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The Role of the Board of Directors: Extraordinary Corporate Events Related Party Transactions

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The Role of the Board of Directors: Extraordinary Corporate Events Related Party Transactions

By Henry N. Schiffman[1]

A board of directors of a company should have two basic responsibilities: establishment of policies for the operation of the company and oversight of the implementation of those policies. The policies and related practices that the board adopts and oversees in regard to extraordinary corporate events are essential to seek to ensure that such events are considered by the board and that investors and other stakeholders receive important information about the effect of these events on the company. Those that the board adopts and oversees in regard to related party transactions with the company are vital to seek to ensure that related party transactions are not detrimental to the company and that purchases and sales of shares by insiders are disclosed to indicate to other investors the outlook for the company of insiders.

This paper discusses considerations regarding these two important matters in relation to selected laws and practices in certain Eurasian countries and in light of what could be considered international best practices.

As a preliminary matter, in considering the role of boards of directors in the Eurasian context, it should be noted that practices vary but that in general boards of directors do not fulfill the responsibilities that are considered best practices2. The legislative frameworks for boards of directors are generally not sufficiently comprehensive and coherent. For example, in the Kyrgyz Republic, the Law on Joint Stock Companies (LJSC) in Article 53 provides that the role of the board is to "carry out general management of

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[2] For example, in an assessment of corporate governance in a Eurasian country, the response was either "no" or "in most cases no" to the following questions:

Is the existing legal framework successfully put into practice?

Are board members enabled to carry out their duties in a professional and informed manner?

Do boards fulfill their strategy setting and monitoring functions properly?

Do the boards and board members operate in a transparent fashion?

Are boards truly independent from management and major or controlling shareholders?

Do boards play an effective role with respect to conflicts of interest or related party transactions?

Do board committees exist?

Do board members possess adequate qualities and competencies?

[2] Reportedly amendments to the LJSC are before the parliament.

[2] IOSCO Principle 14 states: There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

[2] The right of shareholders to information concerning extraordinary corporate events should be distinguished from the right to vote on whether proposed extraordinary events should be approved; for example, the sale or merger of the company. A proposal for an extraordinary corporate transaction can have a significant effect on the price of the securities of a company merely by being proposed. Disclosure of matters on which shareholders are to vote is of course vital to enable them to participate effectively and vote in shareholder meetings.

the company's activities." Rather, this is the role of management. While Article 54(1) appropriately includes the strategic direction role of a board, the LJSC fails to address the second fundamental role of a board—oversight of management for all matters that the board believes are important for the successful conduct of the business of the company. Article 65(2) provides that members of the board of directors may not issue instructions, requests or recommendations to management. But this is precisely what a board must do if it is to fulfill its proper oversight role when management is seriously deviating from the strategy and objectives set by the board. Otherwise, how can the board be held accountable for its performance? The LJSC seems to assume that the management can be set on autopilot and perform properly, but this is misconceived.[3]

In Uzbekistan under the Law on Joint Stock Companies and Defense of Rights of Stockholders (LJS), the provisions on governance are also not coherent. The supervisory board should appoint the management and have audit responsibilities (through a committee of the board) if there is to be clear accountability for the governance of the company. However, under the LJS, responsibility is divided. The stockholders elect the management board, in addition to the supervisory board, and also elect an audit commission. The supervisory board is appropriately given responsibility for formulating general policies for the company, but no responsibility for oversight. This is given to the audit commission. Thus, if there is to be responsibility for poor performance, where is it to be properly placed? In the supervisory board, which is only responsible for policy; in the executive board, which is responsible only for execution; in the audit commission, which is not responsible for policy but only for verifying execution? Perhaps in the general meeting of stockholders which is responsible for the appointment of all three bodies, but this accountability is too diffuse to have any effect. Thus, there is a need for a clear line of accountability under the supervisory board.

Boards of directors in Eurasian countries will have to be more diligent than is generally now the case and will have to assume more responsibilities than are provided by law, or amendments to laws will be needed, if the roles of boards of directors in relation to extraordinary corporate events and related party transactions are to be properly discharged.

