The Role of the Board in Related Party Transactions

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Related Party Transactions

- Play important and legitimate role in economy
- But if left unchecked, could foster opportunism

Points

- (1) Through related party transactions, controlling shareholders and managers may extract private benefits of control
- (2) Potential for abuse and high cost of regulating these transactions has led to a range of regulatory strategies
- (3) Strategies and techniques include: mandatory disclosure, board approval, fiduciary duties, shareholder voting
Regulating Related Party Transactions

LEGAL FRAMEWORK for Related Party Transactions:

(1) Mandatory Disclosure
(2) Duty of Loyalty
(3) Board Approval
(4) Shareholder Voting

Availability of external finance increases and leads to financial development
Why Should One Care About Related Party Transactions?

- Related party transactions involve transactions between a parent company and subsidiary; employees; an enterprise and its principal owners, management or members of their immediate families; and affiliates (OECD Principles; IAS 24 (9); FASB Statement no. 57)

- Related Party Transactions can take various forms including:
  - Transfer pricing;
  - Asset stripping;
  - Inter-company loans and guarantees;
  - Sale of receivables to Special Purpose Vehicle;
  - Leasing or licensing agreement between a parent and subsidiary

- Illicit related party transactions limit the availability of external finance and leads to financial underdevelopment
Definition

Close member of the family

Mr. Bailey

Reporting entity parent

Mercieca Ltd.

Board of Directors / Key management personnel

Close members of the family

Subsidiary A

Subsidiary B

Associate C

Joint Venture D

Legend:
IAS 24.9 (a): 1, 4, 9
IAS 24.9 (b): 2
IAS 24.9 (c): 3
IAS 24.9 (d): 7
IAS 24.9 (e): 8, 10
IAS 24.9 (f): 11

Source: KPMG
Simple Related Party Transaction

- Simple transaction (purchase of services) between two entities ("Buyer" and "Seller") controlled by the same shareholder ("Mr William") who is on the board of both firms.

  **Mr. William**

  - Mr. William owns 60% of Buyer Co. shares
  - Mr. William owns 90% of Seller Co. shares

  **Buyer Co.** 
  **Seller Co.**

  Buyer Co. buys services from Seller Co.

- Main Problem:
  - The proposed transaction may have a legitimate business purpose.
  - William is on both sides of the transaction and may benefit if Buyer acquires overpriced services from Seller.
Legal Regulation of Related Party Transactions

Problem:

- How do we distinguish between those valuable transactions that yield benefits for companies and those abusive transactions which are influenced by a conflict of interest and can be costly for investors?
- Enron and Parmalat illustrate difficulty of identifying these transactions
- Wide range of available strategies for accountants and auditors to facilitate disclosure
  - Prompt, continuous updating of information on related party transactions to market (listing rules)
  - Tool kit approach to identify material transactions (AICPA statement of Auditing Standard 45, sec 334):
    - Criteria identifying material transactions;
    - Information on management controls; information systems;
    - Extended audit; and
    - Review procedures for company transactions.
Enron's Related Party Transactions

- $30 million of compensation
- $350 million of Outside Equity
- 3% equity participations

SPEs connected to:
- LJM1/LJM2 LPs
- General Partner
- Managing Member-Fastow

Swaps and Sales Contracts

Enron stock exchanged for SPE notes—The Phantom Stock
What Mechanism Detect Fraud and Illicit Related Party Transactions?

- Detection is just a matter of time
- Uncovered by:
  - Internal audit
  - Whistle blowers
  - External auditors
  - Parties on other side of transaction
  - Security analysts
  - Plaintiffs bar press

Seldom uncovered by regulators

Board responsibility:
  establish effective detection system
Role of Corporate Governance

- Detect and deter expropriation via
  - Theft
  - Fraud
  - Related party transactions
  - Transfer pricing

  Negatively: Detect and deter bad decisions and their continuation

- Positively: support efficient contracting between all parties (investors, lenders, managers, employee)

- Obtain resources on best possible terms

- Use them in best possible fashion
Limits of Effective Board Monitoring?

- Non-executive Directors can play an important role
  - (1) informed;
  - (2) incented;
  - (3) independent.

