The Law and (Some) Finance of Related Party Transactions: An Introduction

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Working Paper N° 411/2018
July 2018

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We gratefully acknowledge financial support of the LOEWE Research Center Sustainable Architecture for Finance in Europe (SAFE), the European Corporate Governance Research Foundation, and ENEL SpA.

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Abstract

This paper is the introductory chapter of Luca Enriques and Tobias Tröger (eds.), The Law and Finance of Related Party Transactions (Cambridge University Press: forthcoming). Its goal is to sketch out the individual chapters' contributions to the scholarly and policy debates on the adequate regulation of related party transactions (RPTs). For that purpose, we scope the issue by highlighting the principal costs and benefits of shareholder control, which allows both the implementation of entrepreneurial vision and various forms of rent-seeking. We next proceed by putting the challenges of regulating RPTs into the broader context of conflicts of interest and tunneling techniques. Against this background, we then turn to the main regulatory options available for legislators (independent/disinterested director approval, majority of the minority approval, ex post fairness review, and involvement of supervisory agencies), highlighting some of the key insights on each of them from individual chapters. Finally, we show how the chapters in the book can also inform European legislators who are currently in the process of implementing the revised Shareholder Rights Directive rules on RPTs.

Keywords: Conflicts of Interest, Controlling Shareholders, Fairness Review, Independent Directors, Private Benefits of Control, Majority of the Minority Approval, Public Enforcement, Related Party Transactions, Shareholder Rights Directive, Tunneling

JEL Classifications: D23, G32, G34, K22

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1. 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 Hamdani² 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 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.

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¹ While the latter model is dominant in the U.S. and the UK, 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, 492-496. For more recent data confirming that ownership is more dispersed in the U.S. and the UK, see Gur Aminadav and Elias Papaioannou, ‘Corporate control around the world’ (2016) National Bureau of Economic Research (NBER) Working Paper No 23010 <http://www.nber.org/papers/w23010.pdf> accessed 18 June 2018.

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 her idiosyncratic vision or, granting funders enough of such rights, she runs 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.

2. 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 her advantage situations in which her 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

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.
belonging to the company or the shareholders, which is also known as tunneling. 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, 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 she does not share with (other) investors on a pro-rata basis. These include non-monetary 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 Milhaupt and Mariana Pargendler call policy channelling, 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 her affiliates, relatives, and so on, deal with the corporation, the phenomenon is known

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’ (2014) U. Ill. L. Rev. 101 (distinguishing the misappropriation of cash flow, asset and equity entitlements).


as related party transactions (throughout this book: 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 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 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.

Figure 1: Conflicts of interest, tunneling and RPTs

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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, which summarizes when and why RPTs can be of concern for policymakers. RPTs that are both value-destroying 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.


\(^10\) 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.
Table 1: RPTs’ fairness and efficiency

<table>
<thead>
<tr>
<th></th>
<th>Value-creating</th>
<th>Value-destroying</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fair (not harmful for co.)</strong></td>
<td>Good for company’s shareholders and good for society</td>
<td>Good for company’s shareholders but possibly of concern for society (e.g. anticompetitive effects)</td>
</tr>
<tr>
<td><strong>Unfair (harmful for co.)</strong></td>
<td>Bad for minority shareholders and for dynamic efficiency</td>
<td>Bad for shareholders and for society as a whole</td>
</tr>
</tbody>
</table>

As Curtis 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 is to avoid redundancies and other negative consequences of insolvency for local communities, suppliers, and so on, RPTs are an instrument of policy channelling.

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 money from her 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 she 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

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\(^{11}\) Milhaupt and Pargendler (n 7).

\(^{12}\) 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 negative impact of the transaction is externalized to a greater degree than the benefits from propping.
position in a given product market, which is why, as Kon Sik Kim reports in his chapter, South Korea has issued rules on RPTs to facilitate new entrant firms and to foster competition in addition to rules protecting minority shareholders.

A second 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 US and the UK), 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:

13 Kim (n 9).

14 Dammann (n 9).

15 Pacces (n 9).

16 The German codified law of corporate groups represents the most elaborate special regime. For a description see Tobias H. Tröger, ‘Corporate Groups’ in Holger Fleischer, Jesper Lau Hansen and Wolf Georg
3. What law for RPTs?

