



# THE CONSTITUTIONAL COURT OF THE REPUBLIC OF LATVIA

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## J U D G E M E N T

on Behalf of the Republic of Latvia

in Case No. 2014-02-01

13 June 2014, Riga

The Constitutional Court of the Republic of Latvia, comprised of: chairperson of the court hearing Aldis Laviņš, Justices Kaspars Balodis, Kristīne Krūma, Gunārs Kusiņš, Uldis Ķinis and Sanita Osipova,

having regard to the constitutional complaint submitted by Svetlana Ovčiņņikova,

on the basis of Article 85 of the Satversme of the Republic of Latvia and Para 1 of Section 16, Para 11 of Section 17(1), Para 19<sup>2</sup> and Para 28<sup>1</sup> of Constitutional Court Law,

at the court hearing of 28 May 2014 examined in written procedure the case

“On the Compliance of Para 4 of Section 17 of Deposit Guarantee Law with the first sentence of Article 91 of the Satversme of the Republic of Latvia”.

### The Facts

1. The Law on the Guarantees for the Deposits by Natural Persons, adopted by the Saeima on 21 May 1998, entered into force on 1 October 1998. Para 2 of

Section 17(1) of this Law provided that the guaranteed compensation would not be paid for deposits made by members of the council and board of the bank, executive directors and members of audit committee.

With the law of 11 October 2011 “Amendments to the Law on the Guarantees for the Deposits by Natural Persons” Section 17 of the Law on the Guarantees for the Deposits by Natural Persons was expressed in a new wording, excluding from it the regulation regarding deposits made by a board member of the bank. Likewise, the title of the law was expressed in a new wording by the aforementioned amendments, providing that in the future it would be Deposit Guarantee Law.

Whereas with the law of 4 June 2009 “Amendments to Deposit Guarantee Law” Para 4 of Section 17 was expressed in a new wording, providing that the guaranteed compensation should not be paid for deposits of shareholders of a deposit taker, who had qualified holdings in the deposit taker, the chairperson and members of the council and the board, the head of the internal audit service, the company controller and other employees of a deposit taker who were authorised to conduct the planning, management and control of the operations of the credit institution and who were liable for it.

No further amendments have been introduced to Para 4 of Section 17 of Deposit Guarantee Law (hereinafter – the contested norm) and it continues to be in force in the wording of the law of 4 June 2009.

**2. Svetlana Ovčinnikova** (hereinafter – the Applicant) notes in her constitutional complaint that until 21 November 2011 she had been in the position of a board member at the joint stock company “Latvijas Krājbanka” (hereinafter – Krājbanka). The Applicant had had deposits at Krājbanka in the amount of several tens of thousand euros. After the Financial and Capital Markets Commission (hereinafter – the Commission) had adopted the decision on the occurrence of unavailability of deposits at Krājbanka and on partial payment of guaranteed compensation to depositors, the Applicant had turned to the Commission requesting disbursement of the guaranteed compensation. However, the Commission, citing the

contested norm, had refused payment of guaranteed compensation. This decision by the Commission had been appealed against in an administrative court, which recognised it as being legal.

The Applicant notes that the payment of guaranteed compensation has been envisaged to all depositors in the amount defined in the first part of Section 3 of Deposit Guarantee Law. Thus, all persons, who at the moment when the unavailability of deposits occurred, had deposits at the credit institution, are under similar and comparable circumstances. Whereas Para 4 of Section 17 of the same Law is said to establish a differential treatment of the same persons, i.e., the guaranteed compensation is not paid to the board members of the deposit taker.

The differential treatment established in the contested norm is said to have a legitimate aim – to create adverse material consequences to those persons, who have facilitated the occurrence of unavailability of deposits. This deters board members of a credit institution from committing such actions that could leave an adverse impact upon the solvency of a credit institution.

However, the aforementioned differential treatment is said to be disproportional, since the measures applied by the legislator are said to be inappropriate for reaching the legitimate aim. I.e., legal acts do not impose an obligation upon a board member of a credit institution to deposit all his financial resources at the credit institution, where he is in the position of a board member. Thus, if the board member had made deposits in another credit institution, he would not lose the right to handle them freely. Moreover, there are sufficient grounds to believe that if a board member of a credit institution had known of circumstances that might endanger solvency of this credit institution, he would have transferred his deposits to another deposit taker. Since a board member does not have the obligation to deposit all his financial resources at a credit institution, where he has the respective position, the contested norm, allegedly, cannot serve as a means for reaching the legitimate aim.

Moreover, the legitimate aim of the differential treatment envisaged by the contested norm could be reached by measures that are less restrictive upon a

person's rights. I.e., allegedly, the contested norm does not differentiate between adverse consequences, depending upon the guilt and degree of personal responsibility of each board member. Thus, the adverse consequences have an equal impact upon those board members, who by their actions have facilitated the occurrence of unavailability of deposits, and those board members, who are responsible for such issues in the operation of a credit institution that have no direct impact upon availability of deposits. Therefore the legitimate aim could be reached by differentiating the payment of guaranteed compensation, depending upon the degree of guilt of each board member, established by a judgement in a criminal case that has entered into force. Such differentiation of liability, depending upon the degree of guilt of each board member, would deny payment of guaranteed compensation to those persons who, by their failure to act, did not ensure correct management of a credit institution.

The benefit that society gains from the contested norm is said to be small and manifests itself as financial stability, as well as trust in credit institutions. However, if the board member has not acted unlawfully or negligently, then no public benefit from denying the guaranteed compensation to this person can be identified.

**3. The institution, which adopted the contested act, – the Saeima –** holds that the contested norm complies with the first sentence of Article 91 of the Satversme of the Republic of Latvia (hereinafter – the Satversme).