Extraordinary Corporate Events

By definition, an *extraordinary* corporate event is one that does not occur in the ordinary course of business of the company. Thus, *ordinary course of business* is an important concept in relation to the role of the board of directors for extraordinary events. The role of the board of directors in regard to extraordinary events involves establishing policies for two basic responsibilities: approving those matters that require the consent of the company and disclosing the fact of an extraordinary event. The board should also determine the managing of the event when it is in the nature of a crisis.

Extraordinary events

The following types of corporate events should be considered extraordinary:

- A change in control of the company
- The company's acquisition or disposition of a significant amount of assets
- The company's bankruptcy or material default on a debt obligation
- A change in the company's external auditor
- Departure from the company of a chief executive officer, president, chief financial officer or chief operating officer

3 . Reportedly amendments to the LJSC are before the parliament

- The resignation of a company director
- A change in the company's fiscal year
- Entry into or termination of a material agreement not made in the ordinary course of business
- Termination or reduction of a business relationship with a customer that constitutes a specified amount of the company's revenues
- Loss of the right to, or challenge of the right to, material intellectual property
- Creation of a direct or contingent financial obligation that is material to the company
- Events triggering a direct or contingent financial obligation that is material to the company, including any default or acceleration of an obligation
- Material write-offs and restructuring charges
- Any material impairment of a company's assets
- A change in a credit rating or issuance of a credit watch by a rating agency
- Transactions by company officers and directors in the company's securities
- Movement of the company's securities from one exchange or quotation system to another, delisting of the company's securities from an exchange
- A notice that a company does not comply with an exchange or quotation system listing standard
- Conclusion of the company or auditor that security holders should no longer rely on the company's previously issued financial statements or an audit report
- Any material limitation, restriction or prohibition regarding the company's employee benefit, retirement or stock ownership plans

In establishing basic policies for the operations of the company, a company's board will have provided for ordinary events and even for some extraordinary events and the board should be involved in extraordinary corporate events, depending upon the particular type of event, in their determination, approval, or in deciding how management should react to adverse events.

Disclosure of extraordinary events

Most securities or company laws require companies that issue securities to the public to disclosure information about their financial condition and operations only periodically, like quarterly or annually. However, a basic requirement should be to disclose to the public on a rapid and current basis information concerning material changes in the company's financial condition or operations and this would include extraordinary corporate events. The policy embodied in these rules is that the ongoing dissemination of accurate information by companies about themselves and their securities is essential to encourage investment by the public in companies and for effective operation of the securities markets. Indeed, the classic definition of a market price is the price at which a buyer and seller are willing to conclude a transaction based on adequate information. Thus, a high level of transparency is the hallmark of an efficient market and is an important safeguard for stakeholder interests. The extraordinary events listed above are of key importance to investors in making an investment or voting decision in regard to the

frequency of occurrence of the event, the likely market reaction to the event, and the potential impact of the event on a company's operations and financial statements.

The OECD Principles of Corporate Governance state that a basic shareholder right is the right to obtain relevant information on the corporation on a timely and regular basis.[4] The Principles also provide that where stakeholders participate in the corporate governance process, they should have access to relevant information. Thus, most laws or regulations require public companies to make periodic disclosures at annual and quarterly intervals. Some also require important information to be reported on a more current basis. Current disclosure is necessary to maintain the currency and adequacy of the information disclosed by companies periodically. Companies are often required to file "current" reports when specific extraordinary corporate events occur of the type listed above. Since a company's stakeholders are expected to know the ordinary business of the company, the extraordinary matters should be specially disclosed.[5]

Should all extraordinary corporate events be disclosed? This would be administratively burdensome for the company as well as a waste of time for stakeholders if the subject matter were not material to the finances or business of the company. Thus, only *material* matters should be disclosed. Some matters that can be material to a company can be defined quantitatively, for example, in terms of sales or assets. Other matters, like the departure of a key executive or resignation of the company's auditor, are material in a qualitative sense.