Corporate lawmakers around the world attempt to strike the right balance between the need to curb insiders’ tunnelling 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: (1) who screens “good” RPTs in the best interest of the company and society at large from “bad” or harmful ones? (2) How does the screen work? (3) When does it operate (before or after the RPT is entered into)? Table 2 provides schematic answers to each of these questions. While it has no pretence of giving a comprehensive picture, the table does cover most of the tools that comparative research has shown to be widely used across jurisdictions.\(^\text{17}\)

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 or, on the contrary, on the devilish details that dampen the effectiveness of such a tool. 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 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 2 and indicate the main insights that, in our view, the subsequent chapters provide.

### Table 2

<table>
<thead>
<tr>
<th>Screening agent (“who”)</th>
<th>Tool (“how”)</th>
<th>Timing (“when”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lawmakers</td>
<td>Prohibitions</td>
<td>Ex ante</td>
</tr>
<tr>
<td>Untainted agents</td>
<td>Approval</td>
<td>Ex ante</td>
</tr>
<tr>
<td>Principals</td>
<td>Shareholder meeting vote</td>
<td>Ex ante or ex post</td>
</tr>
<tr>
<td>Informed traders</td>
<td>Trading following (mandatory) disclosure</td>
<td>Ex ante or ex post, depending on (mandatory) disclosure timing</td>
</tr>
<tr>
<td>Regulators</td>
<td>Formal and informal enforcement powers</td>
<td>Ex ante or ex post</td>
</tr>
<tr>
<td>Courts</td>
<td>Adjudicating disputes over transactions’ validity and/or fairness; applying criminal sanctions</td>
<td>Ex ante (via injunctions) or, mainly, ex post (liability or nullification suits; criminal proceedings)</td>
</tr>
</tbody>
</table>
3.1. 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 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 Delaware20 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 her removal rights precludes such a qualification. To reinforce loyalty to minority shareholder interests, Alessio Pacces proposes an instrumental role for

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directors who are nominated and appointed by non-controlling 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 of a company’s business and (informal) organizational structure. Unknown unknowns make it possible for insiders to opportunistically filter information, thereby distorting the decision-making process to their advantage.

3.2. 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 UK, Israel, and all major East Asian countries,23 with the notable exceptions of Japan and South Korea24) vest veto power over larger, non-routine RPTs with a majority of shareholders other than the related party itself (majority-of-the-minority or 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

22 Pacces (n 9).


24 On the latter jurisdictions see also Kim (n 9).

25 See also Puchniak and Varottil (n 9).

26 Enriques (n 17) 16.
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 entering into or practicable. 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.\(^\text{27}\) Yet, in his chapter, *Edward Rock* concludes, based on the experience of related party merger transactions in the U.S., that the perils of strategic behavior by hedge funds or actively managed mutual funds appear to be rather theoretical.\(^\text{28}\)

The transaction cost issue is the reason why jurisdictions that provide for MOM approval (e.g., the UK, Hong Kong, Singapore) limit this institution to RPTs above a given size, typically when their value is above 5% 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 very little practical impact, if any.\(^\text{29}\) Moreover, if exchanges face competition for listings, a transaction cost intensive (or, more positively, a stringent anti-tunneling) rule like MOM might prove


\(^\text{28}\) Rock (n 19) (showing that between 2010 and 2017 MOM provisions were only used in one case to block a RPT).

\(^\text{29}\) For a detailed analysis and policy recommendations inferred from French law’s lack of teeth, Helleringer (n 21).
detrimental, creating an incentive to lobby the regulator to have the rule watered down and applied more selectively. An illustration of this can be found in Paul Davies’ chapter, which recounts how the Financial Conduct Authority has created an exemption for “intra-state” RPTs entered into by state-controlled entities, in an overt attempt to entice a giant state-owned corporation into listing in London.30

3.3. Courts: ex post fairness review

Jurisdictions often rely on ex post judicial enforcement of one form or another of a “thou shalt not steal” standard to tackle RPTs. The common feature of the various instances of ex post standard-based review is that courts look into the merits of an RPT to find out whether its terms were “fair” to the corporation/its (minority) shareholders, i.e., whether the company/its shareholders suffered any prejudice (broadly or strictly identified) therefrom.

