RELATED PARTY TRANSACTIONS: THE CHALLENGES FOR POLICYMAKERS

Luca Enriques, University of Oxford and ECGI.

1. Introduction

This paper analyses the policy challenges in regulating transactions with related parties between a corporation and "related parties" (RPTs). Because they are easy to disguise as legitimate business transactions and, thus disguised, they are not even taxed as corporate distributions, RPTs are an effective technology to appropriate value or, in other words, a widely used "tunneling" tool. At the same time, RPTs exist that create value for all parties involved.

Tunneling not only raises distributional concerns in the relationship between controlling shareholders and minorities, but has a negative effect on capital markets: pervasive tunneling may lead to adverse selection in the IPO market: if a prospective issuer is unable to signal its controllers' intention not to engage in tunneling, it may desert the IPO market, leaving it to tunneling-prone issuers. Tunneling may lead to distortions in the market for corporate control: the highest-value user may be unable to buy control from the incumbent controlling shareholder, if the former is unable to extract as high private benefits. Finally, tunneling may well distort managerial and strategic choices within individual companies: controlling shareholders will choose transactions and strategies allowing them to extract more value via tunneling than those maximizing overall firm value.

Because RPTs are a usual suspect as a vehicle for tunneling, a number of jurisdictions provide for specific provisions addressing RPTs. For instance, under the influence of international economic organizations such as the OECD and the World Bank, many Asian countries, including India, have recently broadened the scope of RPT rules and tightened their content.

2. The Legal Tools

How can legal systems prevent RPTs from being used for tunneling purposes without stifling value-creating transactions? We describe some of the most commonly used tools to this effect, briefly highlighting the conditions for them to be effective and their limits.

2.1 Prohibitions

The seemingly most draconian way to address tunneling via RPTs is a simple prohibition of RPTs. That strategy has two main drawbacks: it would also rule out value-creating RPTs and, more importantly, it may not even accomplish much: unless an equally well-enforced prohibition on any form of tunneling is in place, insiders would just avoid RPTs as an expropriation technique and use functionally equivalent substitutes.

Prohibitions selectively targeting a specific category of RPTs, i.e., loans to related parties such as directors and executives, have traditionally been common in Europe and gained traction in the US and China in the first half of the 2000s.

2.2 Procedural Safeguards

Most jurisdictions provide for rules on how to enter into RPTs. In general, procedural rules can be defined as more or less strict, depending on how effectively insulated corporate decision-makers are from the dominant insiders and on the extent to which they put decision-makers in control over the negotiating process. We focus here on two procedural safeguards that at least some jurisdictions currently deploy: approval by a majority of independent shareholders and approval by disinterested/independent directors.

2.2.1 MOM Approval

A popular idea in academia as well as among policy makers is that the most effective procedural safeguard against tunneling is a veto power over RPTs for a majority of the shareholders other than the related party itself (a majority of the minority, or MOM). An increasing number of countries (including the UK and various East Asian countries) provide for such a requirement with respect to larger, non-routine transactions.

A MOM requirement ensures that only fair RPTs are entered into, provided at least three conditions are met:

a. Minority shareholders have a real opportunity to cast their vote.
b. Voting shareholders do so sincerely, for example being truly unrelated themselves to the related party and having been paid no bribe to vote in favor.
c. The MOM approval is the outcome of a well-informed decision-making process, following full disclosure of all material information about the RPT.

Of course, a MOM requirement also makes it more likely that a fair RPT will not be entered into. That may be the case when:

a. Shareholders are ill-informed about the real value to their corporation of the asset to be bought (sold), thinking it is worth less (more) than the related party offers.
b. One or more shareholders have the power to hold out and no agreement is (or can be) reached on the side payment that they request to vote in favor of the transaction.
c. The marginal transaction costs of obtaining MOM approval are such as to make the transaction not worth entering into.