The contested norm was introduced to Deposit Guarantee Law with the law of 4 June 2009 “Amendments to Deposit Guarantee Law”. The draft law was submitted to the Saeima by the Cabinet of Ministers, and the annotation to it noted that such amendments to the law were necessary to specify the procedure in which the guaranteed compensation should be paid to depositors. Likewise, the annotation points to the Directive of the European Parliament and the Council of 30 May 1994 94/19/EC on Deposit Guarantee Schemes (hereinafter – Directive 94/19/EC), which allows adopting such legal regulation that is included in the contested norm. The contested norm has been in force since 20 June 2009; however, a regulation with

similar content was included already in the initial wording of Para 2 of Section 17(1) of the Law on the Guarantees for the Deposits by Natural Persons, which was in force until 1 January 2003.

Section 17 of Deposit Guarantee Law defines cases of exception, when the guaranteed compensation is not paid. Thus, the Saeima upholds the Applicant's view that all those persons, who have deposits in credit institution, are in similar and according to certain criteria comparable circumstances.

Likewise, the Saeima admits that the contested norm with respect to board members of a credit institution who have deposits in the respective credit institution provides for a differential treatment compared to other depositors. However, this differential treatment is said to have a legitimate aim and reasonable grounds.

Allegedly, the legitimate aim of the differential treatment established by the contested norm is to deter preventively board members of a credit institution from committing such actions that might have an adverse impact upon solvency of the credit institution. Thus, the aforementioned restrictions had been established for the sake of a legitimate aim – to protect public welfare and other persons' rights.

The regulation established by the contested norm is said to be appropriate for reaching the legitimate aim, since a board member as the fiduciary of a credit institution must facilitate the implementation of the economic interests of the respective credit institution. Therefore board members should be loyal towards the credit institution, and each of them should perform their duties as honest and careful managers.

The insolvency of a deposit taker, to a large extent, is to be linked with the actions by its board members. If a deposit taker has become insolvent, then, most probably, its board members have not performed their obligations as honest and careful managers.

Allegedly, the legitimate aim of the differential treatment established by the contested norm cannot be reached by other measures, less restrictive upon a person's rights. Likewise, the contested norm ensures that the benefit gained by society exceeds the damage inflicted upon an individual's rights.

A board member is a fiduciary of the members of the company and has been entrusted to manage someone else's property. The task to perform one's duties as an honest and careful manager means that board members are responsible for each imprudent action. If unavailability of deposits has occurred, this means that the board members of the deposit taker have not duly performed their obligations of office. In such a case it would not be fair, if the personal deposits made by board members were equally protected as the deposits made by any other depositor.

Operations of credit institutions are said to be linked to commercial risk, and therefore cases, when a credit institution experiences financial difficulties and no longer can meet its commitments, are possible. In the field of credit institutions the possibility of such risk of business activities must be taken into consideration. Board members of a deposit taker, due to their specific knowledge and professional experience, are the ones who have the obligation to identify risks of credit institutions and to pay greater attention to the way they handle their own financial resources.

**4. The summoned person – the Financial and Capital Markets Commission** – notes that the contested norm complies with the first sentence of Article 91 of the Satversme. The legislator, in introducing the deposit guarantee scheme, had initially provided in the law that the deposits made by board members of a deposit taker would not be guaranteed. Likewise, Directive 94/19/EC also envisages the discretion of a Member State in defining those persons, to whom deposit guarantees do not apply. The contested norm, allegedly, makes the leading officials of a credit institution act with greater circumspection in managing the credit institution and in adopting decisions, as well as deters them from adopting such decisions that might leave an adverse impact upon the operations of a credit institution.

The Commercial Law defines the obligation of a board member of a company to perform the function of managing a company. If the respective person, for any kind of reasons, is unable to perform the aforementioned function, then his

obligation is to resign from the office. A board member cannot justify his actions by using the argument that he has been elected on the board only “for appearance” and, essentially, has not performed management functions. The Commercial Law provides that board members manage the company jointly.

The Commission notes that division of competences between the board members is admissible in a credit institution. However, divided competence does not release them from the duty of supervision – in any case, where the board member has not sufficiently supervised the actions of other board members, he should be prepared to assume responsibility for it. Thus, it is alleged that the statement made by the Applicant – that a board member of a credit institution is not in all cases responsible if insolvency of a credit institution occurs – is unfounded.

In addition to the general obligations of managing a credit institution as a commercial company, Credit Institutions Law imposes an obligation upon its board to manage the risks linked to the operations of a credit institution as specified in legal acts. This obligation comprises a number of activities, for example, adopting decisions on granting loans to persons that are linked with the particular credit institution, informing about all circumstances that can have a significant impact upon stable further management of a credit institution in compliance with legal acts.

The Commission draws the attention of the Constitutional Court to the fact that the Applicant as a board member of Krājbanka had book-keeping of the bank in her competence. Whereas one of the reasons why the Commission adopted the decision to suspend the operations of Krājbanka board had been submitting to the Commission deliberately misleading financial reports. Therefore, the Applicant’s statement that she with her activities could not have facilitated the occurrence of unavailability of deposits is said not to be credible. The fact that in the framework of criminal proceedings the Applicant has been applied the status of a suspect and her deposits in Krājbanka have been seized also makes one question this statement.

5. The summoned person – **the Ombudsman of the Republic of Latvia** (hereinafter – the Ombudsman) – holds that the contested norm is not incompatible with the first sentence of Article 91 of the Satversme.

In the case under review, all those persons, who at the moment, when the unavailability of deposits occurred, had deposits in the credit institution, are in similar and comparable circumstances. Since the Applicant had deposits in Krājbanka until the operations of this credit institution were suspended, she is comparable to others. Whereas the differential treatment created by the contested norms manifests itself in the fact that the Applicant has no right to receive the guaranteed compensation for her deposits. I.e. the Applicant's, as the board member's of the deposit taker, right to the guaranteed compensation is restricted.

