

CHAPTER

2

CORPORATE GOVERNANCE IN THE BALTICS

How hard law and soft law shape governance in Estonia, Latvia and Lithuania, which Board models companies use, and how shareholders set out their expectations.

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2.1
HARD LAW AND SOFT LAW

Legal acts entrench the most important and obligatory principles of corporate governance. The provisions of laws (hard law) typically establish minimum mandatory standards for the corporate governance system. Soft law is based on various instruments that are not legally binding (recommendations, guidelines, codes of conduct and similar) and provide higher, voluntarily applied standards for better corporate governance. The main aspects of hard law and soft law can be summarised as follows:

HARD LAW	SOFT LAW
– establishes minimum standards of conduct – legally binding – sanctions for violation of the law as the means of enforcement – form: laws, codes and regulations	– sets higher standards of conduct (best practice) through recommendations and guidelines – not legally binding, or with a binding force that is "weaker" than that of traditional law – based on the "comply or explain" principle – form: codes of conduct, guidelines and recommendations

Additional sources of soft law include various corporate governance principles, recommendations, guidelines and codes, such as the G20/OECD Principles of Corporate Governance, the OECD Guidelines on Corporate Governance of State-Owned Enterprises and national corporate governance codes.[3]

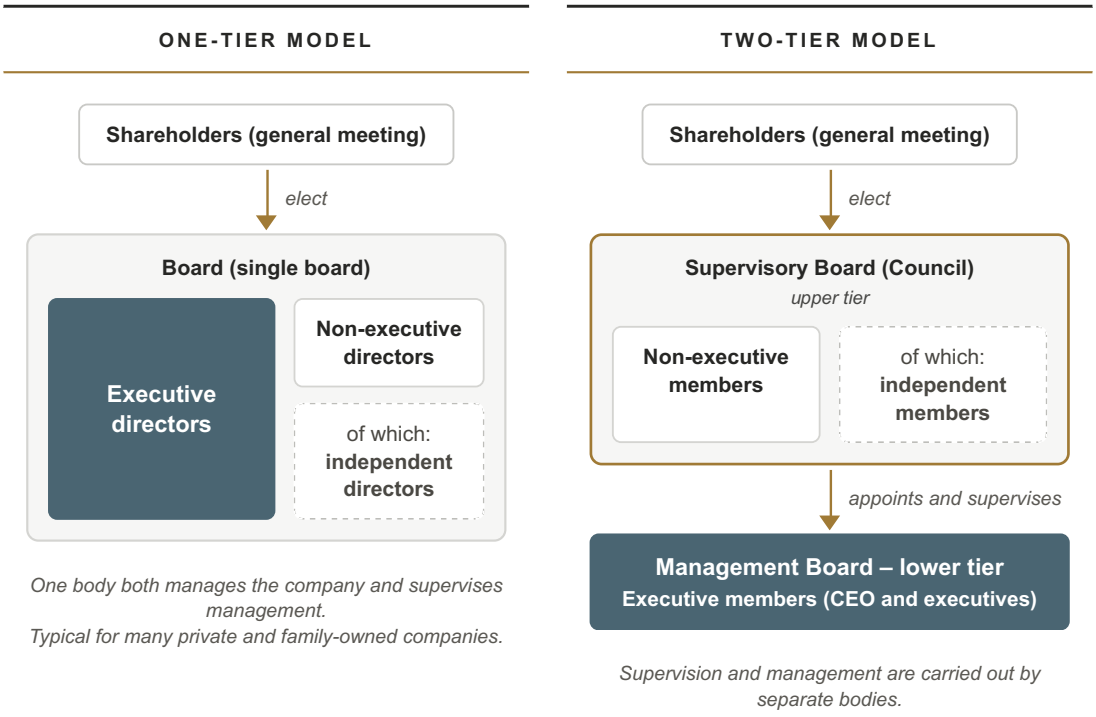
3 OECD (2023), G20/OECD Principles of Corporate Governance; OECD (2024), OECD Guidelines on Corporate Governance of State-Owned Enterprises.

2.2

CORPORATE GOVERNANCE MODELS

There is no single model of good corporate governance. Board structures and procedures vary both within and among countries. Some countries have two-tier Boards that separate the supervisory function and the management function into different bodies. Such systems typically have a Supervisory Board (in the Baltic states also called the Council) composed of non-executive members and a Management Board composed entirely of executives. Other countries have "unitary" (one-tier) Boards, which bring together executive and/or non-executive members.

