Related Party Transactions in East Asia

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Abstract

Related party transactions (RPTs) exist in most countries, including developing countries as well as those already developed. RPTs may take place on an ad hoc basis, or routinely. Routine RPTs are commonly found in a corporate group structure and pose tougher regulatory challenges than ad hoc RTPs do. The degree of prevalence of RPTs and the shape of their regulation vary country by country, reflecting differences in their corporate governance environment. Stated reversely, a glimpse into the actual regulation of RPTs may shed light on essential features of the corporate governance ecosystem of a particular jurisdiction. This is a chapter for Luca Enriques and Tobias Tröger, eds., The Law and Finance of Related Party Transactions (Cambridge University Press, forthcoming). The purpose of this chapter is to examine, from a comparative perspective, the status of RPTs and their regulation in three East Asian countries, namely Japan, South Korea and China. This chapter will primarily focus on routine RPTs involving large listed firms – which will serve as a convenient window through which to view the complex world of corporate governance in the three aforementioned countries. This chapter proceeds as follows. Part II sets out the theoretical framework which serves as a basis for the ensuing discussion. It will address basic perspectives and conventional strategies employed to deal with RPTs. Part III entails a brief survey of the current status of RPTs and the regulatory structure in each jurisdiction. It will first present basic RPT-related data, and go on to outline substantive constraints, procedural constraints and disclosure requirements applicable to RPTs. Based on this survey, Part IV will attempt to make some general observations from a comparative perspective. Part V will offer a conclusion.

Keywords: related party transactions, corporate governance, industrial organization, Japan, China, Korea

JEL Classifications: K2, L2

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Related Party Transactions in East Asia[1]

[A chapter for Luca Enriques and Tobias Tröger, eds., The Law and Finance of Related Party Transactions (Cambridge University Press, forthcoming)]

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I. Introduction

Related party transactions (RPTs) exist in most countries, including developing countries as well as those already developed. RPTs may take place on an ad hoc basis, or routinely. Routine RPTs are commonly found in a corporate group structure and pose tougher regulatory challenges than ad hoc RTPs do. The degree of prevalence of RPTs and the shape of their regulation vary country by country, reflecting differences in their corporate governance environment. Stated reversely, a glimpse into the actual regulation of RPTs may shed light on essential features of the corporate governance ecosystem of a particular jurisdiction.

The purpose of this chapter is to examine, from a comparative perspective, the status of RPTs and their regulation in three East Asian countries, namely Japan, South Korea (henceforth to be referred as Korea) and China. Why do we focus on these three countries? Firstly, they are the three largest economies in East Asia, together accounting for more than 20 percent of the world's GDP. They are closely intertwined with each other, historically, culturally and economically. They have all inherited a Confucian legacy, although to somewhat different degrees. Their legal systems, in general, all belong to the so-called civil law family. More significantly from the perspective of corporate governance, they each experienced a period of government-led economic growth in the 20th century. Despite these commonalities, however, the realities of corporate governance vary substantially between them. Corporate governance is stakeholder (employee)-oriented in Japan, (controlling) shareholder-centered in Korea, and state-led in China. This variation does not seem to be attributable to disparate levels of economic development. Also, although the overall corporate governance landscape is changing, each jurisdiction is evolving differently. This chapter will focus on RPTs – primarily on routine RPTs involving large listed firms – which will serve as a convenient window through which to view the complex world of corporate governance in the three aforementioned countries.

[1] This chapter is funded by the Seoul National University Law Foundation in 2018. I express my deep gratitude to those participants in the two authors' workshops held in Oxford and Frankfurt, Luca Enriques and Peter Muelbert in particular, and Tomotaka Fujita and Xing-Xing Li for giving me useful information on RPTs in Japan and China, respectively. Part of the research for this chapter was undertaken during the period when I was visiting NUS as Visiting Research Professor in 2018. I want to thank Tan Cheng Han and Dan Puchniak for their generous support.

