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Empowering the Audit Committee and the Auditor in Related Party Transactions

Law Working Paper N° 318/2016
August 2016

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Abstract

Currently, the European approach addressing related party transactions is exclusively relying on the disclosure and partial control of the transaction. Listed European corporations must provide in a (financial) summarized overview of these transactions that have taken place in the accounting period. The external auditor controls the transaction in so far it is fair and not misleading. The European Commission considers this approach insufficient to address the risk of extracting private benefits from the corporation and harming the other stakeholders, and in particular, the minority shareholders. The European Commission considers the implementation of an alternative strategy for related party transaction, mandating a disinterested corporate body to approve the self-dealing. However, I believe that the Commission's proposal will more than likely not overcome the major shortcomings of solely disclosing the transactions. I suggest involving the external auditor and the audit committee. The external auditor's duties can be broadened as to include the reasonable assurance that the envisaged related party transactions are economic fair transactions. Further the audit committee monitoring duties can include the work of the auditor regarding related party transactions. The audit committee can serve as the body that approves the related party transaction. This procedure can help to mitigate to overcome the negative effects of certain types of related party transactions.

Keywords: Related party transactions, disclosure, IAS 24, ISA 550, Shareholder Rights Directive, external auditor, audit committee

JEL Classifications: K22, G38, M41, M48

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1. Introduction

It is common practice that directors, managers and shareholders deal with the corporation. These so-called related party transactions can be both beneficial to the corporation and the related party. Kraakman *e.a.* pointed at the many advantages of these transactions. When starting up a corporation and other corporations without a track record can often only transact with their related parties. Similarly, corporations can transact in more favourable terms with insiders that are familiar with the corporation than with unrelated parties and in a group of corporations a business opportunity can sometimes be better developed by another entity than the corporation which first encountered it.[1] But there is a risk that the corporation is exploited when the conditions are less favourable for the corporation than could be realized in an arm's length transaction. Corporate incumbents seek to exploit their position and extract private benefits from the corporation. These benefits can come in many different forms. The incumbent can pursue pecuniary benefits or enjoy advantages from entering into contracts that favour a (controlling) shareholder – tunnelling[2] -, provide in favours for family members or other relatives or boost her status. This vulnerability of corporations in related party transactions does not justify an absolute prohibition of all these transactions. It raises the question how regulators and legislators should approach these related party transactions. At the European level the Commission is moving from a disclosure regime towards an approval system whereby a disinterested body will approve the related party transaction. However, it remains to be seen whether this process will result in better mitigating the exploitation risk of

[1] R. Kraakman e.a., *The Anatomy of Corporate Law*, Oxford University Press, Oxford, 2009, 154.
[2] For an overview of different kinds of tunnelling, see V. Atanasov, B. Black and C. Ciccotello, Unbundling and Measuring Tunneling, *University of Illinois Law Review* 2014, 1697-1738.

the corporation. I show that the current proposal will not accomplish its main goals as the approval procedure will not necessarily be matched with the appropriate information disclosure system. Thereto we suggest to provide in an alternative system of which elements can be found in some of the European member states.

This paper proceeds as follows. First, I summarize the different methods for settling related party transactions. Next, I address the current European disclosure regime for related party transactions and how it is applied in practice. Section 4 briefly studies how the current proposal of the shareholder directive want to mitigate the conflicts of interests in related party transactions and questions the efficiency of the proposed system. In Section 5, I provide in an alternative mechanism. The final section contains my conclusion.

2. Mechanisms for Controlling Related Party Transactions

In his research, Pizzo suggests that related party transactions can be used for two different purposes – more efficient trading or more wealth shifting - depending on the organisational context and the institutional environment.[3] An obvious answer to address the wealth shifting related party transactions is to forbid them. For business transactions, this strategy is not commonly used. In financial law, it is a well-known mechanism. In many countries insider trading, or more precisely, trading on inside information, is forbidden. As one party, the insider, knows more about the corporation's operations and business, regulators consider trading with this insider detrimental for the (functioning of the) capital market. In some countries, like in France and in the US, loans between a corporation and a director are

[3] Michele Pizzo, *Related Party Transactions under a Contingency Perspective*, Journal of Management and Governance, 212-213 (2013).

forbidden if they are not in the regular line of business of the corporation.[4] The risk that this type of transactions provide in some form of stealth compensation is considered too high. While this risk can be easily acknowledged, it remains questionable why this specific transaction is forbidden, while many other relationships between the corporation and directors are not. Contracts of advisory services between a director and the corporation are common practice in many countries and corporations and can easily be used to hide generous compensation of directors.[5]

The most common approach for addressing related party transactions is to disclose the transaction to the market and the shareholders. When the market considers the transaction as detrimental for the corporation, the market will take care, *i.e.*, the stock price will fall and corrective actions will follow. Sometimes the law provides in specific disclosures. According to the Belgian Corporations Act, a the corporation listed on the stock exchange must indicate in its annual report the substantial limitations or the burdens imposed by its parent corporation during the year in question.[6] It includes group related prohibitions to enter a specific market (geographically or product related).

