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1

The Law and (Some) Finance of Related Party Transactions

An Introduction

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I Introduction

The separation of ownership and control is a natural feature of corporations: shareholders routinely delegate decision-making power within the firm among themselves or to one or more managers.[1] Delegation can be explicit, via a consensual decision on who is going to run the company, or implicit, such as when investors buy shares in companies where another investor holds a majority stake and there is no side agreement allowing the former to share control.

Delegation of control responds to the need for effective decision making and harnesses the advantages of specialization: investors may have the necessary funds but lack the skills, the knowledge, and the entrepreneurial (idiosyncratic) vision to successfully run a company. Managers and entrepreneurs (hereinafter, controllers) may be long on skills and vision but short on funds. As Zohar Goshen and Assaf Hamdani[2] highlight, the incomplete contract between investors and the controller creates an intuitive problem: investors will have insufficient information (and knowledge) to fully understand whether the controller is acting in the best interest of both, as opposed to acting in a self-serving

[1] While the latter model is dominant in the United States and the United Kingdom, and common in Japan, the former prevails in most other jurisdictions. For the seminal survey, *see* Rafael La Porta et al., *Corporate Ownership Around the World'* (1999) 54 JF 471, 492–96. For more recent data confirming that ownership is more dispersed in the United States and the United Kingdom, *see* Gur Aminadav & Elias Papaioannou, *Corporate Control Around the World* (2016) National Bureau of Economic Research (NBER) Working Paper No. 23010, www.nber.org/papers/w23010.pdf (accessed June 18, 2018).

[2] *See* Chapter 2. Zohar Goshen and Assaf Hamdani, Corporate Control and the Regulation of Controlling Shareholders, Ch. 2, 26–7.

way, and whether the controller is making managerial and strategic decisions that maximize the value of the company in the long term, as opposed to steering the ship against an iceberg.

The trade-off is clear: either investors reserve control rights for themselves that protect them from the risk of controller opportunism, and of what they may legitimately perceive as mismanagement, or they renounce such rights, exposing themselves to a higher risk of misbehavior and, if the controller sticks to an iceberg-bound vision, greater financial loss. Correspondingly, either the controller retains all-encompassing governance rights and therefore the discretion and job security needed to realize their idiosyncratic vision or, granting funders enough of such rights, they run the risk of being ousted by myopic, distrustful, or even opportunistic investors.

Control can thus be more or less secure, controllers more or less free to pursue their business plans, and investors more or less fearful of agent opportunism. How power is to be allocated between investors and controllers to optimally address these tensions will vary from company to company, from industry to industry and from jurisdiction to jurisdiction. The right trade-off crucially depends on the characteristics of investors (how ready they are to use the powers granted to them individually or collectively), the nature of controllers (be they founders-entrepreneurs, a prominent family with strong political ties, the State itself, a professional CEO, etc.), and the institutional features of the relevant country, including its corporate law and the scope it affords to private contracting.

II Conflicts of Interest, Tunneling, Private Benefits of Control, and Related Party Transactions

Among the institutional features that may affect the distribution of power within corporations is corporate law's ability to effectively constrain controller opportunism, that is, the controller's ability to exploit to their advantage situations in which their interest conflicts with that of the corporation or the interest of shareholders as a class (hereinafter, conflicts of interest).[3] Most commonly, controller opportunism takes the form of the appropriation of value belonging to the company or the

[3] For present purposes we can be agnostic as to whether the company's interest coincides with the interest of shareholders qua shareholders or must be conceived of as comprising the interests of other stakeholders as well.

shareholders, which is also known as tunneling.[4] The proceeds of tunneling (the value extracted from the corporation), in turn, are known as *pecuniary* private benefits of control. As Sang Yop Kang demonstrates in his chapter,[5] rational controllers may consume the latter in a one-off looting of the company or over time in a series of transactions that ultimately generate higher rents in the long run.

Private benefits of control without qualification identify all utilities accruing to a controller that they do not share with (other) investors on a pro rata basis.[6] These include nonmonetary rewards such as the prestige and political power stemming from being at the helm of a large corporation or positive feelings about leaving a prosperous company to one's descendants. When the state is the controller, private benefits of control can also accrue to government officials and elected politicians in the form of political benefits derived from what Curtis J. Milhaupt and Mariana Pargendler call *policy channeling*,[7] i.e., the exercise of influence over a controlled corporation to pursue social or political goals.

