therefore show that if the board member had acted as an honest and diligent steward, the profit indicated in the claim would definitely have been made.<sup>13</sup> The inability to prove the existence or amount of a loss is the most common basis for dismissing such claims.<sup>14</sup>

To win the lawsuit, the company needs its current evidence, such as documents relating to the transaction that caused the loss (written agreements, invoices issued under those agreements, etc.) and primary accounting documents, plus more evidence to be prepared, because estimating the amount of anticipated profit that has been lost is mainly based on economic calculations. To estimate the loss of anticipated profit, we need to analyse the anticipated business that has not taken place, considering various factors potentially affecting profits. To arrive at the profit in the particular business segment, production costs, sales expenses and taxes are deducted from revenues.<sup>15</sup> Economic calculations combined with other "traditional" evidence are key to success, so companies need to allocate adequate resources for finding it and possibly hire not only lawyers but also finance experts and economists.

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<sup>1</sup> The Commerce Act. Latvijas Vēstnesis, 158/160, 04.05.2000. Available here, section 169(1)

<sup>2</sup> Supreme Court Civil Division ruling SKC-102/2014 of 27 May 2014

<sup>3</sup> Supreme Court Civil Division ruling SKC-368/2023 of 28 September 2023

<sup>4</sup> Abramovica L. The significance of an honest steward's diligence in the Commerce Act. Jurista Vārds, 07.11.2006, No. 44

<sup>5</sup> Section 169(2) of the Commerce Act

<sup>6</sup> Torgans, K. Law of Obligations. Second supplemented edition. – Riga: Tiesu namu aģentūra, 2018, page 205

<sup>7</sup> Supreme Court Civil Division ruling SKC-309/2020 of 2 April 2009

<sup>8</sup> Section 1(2) of the Commerce Act

<sup>9</sup> Rudans S. A board member's liability for losses caused to the company, Jurista Vārds, 15.01.2012., No. 42

<sup>10</sup> Supreme Court Civil Division 2016 ruling SKC-2/2016

<sup>11</sup> Supreme Court Civil Division 27 May 2020 ruling SKC-309/2020

<sup>12</sup> Supreme Court Civil Division 23 November 2018 ruling SKC-291/2018

<sup>13</sup> Supreme Court Civil Division 28 September 2023 ruling SKC-368/2023

<sup>14</sup> Novicane. E. A board member's liability for losses caused to the company. Promotion paper, 2020. Available here

<sup>15</sup> Supreme Court Civil Division 22 October 2015 ruling SKC-131/2015