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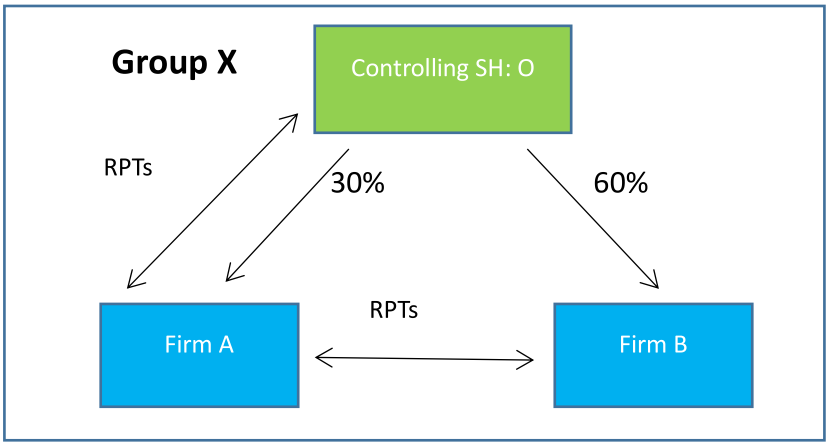
II. Theoretical Framework

A. Model RPTs

Figure 1 shows a simplified example of RPTs between Firm A and Firm B, both belonging to Corporate Group X. Both Firm A and Firm B are under the control of O, its controlling shareholder, who may be a natural person or a corporation. Let us suppose that O's ownership stake in Firm B is larger than in Firm A. In reality, O may engage in transactions with Firm A or Firm B. Such transactions can also be classified as RPTs, which may be called "vertical" RPTs as opposed to "horizontal" RPTs between Firm A and Firm B. As explained later, vertical RPTs outnumber horizontal RPTs in Japan and China and are quite common in Korea as well.

Figure 1: A simplified example of RPTs in a business group



B. RPTs and industrial organization

Routine RPTs normally take place in a group context. Group structure is a form of industrial organization. Routine RPTs, therefore, are closely related to the industrial organization of each jurisdiction. The existing regulation on RPTs may well shape the pattern of industrial organization in the future. Conversely, the current state of industrial organization might affect the form and the intensity of regulation, both in the books and in reality.

From the perspective of industrial organization, a primary function of RPTs is to replace market transactions. According to Ronald Coase, firm boundaries are determined in consideration of transaction costs.[2] Based on their assessment of transaction costs, managers decide either to produce goods and services internally ("self-supply") or to procure them from the markets ("outsourcing").

[Figure 2] Types of organizing economic activity

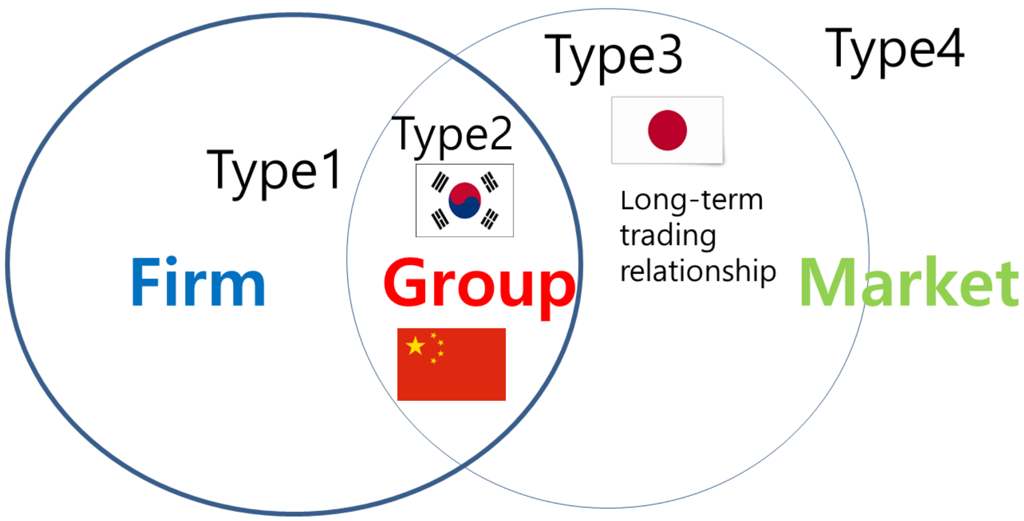


Figure 2 illustrates the principal types of organizing economic activity in each business firm. Type 1 refers to vertical integration into a stand-alone firm, which produces all the necessary parts and components for its end products in-house. In a modern developed economy, however, firms that stick with such a pure form of self-supply are few in number, among large listed firms at least.[3]

What stands in sharp contrast with Type 1 is Type 4, which represents pure outsourcing. Outsourcing has its own merits and demerits. A primary advantage of outsourcing comes from the division of labor. If outsourcing is widely practiced, a number of specialized intermediate-input suppliers will emerge, generating increased efficiency. Outsourcing, however, is often difficult to realize, mainly for two reasons. The first is underdevelopment of markets.[4] This is often a serious problem in developing countries. The second obstacle for outsourcing is high market transaction costs. A car manufacturer, for example, is vulnerable to the strategic

[2] Ronald H. Coase, The nature of the firm, Econometrica N.S. 4, 386-404 (1937).

