

The Role of the Board in Related Party Transactions

Joseph A. McCahery

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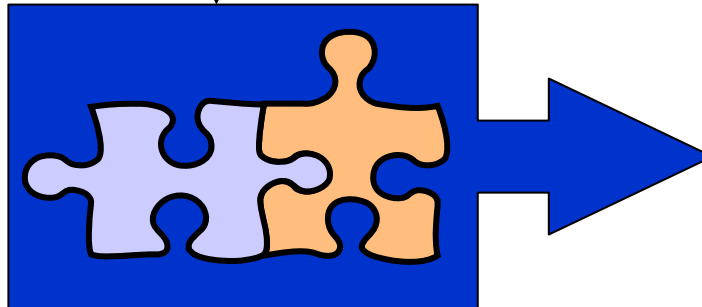
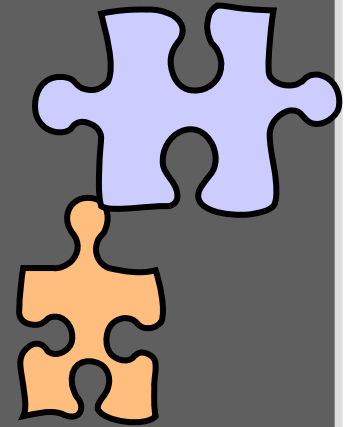
Setting the Theme