However, the differential treatment created by the contested norm is said to have a legitimate aim and to be proportional. The legitimate aim of the contested norm is to deter preventively the board members of a credit institution from taking such actions that might have an adverse impact upon the solvency of the credit institution. Whereas the insolvency of a particular credit institution may lead to a threat to the national financial stability. Thus, it may be concluded that the contested norm had been adopted with the aim of protecting public welfare and other persons' rights.

The restriction established by the legislator upon the board members' right to receive the guaranteed compensation should be recognised as being an appropriate measure for making every member of the board treat with great responsibility the deposits of the particular deposit taker. The contested norm increases the responsibility of board members and ensures the stability of the national financial system.

The Ombudsman notes that the more lenient measure offered by the Applicant is not appropriate for reaching the legitimate aim. I.e., the established criminal liability of a board member for the occurrence of unavailability of deposits of the respective deposit taker does not replace his civil law liability, but not in every

case, where the responsibility of a board member for losses incurred by a credit institution sets it, the features of a criminal offence will be identified.

Likewise, the benefit that society gains from the existence of the contested norm is said to exceed the damages caused to a person. A situation, where a depositor, who himself has participated in the planning, management and control of the operations of a deposit taker and directly or indirectly facilitated the occurrence of unavailability of deposits, could demand the same legal protection as any other depositor is said to be unimaginable in a judicial state. A solution like this could increase the insolvency risk of credit institutions and endanger the rights of other depositors to availability of their deposits.

**6. The summoned person – sworn attorney M.iur. (Oxon) Rūdolfs Engēlis** – notes that board members of a credit institution are able to protect themselves from the risk of unavailability of deposits with sufficient effectiveness and do not need special legal protection in case deposits become unavailable.

The aim of the legal regulation that the contested norm comprises cannot be unequivocally regarded as such that is aimed at punishing a board member of a credit institution. The fact that the legislator allows a board member of a credit institution to deposit his financial resources in any credit institution, allegedly, is a proof of this. There would be grounds to consider that the legislator has decided, by applying the contested norm, not to provide assistance to those depositors, who, in view of their abilities and competence in the field of finances, are able to protect themselves.

Basically, the obligations and responsibility of board members of a credit institution are regulated by the Commercial Law. The obligation of “a honest and careful manager”, defined in Section 169(1) of the aforementioned Law is fully applicable also to a board member of a credit institution, and failure to perform this obligation may cause civil liability. Whereas the way this concept is filled with concrete content depends upon particularities in the operations of credit institutions. A credit institution operates with financial resources that are entrusted to it, which it

has taken from its clients. Hence the requirements regarding the obligation to be “an honest and careful” manager that must be set for the board members of a credit institution are higher than, for example, requirements to be set for board members of a commercial company that is not subject to the financial market control.

Operations of a credit institution are based upon public trust in its financial security and ability to meet its commitments. Therefore the solvency of a credit institution is the most important task and aim of operations for every board member of the credit institution. In large commercial companies, *inter alia*, in the majority of banks, each member of the board cannot be fully involved in dealing with all daily matters. To make the operations and management of such commercial companies effective, board members may divide among themselves the management matters that they supervise. However, also in such a case, the right of a board member not to become involved in the “field of competence” of another board member and not to be informed about other matters of company management is very limited. Any situation like this might lead to the fact that a board member individually has not acted as an honest and careful manager.

A situation cannot be excluded, where the unavailability of deposits occurs due to such circumstances that cannot be reasonably predicted by any of the board members and the negative consequences of which could not be prevented by all reasonable measures of security and caution. However, the probability that such circumstances occur is very low, and such circumstances, allegedly, could be equalled to *force majeure*.

**7. The summoned person – the Association of Commercial Banks of Latvia** (hereinafter – the Association) notes that the insolvency of a credit institution is a significant threat to the general financial stability of the State. The contested norm, in its turn, could deter preventively board members of a credit institution from taking such actions that might, possibly, leave an adverse impact upon the solvency of a credit institution. Pursuant to the Commercial Law, a commercial company is managed by its board. If the management of a commercial company has not been

successful, then the board is jointly responsible for it, irrespectively of the degree of individual guilt of each board member.

The authorisation of the board defined in the Commercial Law means, for example, the obligation of the board to be responsible for keeping the accountancy documents in accordance with legal provisions and due management of the property and financial resources of the company. If any obstacles are created for the board member, which hinder him from performance of his duties or implementation of his authorisation, then the board member may turn to the supervisory institution – the Commission – and inform it that he is unable to perform his obligations in full extent.

The Commercial Law envisages joint responsibility of the board members for losses that they have caused to a company. This means that all members of the board are responsible for such consequences; irrespectively of the way duties had been allocated among them. Even though the contested norm does not apply to the board members' responsibility for losses, nevertheless, losses are caused to a credit institution also due to unavailability of deposits. The contested norm does not envisage the responsibility of the board for concrete losses, but establishes other negative consequences to all members of the board, i.e., denies them the right to receive the guaranteed compensation.

**8. The administrator of insolvent Krājbanka – the limited liability company “KPMG Baltics SIA”** (hereinafter – the Administrator) – notes that the Applicant had been appointed member of the board on 19 June 2006 and had had this status until 21 November 2011 when the Commission suspended operations of Krājbanka board. The Applicant's right to receive financial resources deposited in Krājbanka, in turn, is regulated by the general procedure for satisfying creditors' claims.

The Council of Krājbanka had approved the special fields of responsibility for each board member, but at the same time the joint obligations of board members had been underscored in the allocation of duties, for example, the obligation to manage the bank, to be in the known about all matters of the credit institution, to be

responsible for the whole business activities of the bank, to ensure that a system of internal control is established in the bank, functions and is updated. Thus, the Applicant's statement that she had not had the necessary authorisation to prevent the occurrence of Krājbanka's insolvency, is said to be ungrounded.