Next, the disclosure requirement is often not a stand-alone rule. The disclosure provides the necessary input for legal action for breaching the standard rule of a fiduciary duty or similar applicable rule to be found in most jurisdictions.[7] Many countries provide in (some kind of) a standard controlling the behaviour of the directors. In case the director enters in a related party transaction, she must comply with these standards and courts can assess whether the

[4] L. Bebchuk and J. Fried, *Pay without Performance*, Harvard University Press, Cambridge, 2004, 112-117. For France see specifically article L 225-43 Commercial Code.
[5] R. Kraakman e.a., *The Anatomy of Corporate Law*, Oxford University Press, Oxford, 2009, 169.
[6] Article 524, §7 Belgian Companies Act.
[7] In specific circumstances, minority shareholders can even force the corporation to be dissolved (R. Kraakman e.a., *The Anatomy of Corporate Law*, Oxford University Press, Oxford, 2009, 161-162).

director performed in breach of this duty. In some countries, like Germany, it extends to groups of corporations, *i.e.* the controlling shareholder. When a corporation has entered in a control transfer agreement or profit transfer agreement with its parent corporation, it should be compensated for the annual loss following the transfer.[8] In other countries, like France and Belgium, the transfer of any kind of a subsidiary to another entity of the group must be balanced in the group policy distributing (future) costs and revenues.[9]

Many countries combine the disclosure of the related party transaction with an ex-ante approval mechanism or an ex-post ratification procedure. Under Belgian law we identify an ex ante approval mechanism. The director or member of the executive committee who has a direct or indirect proprietary interest in a decision to be taken by the board or the committee must disclose it before the deliberation of the board and the interest must be mentioned in the minutes of the board or committee.[10] The board of directors must also mention in the minutes the nature of the proposed decision or operation, including the pecuniary consequences for the corporation. For listed corporations the director cannot assist in the deliberation nor participate in the vote.

Relations between a listed corporation and an associated corporation, not being a subsidiary, as well as between subsidiaries of the listed corporation and its associated corporations, not

[8] Section 301-304 Aktiengesetz.
[9] For a more detailed assessment of the differences and similarities in interpretation of the Rozenblum-doctrine (Cass. fr. crim, 4 februari 1985, *D.* 1985, 478 note D. Ohl; *Rev. soc*. 1985, 648 note B. Bouloc; *JCP* 1986, II, 20585, note W. Jeandidier; *Gaz. Pal.* 1985, 377, note J.-P. Marchi (Rozenblum), see E. Wymeersch, "The Groups of Companies in Belgian Law" in *Groups of Companies in the EEC*, Berlijn, de Gruyter, 1993. See also E. Wymeersch, Conflicts of interest in financial services groups, 2007, speech 2 march 2007, to be found here https://eiopa.europa.eu/CEIOPS-Archive/Documents/Speeches%20and%20presentations/3L3_WYMEERSCH.pdf (last accessed 22 August 2016). This doctrine is also criticized, see C. Windbichler, '"Corporate Group Law for Europe": Comments on the Forum Europaeum's Principles and Proposals for a European Corporate Group Law', *European Business Organization Law Review*, 2000, 265-286.
[10] Article 523 Belgian Companies Act.

being subsidiaries of the subsidiary[11], must also follow a specific approval procedure. Prior to the decision or operation, a committee composed of three independent directors, assisted by independent experts, must draft a motivated opinion, and assess the proposed decision or operation, appreciate the advantages and disadvantages for the corporation and its shareholders, determine if it can cause damages to the corporation which are obviously excessive, considering the corporation's policy. The board of directors, when taking its decision, must indicate if the procedure has been followed and, if need be, explain the reasons why the committee's opinion has not been followed. The auditor delivers an opinion regarding the accuracy of the information contained in the committee's opinion and in the minutes of the board of directors' decision.[12] For listed corporations, the committee's opinion, the minutes containing the board of directors' decision and the opinion of the auditor are included in the annual report.

In France there is, next to the ex-ante approval, also an ex-post ratification.[13] Article L. 225-38 of the French Commercial Code reads: "Any agreement entered into, either directly or through an intermediary, between the corporation and its general manager, one of its assistant general managers, one of its directors, one of its shareholders holding a fraction of the voting rights greater than 10% or, in the case of a corporate shareholder, the corporation which controls it must be subject to the prior consent of the board of directors." The regular operations at arm's length are excluded from this procedure. Next, the agreements are subject to an auditor's report. The general meeting must approve the agreements. However, to protect the position of third parties, even if the general meeting disapproves the agreement, it retains

[11] The field of application of this rule is, to say the least, peculiar.

[12] This procedure does not have to be applied for decisions and operations in going concern, under normal market conditions for similar operations, or when they concern less than 1% of the net assets of the corporation.

[13] For an excellent comparative analysis of the French, German and Italian system see P.-H. Conac, L. Enriques and M. Gelter, "Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy", *European Company And Financial Law Review* 2007, 491-528.

its effect vis-à-vis those third parties, unless the agreements are null and void due to fraud.[14] The related party must refrain from participating in the vote.