- 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

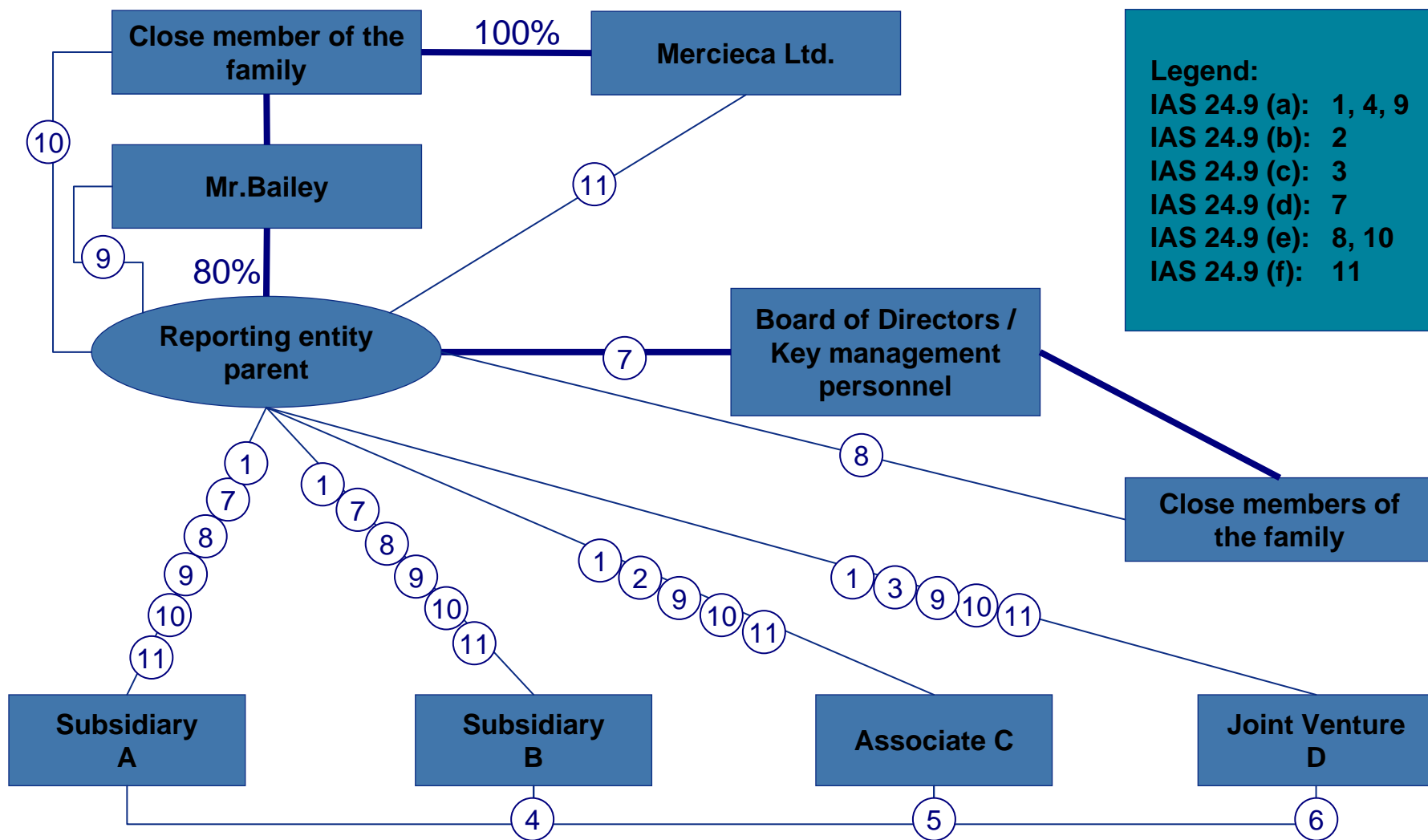


**Availability of external
finance increases and leads
to financial development**

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

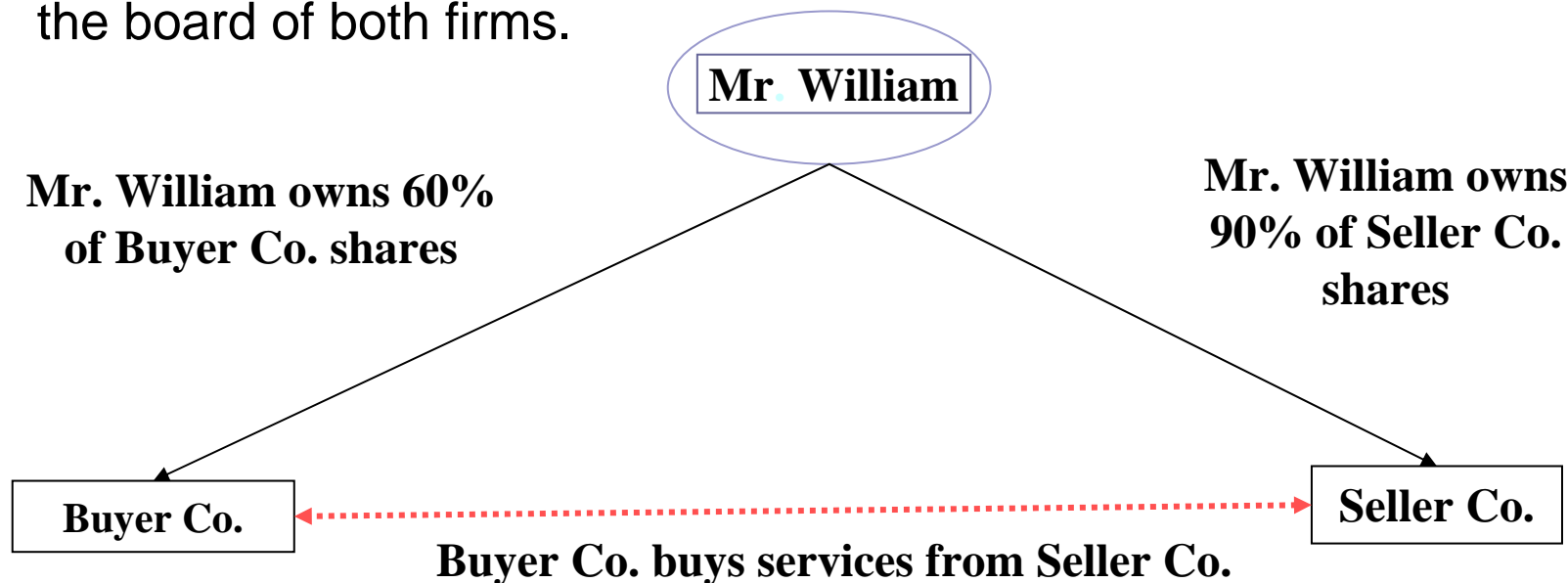
Definition



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.