Jurisdictions may apply different standards of review to different RPTs. Notably, corporate law in many countries provides for more lenient standards when RPTs also qualify as IGTs.31 This is dubious if all group affiliates have minority shareholders and the controller’s stake varies: in this situation the controller has an incentive to disadvantage the company in which she holds a lower fraction of the shares to benefit the company where her shareholding is higher, thereby externalizing some of the costs to outside shareholders of the disadvantaged company.

Ex post standard review can be an alternative to the legal safeguards analysed so far. The country which is closest to such a pure liability rule model among the jurisdictions we survey in this book is Germany. Leaving aside a very specific provision on purchases from


31 For the policy rationale that points to synergies that create overall efficiencies for all group affiliates see Dammann (n 9).
some related parties in the two years following the company’s formation and a rather unspecific and non-binding corporate governance code recommendation, its procedural rules only apply to RPTs in which the director is formally on both sides of the transaction. Ex post enforcement relies on the prohibition of concealed distributions, on directors’ and dominant shareholders’ duty of loyalty, and on the very broad domain of the criminal provision against breach of trust (Untreue). As Tobias Tröger delineates in his contribution, this regime cannot be understood without accounting for the unique industrial organization of the German economy that puts banks at the apex of large industrial groups.

At first glance, Delaware is similar to Germany, because legal redress hinges on whether the RPT is found to be unfair to the corporation and its shareholders. However, Delaware case law introduces various procedural safeguards (disinterested director/special committee/MOM approval) as safe harbors that shield transactions from the entire fairness review that otherwise applies as the default for RPTs. It thus provides strong incentives for subjecting RPTs to such safeguards: the more rigorously the procedural safeguards are complied with, in form as well as in substance, the less the judges will be inclined to rule for the plaintiffs by finding that its terms themselves were substantially unfair.

Delaware corporate law illustrates how standard-based review can interact with procedural (ex ante) safeguards in at least three ways. First, ex post review may provide an additional layer of protections and therefore strengthen (minority) shareholder protection by complementing procedural safeguards. That is the case if compliance with procedural safeguards is only one necessary, yet not a sufficient precondition for RPTs to be unassailable.

32 Aktiengesetz 1965, § 52.

33 German Corporate Governance Code, 5.5.2 <https://www.dcgk.de/en/code/current-version/supervisory-board.html> accessed 18 June 2018


35 Rock (n 19).
That is the case, if a remedy (such as damages and/or nullification) is always available if the transaction is ultimately judged to be unfair. Examples of standard-based remedies that help to police tunneling via RPTs are often found in criminal, bankruptcy, and tax law. In France, prosecution for abuse of corporate assets (abus de biens sociaux) complements procedural safeguards like the ratification of RPTs at the subsequent shareholder meeting.\(^{36}\) In bankruptcy law, actions to recover assets for the benefit of creditors, such as the actio pauliana, can also be used to tackle tunneling, which, as Kristin van Zwieten explains in her chapter, can also take the form of a controller favouring a related creditor.\(^{37}\)

The opposite occurs when a remedy for violations of ex ante safeguards is only available if the transaction is also judged to be unfair. In that case, what ultimately determines whether controllers can escape liability is whether they can show that the transaction was fair, in which case ex post standard-based review effectively weakens ex ante safeguards. Depending on the institutional setup, even MOM approval, on its face a property rule (i.e., a rule that requires the consent of the relevant party, in our case minority shareholders), may operate akin to a liability rule. Rational controllers can essentially neglect MOM-approval rules if they are reasonably certain in proving that the transaction has caused no damage to the corporation and is therefore not only valid but also does not give rise to minority shareholder claims. This is the case, for instance, if under Delaware law the controlling shareholder can prove entire fairness. Even more prominently, this consequence has also been encountered in Israeli corporate law where substantive fairness standards have come to dominate procedural safeguards (MOM approval) as a result of recent law reforms, a development Amir Licht critically dissect in his chapter.\(^{38}\)

\(^{36}\) Helleringer (n 21).