The alternative measures described in the constitutional complaint are said to be inappropriate for reaching the legitimate aim of the restriction upon fundamental rights, since the purpose of Deposit Guarantee Law is to disburse the guaranteed compensation as soon as possible. Hence, the regulation included in the contested norm could be considered as being reasonable and valid.

A claim has been brought against the Applicant as a former member of Krājbanka's board regarding collection of losses and recognising contracts of pledge as being invalid, since the aforementioned transactions had been concluded without any legal or economic substantiation whatsoever. The conclusion of these transactions had been one of the main reasons for the onset of Krājbanka's insolvency.

### **The Findings**

9. The contested norm applies to several groups of persons, to whom in the case of unavailability of deposits the guaranteed compensation from the Deposit Guarantee Fund is not paid. I.e., the contested norm applies to the deposits that have been made by the shareholders of a deposit taker, the chairperson and the members of the council and the board, the head of the internal audit service, the company controller and other employees of the deposit taker, who plan, manage and control the operations of the credit taker.

When hearing the case that has been initiated with regard to a constitutional complaint, the Constitutional Court must take into account the provisions of the Constitutional Court Law and examine the situation to the extent it is necessary to protect the fundamental rights of the person, who has submitted the constitutional complaint. At the same time the Court must comply with the principle of equality

and examine the situation of all those persons, who are in similar and comparable circumstances with the submitter of the constitutional complaint. If the legal norm that is contested by the constitutional complaint applies to an broad range of different situations, the Constitutional Court must specify the extent to which it will examine the contested norm (*see, for example, Judgement of 28 May 2009 by the Constitutional Court in Case No. 2008-47-01, Para 6, and Judgement of 24 October 2013 in Case No. 2012-23-01, Para 11*).

Thus, also in the case under review, the extent to which and the persons with regard to whom the compatibility of the contested norm with the Satversme should be examined must be specified.

The Applicant was appointed a member of Krājbanka board on 19 June 2006 and was in this position until 21 November 2011, when the Commission suspended the operation of Krājbanka board (*see the Administrator's letter of 17 April 2014 No. 06-3-2/341 and the opinion of the Commission in Case Materials, pp. 118 and 136*). The Applicant, also in appealing against the Commission's decision to refuse paying to her the guaranteed compensation for her deposits, turned to the administrative court as the former board member of Krājbanka (*see Judgement of 5 April 2013 by the Administrative Regional Court in Case No. A43010412, and Judgement of 11 November 2013 by the Department of Administrative Cases of the Supreme Court Senate in Case No. SKA – 640/2013, Case Materials, pp. 31 – 37 and pp. 46 – 54*).

The aforementioned allows concluding that the contested norm was applied to the Applicant as to a person who held the position of a board member at the credit institution. The board of a credit institution, in its turn, is its executive body, which manages and represents this commercial company.

Therefore the Constitutional Court shall examine the compliance of the contested norm with the first sentence of Article 91 of the Satversme to the extent it applies to the deposits made a board member of a credit institution in this credit institution.

**10.** The first sentence of Article 91 of the Satversme provides: “All human beings in Latvia shall be equal before the law and the courts.”

The principle of equality embedded in the first sentence of Article 91 of the Satversme must guarantee the existence of a uniform legal order. I.e., its objective is to ensure that such requirement of a judicial state as comprehensive effect of law upon all person and application of law without any privileges is implemented. It also guarantees total effect of a law, objective and impassive application of law, and also that no one is allowed to ignore injunctions of law (*see, Judgement of 14 September 2005 by the Constitutional Court in Case No. 2005-02-0106, Para 9.1*). However, such uniformity of the legal order does not mean treating all alike, since “equality allows differential treatment, if it is justified in a democratic society” (*Judgement of 26 June 2001 by the Constitutional Court in Case No. 2001-02-0106, Para 4 of the Findings*).

The Constitutional Court, in interpreting Article 91 of the Satversme, has recognised that the principle of equality prohibits state institutions from adopting such norms that without reasonable grounds allow differential treatment of persons, who are in similar and according to certain criteria comparable circumstances. The principle of equality allows and even demands differential treatment of persons, who are in different circumstances, as well as allows differential treatment of persons, who are in similar circumstances, if there are objective and reasonable grounds for it (*see, for example, Judgement of 3 April 2001 by the Constitutional Court in Case No. 2000-07-0409, Para 1 of the Findings, and Judgement of 11 November 2005 in Case No. 2005-08-01, Para 5*). Differential treatment has no objective and reasonable grounds, if it has no legitimate aim or if the relationship between the chosen measures and the set aims are not commensurate (*see Judgement of 23 December 2002 by the Constitutional Court in Case No. 2002-15-01, Para 3 of the Findings*).

Therefore, to examine, whether the contested norm complies with the principle of equality that the first sentence of Article 91 of the Satversme comprises, it must be established:

- 1) whether and which persons (groups of persons) are in similar and according to certain criteria comparable circumstances;
- 2) whether the contested norm provides for equal or differential treatment of these persons;
- 3) whether such treatment has objective and reasonable grounds, i.e., whether it has a legitimate aim and whether the principle of proportionality has been complied with.

**11.** The Applicant notes that all those persons, who have deposits in a credit institution at the moment when unavailability of deposits occurs, are in similar and comparable circumstances. The Saeima also upholds this argument provided by the Applicant.

From the vantage point of the first sentence of Article 91 of the Satversme, the decisive factor is, whether a number of groups of persons share one important feature, applicable to all of them. In the case under review, it is important that the Applicant had deposits in a credit institution at the moment when these became unavailable.