[3] The larger the firm becomes, the larger the internal costs, i.e., complicated decision making process, information dissemination costs etc.

[4] Motoshige Ito, Interfirm Relations and Long-Term Continuous Trading, in Business Enterprises in Japan (Kenichi Imai & Ryutaro Komiya eds., MIT Press, Cambridge, 1994) at 113.

behavior of its parts suppliers, and vice versa.[5]

Types 2 and 3 may be perceived as two hybrid options available to a business firm when neither self-supply nor outsourcing is feasible. Of more relevance for our purposes is Type 2, which involves a vertically integrated group structure combined with routine intra-group RPTs.[6] Type 2 may be viewed as a means to achieve self-supply as intra-group RPTs can minimize transaction costs and the risk of opportunism.[7] Formally, they may not be qualified as pure self-supply since Firm A and Firm B are legally separate from each other with a distinct group of shareholders. From a functional perspective, however, intra-group RPTs are different from pure outsourcing as both Firm A and Firm B belong to the same corporate group (X) and are both subject to O's control.[8]

Vertically integrated groups are common in an emerging market economy with under-developed markets. All three countries under review started developing their economies based, at least partly, on the vertically integrated group structure. Japan started parting with this structure when business conglomerates (called *zaibatsu*) were disbanded during the Allied occupation of Japan after World War II. As discussed later, however, Korean and Chinese firms still rely on vertical integration to a larger extent and, as a consequence, engage more heavily in intra-group RPTs, although both of them, China in particular, are now increasingly dependent on outsourcing to other market participants.

Type 3 illustrates a long-term trading relationship with unaffiliated firms, another alternative way of organizing business activity.[9] Type 3 differs from Type 4 in that an car manufacturer, for example, can minimize opportunistic behavior on the part of its parts suppliers while securing a smooth collaboration with them. Type 3 arrangements are common in advanced economies manufacturing complicated products.[10] In this regard, Japan is a prime example. Type 3 arrangements are found

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5 For a succinct discussion of this problem, see, e.g., Benjamin Klein, Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited 213-226, in Oliver E. Williamson & Sidney G. Winter eds., The Nature of the Firm (Oxford 1993).

6 Intra-group RPTs can be found in a business group composed of firms in unrelated industries. For example, a firm in financially distress may depend on its cash-rich affiliates for financing. Such RPTs normally take place on an ad hoc basis.

7 For a discussion on benefits of RPTs, see Sang Yop Kang, Rethinking Self-Dealing and the Fairness Standard: A Law and Economics Framework for Internal Transactions in Corporate Groups, 11 Virginia Law & Business Review 95, 107-109 (2016).

8 If Firm A's decision-making is undertaken to pursue its own interest, not the interest of Group X or its controlling shareholder O, it will become closer to outsourcing. If the reverse is true, it will approach self-supply.

9 On the long-term trading relationship, see, e.g., Ito, supra note 4, 105-115.

10 For a paper pointing out the existence of, and issues involved in, yet another alternative way of organizing economic activity, see Ronald Gilson et al, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, 109 Columbia Law Review 431 (2009)(suggesting "that the change in the boundary of the firm has given rise to a new form of contracting between firms - what we call

in Korean *chaebols* as well. *Chaebol* firms maintain a long-term trading relationship with external firms, often called "cooperative firms".[11]

C. Rationale for regulating RPTs

As mentioned earlier, intra-group routine RPTs may bring greater benefits in developing countries. RPTs, even those conducted routinely among member firms, may entail substantial costs, however. The most serious problem with RPTs is the risk of so-called "tunneling".[12] Depending on how price terms are determined, wealth may be transferred from Firm A to Firm B. Wealth transfers can be divided into two groups in theory. The first is the type of wealth transfer which may be potentially in the long-term interest of Firm A. A prime example of such type of wealth transfer is one undertaken to prop up an ailing affiliate (propping). The second type of wealth transfer is undertaken primarily to serve O's personal interest at the expense of Firm A. It is sometimes difficult to distinguish between the two types of wealth transfer as an RPT may have a dual motive. The second type of unjustified wealth transfer is widely and better known as tunneling.