Finally, procedural safeguards may trump ex post standard-based review, as is the case when compliance with ex ante safeguards immunizes the transaction, i.e., preventing judges from declaring a transaction void or even from finding for the plaintiff in a liability suit despite evidence that the transaction is, in fact, harmful to the corporation. Once again, Delaware can serve as a useful example, where once the standard for review shifts to business judgement as a result of observed procedural safeguards, the RPT is de facto shielded from judicial review. Similarly, the UK de facto supplants its substantive fiduciary duty standard with procedural safeguards, which, if observed, relieve courts from looking into the substantive fairness of the RPT, as Paul Davies explains in his chapter.

3.4. Regulators: the role of public enforcement

Conceptually, supervisory agencies can be tasked with enforcing both procedural and substantives duties with regard to RPTs. Legislators therefore have the option to rely on public instead of private enforcement involving the court system. As Marcello Bianchi, Luca Enriques and Mateja Milic describe in their contribution, the Italian example – which is not unique – indicates that one key advantage of this regulatory strategy may follow from the specific expertise of regulators in detecting tainted transactions bolstered by their investigatory powers. Similar to the effect of non-binding negative independent advice on RPTs (see 3.1.), a request for additional information from the company on the terms of the transaction may itself serve as an intimidating signal that shapes controllers’ behavior at the margin.

39 For an overview of Delaware case law Rock (n 19).


41 See Enriques et al (n 23) 165 (showing that also in Brazil the regulator plays an active role in enforcing anti-tunneling laws). More generally, where camouflaging tunneling RPTs involves inaccurate public disclosure of facts material to investors, market supervisors are called on to indirectly police RPTs.

involvement of supervisors hence partly overcomes informational asymmetries and also attenuates the well-known free-riding problem in private enforcement resulting from the positive externalities the plaintiff creates for other shareholders. However, the experience of Italy also indicates the limits of such a strategy: regulators, as part of the administration, are rather susceptible to swings in the political climate and their stance on enforcing anti-tunneling rules or investor protection laws in general thus hinges on a potentially fragile consensus on these issues.

4. **Reshaping RPT rules in the EU: lessons from within and outwith**

RPTs have been the focus of corporate law reforms in a number of jurisdictions, often due to pressure from international organizations such as the OECD and the World Bank,\(^{43}\) as documented by *Puchniak and Varottil* for common law East Asia.\(^ {44}\) As we write, member states of the European Union are tasked with the implementation, by 10 June 2019, of Directive 2017/828, amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (hereinafter the Shareholder Rights Amending Directive, or SRAD),\(^ {45}\) which requires member states to put in place a set of rules addressing RPTs.

According to the new Article 9c of Directive 2007/36/EC, member states have, first of all, to define “material” transactions with related parties (such parties being in turn defined with a renvoi to the IFRS Regulation). In doing so, they have to take into account an RPT’s relevance regarding the economic decisions of a company’s shareholders and their risks for the company and its shareholders. Material transactions so defined (including those between a related party and a company’s subsidiary and those with the same related party which cross the relevant quantitative thresholds once aggregated within a rolling 12-month period) have to be disclosed at the time the RPT is entered into at the latest. Information has to be provided “at


\(^{44}\) Puchniak and Varottil (n 9).

least on the nature of the related party relationship, the name of the related party, the date and
the value of the transaction and other information necessary to assess whether or not the
transaction is fair and reasonable from the perspective of the company and of the shareholders
who are not a related party, including minority shareholders.” In addition, member states have
the option to require that, alongside the announcement, a report be published that assesses
“whether or not the transaction is fair and reasonable from the perspective of the company and
of the shareholders who are not a related party, including minority shareholders, and explaining
the assumptions it is based upon together with the methods used.” The report may be prepared
by a third party, the administrative or supervisory body of the company, the audit committee
or any committee of which the majority is composed of independent directors.

In terms of process, material RPTs are to be approved either “by the general meeting or
by the administrative or supervisory body of the company according to procedures which
prevent the related party from taking advantage of its position and provide adequate protection
for the interests of the company and of the shareholders who are not a related party, including
minority shareholders,” and without the participation of the director or shareholder who is a
related party. Member states, however, may opt out of this last requirement, “provided that
national law ensures appropriate safeguards which apply before or during the voting process to
protect the interests of the company and of the shareholders who are not a related party, including
minority shareholders, by preventing the related party from approving the transaction
despite the opposing opinion of the majority of the shareholders who are not a related party or
despite the opposing opinion of the majority of the independent directors.”