**Hence, a board member of a credit institution and other persons, who had deposits in this credit institution at the moment when unavailability of deposits occurred in this institution, are in similar and comparable circumstances.**

**12.** The Applicant notes that the contested norm envisages differential treatment of board members of a credit institution, because they, in difference to other depositors, are denied the right to receive the guaranteed compensation in case of unavailability of deposits. The Saeima also holds that the contested norm envisages differential treatment of board members of a credit institution.

Pursuant to the contested norm the Applicant has no right to receive the guaranteed compensation from the Deposit Guarantee Fund for her deposits in Krājbanka. Therefore, in accordance with Section 192 – 194 of Credit Institutions

Law her right to regain resources deposited in Krājbanka must be established in the general procedure for satisfying creditors' claims. The Administrator notes that creditors' claims will be satisfied depending upon the amount of resources regained in the framework of Krājbanka's bankruptcy procedure. Even though all possible measures have been taken to satisfy all creditors' claims that have been registered and recognised, the Administrator forecasts that the amount of resources obtained by regaining assets will not be enough to cover all recognised creditors' claims in full (*see the Administrator's letter of 17 April 2014 No. 06-3-2/341, Case Materials, p. 136*).

**Thus, the differential treatment manifests itself in the fact that in the case of unavailability of deposits board members of a credit institution are denied the right to receive the guaranteed compensation from the Deposit Guarantee Fund.**

13. The legislator may adopt legal regulation that creates differential treatment of reciprocally comparable groups of persons only if such action is justified by the legitimate aim to be reached. When restrictions upon rights are established, in the legal proceedings before the Constitutional Court the obligation to identify and justify the legitimate aim first of all falls upon the institution, which adopted the contested act (*see, for example, Judgement of 1 November 2012 by the Constitutional Court in Case No. 2012-06-01, Para 12*).

The Applicant holds that the legitimate aim of the differential treatment established by the contested norm is creating adverse material consequences to those persons who have facilitated the onset of a credit institution's insolvency. The Saeima also upholds this opinion expressed by the Applicant and notes that the legislator has adopted the contested norm with the aim of preventing such measures for deposit protection that might create incentives for incorrect management of credit institutions. I.e., the aforementioned regulation could deter preventively board members of a credit institution from committing such actions, which could, possibly, leave an adverse impact upon the solvency of the credit institution.

The Association also holds that the contested norm provides for the liability of a board member of a credit institution in a situation, where the society incurs losses. Even though the contested norm is not applied as liability for concrete losses, it, nevertheless, is said to envisage adverse material consequences to board members, which are manifested as not paying the guaranteed compensation (*see the opinion of the Association in Case Materials, p. 154*).

A number of summoned persons point to another legitimate aim of the differential treatment. It is noted in the opinion by the Commission that the aim of the deposit guarantee system and of the contested norm is not punishing a person, but ensuring stability of the national financial system and public trust in the financial system (*see opinion by the Commission, Case Materials, p. 118*). R. Eņģelis, in turn, notes that the legitimate aim of the differential treatment caused by the contested norm is not providing protection to those depositors, whose need for the protection envisaged by the legislator, in view of their knowledge and ability to help themselves, is not that big (*see opinion by R.Eņģelis, Case Materials, p. 131*).

If the contested norm were aimed only at creating adverse material consequences to board members of a credit institution, they would have the possibility to avoid these, for example, by depositing their financial resources in any other credit institution. In such a case, the contested norm would not be effective with respect to the aim identified by the Saeima.

One can uphold the opinion provided by the Saeima that the decisions and the actions taken by the Applicant as the legal representative of Krājbanka had significant and, perhaps, even decisive influence upon management of the credit institution and ensuring its solvency. Thus, for example, the Applicant's special field of responsibility covered supervision of the bank's book-keeping, management and control of the accountancy system and internal control system, budget planning, management and control of its implementation [*see allocation of duties of Krājbanka's board members approved at the extraordinary sitting of Krājbanka Council on 7 February 2011 (Minutes No. 2), Case Materials, p. 142*]. Likewise, information provided by the Commission also reveals that the accountancy of the

bank had been within the competence of the Applicant as a board member of Krājbanka. Whereas one of the reasons for suspending operations by Krājbanka's board had been submitting of intentionally misleading financial reports to the Commission (*see opinion by the Commission, Case Materials, p. 119*).

However, the regulation of the contested norm cannot be assessed as such that is aimed at creating adverse financial consequences to the board members of a credit institution for incorrect management of the credit institution. The Constitutional Court upholds the opinion provided by R. Eņģelis that in general the contested norm has very small restricting impact upon the material interests of a board member of a credit institution. I.e., every board member of a credit institution has the right to choose, whether he keeps his monetary resources in the credit institution managed by him or any other credit institution, or invests them otherwise (*see the opinion by R.Eņģelis, Case Materials, p. 134*).

To establish, whether the differential treatment created by the contested norm is aimed at reaching any other legitimate aims, the general aims of the deposit guarantee system must be identified. I.e., the most important aims of a deposit guarantee system is, firstly, to protect those depositors, to whom the loss of a deposit would cause significant worsening of the financial situation; secondly, to decrease the need for depositors to monitor constantly and follow the indicators of solvency and the financial situation of their credit institution; thirdly, to provide to depositors fast and effective financial protection if the deposits become unavailable; fourthly, to protect the stability of the national financial system and of economy in general, decreasing the risk that the financial difficulties of one credit institution might cause a mass-scale panic and withdrawing of deposits from other credit institutions (*see: Wood P. R. Regulation of International Finance. London: Sweet & Maxwell, 2007, p. 685*).