3. The Current European Disclosure System

Currently, the European approach for mitigating the risks of related party transactions is based on the disclosure of the transaction which should allow the investors and shareholders to evaluate which transactions the corporation is engaged in. Broadly speaking, the disclosure is directed towards the remuneration of top executives and board members on the one side and all other related party transactions on the other side. The external auditor must control whether the disclosed (and undisclosed) related party transaction are fairly represented in the annual report and is not misleading.

3.1.Reporting and Control Standards

Many European Members states follow the route of a procedure of disclosure in combination with a corporate decision process, excluding the conflicted director or manager or, less intense, the shareholders. The current European legislation is more limited. Regulation (EC) No 1606/2002 of the European Parliament and of the Council[15] states that the consolidated financial statements of listed EU corporations must be presented according to the International Financial Reporting Standards (International Accounting Standards) of which International Accounting Standard 24 (IAS 24), addresses the disclosure rules of related party

[14] Article L. 225-41 French Commercial Code.
[15] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, O.J. L. 243 of Sep. 11, 2002.

transactions. The Transparency Directive[16] enlarged the field of application and requires that also non-EU corporations listed in the EU apply IFRS. The current edition of the standard was issued in 2009 and endorsed by the European Commission in Commission Regulation (EC) No 632/2010[17]. After this enactment came into force, the two (fourth and seventh) accounting directives are amended aligning the disclosure requirements for related party transactions with these financial reporting standards.

IAS 24 provides a disclosure regime of related party relationships.

A related party includes – but is not limited to – persons and close members of that person's family that has (joint) control over the corporation or has a significant influence over the corporation as well as the key management personnel of the corporation or its parent. The standard further identifies what *control* is as well as what comprises *significant influence* and who belongs to the *key management personnel*.

Control is defined as the "power to govern the financial and operating policies of an entity so as to obtain benefits from its activities". A shareholder will be in a position to significantly influence the corporation when she has the "power to participate in the financial and operating policy decisions of an entity, but is not in control over those policies. Significant influence may be gained by share ownership, statute or agreement." IAS 28 Investment in associates and joint ventures fine-tunes what can be considered as significant influence. The European Commission endorsed the current version of IAS 28 in Commission Regulation (EU) No

[16] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, O.J. L. 390/1 of Dec. 31, 2004.

[17] Commission Regulation (EC) No 632/2010 of 19 July 2010 amending Regulation (EC) N° 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) N° 1606/2002 of the European Parliament and of the Council as regards International Accounting Standard (IAS) 24 and International Financial Reporting Standard (IFRS) 8 (Text with EEA relevance), O.J. L. 186/1 of Jul. 20, 2010.

1254/2012 of 11 December 2012.[18] Controlling directly or indirectly 20 per cent or more of the voting power is presumed significant influence. The presumption is rebuttable but the standard notes that a significant influence or even controlling voting block of another shareholder does not necessarily preclude a significant influential position in the corporation. Conversely, voting power of less than 20 per cent will not be considered significant influence unless it is shown clearly that the shareholder has this kind of influence, *i.e.* power to participate in the financial and operating policy decisions. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence. The standard continues with a number of examples illustrating a significant influential position[19] and addresses other issues like the use of options and other convertible instruments which can result in a significant influential position in the corporation. Further, IAS 28 excludes situations whereby corporations only share a common director or other key personnel, only offer finance or are important clients or suppliers.

IAS requires the disclosure of the compensation of the key management personnel of the corporation. Key management personnel is defined as "those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity". The notes to the accounts must contain information on the short-term benefits, long term benefits, termination benefits, share-based payments and the post-employment benefits.

[18] Commission Regulation (EU) No 1254/2012 of 11 December 2012 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 10, International Financial Reporting Standard 11, International Financial Reporting Standard 12, International Accounting Standard 27 (2011), and International Accounting Standard 28 (2011), O.J. L. 360/1 of Dec. 29, 2012.

[19] Evidence of significant influence can be:

(a) representation on the board of directors or equivalent governing body of the investee;
(b) participation in policy-making processes, including participation in decisions about dividends or other distributions;
(c) material transactions between the entity and its investee;
(d) interchange of managerial personnel; or
(e) provision of essential technical information.

When shareholders are controlling the corporation or have a significant influence in the corporation or when other related parties contract with the corporation, the latter is required to disclose in the notes to the financial statements the nature of the relationship as well as "information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements". "This information should include at least (a) the amount of the transactions; (b) the amount of outstanding balances, including commitments, and: (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and (ii) details of any guarantees given or received; (c) provisions for doubtful debts related to the amount of outstanding balances; and (d) the expense recognised during the period in respect of bad or doubtful debts due from related parties."

IAS 24 offers significant discretionary power to the reporting corporation as it can take into account, for determining the level of detail in reporting these transactions, the closeness of the related party relationship as well as other factors in establishing the level of significance of the transaction. Overall, while the reporting standard requires the disclosure of related party transactions, it is far from certain that third parties will be duly informed on the exact nature, size and effect of the related party transactions when the corporation limits its reporting to the strict minimum level of compliance with IAS 24, as we will illustrate in the next section.