Our main focus in this book, though, is on the risk of *pecuniary* private benefit extraction. More specifically, this book focuses on a frequently used tool for siphoning off value from a company: entering into transactions with a company or one of its subsidiaries on unfair terms. Because the controller can either be directly on the other side of these transactions or have their affiliates, relatives, and so on, deal with the corporation, the phenomenon is known as related party transactions (RPTs). Compared to outright theft, an RPT has the great advantage of having at least the appearance of a legitimate business transaction. As Figure 1.1 illustrates graphically, all RPTs involve a conflict of interest, but conflict-of-interest situations cover a broader set of transactions and situations. Some RPTs also result in tunneling. Tunneling, in turn, can also be the outcome of other forms of conflicts of interest. An important example of that are various instances of equity tunneling, in which the controller's private benefits of control stem from a shift in the relative participation of shareholders in the company's cashflows. As Jesse

4 The term was coined in Simon Johnston et al., *Tunneling'* (2000) 90 AER 22 and then developed by Vladimir A. Atanasov et al., *Unbundling and Measuring Tunneling'* 5 U. Ill. L. Rev. 1697 (2014) (distinguishing the misappropriation of cash flow, asset, and equity entitlements).

5 *See* Sang Yop Kang, Optimally Restrained Tunneling: The Puzzle of Controlling Shareholders' "Generous" Exploitation in Bad-Law Jurisdictions, Ch. 3, 64.

6 *See, e.g.*, Michael J. Barclay & Clifford G. Holderness, *Private Benefits of Control in Public Corporations* 25 JFE 371, 374 (1989).

7 *See* Curtis J. Milhaupt and Mariana Pargendler, Related Party Transactions in State-Owned Enterprises: Tunneling, Propping, and Policy Channeling, Ch. 9, 249.

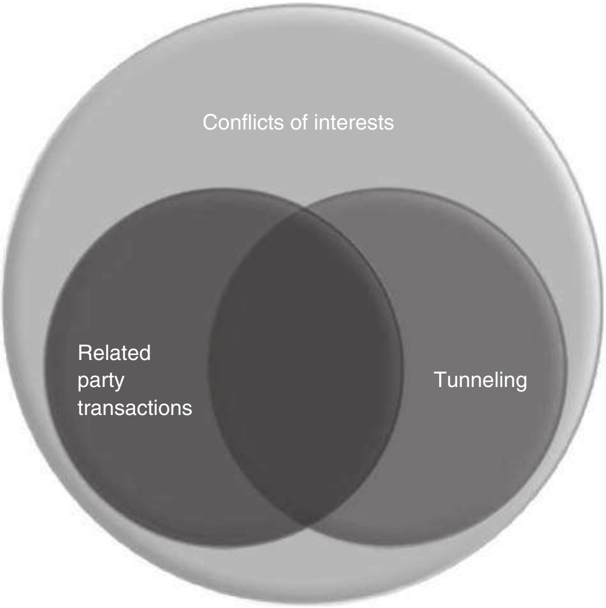

Figure 1.1 Conflicts of interest, tunneling, and related party transactions

Fried shows in his chapter,[8] that is what happens when newly issued shares are overpriced and minority shareholders alone (or disproportionately) subscribe to them.

As this book's chapters reiterate at various points, individual RPTs can be in the best interest of the individual company involved and create value for society as a whole.[9] While in most cases a transaction in the best interest of the company will also create value for society, and vice versa, that may not always be the case. We can call transactions that are in the best interest of the company "fair" and those that enrich the relevant parties (without offsetting third-party effects) "value-creating." That allows us to draw Table 1.1, which summarizes when and why RPTs can be of concern for policymakers. RPTs that are both value-destroying

[8] *See* Jesse M. Fried, Powering Preemptive Rights with Presubscription Disclosure, Ch. 4, 81–3.