Minimizing tunneling is commonly presented as the rationale behind regulating RPTs. RPTs, and intra-group routine RPTs in particular, have a deleterious side effect. As an area of the economy dominated by RPTs expands, market opportunities for stand-alone firms are bound to shrink. This very issue is now attracting much attention from the general public in Korea. As discussed later, part of Korea's RPT regulation purports to address this concern. The goal of RPT regulations in most jurisdictions, however, is to minimize the risk of tunneling without undermining the potential benefits of RPTs.

D. Overview of regulatory framework

1. Laws applicable to RPTs

RPTs attract attention from many different areas of law. These include corporate law, capital market law, criminal law, tax law and, in the case of Korea, fair trade law. An egregious incident of tunneling may lead to a criminal sanction in many jurisdictions. In Korea, for example, it is not unusual for the head of a business group to be indicted on a charge of breach of trust, a charge normally invoked for

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contracting for innovation.")

[11] Unlike in Japan, the long-term relationship between Korean firms does not normally involve equity investments.

[12] For a seminal work on tunneling, see Simon Johnson, et. al, Tunneling, 90 American Economic Review 22–27 (2000). Tunneling can be divided into three types, namely cash-flow tunneling, asset tunneling and equity tunneling. Vladimir Atanasov et al, Law and Tunneling, 37 Journal of Corporation Law 1 (2011). This Chapter will focus on asset tunneling.

tunneling. Such instances are not confined to Korea and similar cases have been found in European countries including France and Italy as well.[13] This chapter, however, will primarily focus on corporate and capital market law.

2. **Regulatory options**

A variety of regulatory approaches are being employed to deal with RPTs, with four types attracting most attention from policy makers. Listing them in order of restrictiveness, these are: (1) outright prohibition; (2) substantive constraints; (3) procedural constraints; and (4) disclosure requirements.[14]

The most radical measure against tunneling is to prohibit RPTs altogether and, as a consequence, to have Firm B rely on either pure self-supply or outsourcing. No major industrial jurisdiction, however, is known to adopt such a drastic solution because RPTs, as mentioned earlier, may bring substantial benefits depending on the circumstances. A notable exception is prohibiting credit extension to directors. Corporate statutes in Korea and China have such provisions (Korean Commercial Code Art. 542-9(1), Chinese Company Act Art. 115, respectively). This chapter will mainly address the other three types of regulation.

The term "substantive constraints" is intended to refer to regulatory measures purporting to secure the fairness of an RPT. When controlling tunneling, what matters most is the fairness of the contract terms. If substantive constraints such as fiduciary duties work properly, we may not need other regulatory measures such as board approval or disclosure. But substantive constraints too often fail, for reasons discussed later. So, policy makers impose procedural constraints in addition to substantive constraints. Procedures, however, often fall short of guaranteeing the fairness of the transaction. Another regulatory option gaining popularity recently is to require the disclosure of relevant information on RPTs. Although these three approaches are conceptually distinct from each other, there are some overlaps. For example, some jurisdictions require firms to seek and disclose an opinion of an outside expert on the fairness of an RPT, which involves all three elements. Many advanced jurisdictions, in one way or another, rely on all three different approaches in controlling the tunneling risk arising from RPTs.

3. Substantive constraints: fairness and the arm's length test

[13] Simeon Djankov et al, The Law and Economics of Self-Dealing, 88 Journal of Financial Economics 430, 437 (2008) ("most countries impose severe criminal sanctions when the transaction has been approved in violation of the law"). This so-called "criminalization of corporate law" is observed in the U.S. as well. See Lisa M. Fairfax, The Criminalization of Corporate Law, 2 Journal of Business & Technology Law 1 (2007) and articles included in the same Issue.

[14] Luca Enriques, Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal), 16 European Business Organization Law Review 1, 13-25 (2015).

Fairness in process and substance

Decision makers of a firm involved in an RPT owe an equivalent of fiduciary duties under corporate statutes. They can discharge their fiduciary duties by satisfying the fairness standard. Fairness is required not only for the substance of the transaction but also for the process. This point is most conspicuously embodied in the entire fairness standard adopted by state courts of Delaware. The ultimate reason for requiring procedural fairness, however, is to ensure fairness in substance. This point has been emphasized by the Delaware Court of Chancery in the famous *Trados* decision.[15] The court held that the entire fairness standard was met as long as the price was fair even if the directors were not disinterested and the process was unfair. Thus, the critical question is of substantive fairness, which seems pertinent to RPTs because it is a crucial concept in terms of restraining tunneling arising from RPTs.