The World Bank's Doing Business Report has been instrumental in focusing lawmakers' minds on improving RPTs laws by ranking countries, inter alia, according to how strictly they regulate them. See International Finance Corporation, Doing Business 2014 96–97 (11th ed. 2013), available at http://www.doingbusiness.org.

2.2.2 Independent Directors' Approval

Jurisdictions may require involvement of independent directors in the approval process. For independent directors to play an effective role in the protection of minority shareholders, the key issue is of course how truly independently from controllers one can expect them to act. In part, that will depend on how "independence" is defined and, primarily, on whether being nominated by the controlling shareholder precludes that qualification. Even where a director is nominated and appointed with the involvement of minority shareholders substantial independence is not guaranteed, as that is mainly a function of an individual's assertiveness and reputational concerns.

Independent directors have inferior knowledge of a company's business than dominant shareholders. The presence of what are to him unknown unknowns may well allow insiders to filter the pieces of information based upon which directors' decision will be made.

Independent director involvement may also vary in intensity: a non-binding advice on RPTs is a particularly weak tool. A requirement that the transaction be approved not only by the board as a whole but also by a majority of the independent directors or such directors' binding advice will be more effective. But the strongest form of involvement is finally the "independent negotiating committee" often used in the U.S.: a small number of independent directors conduct negotiations on the transaction and decide upon it, usually with freedom to search for alternative counter-parties.

2.3 Disclosure

Mandatory disclosure is still today a widely used technique to address RPTs. In isolation, mandatory disclosure is insufficient to prevent tunneling, which is well documented even via transactions that are publicly disclosed. Its importance is more in supporting internal decision-makers' independence (they will act more assertively if they know the RPT they may approve will be subject to public scrutiny) and in facilitating private and public enforcement against tunneling.

Financial reporting standards nowadays require disclosure (and therefore audit) of information relating to material RPTs almost everywhere. Some jurisdictions also provide for ad hoc, immediate disclosure of larger RPTs, whether as a step in the process leading to MOM approval or as an independent requirement once the transaction has been entered into.

2.5 Ex Post Standard-Based Review

Jurisdictions usually rely also on ex post judicial enforcement of one form or another of a "don't tunnel" standard to tackle RPTs. Generally, what the various manifestations of ex post standard-based review have in common is that courts look into the merits of an RPT to find out whether its terms were "fair" to the corporation, i.e., whether it suffered any prejudice (broadly or strictly identified) therefrom.

Different standards of review may apply to different RPTs within the same jurisdiction. Notably, corporate law in many countries provide for more lenient standards when RPTs also qualify as intra-group transactions.

3. The Challenges of Enacting Effective Reforms

For anti-tunneling reforms to be effective in the long run two elements are crucial: first, the law in action has to follow through on the reformed law on the books; second, the new legal environment must be either supported by relevant market players or in tune with social perceptions about tunneling.

Good enforcement institutions are key because in this area there is no such thing as an effective bright line rule, and even self-enforcing provisions prove illusory. The problem is that even reform-minded policymakers will hesitate to unleash incompetent judges by easing shareholder access to justice. Unpredictability of outcomes and outright wrong decisions, no matter whether in favour of plaintiff shareholders or defendant insiders, may well harm an equity market's reputation no less than the absence of avenues for judicial redress. That may explain why in countries with traditionally weak enforcement institutions it is often securities regulators who have taken the lead in enforcing anti-tunneling rules.

Even fervent enforcement by a committed securities regulator, backed, as it may, by law reforms tightening RPT rules, can reveal itself to be no more than a flash in the pan where either no social norm against tunneling exists or market players do not themselves effectively demand high compliance rates and strict enforcement.

Unless social norms themselves evolve in unison with the new stricter rules and thus make tunneling socially unacceptable, the social perception may soon become one of overzealous bureaucrats harassing successful entrepreneurs/employers for the benefit of anonymous and often foreign investors, at which point it will be easy for the powerful business elite to obtain laxer enforcement and/or a "counter-reform."