Auditors must control the reliability of the financial reports of the corporation. The International Standards on Auditing provide the auditor in a framework to control the related party transactions. Currently ISA 550 states that the audit must, regarding the related party transaction be performed as to obtain "an understanding of related party relationships and transactions sufficient to be able: (i) To recognize fraud risk factors, if any, arising from

related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and (ii) to conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions: a. achieve fair presentation (for fair presentation frameworks); or b. are not misleading (for compliance frameworks); and (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework." The auditor must be alert that the related party transactions are identified and adequately reported, but there is no reporting nor assessment as to whether the transaction is wealth shifting for the corporation or efficient trading.

3.2.The Disclosure System and Tunneling

There are many different types of related party transactions. In this section we focus on those transactions that take place between the corporation and its controlling or significant shareholders. Corporations report a wide variety of transactions with their major shareholders. However the reporting takes place through different methods. First, some corporations provide an overview of the financial considerations related to the shareholder transactions. Other corporations consolidate all transactions that take place with the related shareholder and disclose only the non-eliminated considerations on consolidated level. A third type of reporting is providing in a narrative overview of the relations between the corporation and the shareholder as well the involved consideration.

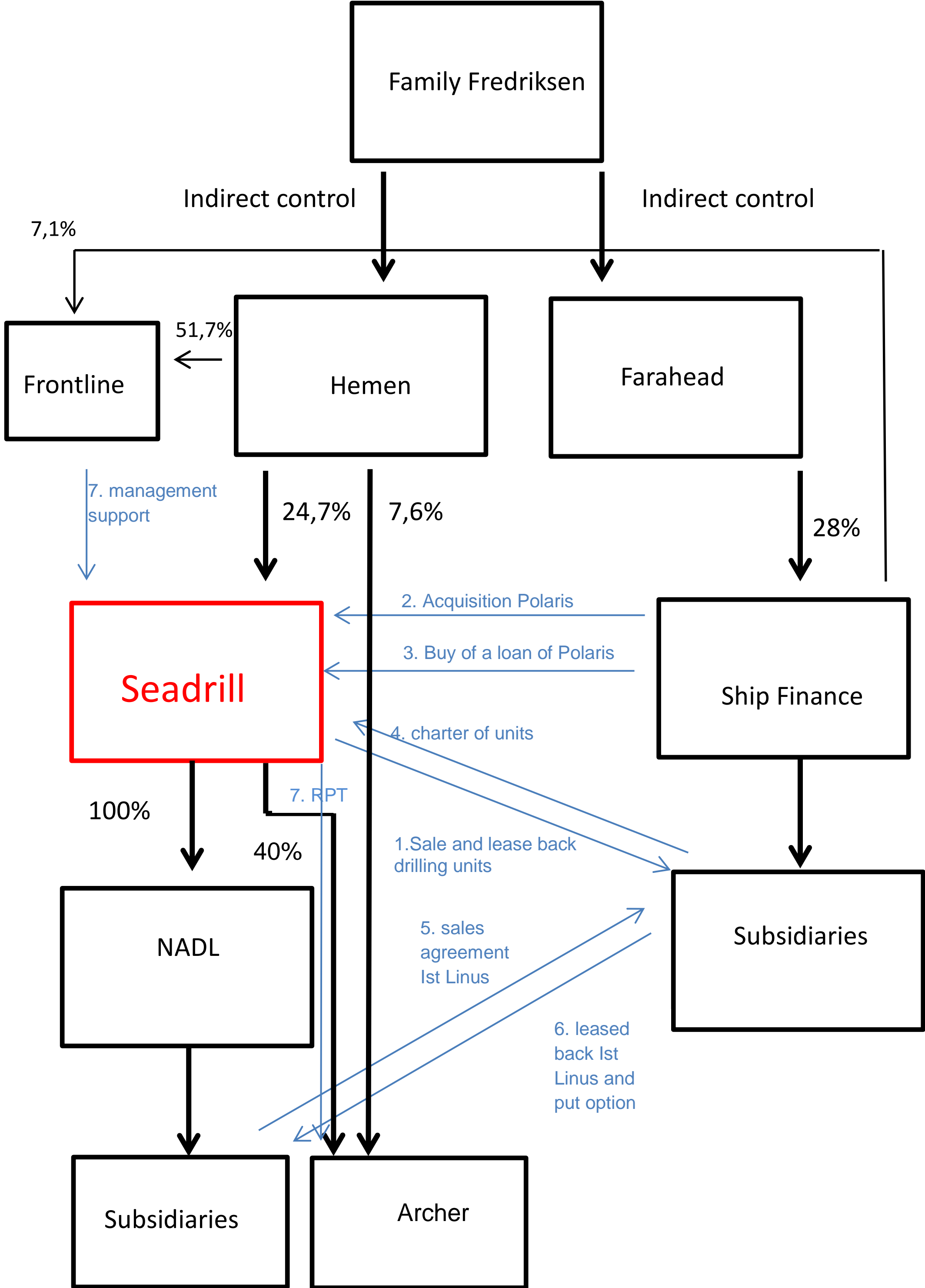
Other corporations extensively report on the different transactions between the corporation and its significant or controlling shareholder. An example of this type of reporting can be found in the annual report of the Norwegian corporation Seadrill (Figure 1).[20]

I studied the narrative report of the related party transactions with two of the four associated parties of Seadrill, Frontline and Ship Finance. The results of our assessment can be found in figure 1. With the subsidiaries of the associated corporation Ship Finance, Seadrill entered into different sale and lease back operations (1.). The operations are structured in such a way that the corporation consolidates the entities that control the vessels. The total lease costs are considerable and add up to $300 million. This operation goes hand in hand with charter contracts (4.). There is no information disclosed as to the strategic interest of the corporation for entering in this type of transaction and neither regarding the conditions (at arm's length) of the operations.