Unless member states provide otherwise, the disclosure and procedural requirements
“shall not apply to transactions entered into in the ordinary course of business and concluded
on normal market terms.” Similarly, member states are allowed to opt for additional
exemptions, namely for:

a. “transactions entered into between the company and its subsidiaries provided that they
are wholly owned or that no other related party of the company has an interest in the
subsidiary undertaking or that national law provides for adequate protection of interests
of the company, of the subsidiary and of their shareholders who are not a related party,
including minority shareholders in such transactions;
b. “clearly defined types of transactions for which national law requires approval by the general meeting, provided that fair treatment of all shareholders and the interests of the company and of the shareholders who are not a related party, including minority shareholders, are specifically addressed and adequately protected in such provisions of law;

c. “transactions regarding remuneration of directors, or certain elements of remuneration of directors, awarded or due in accordance with Article 9a” SRAD (laying out say-on-pay rules);

d. “transactions entered into by credit institutions on the basis of measures, aiming at safeguarding their stability, adopted by the competent authority in charge of the prudential supervision within the meaning of Union law;

e. “transactions offered to all shareholders on the same terms where equal treatment of all shareholders and protection of the interests of the company is ensured.”

This framework was the outcome of a serious retreat from the more prescriptive rules of the European Commission’s initial proposal, which defined, albeit coarsely, which transactions triggered disclosure and special approval rules, imposed shareholder approval as a mandatory procedural requirement, and provided that, if the RPT “involves a shareholder, this shareholder shall be excluded from that vote.” The rule thus required MOM approval for transactions with a controlling shareholder.

Given the open-ended character of the SRAD provisions on RPTs, member states have broad discretion in implementing the Directive. With the notable exception of Germany, which has traditionally been reluctant to effectively tackle tunneling (a phenomenon for which Tobias Tröger provides a political economy explanation in his chapter⁴⁶), most of the member states will have the option of changing practically nothing in their rules. In terms of procedural requirements, so long as member states’ legislation prevents the related party from taking part in the approval of the transaction, nothing else is required except subjecting the RPT to board

⁴⁶ Tröger (n 34).
approval, which many member states require already. As far as disclosure is concerned, given the looseness of the SRAD criteria for the definition of material RPTs, member states may effectively emasculate the new disclosure rules by devising high quantitative thresholds or narrow-scope qualitative criteria.

While the final impact of the new RPT regime on individual jurisdictions may be small, the SRAD is having the effect of focusing European policymakers’ minds on how to regulate RPTs in their jurisdiction: the flexibility of the Directive does not prevent legislators in the member states from exercising their discretion in a way that consistently picks the regulatory tools that effectively constrain controller rent-seeking (e.g. requiring an external fairness opinion at a very low threshold level and making MOM mandatory). However, the SRAD does not prevent member states from either relegating the new rules to a handful of “material” transactions or from requiring mere board approval with the abstention of the related party.

Whether the implementation of the Directive will lead to more effective protection of the interests of minority shareholders or the watering-down of existing safeguards will depend, of course, on what the pre-existing rules are in individual member states, their interplay with newly created safeguards and the interest groups dynamics within each member state.

Whatever the final outcome, many of the chapters of this book provide insights as to the policy options to consider now and in future reform initiatives, as the following non-exhaustive list illustrates:

1. How pervasive should RPTs’ ad hoc disclosure be? The Italian case studies by Marcello Bianchi, Luca Enriques and Mateja Milic\(^ {47} \) indicate that comprehensive ad hoc disclosure of the material terms of the transaction has a prescreening effect that precludes unfair RPTs from proceeding. However, it should not be overlooked that the transparency created was driven by supervisory requests for additional information that represented a first step in a potentially far more incisive enforcement procedure. Controllers’ reactions may thus only be an early response to the effective enforcement of substantive standards. From this perspective, the authors’ findings corroborate the

\( ^{47} \) Bianchi, Enriques and Milic (n 42).
notion that transparency only works as a deterrent if disclosure triggers undesirable legal or market sanctions for the controller.