Figure 2.1 **One-tier and two-tier corporate governance models**

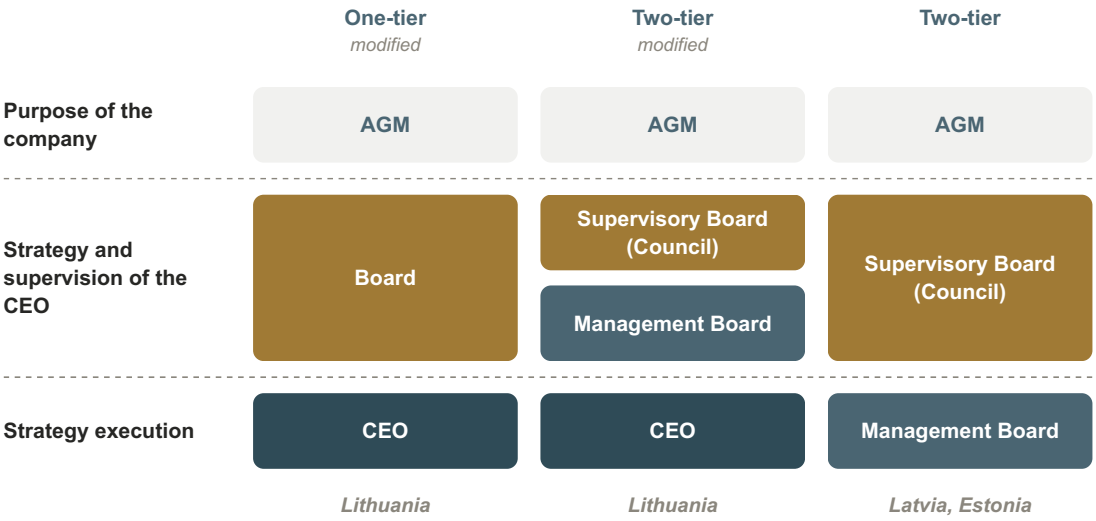


Some of the differences between the two models:

ONE-TIER	TWO-TIER
A single body responsible for both the management and the supervision of the company's operations	Clear distinction (including in liability) between the supervisory and management functions
Risk that non-executive directors align too closely with executive directors (less independence)	Supervisory Board members are more independent

ONE-TIER	TWO-TIER
Non-executive directors have more contact with the company itself	Supervisory Board members receive only limited information, and at a later stage (reduced involvement)
Faster decision-making. Lower administrative burden, as only one body needs to hold meetings and only one set of minutes has to be drawn up	Decision-making on specific matters may be delayed because Supervisory Board meetings are less frequent

Figure 2.2 Corporate governance models followed in the Baltic states



In the Modified structure CEO is a separate compulsory body. The particular features of the corporate governance models in each of the Baltic states:

ESTONIA	LATVIA	LITHUANIA
– **two-tier** – the Supervisory Board (*nõukogu*) and the Management Board (*juhatus*) – a private limited company is not obliged to have a Supervisory Board – a public limited company must always have a Supervisory Board	– **two-tier** – the Supervisory Board (*padome*) and the Management Board (*valde*) – the two-tier structure is mandatory for a joint-stock company	– **two-tier**: the Supervisory Board (*stebėtojų taryba*), the Management Board (*valdyba*) and the CEO* – **one-tier**: the Board (*valdyba*), composed of executive and/or non-executive members, and the CEO* – a private limited company is not obliged to have a Supervisory Board or a Management Board – a public limited company must always have a Supervisory Board or a Management Board *The *CEO is a separate, compulsory management body in both the two-tier and the one-tier model*

2.3

SHAREHOLDERS' LETTER OF EXPECTATIONS

Shareholders have specific expectations of what kind of business the company should be, what goals it should reach and how it should behave. These expectations can be written down in a document called the shareholders' letter of expectations. This letter is important because it helps the shareholders and the company's Board, which is responsible for achieving the shareholders' goals, to understand each other and work together effectively. The letter outlines the shared expectations and priorities of the shareholders and provides guidance to the Board in order to maximise long-term value and ensure that the company's activities benefit the shareholders, the communities and society as a whole. A shareholders' letter of expectations is usually more applicable to state-owned and municipally owned enterprises (SOEs and MOEs) and other companies with a relatively small number of shareholders, and less applicable to listed and other companies with very dispersed ownership. In the latter case, the definition of the purpose and long-term goals lies with the Board. In the case of SOEs and MOEs, the shareholders' letter of expectations, which should be publicly available on the company's website, plays an important role in protecting the Board and the company against political interference.