At the penultimate day of the accounting period the corporation acquired one of the corporations controlling one of the vessels from Ship Finance accompanied with the "purchase" of the outstanding loan of $97 million (2. and 3.). The price "for the shares and for the loan" amounted to $111 million. Again, any information on the arm's length of the transactions is missing. In 2013 a variable interest entity of NADL sold the "West Linus" to a subsidiary of Ship Finance and chartered it back from this subsidiary for a term of 15 years (5. and 6.). The transaction consideration of $600 million reflected the market value. The transaction was accompanied with a loan agreement between Ship Finance and its subsidiary of $195 million but reduced to $125 million, an amount reported as long term debt in the consolidated balance sheet of Seadrill.

[20] Seadrill has its headquarters in London and is also listed at the NYSE.

Figure 1: Reported Related Party Transactions of Seadrill (2014)



Source: based on chapter on related party transaction in the annual report of Seadrill and Ship Finance 2014

Finally, Frontline, a subsidiary of Hemen, the significant shareholder of Seadrill provided management and administration services.

Next to these transactions, Seadrill entered in related party transaction with Archer, an associated corporation in which it holds an equity interest of 40 per cent (7.) and with Metrogas for which I could not identify in the report which relationship exists between this corporation and Seadrill.

3.3. Assessment of the IAS 24 Disclosure System

The current disclosure system does insufficiently distinguish the transactions that take place in the group downstream, which can shift assets or revenues to another party without an effect on the group's position and the transactions that take place between a corporation with an "external" related party, increasing the likelihood of "tunnelling" and other adverse behaviour. The accounting disclosures' goals are unrelated to any theory of related party transactions – conflicts of interests theory, efficient transaction perspective or contingency perspective – and only offer a (consolidated) overview of all transactions. The current reported accounting information is barely sufficient for third parties to assess the importance of the transactions for corporations, let alone the assessment of the interests of the transactions for corporate performance. The aforementioned example of extensive disclosure of Seadrill's related party transactions (figure 1), illustrate the different types of transactions and show how the disclosure regime falls short in providing adequate information of the wealth enhancement or wealth transfer of the transactions. Transactions between 1) Seadrill and NADL or subsidiaries of NADL, 2) between Seadrill and other (not-fully owned) subsidiaries, between 3) NADL and its subsidiaries, 4) between Seadrill and Hemen, 5) between Seadrill and Archer, 6) between Seadrill and Ship Finance or its subsidiaries and 7) between Seadrill's subsidiaries and Ship Finance or its subsidiaries can all have a different positive or negative

effect on the position of Seadrill. These examples already set aside corporate opportunities in the group controlled by the Family Fredriksen which are not necessarily known by the corporation Seadrill or any of its other minority shareholders. While transactions under 1) and 3) and in a lesser degree 2) primarily can affect the position of creditors of the involved corporations and unlikely that of the minority shareholders of Seadrill, the other transactions can negatively affect the results of the corporation and shift advantages to the related party and similarly the corporate opportunity if passed on to another corporation, or can deprive the corporation of future business. There can be valid reasons for entering into many different kinds of related party transactions or for having the opportunity developed by another party. However, the current accounting rules leave ample room for any kind of assessment reporting, triggering suspicion over efficiency.

4. The new Shareholder Rights Directive Proposal

4.1 A new European Strategy

At the European level, the European Commission opined that the disclosure requirements in IAS 24 and the national rules are, for listed corporations, not sufficient for mitigating appropriately the potential conflicts of interests that result from these transactions. The Commission addresses this issue in the proposal for a new shareholder rights directive. In the original proposal of the Commission of April 2014[21], the corporation must not only announce transactions with related parties that represent more than 1% of their assets accompanied with an assessment report of a third party, but also invite the non-interested shareholders to vote on these transactions with related parties representing more than 5% of the corporations' assets

[21] The original proposal can be found here http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2014%3A213%3AFIN (last accessed 20 August 2016).

or transactions which can have a significant impact on profits or turnover. These transactions can only be concluded under the condition of a future shareholder approval or the corporation can only enter in this agreement after the approval has been granted. The proposal heavily relied on the statement of the European Corporate Governance Forum on related party transactions of 2011 which provided a similar approach and according thresholds[22].

This approach is criticized[23] and in the meantime the pending proposal changed the approval approach. Under the European's Parliament approved proposal of 8 July 2015, the Member States can have the non-interested shareholders approve the material transactions with related parties but can also make use of procedures involving the administrative or supervisory body "in accordance with procedures which prevent a related party from taking advantage of its position and provide adequate protection for the interests of the corporation and of shareholders which are not related parties, including minority shareholders."[24] Exceptions are provided for transactions with wholly owned subsidiaries and transactions in the ordinary course of business concluded on normal market terms.