Disclosure based on law or policy

A question arises as to whether the board should adopt a policy that information concerning extraordinary corporate events be disclosed even in the absence of a requirement in a law or regulation in this regard. In addition to requirements of company and securities legislation, there has been promotion of disclosure of material events by codes of best practices of associations, listing requirements of stock exchanges, and guidelines of institutional investors that should influence policies and practices of companies. The OECD Principles of Corporate Governance state that the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation. Under the Principles, one of the basic functions of the board of directors is to oversee the process of disclosure and communications.

Thus, even if not required by law or regulation, it is recommended that the board adopt a policy of disclosure of extraordinary corporate events. There would be certain benefits of such policy. Often information about an extraordinary corporate event is disclosed informally or by rumor that may or may not contain the true facts. The truth may be more beneficial to the company than the falsehood contained in a rumor. In addition, if the extraordinary event is negative, the release of the information may also provide an opportunity to temper the impact of that event by disclosing some offsetting factor that may not be generally known.

Should events other than those listed above that are considered important to shareholders and other stakeholders be disclosed? Perhaps, but for most Eurasian countries, it may be a considerable accomplishment to disclose the events listed above and resources should be devoted primarily to identifying and disclosing these.

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4 . IOSCO Principle 14 states: There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

5. The right of shareholders to information concerning extraordinary corporate events should be distinguished from the right to vote on whether proposed extraordinary events should be approved; for example, the sale or merger of the company. A proposal for an extraordinary corporate transaction can have a significant effect on the price of the securities of a company merely by being proposed. Disclosure of matters on which shareholders are to vote is of course vital to enable them to participate effectively and vote in shareholder meetings.

Board action regarding disclosures

Some extraordinary events possibly requiring disclosure require considerable judgment and the board of directors should determine in difficult cases either particular matters need to be disclosed under its policy and precisely when and what information about the matter in issue should be disclosed. This could be a matter initially for a corporate governance committee of the board, if there is one. For example, concerning disclosure of a customer terminating or reducing the scope of a business relationship with the company, the board would determine the threshold of materiality and when a matter must be disclosed. The board could adopt a policy that would require disclosure when a company becomes aware that a customer terminates or reduces a business relationship and the loss of revenues to the company equals 10% or more of the company's consolidated revenues during the company's most recent fiscal year. The board could also decide that no disclosure is required if the company is in negotiations or discussions with a customer, or a suspension or reduction of orders occurs, until an executive officer of the company is aware that the termination or reduction has occurred or will occur.

Another example is in regard to a board's policy to disclose information whenever the company enters into a transaction or agreement that subjects the company to a material direct or contingent financial obligation. This relates to the creation of financial obligations including direct obligations such as registered sales of debt securities, private placements and bank loans or credit facilities, contingent obligations such as guarantees, and obligations to purchase assets that are unconditional or conditioned on certain events. The board could determine that disclosure would be required only when the company enters into a definitive agreement that is unconditional or subject only to customary closing conditions. What information should the company provide? The board could decide that the company should provide a brief description of the transaction or agreement, the nature and amount of the company's material direct or contingent financial obligation, a description of events that may cause the obligation to arise, and management's analysis of the effect of the direct or contingent financial obligation on the company. The board could decide to limit disclosure to obligations with respect to which a specified level of probability exists that a contingency would occur. For example, only if the contingency is likely to occur or if there is a significant possibility that the contingency would occur. The board would also determine a materiality standard such as a percentage of assets, equity, revenues or net income.

Eurasian legislation on disclosure

The Kyrgyz Republic and Armenia, for example, have requirements for board approval of significant transactions or disclosure of material information without distinguishing whether this is in relation to extraordinary events. However, the nature of some of the provisions suggests that the matters to be disclosed are extraordinary.

The Law of the Kyrgyz Republic on the Securities Market (LSM) provides in Article 54 for the board of directors to approve transactions in property that have a value of 20 percent or more of the assets of the company. Such large transactions may be considered extraordinary events.