In view of the aims referred to above, the legislator has the right to define in legal acts the circle of those persons, to whom financial protection must be provided, as well as the amount of compensation to be disbursed, and the procedure for granting it. Thus, the legislator has also the right to provide that some categories of

depositors may be denied financial protection in the case of unavailability of deposits.

The Constitutional Court has also recognised that the legal acts of the European Union, insofar the fundamental principles of the Satversme are not affected, must be taken into consideration in both applying and interpreting national legal acts and in preventing possible conflicts between the Latvian and the European Union law. In examining the content of national legal norms, the requirements of the European Union directives that have been transposed in Latvia must be taken into consideration (*see, for example, Judgement of 17 January 2008 by the Constitutional Court in Case No. 2007-11-03, Para 25.4, and Judgement of 2 May 2011 in Case No. 2011-17-03, Para 13.3*). Thus, for example, the norms of Directive 94/19/EC, which were not amended by Directive 2009/14/EC, provide that the Member States have the right not to envisage deposit guarantee protection to concrete groups of persons, if they consider that these groups of persons do not need special financial protection. I.e., the second part of Article 7 of Directive 94/19/EC and Para 7 of Annex I provides that it is possible to exclude from deposit guarantee, for example, the director of a credit institution, its manager or officials personally liable. Thus, a Member State has been given the discretion to define, which groups of persons will not be granted the deposit guarantee.

Rational and economical use of the resources in the Deposit Guarantee Fund is ensured by not providing the protection envisaged by law in the case of a credit institution's insolvency to certain groups of depositors. Moreover, Section 15(1) of Deposit Guarantee Law provides: if there is not enough resources in the Deposit Guarantee Fund for paying the guaranteed compensation, then the unavailable resources are granted from the State budget. Thus, in addition, the contested norm may be aimed also at rational and economical use of the State budget resources.

After the operations of Krājbanka were suspended at the end of 2011, approximately 335.6 million lats (477.5 million euros) had to be ensured for paying the guaranteed compensation to the clients of this credit institution. However, at that moment only approximately 149.9 million lats (213 million euros) were accrued in

the Deposit Guarantee Fund. Due to this reason, approximately 185.6 million lats (264 million euros) were given as loan to the Deposit Guarantee Fund by the State of Latvia, i.e., the State Treasury, from the State budget (*see Commission's Annual Report and Activity Report, 2011, pp. 22 and 23*).

It follows from the abovementioned that the legitimate aim of the differential treatment created by the contested norm is also ensuring economical use of the resources of the Deposit Guarantee Fund and the State budget and protecting those persons, who need special protection by the State in the field of finance.

**Thus, the contested norm protects the interests of public welfare and other persons' rights.**

**14.** Upon identifying the legitimate aim of differential treatment, its compliance with the principle of proportionality must be assessed and thus, the following must be established:

firstly, whether the measures used by the legislator are appropriate for reaching the legitimate aim; i.e., whether the legitimate aim of the restriction may be reached by the contested norm;

secondly, whether such action is necessary; i.e., whether the aim cannot be reached by other measures, less restrictive upon a person's rights and legal interests;

thirdly, whether the legislator's action is appropriate; i.e., whether the benefit gained by society exceeds the damage caused to a person's rights and legal interests.

**14.1.** The regulation established by the contested norm denies the right to receive compensation from the Deposit Guarantee Fund to the board members of a credit institution if deposits have become unavailable. In such a case there is no need to make the disbursement either from the Deposit Guarantee Fund or the State budget. Thus, savings of financial resources is ensured and disbursement thereof mainly to those persons, who need special protection by the State in the field of finance.

The contested norm entered into force on 20 June 2009, but the Commission suspended the authorisation of Krājbanka's board on 21 November 2011. Whereas

on 22 November 2011 the Commission adopted a decision, establishing that unavailability of deposits had occurred in Krājbanka. Thus, the Applicant had sufficient time to become aware of the legal consequences caused by the contested norm and to adopt an informed decision on continuing to keep her financial resources in the particular credit institution.

**Therefore, the measures chosen by the legislator are appropriate for reaching the legitimate aim.**

**14.2.** The restriction upon rights defined in the contested norm is necessary, if no other means exist that would be equally effective and the selection of which would place lesser restrictions upon persons' fundamental rights. In assessing, whether the legitimate aim can be reached by other means, the Constitutional Court underscores that a more lenient measure is not just any other measure, but such that would allow reaching the legitimate aim in at least the same quality. The Constitutional Court must not examine, the extent to which alternative solutions would be more appropriate for reaching the legitimate aim (*see Judgement of 13 May 2005 by the Constitutional Court in Case No. 2004-18-0106, Para 19 of the Findings, and Judgement of 13 February 2009 in Case No. 2008-34-01, Para 22*).

The Applicant holds that a more lenient measure exists that would allow reaching the legitimate aim and would be less restrictive upon a person's rights; i.e., differential payment of compensation, depending upon the degree of guilt of each board member, established by a judgement in a criminal case that has entered into force.

**14.2.1.** The Administrator, as well as all summoned persons note that the more lenient measure proposed by the Applicant cannot be recognised as being such that would allow reaching the legitimate way as effectively as by the contested norm. The solution offered by the Applicant would be, first of all, contrary to the meaning and essence of the deposit guarantee system, and, secondly, would significantly endanger one of the fundamental principles of commercial law – the principle of board members' joint responsibility.