The proposal offers several different options for approving the transaction. In all cases the conflicted party must be prevented from taking part in the decision process. For example, if the option is used that the general meeting must approve the transaction, the conflicted

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[22] For the statement of the ECGF see http://ec.europa.eu/internal_market/corporation/docs/ecgforum/ecgf_related_party_transactions_en.pdf, last accessed 1 March 2016.

[23] Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal),* European Business Organisation Law Review, 16, 27-31 (2015). Others defend the role of the general meeting of shareholders, see M. Roth, *Related party transactions: board members and shareholders The European Commission proposal and beyond*, working paper, January 2016, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710128 (last accessed 23 August 2016).

[24] Article 9c (2), Amendments adopted by the European Parliament on 8 July 2015 on the proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (COM(2014)0213 – C7-0147/2014 – 2014/0121(COD)), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2015-0257+0+DOC+XML+V0//EN, last accessed 25 February 2016.

shareholder shall be excluded from the voting. However, Member States can opt for allowing the conflicted shareholder to participate in the vote if there are adequate safeguards to protect the interests of the other shareholders. While the proposal only protects the interests of the other shareholders (and hence not these of the corporation itself), these safeguards must guarantee that the transaction will not be approved if the majority of the non-conflicted shareholders oppose the transaction or the majority of the independent board members[25] is opposing. If the Member States have opted for the approval by the administrative or the supervisory board, the representatives of the related party or the related party (*i.e.* the shareholder) must be excluded from preparing the report accompanying the announcement of the material transaction.

At the moment of writing, the Directive is not yet approved and it is not clear if major modifications will change the current proposal. Hence I do not address the specificities of the current proposal but provide next a number of general considerations and observations that partially follow from our findings of the disclosure of related party transactions as well as an alternative system to mitigate related party transactions with negative effects.

4.2. Evaluation of the Proposed Strategy

For sure, the proposal will enhance the disclosure of the related party transactions and consequently improve the position of the shareholders and the capital market for monitoring the merits and costs of the related party transaction.

[25] This requirement needs further fine-tuning. Indeed, this section only refers to the opinion of the independent directors, while the previous section refers to a report that can be issued by an independent third party, the supervisory board or a committee of independent directors. These sections seem not yet to be in line with one another.

However, it can be questioned whether it is necessary, as proposed, to divulge information on all related party transactions and organize an approval system with many options while other European rules have already installed a system to adequately monitor the financial statements of which the related party transaction approval process can make use.

The proposal for a new regulated party transaction procedure excludes, in the previous example of related party transactions that Seadrill has entered, the first type of transactions from the approval requirements, which lowers the administrative red tape (while the reporting requirements of IAS 24 remain unaltered). It will partially envisage the related party transactions under 2), 3) 4), 5) and 6) as transactions between the corporation and a related party. However, many other wealth enhancing and wealth transferring transactions will be excluded too as the proposal only envisages material transactions between the listed corporation and its related parties and not between related parties mutually[26]. Some scholars argue that related party transactions between group members are less "visible" than transactions with the directors and the officers, a problem that the new proposal does not solve.[27] Consequently, when a related party wants to expropriate assets of the corporation, it is more than likely that the transaction will be wrapped up in a transaction that is not submitted to the new legislation.

Under the current proposal[28], Member States can provide the approval right to the administrative or the supervisory body or the general meeting of shareholders. Member States

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[26] The "under-inclusiveness" was also present in the original proposal, see Tobias Tröger, *Corporate Groups*, Safe Working paper No. 66 (22 September 2014), 28, Available at http://ssrn.com/abstract=2500101 (last accessed 1 March 2016)

[27] Klaus Hopt, *Groups of Companies*. In Jeffrey Gordon and Georg Ringe, *Oxford Handbook of Corporate Law and Governance*, chapter 25, 14-15 (Oxford University Press, in press 2016).

[28] Article 9c (2), Amendments adopted by the European Parliament on 8 July 2015 on the proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (COM(2014)0213 – C7-0147/2014 – 2014/0121(COD)),

can provide a voting right for the shareholders on the material transactions of previously, by management or supervisory board, approved transactions.[29] In all circumstances, the approval should be granted by the disinterested parties, whether it is the disinterested board members, the supervisory board members or the disinterested shareholders[30]. The decision can only follow upon the provision of a report in which it is confirmed that "the transaction is fair and reasonable from the perspective of the company". Arguably, transactions should not be entered into in the first place when, from the perspective of the corporation, it is not fair and/or not reasonable. Most corporation laws make the board of directors[31] liable when entering in transactions that harm the corporation. Consequently a report will only be provided for transactions which are considered or can be packaged as fair and reasonable[32]. It is hard to believe that there will be transactions to be assessed by the independent third party, the supervisory body or a committee of independent directors and which will not receive a "clear" report because that type of transactions will unlikely be presented for approval in the first place. Even if the transaction with the negative report is presented for approval, I can hardly believe any corporate organ will approve the transaction of which the negative effects for the corporation have been reported.