With respect to disclosure, the LSM in Article 44, entitled Information on Securities Issuance to be Disclosed by Issuer, provides that "an issuer shall disclose information on securities and financial and economic activities as follows: … notice of material facts pertaining to financial and economic activities of the issuer." This information is to include information determined by the securities commission to be material. This article also requires certain material information to be included in a quarterly report, such as changes in the members of the board of directors, changes in the ownership of the issuer by members of the issuer's management body, changes in shareholders of the issuer owing 20% or more in the issuer's authorized capital, and changes in the legal entities in which the issuer owns 20% or more of the authorized capital. This article also provides for current disclosure of material facts pertaining to financial and economic activities of the issuer within five business days.

Article 51 further elaborates requirements for current disclosure of information. That article requires disclosure of certain material events, including:

- information on reorganization of the issuer, its subsidiaries and dependent companies;

- information on facts which have caused: a one-time increase or decrease of the value of the issuer's assets by more than 10%; a onetime increase of the issuer's net profit or loss by more than 10%; and one-time transactions involving sums of money or property of 10% or more of the issuer's assets as of the date of transaction;

- information on the issuer's securities issuance and on accrued and/or paid income on the issuer's securities.

Such notifications of material events are to be sent to the securities commission within five days following such events and the notices are to be published within the same period of time in mass media that covers most of the issuer's securities owners.

In Armenia, under the Law on Joint Stock Companies, Article 96, entitled "Required Disclosure of Information," an open joint-stock company must disclose in the media: a) the annual report, balance sheet, and profit and loss statement of the company; b) in the event of an open subscription for shares, the prospectus; c) an announcement on holding an annual meeting; and d) other information required by this Law, the Law on Securities Market Regulation (LSM) as well as other laws and legal acts. Under the LSM, there are many requirements for reporting of significant information concerning issuers. Requirements for current reporting of extraordinary corporate events are contained in Rule 31 of the Securities Commission of Armenia.

In Georgia the securities commission Rule on the Rights of Shareholders of Reporting Companies and the Duties of the Members of the Managing Body requires a designated person or both boards to provide information on extraordinary corporate events, but only on the specific request of a shareholder, subject to the ability to withhold information considered damaging to the commercial interests of the company. The information provided in response to such requests is also to be published for the information of the general public.

Crisis management

The board of directors should adopt a policy for action in the event that a negative extraordinary corporate event occurs. There should be a written plan and a management team that is trained to execute it. What a company communicates and how it is communicated can be crucial for the effect in the market and reaction of government enforcement officials to the event.

Whether or not investors and their lawyers, securities regulators, and even prosecutors react adversely to the company if there is a negative extraordinary corporate event can depend on whether the negative corporate event is properly explained to the public. A negative event like the loss of a material customer relationship shortly after a company has issued new securities could perhaps be challenged in shareholder lawsuits as a failure by the company to disclose a material risk in relation to the sales of the securities unless it is explained in the press release accompanying the event that the loss of the business was unforeseen.

Related Party Transactions

When parties related to a company engage in business transactions with their company, they often have an ability to engage in transactions that are less favorable to the company than would be the same transactions with unrelated parties. This is because of their positions of influence in the company, superior knowledge of company operations, or personal relationships with company officers. There are several types of related parties: company directors, officers, their family members, shareholders with significant shareholdings and companies in which these persons have significant influence by virtue of shareholdings, managerial positions, or personal relationships.

What types of related party transactions can be abusive? Almost any business transaction can be abusive if conducted at prices or other conditions that are more favorable to the related party than would be the price or conditions for the same transaction with unrelated parties. These types of transactions would include:

- Purchase of assets from the company
- Sales of assets to the company
- Purchase or sale of the company's shares from or to the company
- Provision of services to the company

For example, in Ukraine there is no explicit fiduciary duty for company directors and reportedly, since they are not bound by any legal requirement, they sometimes exploit conflicts of interest in related party transactions by asset stripping and self dealing. These practices are not directly prohibited by Ukrainian law and formally such transactions are in conformity with law and appear to be on an arm's-length basis.

Under the OECD Principles, the responsibilities of the board of directors includes "monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions."

