RELIABILITY AND REPUTATION OF THE BOARD MEMBER IN LATVIA

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Abstract

Research purpose. The purpose of this article is to investigate the most important risk factors in the assessment of the reliability and reputation of the Board Member for the implementation of responsible business activities in Latvia.

Design/Methodology/Approach. The research methods used in the current article are a comparative analysis of the legal bases and other regulative documents and case studies. The case study is based on the economic and legal analysis of legal acts using descriptive, analytical, deductive and inductive methods, based on which the authors draw conclusions about the reliability and reputation of the Board Member in assessing the key risk factors of their responsibility. The following data collection methods were used to achieve the set goal: analysis of special literature and internet resources and document analysis.

Findings. The risks of the responsibility of a Board Member are still not a completely researched topic in Latvia. There is no common understanding of the reliability and reputation of a Board Member. The legal framework is incomplete, which has a negative impact on the responsible business in Latvia.

Originality/Value/Practical implications. The study contributes to the implementation of a responsible business environment by creating a common understanding of the risks of a Board Member's responsibility.

Keywords: Reliability and Reputation; Board Member; Entrepreneurship; Legislation; Latvia.

JEL codes: K15; K20.

Introduction

The position of a Member of the Board and Council of a commercial company has a heavy burden of responsibility, because when concluding transactions and managing the day-to-day business of the company, all responsibility lies with company's governing body – the Board. It is important to ensure that the Board works as a whole. The commercial law stipulates that the Board must act as a good and careful master. So the key to a Board Member is to be loyal, to exercise due diligence in decision-making, to have good faith and to abide by the law. The legal status of the company must correspond to the nature and scope of the company. The appropriate legal status for state-owned commercial enterprises is a joint-stock company or a limited liability company. They must be subject to the same administrative structures as private companies and shall be subject to the same legal requirements as set out in the commercial law and other legislative acts for private companies.

The management body of a capital company is elected and approved by the members of the company. When electing the Board and Council Members of the company, the suitability assessment criteria include one of the most important criteria, which is the basis for choosing a Board Member – impeccable reputation. The law imposes a requirement of good reputation. At the same time, it should include specific features, objective criteria against which to measure this reputation. How to measure it? There are

different, opposing views on this issue, which are expressed both in publications and in the special legal literature.

An impeccable reputation is a prerequisite for holding important national positions, which is set by both politicians and public organisations. The important question is how to assess reputation, what are the measurable criteria for 'good' or 'bad' reputation. Social anthropologist Klāvs Sedlenieks pointed out that reputation is not a legally provable case that could be decided in a courtroom. However, this does not detract from the importance of reputation in assessing the performance of officials.

Reputation is a person's moral assessment, his or her public identity, or, in other words, his or her reliability. A person's public identity can be threatened by various scandals, which can sometimes be artificial, so it is always necessary to make a very careful assessment and it should not be based solely on rumours. Reputation is very difficult to measure by any objective criteria, because it is largely based on public perceptions of whether or not it is fair and ethical.

In turn, reliability is fostered by the company's internal corporate culture, because the employee must feel valued. Thus, the employee treats his or her employer, the company in which he or she works, as a significant value for him or her. It is mutual respect, keeping promises, fulfilling all responsibilities in good faith, and information providing. If, for example, an employee learns about a serious process in the company from newspapers and not from his or her employer in an informative meeting or report, this, of course, does not promote mutual trust.

Literature Review

1) The place of intangible assets in the regulatory framework of reputation and reliability

The concept of intangible assets – intangible or incomprehensible assets. Intangible assets do not have a physical form, they are intangible. They are also not financial assets. Intangible assets or intangible investments (term according to the Law on Annual Accounts and Consolidated Annual Accounts) belong to the group of long-term investment assets, which in turn consists of: development costs; concessions, patents, licenses, trademarks and similar rights; other intangible investments; and goodwill (The Consulting platform 'Ifinances' of the Republic of Latvia, 2020).