[9] *See* Alessio M. Pacces, Procedural and Substantive Review of Related Party Transactions: The Case for Non-Controlling Shareholder-Dependent Directors, Ch. 7, 195; Jens Dammann, Related Party Transactions and Intragroup Transactions, Ch. 8, 222–6; Kon Sik Kim, Related Party Transactions in East Asia, Ch. 11, 325–6; Dan W. Puchniak and Umakanth Varottil, Related Party Transactions in Commonwealth Asia: Complexity Revealed, Ch. 12, 328–334, among others.

Table 1.1 *Related Party Transactions' Fairness and Efficiency*

	Value-creating	Value-destroying
Fair (not harmful for company)	Good for company's shareholders and good for society	Good for company's shareholders but possibly of concern for society (e.g., anticompetitive effects)
Unfair (harmful for company)	Bad for minority shareholders and for dynamic efficiency	Bad for shareholders and for society as a whole

and unfair would be policymakers' primary concern. But they may also want to keep an eye on unfair RPTs when they create value for society. Allowing these transactions to go through to the detriment of a company's minority shareholders may have a chilling effect on capital markets development and their aggregate ex-ante effect may thus be inefficient.[10] For similar reasons, policymakers may also worry about fair RPTs that have a negative effect on the degree of competition in the market in which a company operates as part of a large, dominant conglomerate in a given jurisdiction's economy.

As Curtis J. Milhaupt and Mariana Pargendler remind us, a controlling shareholder may use RPTs to "prop up" a subsidiary on the verge of bankruptcy, for instance by lending to it at a below-market (or even zero) interest rate.[11] Given the very soft budget constraints of the state as a controller, propping is more likely for financially distressed state-controlled entities than for private entities. Whenever the reason for propping of a state-owned enterprise (SOE) is to avoid redundancies and other negative consequences of insolvency for local communities, suppliers, and so on, RPTs are an instrument of policy channeling.

A private controller can equally engage in propping, either by using a partly-owned subsidiary to prop up a distressed one, thereby engaging in tunneling vis-à-vis the lending company,[12] or by injecting some

[10] That is the reason for being concerned about RPTs even if it were the case that share prices, at the IPO stage and in the secondary market, discount the expected losses from RPTs for outside investors.

[11] *See* Milhaupt and Pargendler (note 7) 248.

[12] Private benefits of control accrue if the controlling shareholder's stake in the favored (propped) company is higher than in the disadvantaged (propping) company, because the

money from their own pockets. The latter course of action may well be in the controller's self-interest, if the cost of propping (such as the opportunity cost of the related funds) is lower than the sum of (a) the present value of the private benefits they can expect to extract from the propped up firm if it survives and (b) the value of the negative repercussions on the controller's reputation that would otherwise stem from the bankruptcy of the distressed controlled firm. Propping may also be used to gain or preserve a dominant position in a given product market, which is why, as Kon Sik Kim reports in his chapter,[13] South Korea has issued rules on RPTs to facilitate new entrant firms and to foster competition in addition to rules protecting minority shareholders.

Another example of RPTs that may well serve a legitimate business purpose and be in line with a company's interest are transactions between entities that are part of the same group, known as intragroup transactions (IGTs). IGTs can be a matter of routine in integrated groups, that is, within a single firm comprising multiple legal entities, each in charge of different stages of production and all subject to the coordination of their activities via (more or less informal) hierarchical instructions and (usually formalized) IGTs.

Not only is organization in the form of business groups common in all jurisdictions, but it is also the case that, with a few notable exceptions (chief among them, the United States and the United Kingdom), minority shareholders are present either in more than one group entity or in at least one of the lower-tier entities, i.e., in companies controlled by another group entity. In such groups, IGTs become a potential avenue for tunneling to the detriment of minority shareholders, and an insidious avenue at that, as Jens Dammann highlights in his chapter[14]: first of all, IGTs are almost inevitable (and therefore easy to justify) within an integrated group; second, there is often a high volume of them; third, they are often inextricably intertwined one with the other; and fourth, they often involve a bilateral monopoly relationship between the two entities. For all of these reasons, it is especially difficult to judge whether IGTs are harmful for individual companies and their outside shareholders (a point that Alessio M. Pacces makes more generally for RPTs

negative impact of the transaction is externalized to a greater degree than the benefits from propping.

[13] *See* Kim (note 9) 307–8.