Board policies for related party transactions

The board should adopt policies on related party transactions in the implementation of its fiduciary duty to shareholders. The board's primary duty is to place the interest of the company and its shareholders before the personal interests of board members or company managers. Specific policies should address prevention of exploitation of conflicts of interest. Conflicts of interest will often arise, especially in companies with commercially active outside board members and in countries or communities where there is little competition in the sale of certain goods or services. There is nothing abnormal about the presence of conflicts of interest in these situations. But they must be managed properly so that they do not lead to the detriment of the company and its shareholders.

The board could adopt a strict policy that the company will not engage in certain transactions with related parties under any circumstances. For example, the purchase or lease of real property from a related party. For retail or construction businesses, for example, the location of retail outlets or real property constructed for lease or purchase is critical and it would be a strange coincidence if a related party owned property to sell or lease to the company that was optimal for the company. Another prohibition could be on credit by the company to a related party. Even if a sale of assets by the company to a related party is to be permitted, it could not be on credit. If the related party is creditworthy, credit could be supplied by a third party like a bank.

When transactions with related parties are permitted, the basic rule of fairness for the board policy should be that companies must not enter into a transaction with or for the benefit of a person who is related to the company if such transaction would be entered into on less favorable terms and conditions, or not at all, with or for the benefit of persons who are not related to the company. Related party transactions could also be permitted with restrictions. Restrictions could relate to quantitative limits on transactions with any one related party and an aggregate limit on all such transactions with related parties.

Where transactions with related parties are permitted, the board should require that they be subject to special approval procedures, for example, independent appraisal of the fairness to the company of the price of a transaction and unanimous approval by the uninterested board members, even for transactions that ordinarily would not be subject to a decision by the board.

Disclosure of pecuniary interests

The board should adopt a policy for directors and managers to periodically disclose their financial interests and to refrain from deliberations or decisions concerning a matter in which they have a direct or indirect pecuniary interest. The board should also provide for sanctions if the policies and related rules are not compiled with, for example, persons responsible for violations could be suspended or dismissed from office.

The board should require a notice in writing to the board of directors or secretary of the company, disclosing at least annually the names and addresses of the officers' and directors' business associates and reasonably full particulars of every material commercial, financial, agricultural, industrial or other business or family interest that such person has at the time. Thus, the officer or director will be regarded as interested in any proposed transaction between the company and any person or company named in the disclosure. A director or officer of the company who has an interest in a proposed transaction with the company should be required to leave any meeting at which the proposed transaction is discussed and refrain from voting on any matter related to it that becomes the subject of action by the board of directors or management but such interest should not disqualify the interested person for purposes of constituting a quorum for a meeting.

The financial interests to be disclosed should be business or family financial interests. Family could be defined as related by marriage or to the second degree of consanguinity. Business interest should be defined as an interest in (i) any company if the person owns, directly or indirectly, ten percent or more of any class of securities with voting rights or a ten percent net profits interest of an unincorporated company, or is an officer or director of the company and (ii) any partnership if the person is a partner.

In addition to a requirement for an annual disclosure of material interests, the board should require disclosure of interests in particular transactions that come before the officer or director of the company. Thus, an officer or director of a company who (i) is a party to a contract or a proposed contract with the company or (ii) is an officer or director of, or has an equity interest in or a business or family relation to any person or company that is a party to a contract or a proposed contract with the company, must disclose in writing to the company the nature and extent of the interest or relation at the time the transaction is presented for action by the company's officers or directors.

If there are not adequate provisions in the company law, the board should adopt provisions in its by-laws for sanctions for failure of an officer or director of a company to disclose an interest in a transaction or proposed transaction with the company. If the person fails to disclose an interest, the board should set aside the transaction on such terms as it thinks fit and suspend the person from office for a period of months or, if permitted under the applicable law, remove the person from office permanently.