Intangible assets in many business sectors today are playing an increasingly important role in a company's financial management and planning. In the legislation of the Republic of Latvia for the accounting of intangible assets, there is not a sufficient unified theoretical basis. The 38th International Accounting Standard (IAS) defines intangible assets as follows: An intangible asset is an identifiable non-monetary asset that is not in physical form and is held for use in the production or supply of goods or services, for lease to others or for administrative purposes (The Consulting platform 'Ifinances' of the Republic of Latvia, 2020).

The most critical and strategic asset a company assesses is its reputation. A 'reputation improvement plan' is a critical document for the Board of directors or Members. In practice, reputation improvement plans vary enormously in terms of structure, format and content. A successful reputation improvement plan and programme will only occur when at least the following combined forces are effective: a vision of something better (a clear target embedded in a plan) and a few practical first steps to achieve it (to launch the process). Reputation is not a gift but really hard work. (Klaas Jagersma, 2010)

The most important strategic and long-lasting asset a company owns is its reputation. Whilst corporate reputation is undoubtedly an important and significant corporate asset, serious valuation problems have made these key intangible assets excluded from the financial statements. Therefore, a 'reputation index' was created, which covers the main dimensions and assesses the various organisational components, including corporate strategy, financial strength and viability (Kravens, Olivers, Ramamoorti, 2003).

Corporate reputation can be managed and accumulated. Consumers are willing to pay a higher price for the goods and services offered, which in turn leads to greater customer loyalty. Therefore, reputation is one of the most valuable forms of a company's 'capital'. Ensuring the functional and social expectations of society, on the one hand, and the success of creating a unique identity, on the other hand, creates trust, and this trust forms the informal structure of the company. This framework provides returns and creates reputational capital. A positive reputation provides the company with a long-term competitive advantage. The higher the company's reputation capital, the lower the costs of supervision and control.

There are many contradictory models of reputation and trustworthiness, but in this study, the authors will strictly adhere to the study of the reputation and trustworthiness system in regulatory enactments both in the Republic of Latvia and in the European Union in relation to Board Members.

There are currently almost 140,000 commercial companies in Latvia, with one or more Board Members at the helm. Each of them is responsible for the company's growth and development, but in the event of failure, a situation may arise where the company's members or creditors want to assess the liability of Board Members. In general, it can be said that along with stricter legal requirements, the burden of liability of the Board is also increasing; therefore, the number of claims and legal proceedings against the Board Members is gradually increasing. (Zivtīņa, 2019)

For many capable and high-potential professionals, this requires a careful assessment of the risks involved in becoming a Board Member. One of the mitigators of these risks is the Board Member's civil liability insurance (D&O liability insurance), which protects the Board Member in cases where sued, for example, to compensate the company for losses (Sorainen, 2019).

2) Reliability and reputation system in the Republic of Latvia

The measure of impeccable reputation and reliability is enshrined in many laws and often in different forms.

One way in which the legislator immediately lists the criteria of impeccable reputation is given as follows: if a person meets the criteria, then there is impeccable reputation, if a person does not meet the criteria, then there is no impeccable reputation. This is the strictest, simplest approach.

The second approach is to include the open concept in legislation. This often leads to confusion, leading to the interpretation of what constitutes an impeccable reputation. In this case, both candidates and evaluators must be very careful, because this allows the manipulation to affect the independence of the official. Even minor infringements that would not be correct could be considered to affect reputation. The guarantee of independence with this vague concept can be easily torpedoed; the risks are pointed out by legal expert E. Pastars.

It is also believed that an impeccable reputation can be proved by other people, authoritative people in certain professions. And as proof, there may be a presumption that you have an impeccable reputation until proven otherwise. According to the commercial law, a capital company is a commercial company whose share capital consists of the total amount of nominal values of shares or stocks. There are two types of companies: limited liability companies and joint-stock companies. Section 140 of the commercial law stipulates that the founder of the company shall be a natural person or a legal person or a partnership who has performed the activities related to the founding of the company or on whose behalf these activities of founding have been performed.