When shareholders are assigned with this task, there seems to be some information missing which can be considered pivotal for the decision process. The nature of the transaction, the amount of the transaction and the name of the related party must be provided as well as other

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http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2015-0257+0+DOC+XML+V0//EN, last accessed 25 February 2016.

[29] It is unclear what the consequences should or could be when the shareholders vote down the approved transaction.

[30] If adequate safeguards are provided, the member state can allow the involved shareholder to participate in the vote.

[31] Or in the case the transaction can be entered into by another organ, that other organ. In other cases, the company law provides alternative mechanisms to protect the parties that can be damaged due to the transaction. As an example I can refer to the merger between the parent and the subsidiary. Mergers must be approved by the shareholders and there are specific provisions that protect parties (like minority shareholders and creditors) that can suffer from this decision.

[32] It is also assumed in the proposal of the Directive as it states that the report confirms that the transactions is fair and reasonable. The Directive does not provide the possibility to deny the fairness and reasonableness.

information necessary to assess the economic fairness of the transaction. As the transaction will predominantly be part of the operational business of the corporation, the shareholders will also have to be informed on the (operational) usefulness for the corporation, so as to allow the shareholders to provide an informed vote.[33] However, this information should not be provided according to the current proposal which causes a large information asymmetry problem. This problem is often used by the antagonists for shareholder empowerment denying shareholders more rights.[34]

Therefore, I am of the opinion that the current proposal creates a number of administrative burdens which can be effective for combatting the transactions in the conflict of interest hypothesis, but is unlikely to be efficient. I believe that an alternative approach whereby the audit committee is evaluating the related party transaction and with a specific control by the external auditor can simplify the process but at the same time be more efficient and effective.

5. An Alternative System for Addressing Tunneling Behaviour

Currently, the auditor must control the related party transactions, both those reported in the accounts as well as those that are not reported[35] for rendering his opinion of the financial statements of the corporation. Therefore the external auditor should already have obtained a reasonable amount of information regarding related party transactions. This control must

[33] This information is less necessary to be provided explicitly for the other approval bodies of which it must be assumed that they are well informed on the operational activities and business lines of the corporation.
[34] For an assessment see, W. Bratton and M. Wachter, "The Case against Shareholder Empowerment" in W. Bratton and J. MCCahery (eds.), *Institutional investor activism: Hedge funds and private equity, economics and regulation*, Oxford, OUP, 2015, 737-741.
[35] To the extent that if those transactions go unreported, the financial statement do not offer a fair and true view of the corporation's financial position.

allow the external auditor to "obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error."[36]

Besides according to the International Standards of Auditing 550, the business rationale for entering in related party transactions must be taken into account when the auditor is controlling these transactions. The ISA reads: "For identified significant related party transactions outside the entity's normal course of business, the auditor shall:

(a) Inspect the underlying contracts or agreements, if any, and evaluate whether:

(i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

(ii) The terms of the transactions are consistent with management's explanations; and

(iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

(b) Obtain audit evidence that the transactions have been appropriately authorized and approved."

Therefor we are of the opinion that this work can be further extended to include an assessment of the fair and reasonableness of the transaction to be provided in the report that the proposal of the shareholder directive is envisaging. Currently, the audit must not include this kind fairness assessment. An "unfair" transaction, duly reported in the financial statements, does not affect the true and fair view of the financial statement and the latter is still "free from misstatement". However, it is not illogical to provide the external auditor with this assurance task as in some member states he is already responsible for a comparable task, *i.e.* controlling

[36] International Auditing and Assurance Standards Board, *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*, Vol. I, 76 (IFAC, New York, 2014).

contributions in kind of a capital increase.[37] This kind of control does not impede the independence of the auditor. I therefore argue that auditors are both appropriately equipped and adequately positioned for assessing the fairness of the transactions.

In addition, in some countries the external auditor is already used to provide in a special report for related party transactions. In France the external auditor must submit a special report for the related party transactions to the general meeting of shareholders.[38] The report must inter alia report on the motives that justify the benefit of the related party transaction according to the board of directors as well as all other elements that the shareholders need for evaluating the advantages and/or disadvantages of the corporation in the transaction.[39] Similarly, this type of reporting is also provided in the Czech Republic as well as in Belgium.[40]

Under the Audit Regulation (EU) No 537/2014 and Audit Directive 2014/56/EC[41], the audit committee of the corporation is provided with specific duties both regarding the audit of the financial statement as well as regarding the work of the external auditor.[42] The audit committee must monitor the (performance of the) statutory audit of the annual and