Several items are considered key in formulating the shareholders' letter of expectations:

- Shareholders' plans to hold the shares in the company
- Purpose, strategic destination and ultimate goal(s)
- Financial commitment and contingency planning
- Targeted returns (return on equity - ROE, required rate of return - RRR, dividends, value growth)
- Role of the company as a part of the economy and society

Through the shareholders' letter of expectations, the **shareholder(s) determine the direction of the company's development**. As the possible approaches can be mutually exclusive, one should be selected.

1. **Increasing long-term value.** Profits are invested in long-term value creation: R&D, patents, the development of unique ideas and the building of synergies. This also implies that shareholders are not concerned with fast returns or rapid

growth in market share; they are willing to invest in the development of a particular service or product without expecting a return in the short term.

2. **Maximising growth.** In taking this path, shareholders focus on future value rather than present value and prioritise future investment. Profits are used as a source of finance for growth, and an important financial objective is to increase turnover.
3. **Maximising profits**. In this case, shareholders target the withdrawal of dividends from the profits generated through increased efficiency and business development.

While setting out one of these three directions, the shareholders' letter of expectations should also include expectations regarding financial and non-financial objectives.

1. **Financial objectives** arise from the selected development direction and include expectations related to capital structure (leverage) and expected return.
2. **Non-financial objectives:**
    a. environmental responsibility – integrating environmental responsibility into company operations, adopting environmentally friendly practices, promoting energy efficiency and reducing carbon emissions;
    b. social responsibility – engaging in activities that benefit the community, such as supporting local initiatives, investing in community development programmes, promoting social inclusion and contributing to the overall well-being of residents;
    c. stakeholder engagement – actively engaging with residents, community organisations and other stakeholders to understand their needs, concerns and expectations;
    d. innovation and technological advancement **–** embracing innovation and using technology to enhance service delivery, operational efficiency and customer experience;
    e. corporate governance – upholding high standards of corporate governance, transparency and accountability, ensuring fair and ethical business practices and complying with legal and regulatory requirements;
    f. for public sector enterprises, other non-financial objectives (public policy objectives) may be defined; these should be financed by the state in a clear and transparent way.

The shareholders' letter of expectations should be defined for a period longer than the company's strategy and should be updated if there are significant changes in the shareholders' expectations, but not too often. It is bad practice for shareholders

to update their letter of expectations every year or every two years, because the Board would then have to adapt the company's strategy each time.

The Board is entitled to propose changes to the owners' expectations where there is an evident and very important need.

It is good practice for SOEs and MOEs to disclose the shareholders' letter of expectations and make it publicly available on the company's website and in its reports.

KEY TAKEAWAYS

A. Corporate governance in the Baltic states rests on both hard law and soft law. Laws set the minimum mandatory standards; codes, guidelines and recommendations set higher, voluntary standards, applied on a "comply or explain" basis.

B. The G20/OECD Principles of Corporate Governance, the OECD Guidelines on Corporate Governance of State-Owned Enterprises and the national corporate governance codes are the main soft-law reference points.

C. All three Baltic states use the two-tier model, with national differences; in Lithuania a one-tier option also exists, and the CEO is always a separate compulsory body.

D. A shareholders' letter of expectations sets out what the owners expect of the company: their plans for holding the shares, the company's purpose and strategic direction, financial commitments, targeted returns and the company's role in the economy and society.

E. The letter is most relevant to SOEs, MOEs and companies with a few shareholders. It should cover a period longer than the company's strategy, be updated only when expectations change significantly, and be publicly disclosed.

QUESTIONS FOR THE BOARD

1. *Which laws and which corporate governance code apply to our company?*
2. *Does our governance structure (one-tier or two-tier; Supervisory Board, Management Board, CEO) match what the law requires for our type of company, and does it work well in practice?*
3. *Are the roles, responsibilities and liabilities of the Supervisory Board, the Management Board and the CEO clearly separated and understood by all involved?*
4. *Do Supervisory Board members receive sufficient and timely information to exercise real oversight, and are they sufficiently independent of management?*
5. *Do we have a shareholders' letter of expectations, and does it state clearly the owners' chosen development direction and their financial and non-financial objectives?*
6. *Is the company's strategy aligned with the letter of expectations, and how do we handle differences between what the owners expect and what the Board considers achievable?*
7. *If we are an SOE or MOE, are public policy objectives clearly defined and separately financed, and is the letter of expectations publicly available on our website?*
8. *When was the letter of expectations last reviewed, and is there an agreed process for the Board to propose changes to the owners where circumstances require?*