[14] *See* Dammann (note 9) 218–220.

characterized by asset specificity),[15] which has led some jurisdictions to provide specific rules there for.[16]

III What Law for Related Party Transactions?

Corporate lawmakers around the world attempt to strike the right balance between the need to curb insiders' tunneling and preserving the advantages of letting a company enter into fair and value-creating RPTs. They have to do so in the knowledge that, in a world of information asymmetries and uncertainty, distinguishing between transactions that are "good" and transactions that are "bad" is difficult even for internal decision makers, let alone for outsiders including enforcement institutions, that frequently can neither observe nor verify critical facts.

Here, the following fundamental questions arise: Who screens "good" RPTs in the best interest of the company (and society at large) from "bad" or harmful ones? How does the screen work? When does it operate? Before or after the RPT is entered into? Table 1.2 provides schematic answers to each of these questions. While it has no pretense of giving a comprehensive picture, the table does cover most of the tools that comparative research has shown to be widely used across jurisdictions.[17]

Many chapters in this book provide insights on which jurisdictions rely on what players using which tools at what point in time. The various contributions shed light on the contextual elements that have to be present to make a tool effective and/or on the devilish details that, on the contrary, dampen its effectiveness. In the process, some of the chapters also highlight the idiosyncratic features that make an institution more or less capable of performing its screening functions well. Others look into the political economy reasons for relying on one tool or the other. Taken together, these chapters round the picture and improve our understanding of how

[15] *See* Pacces (note 9) 196.

[16] The German codified law of corporate groups represents the most elaborate special regime. For a description, *see* Tobias H. Tröger, *Corporate Groups,* in GERMAN AND NORDIC PERSPECTIVES ON CORPORATE AND CAPITAL MARKET LAW (Holger Fleischer, Jesper Lau Hansen, & Wolf Georg Ringe eds., 2015); for a comparative survey of important jurisdictions' responses to the regulatory challenge of corporate groups, *see* Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation'* 59 AJCL 1, 45 (2011); European Model Company Act (EMCA), ch. 16, *Introduction* (2016) 3–4, http://law.au.dk/fileadmin/Jura/dokumenter/CHAPTER_16_GROUPS_OF_COMPANIES.pdf (accessed June 18, 2018).

[17] For a comparative survey, *see* Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)* 16 EBOR 1, 13–25 (2015).

Table 1.2 *Screening tools for RPTs*

Screening agent ("who")	Tool ("how")	Timing ("when")
Lawmakers	Prohibitions	Ex-ante
Untainted agents	Approval	Ex-ante
Principals	Shareholder meeting vote	Ex-ante or ex-post
Informed traders	Trading following (mandatory) disclosure	Ex-ante or ex-post, depending on (mandatory) disclosure timing
Regulators	Formal and informal enforcement powers	Ex-ante or ex-post
Courts	Adjudicating disputes over transactions' validity and/or fairness; applying criminal sanctions	Ex-ante (via injunctions) or, mainly, ex-post (liability or nullification suits; criminal proceedings)

policymakers can curb tunneling via RPTs without overburdening firms and/or curtailing the idiosyncratic vision of the controller.

In the remaining part of this section we look at the key characteristics of the tools identified in Table 1.2 and indicate some of the main insights that, in our view, the subsequent chapters provide.

A Untainted Agents: Disinterested/Independent Directors' Approval

Untainted agents screen conflicted transactions when jurisdictions require the involvement of independent directors in the approval process, as is the case for instance in Italy,[18] or when jurisdictions make such involvement strongly advisable, as is the case under Delaware case law with regard to some transactions with controlling shareholders.[19] The same policy rationale underpins regimes that

[18] *See* Regulation Containing Provisions Relating to Transactions with Related Parties (adopted by Consob through Resolution No. 17221 of 12 March 2010, later amended by Resolution No. 17389 of 23 June 2010, www.consob.it/mainen/documenti/english/laws/reg17221e.htm).