In its turn, Section 1 of the Law on Governance of Capital Shares of a Public Person and Capital Companies stipulates that there are the following types of capital companies: a capital company of a public person, a capital company in which all capital shares or voting shares belong to one public person; a capital company controlled by a public person, a capital company in which one or more public persons have a direct decisive influence; a public-private capital company, a capital company in which all capital shares or voting shares belong to several public persons; private capital company, a capital company in

which the capital shares or stocks belong to a public person and another person (except for the owners of personnel shares); state capital company, a capital company in which all capital shares or voting shares belong to the state; capital company of a derivative public person, a capital company in which all capital shares or voting shares belong to one derivative public person; local government capital company, a capital company in which all capital shares or voting shares belong to one local government.

The commercial law stipulates that the governing bodies of the company are the meeting of Members and the Board, as well as the Council. The same regulation is also given in Section 65 of the Law on the Governance of Capital Shares and Capital Companies of a Public Person and stipulates that the management of a company is carried out by a participant, a meeting of Members and the Board, as well as a Council (if one has been established).

The commercial law in relation to capital companies, the founders of which are natural persons or private legal entities, does not prescribe any criteria and requirements for the assessment of reputation and election of the governing bodies of these companies – the Board and Council. The situation is different if a governing body is elected – the Board and/or Council in capital companies where its founders and Members are public persons.

The guidelines for the selection of Board and Council Members also set an impeccable reputation as one of the criteria. Generally defined, an impeccable reputation in the field of corporate governance is an action of a Council or Board Member that does not give an independent observer doubts about the professional performance of the duties of a particular official or a Board or Council Member (G20/OECD Principles of Corporate Governance).

On 25 January 2020, the Cabinet of Ministers approved the procedure for nominating new Members of the Board and the Council. The purpose of the regulations is to promote open, fair and professional selection of Members of the Board and Council of state and derivative public persons, including local governments and capital companies. Until now, the criteria for determining the number of Members of the Board and the Council have been regulated by the Cabinet of Ministers Regulations No. 686 ‘Procedures for Nominating Candidates for Positions of Board and Council Members in Capital Companies in Which the State as a Participant (have the right to nominate the Members of the Board or Council and Members of the Board in state-owned companies in which the Council has been established’, but they are only applied to state-owned companies. In order to improve the procedure for the selection of Members of the Board and Council of both state and local government capital companies, it will be regulated by new Cabinet of Ministers Regulations No. 20 ‘Procedure for Nomination of Members of the Board and the Council in Capital Companies in Which the Capital Shares Belong to the State or a Derivative Public Person’ (Legal acts of the Republic of Latvia, 2020).

The Law on Governance of Capital Shares of Public Person and Capital Companies provides an explanation of the concept of corporate governance, stipulating that it is a set of measures for achieving the objectives of the capital company and controlling the capital company's activities, as well as assessing and managing risks related to the capital company's activities. This is in line with the objective of the new Cabinet of Ministers regulations to ensure compliance of the nomination process for the Members of the Board and Council Member with the principles of good corporate governance and open, fair and professional selection of the Members of the Board and Council, which promotes the establishment of an institution in professional and competent state and derivative public entities, including local governments.

Since this year, the Interdepartmental Coordination Centre (PKC) has been ensuring the selection of candidates for Members of the Council of State Capital Companies together with the shareholders and manages the work of nomination commissions. As the Interdepartmental Coordination Centre explains, ‘The approved procedure will be followed when selecting and evaluating candidates for Board and Council Members in the case of management of state capital shares, derivative public capital shares, as well as public capital companies and subsidiaries of public capital companies’.