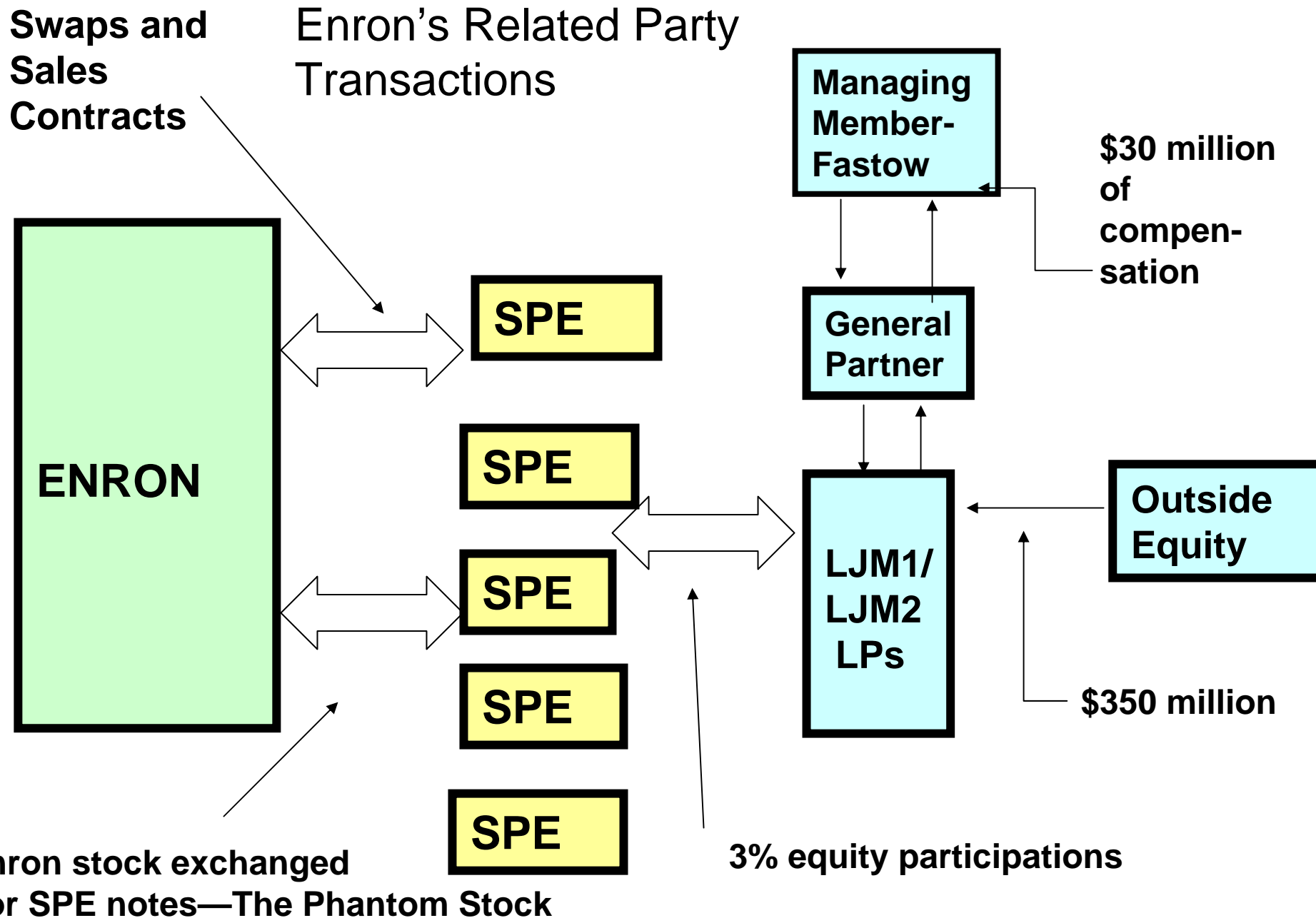


- Main Problem:
 - The proposed transaction may have a legitimate business purpose.
 - William is on both sides of the transaction and may benefit if Buyer acquires overpriced services from Seller.

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.



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

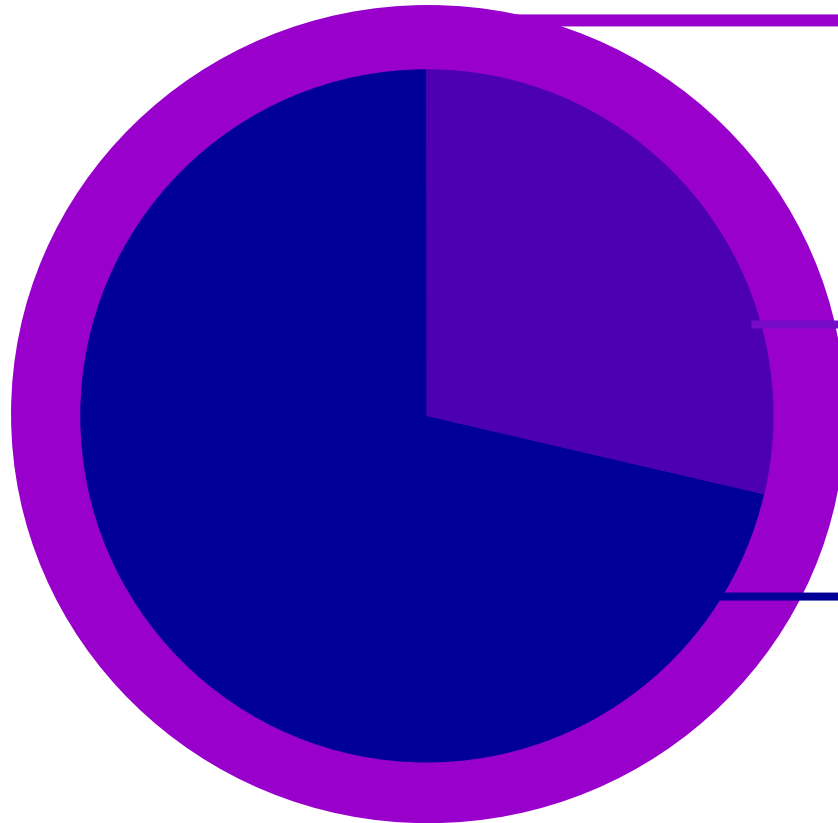
Limits of Effective Board Monitoring?

- 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:



Corporate Law
Fiduciary duties; board approval; shareholder voting; Prohibitions on certain transactions

Mandatory Disclosure: Listing Rules and Securities Regulation

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

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