Purchase or sale of shares by insiders

A basic policy of the board, as suggested above in the discussion of Extraordinary Corporate Events, if not required by law, should be the timely disclosure of purchase or sales of a public company's shares or other securities by certain related parities--officers, directors, and shareholders who own ten percent or more of any class of securities that have voting rights. Since the action by these related parties ("insiders") can provide a significant signal concerning a positive or negative outlook for the company by insiders, as a matter of fairness to other shareholders, this information should be disclosed as soon as possible after the purchase or sale of shares by insiders. Such disclosure could be accompanied by (truthful) explanations that could temper a negative implication. For example, in the case of the sale of shares, this might be pursuant to an established program to periodically sell shares to diversify assets of an insider who has a disproportionate amount of his or her wealth in shares of the company. Any complementary information should be subject to the basic rule regarding disclosures that must state material facts and not omit facts that otherwise would make what is disclosed misleading.

Transactions between related companies

Related party transactions also refers to transactions between related companies like between parent companies and their subsidiaries or companies (sister companies) with a common parent company. While each company has a responsibility to enter into only those transactions that are beneficial to it, because of the dominance of a parent over a subsidiary or of the parent over a sister company, abusive transactions can result. Thus, as with any related party, the rule of non-preferential treatment in transactions between related companies should apply and special disclosure of material such transactions should be required. Disclosure of which companies are related to the company in question is a minimum requirement. Related companies could be defined as companies in which a company owns or controls twenty percent or more of any class of shares with voting rights of another company or otherwise exercises a significant influence over the management or policies of the company. Consolidated financial reporting that should be required when companies have material company affiliations can also provide transparency into transactions among related companies.

Eurasian legislation and practice on related party transactions

In Armenia, Article 40 of the Securities Market Regulation Law contains a general fiduciary duty for board members, to "perform their official duties contentiously and with proper attention, which under similar conditions would have been used by a person holding similar position in managing of his or her own business, [to protect] the interests of the issuer and its securities owners." This provides a fairness standard for transactions by directors with their company but creates no legal duty for other related parties in their transactions with the company. The Law on Joint Stock Companies, however, provides rather comprehensive provisions for transactions of companies with related parties, including notice of related interests and a standard of fairness.

Article 62 generally defines as related parties company directors, officers, shareholders with 20 percent or more of shares with voting rights, their family members and companies in which these persons own 20 percent shareholding interests or managerial positions. Under Article 63, these persons must inform the board, the audit committee and the company auditor the names of legal entities in which they own 20 percent or more shareholding interests or managerial positions and past and future transactions in which they are related parties. Under Article 64, depending upon whether the company has more than 500 shareholders of the company, there are special approval procedures for related party transactions by disinterested or independent board members. The board must determine that the purchase or sale of goods or services by the company is not higher or lower than the market price, respectively. In some circumstances if the value of the related party transaction is more than 2 percent of the value of the assets of the company, approval by a meeting of shareholders is required.

These provisions are generally appropriate. However, Article 65 contains a curious provision regarding the consequences of failure to comply with the Article 64 procedures for a related party transaction. If the transaction results in damage to the company, the related party who engaged in the transaction is exempt of liability for damages if he or she acted in good faith and did not or could not know that the consummation of the transaction would cause damage to the company. In many circumstances a party could not foresee that a transaction would result in damage to the company so this provision weakens the otherwise desirable provisions.

In the Kyrgyz Republic, Articles 75 and 76 of the Law on Joint Stock Companies contain virtually the same provisions as the Armenian law in the definition of related parties and the requirement for notice by related parties of their related interests. However, Article 77 only requires approval of transactions with related parties by the board if the party is an executive officer or director of the company, rather than the wider categories of related parties—significant shareholders, family members and companies in which related parties have significant ownership interests. Under Article 73, if a transaction involves property of the value of 20 percent or more of the assets of the company, the transaction must be approved by the general meeting of shareholders. Under Article 78, if the approval procedures of Article 77 are not

complied with, the transaction is voidable and if the company incurs losses as a result of the transaction, the related party is liable for the losses.

In Ukraine the role of the board with respect to conflicts of interest in related party transactions depends upon the company charter. If it requires the board to approve related party transactions, then the Board plays some role in this regard. Reportedly in practice, however, it is the management's role, with general managers often being given broad authority to enter into most contracts except those exceeding a certain value.