The new unified approach to the selection of candidates for the Members of the Council and the Board of state capital companies is determined by the amendments to the ‘Law on Governance of Capital Shares of Public Persons and Capital Companies’ that came into force on 1 January 2020 and the Cabinet Regulation No. 20 ‘Procedure for Nomination of Members of the Board and the Council in Capital Companies in Which the Capital Shares Belong to the State or a Derivative Public Person’ (see Fig.1).

Fig.1. Minimum requirements for the candidate of the Member of the Board or Council of State Capital Companies
(Source: Legal acts of the Republic of Latvia, 2020)

As a result of the project initiated by the European Commission (EC) and KMPG Baltics and initiated by the Cross-sectoral Coordination Center, an independent evaluation of the management of state-owned companies was prepared, analysing the existing processes of goal setting, monitoring and performance evaluation. Proposals are also made to improve the governance of state-owned companies, taking into account their different operating profiles and scope.

Upon the completion of the project, an international assessment and comparison of Latvian governance with models in other European Union and Organization for Economic Co-operation and Development (OECD) countries was obtained.

The principles of corporate governance and recommendations for their implementation have been developed, taking into account the requirements set for capital companies in the legislation of the Republic of Latvia, as well as the recommendations of the European Union and the OECD for corporate governance. The principles of corporate governance would be applicable not only to capital companies whose shares are listed on a regulated market organised by NASDAQ OMX Riga, AS, but also to any other capital company.

The purpose of the regulations of the Cabinet of Ministers is to ensure the compliance of the process of nominating the Members of the Board and the Council with the principles of good corporate governance practice, to ensure open, fair and professional selection of the Members of the Board and the Council. The requirements of the regulations for candidates for the position of Members of the supervisory Board and the management Board, in addition to the restrictions specified in the Law on Governance of Capital Shares and Capital Companies of Public Persons (the Law), determine five basic criteria for personnel

selection : knowledge of the state language and foreign language required for the performance of professional duties at an appropriate level; appropriate education, which provides the knowledge and competence base required for the position; relevant work experience and skills; as well as impeccable reputation and other essential professional skills and competencies scope.

Andris Grafs, Vice President of the Baltic Institute of Corporate Governance, Head in Latvia, pointed out that in all the Baltic States, there is a tendency for corporate governance to become an increasingly important issue on the agenda. There are several reasons for this.

First, the responsible business culture is growing in the business environment; entrepreneurs think more about business sustainability, efficiency and growth. If a company is ambitious and plans to grow not 10% a year, but 10 times a year, then effective corporate governance is a component without which it will not be possible.

Second, crises and corporate disputes in other companies call for the review of the principles in which strategic decisions are made, how risks are managed and how cooperation between a company's shareholders, the Board and the Council and so on takes place.

Third, there is an increasing 'pressure' from investors and banks to put corporate governance in order. Each bank assigns a credit rating to a company that needs financing for development, which determines the terms of financing. Summarising the experience of five Latvian banks, including Baltic International Bank, it can be concluded that aspects related to corporate governance affect up to 25% of the credit rating of a company formed by banks: banks evaluate the owners of the company, the operational experience and reputation, the professionalism of company management, strategic decision-making practices, risk management, transparency, the quality of information provided and other aspects. Therefore, it is expected that these issues will be paid more and more attention to by companies themselves, banks and investors in the coming years.

At least one 'reputation case' has been dealt with in depth in court. In 2015, the then Chairman of the National Electronic Media Council (NEPLP) Ainārs Dimants challenged the decision of the Saeima on his dismissal in court. The Saeima relied on Section 59, Paragraph 3, Clause 3 and Section 56, Paragraph 3 of the Electronic Media Law (good reputation). Politicians in the debate emphasised that the Chairman of the Council had lost his good reputation and also referred to the conclusion of the audit report of the State Audit Office that the NEPLP had not acted effectively with finances (Journal 'Jurista vārdi', 2019).