The State has undertaken, in case a credit institution becomes insolvent, to fulfil the commitments of this credit institution *vis-à-vis* its creditors in a certain amount. The Commission regulates and supervises the operations of credit institutions. Thus, the State has established legal regulation for the protection of depositors of credit institutions (creditors); i.e., a deposit guarantee scheme, in the framework of which a depositor is paid the guaranteed compensation, if he is entitled to it. This legal regulation has been implemented in accordance with Directive 2009/14/EC of 11 March 2009, which amended Directive 94/19/EC. Section 3(1) of the Deposit Guarantee Law provided that the guaranteed compensation to one depositor for the deposit made in the credit institution is in the amount of guaranteed deposit, but not exceeding 100 000 euro. Pursuant to the aforementioned regulation, each deposit made in the credit institution up to 100 000 euros is protected in case the credit institution becomes insolvent, and the disbursement of deposit in this amount is guaranteed to the depositor. Thus, the legislator, by defining the right to receive the guaranteed compensation, has protected the depositors' – creditors of the bank – right to own property.

In difference to the general principles of insolvency, pursuant to which the insolvent company is primarily protected, so that it would be able to meet its commitments *vis-à-vis* creditors, the solutions in cases of credit institutions becoming insolvent are aimed at protecting depositors – thus, a special type of creditors. The operation of a credit institution is always assessed in interconnection with its possible impact upon the whole financial sector and economy. Therefore the solution that is envisaged for the case if a credit institution becomes insolvent must be as effective and timely as possible, to ensure simultaneously the stability of the financial sector and the protection of depositors' interests (*see Judgement of 1 March 2013 by the Constitutional Court in Case No. 2012-07-01, Para 13 and Para 15.2*).

One of the purposes of Deposit Guarantee Law is to create a system that would ensure to depositors in case of unavailability of deposits the possibility to receive the guaranteed compensation within a short period of time. Pursuant to Section 20<sup>1</sup> (1) of Deposit Guarantee Law, the guaranteed compensation is paid no

later than within 20 days after the unavailability of deposits has occurred. Within this short period of time the responsible institution – the Commission – cannot assess in a sufficiently detailed way all causes of unavailability of deposits and the individual responsibility of each member of the board, as well as to initiate the necessary criminal procedural measures for seizing financial resources. Within this restricted period of time, the primary objective of the Commission is to pay the guaranteed compensations in accordance with the information included in accountancy documents of the credit institution as soon as possible.

The annotation to the draft law, by which the contested norm was introduced into Deposit Guarantee Law, also underscores that the payment of the guaranteed compensation from the Deposit Guarantee Fund in as timely manner as possible would facilitate depositors' trust in the stability and security of the national financial system (*see annotation to the draft law No. 1177/Lp9 "Amendments to Deposit Guarantee Law" submitted to the Saeima on 20 April 2009*).

The European Commission has also noted that the payment of the guaranteed compensation from the Deposit Guarantee Fund within seven days will decrease the negative impact of the insolvency of a credit institution upon society and also will ensure that the depositors do not have to use the services of the national social welfare system (*see The Proposal by European Commission of 12 July 2010 for a Directive on Deposit Guarantee Schemes COM/2010/0368 final, Para 3.2 of the explanatory Annex*).

Thus, the solution proposed by the Applicant would endanger the rights of other depositors of the credit institutions to timely payment of the guaranteed compensation from the Deposit Guarantee Fund.

**14.2.2.** Section 301 and Section 302 of the Commercial Law provide that the board supervises and manages all matters of the commercial company only jointly and that it also manages and acts with the property of the company only jointly. The Commercial Law does not prohibit the board to divide its competence among its members. However, division of competence does not release a board member from the obligation established in law to manage all operations of the company, but only

changes the nature of this obligation. I.e., the board member independently decides on those issues that fall within his field of responsibility, at the same time cooperating with other board members. If a board member develops reasonable doubts about the legality of actions taken by other board members, his responsibility is to respond adequately to this. Thus, a board member may not, justifying it by an agreement of private law nature, evade the responsibility established in law, even if he has assumed responsibility only for one set of matters and allowed other board members to decide upon other matters in managing the credit institution.

Section 169 of the Commercial Law defines the limits of the liability by members of the board and the council. I.e., the board member as the fiduciary of the parties of the commercial company, entrusted with the management of others' property, must facilitate reaching of the aims of the company – implementing the economic interests of the participants. Therefore the board member must be loyal both to the commercial company as an independent subject of law, as well as to the economic interests of all its participants, and, pursuant to Section 169(1) of the Commercial Law, must perform his obligations as an honest and careful manager (*see Judgement of 25 January 2012 by the Department of Civil Cases of the Supreme Court Senate in Case No. SKC-25/2012, Para 8.4, the Judgement is published on [www.at.gov.lv](http://www.at.gov.lv), accessed on 4 June 2014*).

The concept of “an honest and careful manager” used in Section 169(1) of the Commercial Law is the general clause, from which, depending upon, for example, the size of the commercial company, type of business activities or market situation, the concrete obligations of the board member are derived. The features of an honest and careful manager comprise a number of objective obligations, for example, to comply with laws, the articles of association and the decisions of the shareholders meetings, the obligation to be loyal and avoid taking decisions in a conflict of interest situation, as well as the obligation to adopt economically substantiated, informed decisions. A significant criterion for assessing the legality of actions taken by the board member of a commercial company is their compliance with the aims set for the operations of this commercial activity.

A board member has the obligation to control and to manage the financial status of a commercial company. Thus, a board member's liability remains also in those cases, where he has not been able to assess adequately the financial status of a commercial company. The duty of care of an honest and careful manager is a tool for protecting creditors' interests, and its basic function is to ensure that the commercial company is well-managed and does not become insolvent. A board member may not plead inability to perform his duties of office, since he must act in a way that complies with the principles that regulate commercial relationships, business practice and the prevailing ideas on good management of commercial companies.

Moreover, the second and the third part of Section 169 of the Commercial Law provides: if a board member is unable to prove that he individually has acted as an honest and careful manager, then he bears joint liability for the losses caused by other members of the board. Thus, the legislator has introduced a presumption that all members of the board bear joint liability for the management of commercial companies, irrespectively of the allocation of management duties among them. Even if a member of the board has not performed a management function, he has all obligations defined in the law, *inter alia*, the obligation to bear liability for the losses caused to the commercial company or to third persons.