- But, this is difficult for independent directors to achieve:
  - 1) being informed requires time and energy in getting to know the company, its managers and its strategy;
  - 2) being incented requires the monitor to have an interest in the company’s outcomes
  - 3) making it difficult to be independent

Effective external board members have to be part of the management process.
What Mix of Measures is Required?

(1) Greater involvement of non-executive directors needed for those transactions that may imply a conflict of interest with management or controlling shareholder;

(2) By imposing penalties on false disclosure, a legal mandate allows honest companies to distinguish themselves;

(3) Effective private intermediaries are essential to detect and deter complex related party transactions; and

(4) Since a reputation model alone will not work, codes of conduct are needed as well.
Legal Framework:

- **Codes of Conduct**: - Comply or explain approach - Defines and regulates material conflicts; disclosure rules on holdings; rules on shareholders’ rights; liability rules for directors

- **Mandatory Disclosure**: Listing Rules and Securities Regulation

- **Corporate Law**: Fiduciary duties; board approval; shareholder voting; Prohibitions on certain transactions
Fiduciary Duties

- Similar approaches in common law and civil law jurisdictions—less willing to review conflicted transactions approved by board

- US has more developed case law:

- Duty of loyalty: proscribes managers from entering self-dealing or unfair transactions

  1. Courts review conflicted transactions, but less willing to review decisions approved by disinterested director

  2. Incentives for direct and derivative shareholder suits (procedural obstacles are high outside US)
Prohibitions on Conflicted Transactions

- Company loans prohibited to buy company stock (§ 402 SOXA)
- Restrictions on transactions between managers and third parties (non-compete rule for top executives, Gr)
- Insider trading: restrictions on short-term sales (16(b) and SOXA amendments; UK Listing Authority’s Model Code §2)
- Ban on insider trading by officers and directors prior to disclosure of material, non-public information (Art 2, EU Market Abuse Directive [2003])
Board Approval

Anglo-Saxon & some Continental European jurisdictions encourage board approval of conflicted transactions: supplies strong protection from shareholder challenge

1) US states that follow Revised Model Business Corporation Act (RMBCA) give business judgment rule protection to conflicted transactions after approval

2) Non-RMBCA (Del) permit such approval to shift the burden of proof to fairness (or unfairness) from the defending director to the challenger

3) Board approval of conflicted transactions (NL,Fr)

4) Directors must disclose personal interests in company related transactions (§ 317CA 1985; Comment to §5.02(a)(1) ALI Principles on Corporate Governance 1994)

5) Minority shareholder approval of controlling shareholder transactions (§5.10 ALI Principles of Corporate Governance)
Shareholder voting

- Shareholder voting (alternative to board approval)
  - Fr: (Art L. 225-40 Code de commerce)—requires shareholder approval of conflicted transactions
  - Other jurisdictions have less demanding rules:
    - UK (charter provisions)
    - US, Gr (self-dealing transactions not subject to shareholder approval)
Mandatory Disclosure: US

- Stringent disclosure mandates (publicly listed firms)
  - US securities law (SEC S-K, (all major transactions, 5%); item 402 (executive compensation); 404 (certain relationships & related party transactions)
  - Accounting rules (GAAP: SFAS 57 (related party disclosure): all material transactions between firm & officers
  - State law: fiduciary duty law requires disclosure of conflicted transactions
  - Sarbanes-Oxley 16(a): officers must disclose trades in companies shares (w/in two days)
Mandatory Disclosure Presupposes Effective Enforcement

- **EU & US Experience**
  - Effective enforcement tools needed
  - Presumption: clear, open, effective disclosure
    - Trade-offs
      - Capital market implications
      - Facilitates other regulatory tools and institutions

- **But may create burdens**
  - May be costly for companies
  - Centralized disclosure system—front end costs
  - Restricted impact—does not impact all firms equally

- **Administrative Liability for non-notification**
  - Interested parties must disclose 20%
  - Administrative measures needed
  - Follow best practice—adopt codes, internal systems
The Role of Best Codes for Curbing Related Party Transactions

Shareholders
Supervisors
Directors
Family members
Employees
Creditors
Others

SOFT LAW SUPPLEMENT

Corporate Governance Guideline

Information & Incentive Problems:
- Adverse selection
- Moral Hazard
- Self-dealing

Supervisory Board
- Disclose any conflicts to shareholders
- Termination

- Conflicted transactions require approval
- Whistleblowers protected from retaliation