In its judgment on 22 September 2017, the Supreme Court indicated that the basis for the release of an official may also include the indefinite concept of law. Such is the concept of good reputation referred to in Section 56, Paragraph 3 of the Electronic Media Law, in the fulfilment of which the institution has a wide freedom of assessment. Its judicial review is limited, that is, in the case of freedom of assessment, the court only examines whether there has been manifested an error or a serious procedural irregularity (Journal 'Jurista vārdi', 2019).

Usefulness considerations in the case of freedom of assessment do not have to be made and cannot be examined by the court accordingly. Whilst acknowledging that the applicant had acted unlawfully as the Chairman of the Council, the court concluded that he or she was thereby damaging his or her reputation, which was the basis for his or her dismissal. The Supreme Court finds such a conclusion correct, namely, that a person's unlawful conduct is incompatible with good reputation, regardless of whether and to what extent violations of the law are perpetrated in society in similar situations (Supreme Court Judgement of 11 January 2013 in Case No. SKA-53/2013 (A42680309), Paragraph 8).

Unfortunately, the experience shows that too wide a range of interpretations of reputation only paves the way for political manipulation of the management of social media and thus also threatens the independence of public service media. (Legal acts of the Republic of Latvia, 2015)

It should be taken into account that the commercial law does not set and determine such reputational requirements for capital companies of private legal entities, which are set and developed in the regulations of the Cabinet of Ministers 'Requirements for Candidates for the Positions of the Board and Council' (Legal acts of the Republic of Latvia, 2020).

The commercial law, in accordance with Article 4.1, imposes only a restriction on commercial activities imposed on a natural person and stipulates that if a natural person is deprived of the right to conduct all or a certain type of commercial activities based on a decision in criminal proceedings, the following is prohibited: to be a Member of the Board or Council of a capital company. However, it must be borne in mind that this applies only to a natural person who has been deprived of the right to engage in a certain type of commercial activity and that the prohibitions imposed apply only to the type of commercial activity specified in the relevant decision. If the legal status of such a person allows him or her to make decisions in a commercial company, he or she is prohibited from taking decisions in matters that relate to the type of commercial activity specified in the relevant decision (Legal acts of the Republic of Latvia, 2000).

In its turn, Article 4.2 of the Commercial Law prescribes restrictions for a natural person based on the criminal or administrative infringement proceedings to hold certain positions, and a natural person is deprived of the right to hold certain positions in a commercial company and its administrative institutions as being a Member of the Board or the Council (Legal acts of the Republic of Latvia, 2000).

As Kalniņš pointed out in his book 'The Further Development of Law/Theory and Practice of Private Law', the content of the criterion 'impeccable reputation' as a concept (general clauses) that can be fulfilled with a certain content can be revealed using legal methods, because 'their content derives from their scope and can be clarified by means of generally accepted examples, by looking at groups of typical cases and identifying their specific elements' (Journal of the University of Latvia 'Law' No 8, 2015).

Methodology

The research methods used in the current article are a comparative analysis of the legal bases and other regulative documents and case studies. The case study is based on the economic and legal analysis of legal acts using descriptive, analytical, deductive and inductive methods, based on which the authors draw conclusions about the reliability and reputation of the Board Member in assessing the key risk factors of their responsibility. The following data collection methods were used to achieve the set goal: analysis of special literature and internet resources and document analysis.