2. How should independent directors be involved in the RPT approval process? Alessio Pacces explores a more subtle, yet critical, dimension of the question by showing that the effect of independent director involvement hinges pivotally on who appoints and dismisses them. Only minority shareholders’ full control of the selection and removal process guarantees independent directors’ stable and consistent loyalty and leads ceteris paribus to more efficient outcomes.

3. To what extent should shareholders be given a say on RPTs? Assaf Hamdani and Yishay Yafeh shed light on the consequences of shareholder empowerment in RPT policing in the age of institutional investor capitalism (a reality for most European jurisdictions as well). Based on data on Israeli listed companies’ RPTs, they find that a fierce anti-controller stance is not to be expected from these agents who may suffer from various conflicts of interest as long as they provide multiple services and are not independently owned. Edward Rock, on the other hand, shows that activist funds in the U.S. rarely, if ever, use MOM-approval requirements to exploit hold-up situations and points to the lack of exit options for hedge funds that fail to reach a favorable deal: to retain credibility, they have to go through with their threat to block value-creating RPTs thereby hurting themselves even more. By looking at English law, Paul Davies shows that default MOM requirements – like those flowing from fiduciary law – tend to be supplanted by board approval. On the one hand, this may reduce transaction costs and lead to more effective bargaining between the board and the controller. On the other, it may also increase controllers’ leeway for tunneling if they can influence board resolutions. The French example, scrutinized by Geneviève Helleringer, emphasizes

48 Hamdani and Yafeh (n 23).

49 Rock (n 19).

50 Davies (n 30).

51 Helleringer (n 21).
the relevance of timing. Ex post ratification under French law is mostly routinary and, at least until recently, plagued by serious disclosure deficiencies.

4. Which RPTs should be exempt? When it comes to assessing whether alternative safeguards are sufficient to prevent tunneling and whether applying the RPT regime would therefore lead to redundancies, thorough analyses point to the importance of embracing the covered transactions’ intricacies accurately. For instance, Jesse Fried shows in his model that, in light of informational asymmetries, pre-emption rights are insufficient to prevent equity tunneling.\(^\text{52}\) Hence, that such rights assist a given share issuance directed also to related parties should \emph{per se} be no good reason for an unconditional exemption from RPT rules. This only changes if additional precautions are introduced, such as disclosure about the controlling shareholder’s intentions, that are apt to overcome information deficits of minority shareholders and thus prohibit equity tunneling effectively.

5. What should the role of courts and securities regulators be in the enforcement of RPT rules? In their chapter, Dan Puchniak and Umakanth Varottil\(^\text{53}\) illustrate vividly that any social planner who considers regulating RPTs in a rule-based system that entrusts courts with a critical function in enforcing these rules should carefully consider the context in which such courts will operate (e.g. rule of law, expertise and business acumen of judges, enforceability of judgments, particularly in cross-jurisdictional contexts). Similarly, Amir Licht\(^\text{54}\) shows that, for Israel, transplanting a rule (the entire fairness test \emph{ex post} review of RPTs) that arguably works reasonably well if applied by a seasoned and specialized court like the Delaware Court of Chancery potentially overburdens less adept judiciaries and may therefore prove inferior to procedural requirements that are easier to police for non-specialist courts. In a similar vein, Paul Davies delineates English courts’ reluctance to apply substantive fiduciary standards

\(^{52}\) Fried (n 8).

\(^{53}\) Puchniak and Varottil (n 9).

\(^{54}\) Licht (n 38).
(fairness tests) and their proclivity to rely on procedural safeguards instead. Along comparable lines, Marcello Bianchi, Luca Enriques and Mateja Milic\textsuperscript{55} demonstrate the possible advantages of enforcement of RPT rules by a skilled and determined securities regulator, but also indicate the political risks that are associated with giving an administrative body a critical role in the process.

This brief and incomplete sketch of some of the relevant questions for policymakers and the answers the contributions to this book suggest hint at what could be the main contribution of our volume. We hope to provide a broad and diverse source of information on what works in RPT regulation and under which circumstances. From this perspective, the book should be useful beyond current reform debates in Europe.

\textsuperscript{55} Bianchi, Enriques and Milic (n 42).
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