[19] On Delaware's regime that makes independent director approval a prerequisite for shifting the burden of proof in the judicial review of related party merger transactions (entire fairness standard), *see Weinberger* v. *UOP, Inc.*, 457 A.2d 701, 709 (Del. 1983); *Kahn* v. *M & F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014). *See also* Edward B. Rock, Majority of the Minority Approval in a World of Active Shareholders, Ch. 5, 108–110.

insulate RPTs from further judicial scrutiny if directors disinterested in the specific transaction (but not necessarily without ties to the controller) consented to them. However, the necessary degree of neutrality of screening agents is significantly lower in these approaches favored for example in Delaware[20] for transactions with directors and in France for all transactions in which a director or a substantial shareholder has an interest.[21]

Independent directors (and *a fortiori* merely disinterested ones) will play an effective role in the protection of (minority) shareholders only if they can be expected to act truly independent from controllers in the approval process. In part, that hinges on how "independence" is defined and, primarily, on whether being nominated by the controlling shareholder or being subject to their removal rights precludes such a qualification. To reinforce loyalty to minority shareholder interests, Alessio M. Pacces proposes an instrumental role for directors who are nominated and appointed by noncontrolling shareholders and can also be removed at the latter's discretion.[22]

Even assuming true independence, a handicap independent directors still face is their inferior knowledge about a company's business and (informal) organizational structure. What are to them unknown unknowns make it possible for insiders to opportunistically filter information, thereby distorting the decision-making process to their advantage.

B Principals: the Role of (Minority) Shareholders

Both scholars and policymakers frequently consider direct (minority) shareholder involvement the most potent procedural safeguard against tunneling. Therefore, an increasing number of countries (including the United Kingdom, Israel, and most major East Asian countries,[23] with the notable exceptions of Japan and South Korea[24]) vest veto power over larger, nonroutine RPTs with a majority of shareholders other than the

[20] Delaware General Corporation Law, Del. Code. Tit. 8, § 144 (2018).
[21] For France *see* Geneviève Helleringer, Related Party Transactions in France: A Critical Assessment, Ch. 14, 406, 420.
[22] *See* Pacces (note 9) 209–212.
[23] Luca Enriques et al., *Related Party Transactions*, in John Armour et al., THE ANATOMY OF CORPORATE LAW 145, 156–7 (3rd ed. 2017). *See also* Assaf Hamdani and Yishay Yafeh, Institutional Investors as Minority Shareholders, Ch. 6, 137–140 and Puchniak and Varottil (note 9) 327–334.
[24] On the latter jurisdictions, *see also* Kim (note 9) 285, 313.

related party itself (majority of the minority (MOM) approval in companies with a dominant shareholder).

The MOM requirement does not per se ensure that only fair RPTs are entered into. Indeed, that may not be the case if the voting process is flawed, if self-interested shareholders (other than the related party but still in some relationship with that party) are counted for MOM-approval purposes,[25] disclosure is partial and/or biased, or the meeting takes place at a moment in time when vetoing the RPT is no longer a viable choice for the corporation.[26]

The MOM requirement also makes it more likely that a "fair" RPT (i.e., a transaction in the best interest of the company) will *not* be entered into. That may be the case when 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 or when the relative transaction costs of obtaining MOM approval, including following the required disclosures to the public, are such as to make the transaction no longer worth or practicable entering into. An additional reason for "false positives" in the presence of MOM approval is that one or more shareholders may put together a stake that is sufficient to veto the transaction, whether because, in good faith, they think that it is harmful for the company/the shareholders or because they are attempting to extract a higher price for their shares.[27] Yet, in his chapter, Edward B. Rock concludes, based on the experience of related party merger transactions in the United States, that the perils of strategic behavior by hedge funds or actively managed mutual funds appear to be rather theoretical.[28]

The transaction cost issue is the reason why jurisdictions that provide for MOM approval (e.g., the United Kingdom, Hong Kong, Singapore) limit this tool to RPTs above a given size, typically when their value is above five percent of the company's market capitalization. France is an exception, because a shareholder vote is only dispensable for routine self-interested transactions (i.e., those the company itself assesses to be entered into in the ordinary course of business and at market conditions). However, MOM approval in France is only ex-post, at the annual meeting, and denial of approval of a properly board-approved transaction has

25 *See also* Puchniak and Varottil (note 9) 347.
26 Enriques (note 17) 16.
27 Specifically on this problem, *see* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 Cal. L. Rev. 393, 402 (2003).
28 *See* Rock (note 19) 115–6 (showing that between 2010 and 2017 MOM provisions were only used in one case to block an RPT).