Research limitations. The research is based on a scientific research analysis method analysing reputation and reliability of Board Member, using wide references (journal articles, books, Internet resources and official databases of Legal acts of the Republic of Latvia and OECD), including analysis about

- 1) different viewpoints from experts and researchers about reputation, at first personal moral assessment/his or her public identity, subjective and objective criteria, concluding the summary of views, corporate reputation can be managed and accumulated and 'Reputation improvement plan' is a critical document for the Board of directors or Members;
- 2) the place of intangible assets in the regulatory framework of reputation and reliability. Because the most important strategic and long-lasting asset a company owns is its reputation;
- 3) reliability and reputation system in the Republic of Latvia. The measure of impeccable reputation and reliability is enshrined in many laws and often in different forms: first, to list the criteria of impeccable reputation; second, to include the open concept in legislation; and third, to prove an impeccable reputation by other people;
- 4) The European Union and OECD recommendations established in Latvian legislation on the criteria set for the Board Members, including the reputation requirements evaluating only the public sector in Latvia;

5) at least one ‘reputation case’ in Latvia, based on the official information: the Chairman of the National Electronic Media Council (NEPLP) Ainārs Dimants challenged the decision of the Saeima on his dismissal in court; the authors have selected and analysed case No. SKA-53/2013 (A42680309), case No. SKA-767/2017. In its judgment in 22 September 2017, the Supreme Court indicated that the basis for the release of an official may also include the indefinite concept of law. Such is the concept of good reputation referred to in Section 56, Paragraph 3 of the Electronic Media Law, in the fulfilment of which the institution has a wide freedom of assessment.

Authors used document analysis scientific research method to obtain the information and evaluate processes that concern reliability and reputation of the Board Members. Any written and digital materials that include information about phenomenon researched are considered documents. On the basis of the methods of scientific induction and scientific deduction, the authors of the study conclude that strengthening the existence of credibility and reputation in legislation in the public sector may have consequences that affect the business environment in the private sector.

Results

The guidelines for assessing the reputation of Members of the Board and Council in capital companies, both private capital companies and capital companies with the state capital management institution, as a criterion for holding responsibility for non-performance or removal from office, have not been studied sufficiently in Latvia. As well as, in the case-law, there are only a few cases where an unacceptable reputation is a justification for losing the position of a Board Member. Analysing the current legal situation and criteria that determine the reputation of a Board Member, the work examines the legal factors that influence the impact of the commercial law and the Law on Governance of Capital Shares of a Public Person and Capital Companies and the practice of applying these norms when assessing the reputation of a Board Member in a capital company and applying assessment criteria.

Conclusions

The authors of the study by analysing the content of legal acts regulating the choice of public and private management bodies – the Board and Council – by taking into account the risk factor, good reputation, which affects the implementation of a responsible business environment to ensure compliance with good corporate governance practices, conclude:

- the new, unified procedure for the selection of Members of the Council of capital companies helps to strengthen internationally recognised management principles, ensuring uniformity and transparency of the process in selecting the most suitable candidates for positions;
- a candidate for a Member of the Board or the Council shall be deemed to be a person of an impeccable reputation if there is no evidence to the contrary and there is no reason to have sensible doubt about the impeccable reputation of the person. When assessing the reputation of a candidate for a Member of the Board or the Council, the information available to the shareholder or the Council, as well as the nomination commission, which is available for the assessment, shall be taken into account;
- In Latvia, the general legal framework for the functions, activities and responsibilities of the Board is set out in the commercial law, where Section 169 provides for a broad concept of the liability of the Board and special laws, such as the Law on Management of the diligent owner and jointly and severally with the other Members of the Board must be liable for the damage he or she has caused to the public;
- the content of the criterion ‘impeccable reputation’ as a content-enforceable concept (general clause) can be detected through legal methods. Their content can be clarified with the help of

generally accepted examples by looking at typical cases and identifying their characteristic elements;

- if the law prescribes the requirement of good reputation, at the same time, it should include certain features, objective criteria according to which this reputation should be measured;
- the Council of the Coordinating Institution for the Management of State Capital Shares and State Capital Companies developed the guidelines for the selection and evaluation of candidates for Members of the Board and Council of a capital company in capital companies in which countries have the right to nominate Members of the Board and Council. It would also be advisable to include the features included in these guidelines in the commercial law on the selection of Members of the Board and Council in private companies.

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