[37] See article 602 Belgian Companies Act. The external auditor must provide an overview of the contributions, the valuation techniques used – it is the board of directors that is responsible for selecting and applying the valuation methods - and whether the value of the contributions and the compensation in shares are in accordance.
[38] L. 225-40 French Commercial Code.
[39] R. 225-31 French Commercial Code. It must be mentioned that the quality of the report of the auditors is criticized for being insufficient to assess the related party transaction adequately (M. Germain and V. Magnier, *Les Sociétés Commerciales*, LGDJ, Issy-Les-Moulineaux, 2014, nr. 2205, p. 475).
[40] In the report of CEZ, a corporation of the Stoxx Europe Small 200 companies the auditor obtained “moderate assurance as to whether the report on related parties is free from material misstatement” (CEZ, *Annual report 2014*, 7). We are of the opinion that “moderate” assurance can be increased to a higher level. Article 524 of the Belgian Company Law requires the corporation to disclose the assessment of the auditor of the faithfulness of the advice of the committee of three independent directors assessing the related party transaction (including some transactions with shareholders).
[41] Regulation (EU) No. 537/2014 of the European Parliament and of the Council of 16 Apr. 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC, O.J. L. 158/77 of May 27 2014; Directive 2014/56/EC of the European Parliament and of the Council of 16 Apr. 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, O.J. L. 158/196 of May 27 2014.
[42] Christoph Van der Elst, *The European Legislative Framework for Audit Committees*, European Company Law 12, 1, 26-33 (2015).

consolidated financial statements. Consequently, the audit committee is familiar with the work of the auditor. As the committee is composed with board members, it is also familiar with the operational activities of the corporation and can efficiently evaluate the transaction before providing the approval or disapproval. The composition of the audit committee can guarantee the independence of the members as to the transaction submitted for approval. Directive 2014/56/EC identifies the audit committee as a subcommittee of the (supervisory) board, composed solely of non-executive directors and the majority of the members must be independent. Furthermore, at least one member of the audit committee must be competent in accounting and/or auditing and the committee members as a whole must have competence relevant to the sector in which the audited entity is operating.[43] The Directive 2014/56/EC provides in a number of exceptions regarding the establishment of the committee or the composition of the committee. Some of these exceptions as well as the condition that only the majority of members of the audit committee must be independent, can impede the goals of the proposal preventing the approval of the transaction by unrelated parties and/or representatives. This hurdle can be mitigated with the requirement that an audit committee can only serve as the approving body for related party transactions if the condition of independence vis-à-vis the transaction is complied with.

The audit opinion of the external auditor is made publicly available. It can contain a provision whereby the external auditor explicitly confirms that he has investigated the related party transactions in accordance with the legal requirements and can confirm that the related party transactions have taken place in accordance with the legal requirements. This information can comfort the shareholders and the investors.

[43] Article 39 of the amended Directive 2006/43/EC

Of course, there must also be provided in a duty for the related party to disclose the transaction to the audit committee and the auditor. In the current version of the European accounting legislation as well as in the proposals for a new shareholder rights directive this active role is not provided for all related parties, in particular for the significant shareholder. It is the responsibility of the board for complying with the accounting legislation and, if the general meeting is invited to vote on the related party transaction, the significant shareholder should – in principle – refrain from voting. It is in my opinion logic that there is a more active duty for the significant shareholder or other related party that is not directly or indirectly (re)present(ed) in the board of directors to inform this board (and consequently the audit committee) of the aimed related party transaction. It is obvious that in many cases this information duty is superfluous as the board of directors is closely related to the related party, but there are situations where the board is not necessarily aware that the transaction is with a related party. It can be the case when the corporation enters into a transaction with another (overseas) corporation that shortly before had been acquired by the parent of the corporation. An analogous disclosure duty of the significant shareholder like the existing disclosure duty for board members entering in related party transactions with the listed corporation is reasonable. I will leave it open for further discussion whether this shareholder disclosure duty should be extended to some of the corporate opportunities that the shareholder discovers but has the opportunity exploited by another entity.[44]

6. Conclusion

[44] For a recent and interesting discussion about the exploitation of a corporate opportunity by a non-executive director see Simon Witney, *Corporate opportunities law and the non-executive director*, Journal of Corporate Law Studies 16 (1), 145-186 (2016).

According to the accounting rules, corporations must provide in a (financial) summarized overview of related party transactions. I found that the reporting standards are often insufficient for investors and shareholders for assessing the wealth shifting potential of the related party transaction.

In its proposal to revise the shareholder rights directive, the European Commission provides – in its current version - in a process of disclosure of the transaction, the assessment of the fairness of the transaction for the corporation and its minority shareholders by an independent body and an approval by the (supervisory) board and/or the shareholders. The proposed measures, with many opt-ins and opt-outs, will more than likely not mitigate the major concerns of the capital market regarding conflicts of interest of this business phenomenon.

Therefore I suggest involving the external auditor, like it is the case in a number of Member States, and the audit committee. The external auditor must be independent and its audit duties already include the control over the related party transactions. Consequently, the audit duties can be broadened as to include the reasonable assurance that the envisaged related party transactions are economic fair transactions. Further the audit committee, composed of non-executive and in majority independent directors, must be established in public interest entities with a duty to monitor *i.a.* the performance of the work of the auditor. Consequently, it can (and already partially does) include the work of the auditor regarding related party transactions. The audit committee can serve as the body that approves the related party transaction. Every year the auditor can provide in his report the results of his assessment of the fairness of the related party transactions. I am of the opinion that this procedure is less burdensome and can help to mitigate the wealth shifting risks of the related party transaction.

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