The Constitutional Court also notes that the liability of a board member of a commercial company for not performing the obligations of an honest and careful manager may set in irrespectively of the fact, whether his guilt for losses caused to the commercial company has been established by a judgement in a criminal case that has entered into force. I.e., a judgement in a criminal case that has entered into force is not a mandatory pre-requisite for recognising civil law liability of board member of a commercial company for failure to perform obligations of an honest and careful manager.

In view of the importance of credit institutions in economy, all regulation of their operations, *inter alia*, special requirements set for the board members of a credit institution, the extensive rights granted to the Commission to supervise the operation of a credit institution and, in certain cases, to influence it, is aimed at

maintaining solvency and financial stability of a credit institution. The operation of a credit institution is based upon public trust in the security of financial services that it provides, ability to meet its commitments, to preserve and successfully manage assets entrusted with it. Therefore solvency of this credit institution is the most important objective and aim of operations for each board member of this credit institution.

In order for the board members to be able to manage successfully a large commercial company, as, for example, a credit institution, the level of their mutual trust should be high, and they should share to sufficient extent information about the operation of the commercial company and the decisions that need to be adopted. However, every member of the board should be aware of his own civil law liability and direct obligation to act as an honest and careful manager.

Thus, the opinion of the summoned persons can be upheld – that the alternative to the contested norm proposed by the Applicant would significantly endanger the principle of joint liability of the board members of a credit institution.

In the course of hearing the case, the Constitutional Court has not established other possible alternatives that would infringe upon the Applicant's fundamental rights to a lesser extent.

**Thus, there are no other, more lenient measures by which the legitimate aim of the differential treatment could be reached in the same quality.**

**14.3.** The Applicant notes that board members are not always responsible for a credit institution becoming insolvent. Thus, allegedly, the differential treatment created by the contested norm does not give any benefit to other persons.

Whereas the Saeima holds that the status of a board member of a credit institution *per se* can be the grounds for recognising the person as being such that is not to be protected in case deposits become unavailable.

Thus, the Constitutional Court must assesses, whether the status of a board member of a credit institution may serve as the grounds for denying this person the right to receive compensation from the Deposit Guarantee Fund if deposits become unavailable.

**14.4.** Pursuant to the first part of Section 301 of the Commercial Law, the board is the executive body of a commercial company, which performs two main functions: the function of management and representation. Management is implementation of measures aimed at ensuring the company's commercial operations internally, i.e., business and organisational management, aimed at reaching the aims of the company. Whereas representation is representing the company externally, all those matters, where the company enters into relationship with a third person, pertain to representation (*see Decision of 8 November 2012 by the Constitutional Court on Terminating Legal Proceedings in Case No. 2012-04-03, Para 14*).

The important role of the board in the management of a credit institution follows also from the Credit Institutions Law, the norms of which vis-à-vis the provisions of the Commercial Law are applicable as the special legal norms. Since Section 24 of the Credit Institutions Law defines stricter criteria that must be met for a person to become a board member of a credit institution, for example, particular education, experience and impeccable reputation. Pursuant to the aforementioned regulation of the law, the legislator has defined high requirements and stringent restrictions for taking the position of a board member of a credit institution to ensure that credit institutions are managed by persons who are competent in financial matters.

It also follows from Chapter XII of the Commission's Regulation of 25 September 2009 No. 112 "Regulation on the Issue of Credit Institution and Credit union Operating Licences, Obtaining Permits Regulating the Operation of Credit Institutions and Credit Unions, Settlement of Documents and Provision of Information" that before a person is appointed as a member of the board of a credit institution, *inter alia*, his or her impeccable reputation and sufficient competence in matters of financial management must be verified. Similarly, Para 32 and Para 34 of Recommendations No. 166 of 25 July 2013 by the Commission "Recommendations for the Assessment of the Suitability of Management and Supervisory Board Members and Key Function Holders" provide that in assessing the suitability of

board members, the Commission and the credit institution itself must take into consideration the person's knowledge and competence, as well as practical experience in managing commercial companies.

The business operations of credit institutions are specific, *inter alia*, also because credit institutions act with the monetary resources they have been entrusted with, which they have attracted from their clients in the form of deposits. Likewise, an essential element in the business operations of credit institutions is appropriate risk management linked with issuing these monetary resources as loans to other persons or other financial markets. Thus, for example, Section 8(3) of the Credit Institutions Law establishes the obligation of the board and the council of a credit institution to inform the Commission about all circumstances, including suspicious and fraudulent transactions that might have a significant impact upon further stable management and operations of a credit institution in compliance with regulatory enactments or which might significantly threaten the reputation of a credit institution.

The persons, who take the position of a board member in a credit institution, are presumed to have abilities and knowledge in the field of financial management, as well as the ability to adopt adequate decisions under the risks that are typical of commercial activities that credit institutions engage in. Therefore, it would be reasonable to consider that the abilities of such persons to understand the risks with regard to the management of their private financial resources could also be presumed.

**Therefore, the legislator, by restricting the rights of a board member of credit institution to receive the guaranteed compensation from the Deposit Guarantee Fund in case of unavailability of deposits, has complied with the principle of equality included in the first sentence of Article 91 of the Satversme.**

## **The Substantive Part**

On the basis of Section 30-32 of the Constitutional Court Law, the Constitutional Court

**held :**

**to recognise Para 4 of Section 17 of Deposit Guarantee Law as being compatible with the first sentence of Article 91 of the Satversme of the Republic of Latvia.**

The Judgement is final and is not subject to appeal.

The Judgement enters into force on the day it is published.

Chairperson of the court hearing

A. Laviņš