Limitations of the arm's length test

The concept of substantive fairness is bound to remain abstract. What is most widely accepted as supporting fairness appears to be the arm's length test. The arm's length test is straightforward and easy to understand. It does have limitations, however. The first limitation relates to market price, which is almost universally accepted as satisfying the arm's length test. In many intra-group RPTs, however, the relevant market price is often not available.[16] Services and parts involved often have idiosyncratic features. Consequently, judges exercise much discretion in determining the hypothetical market price. Moreover, under the arm's length test, the end result of the judge's exercise of discretion will likely point to a "range" of price (e.g., US$40 to 42), rather than a definite price (US$41).[17] Thus, the controlling shareholder O can still extract substantial profits through RPTs without deviating from the fairness range.[18]

The second limitation relates to its insufficient attention to the "need" for the transaction involved. Suppose Firm A purchases real estate from Firm B in an effort to rescue Firm B from financial distress. Can we say that the RPT is fair as long as the price remains in the fairness range? If we understand the arm's length test narrowly, we may well conclude that Firm A does not suffer any loss as long as the price does not deviate substantially from the range of fair market price. Can we still say that the RPT is fair even if Firm A does not really need the real estate for its business or if the RPT has the effect of reducing Firm A's investment in more promising business

[15] *In re Trados Incorporated Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013).

[16] Kang, supra note 7, at 134.

[17] Id. at 133-134.

[18] It seems partly due to this regulatory black hole that the practice of so-called "funneling of business" to members of the controlling family persists in Korea despite statutory restrictions on RPTs.

projects?

The third, and more fundamental, defect of the arm's length test is that it may lead to inefficient results if narrowly construed. The arm's length test may be construed as not taking into account the potential benefits of maintaining a long-term relationship between the trading affiliates. If Firm A and Firm B keep engaging in a range of RPTs, it may make less sense to examine RPTs on an individual transaction basis.[19] In jurisdictions populated by business groups, there is a strong demand from the business community for the deployment of an all-encompassing, rather than individual, perspective.

Efficacy of shareholder lawsuits

It is widely acknowledged that the role of shareholder lawsuits is crucial in enforcing substantive constraints such as the fairness requirement. If access to shareholder lawsuits is somehow limited or the plaintiff shareholder is not given an effective means to secure evidence, substantive constraints will remain no more than "a cake in the picture."

4. Procedural constraints

Board approval

It is now standard practice to impose on a firm engaging in an RPT a procedural constraint such as approval by a corporate organ. The most common corporate organ authorized to approve RPTs is the board of directors. In some jurisdictions, the general meeting of shareholders (GMS) is empowered to exercise such power for material RPTs, alone or in addition to the board of directors. As a regulatory option, board approval has its own advantages and disadvantages. The most obvious advantage is that it is less cumbersome to have a board meeting than a GMS. Moreover, directors are supposed to be better informed and better qualified than the average shareholder. On the other hand, directors may be lacking in terms of motivation and independence which are essential to properly perform their screening function. The degree of independence required by law (as well as actual independence) differs from country to country.[20] In an effort to enhance independence, the board may delegate its power to a special committee composed solely of disinterested directors. It is now increasingly popular for the board or the special committee to obtain an opinion from a third-party expert on the fairness of

[19] Kang, supra note 7, at 135-136.

[20] Dan W. Puchniak & Kon Sik Kim, Varieties of Independent Directors in Asia: Divergent Convergence, in Dan W. Puchniak et al, Independent Directors in Asia: A Historical, Contextual and Comparative Approach (2017 Cambridge University Press) 89, 102-110 (discussing different requirements for independence in various Asian jurisdictions).

the RPT involved.[21]

GMS approval

The greatest merit of GMS approval may be that the shareholders, who are the ultimate stakeholders, participate in decision making. There are some concerns about GMS approval, however. Shareholders often have neither the necessary expertise nor incentive. This problem may be somewhat mitigated with the increase of holdings of institutional investors. Another concern is the cost of holding a GMS, which may be non-negligible in a large listed firm. In the case of a material RPT, the potential benefit may outweigh the cost. The cost may be further reduced if we allow the GMS to give comprehensive approval for a group of routine intra-group RPTs.

Effect of approval

A more delicate, and often ignored, issue is the effect of the existence or absence of required approval. This varies depending on the jurisdiction. In Delaware, for example, the RPT remains valid if its fairness can be demonstrated (Delaware Code Title 8 §144(a)(3)). In Japan and Korea, however, the absence of approval renders the RPT involved null and void.[22]

The existence of approval does not necessarily immunize managers involved in RPTs. In Delaware, for example, the plaintiff can still, in principle, challenge the fairness of the approved RPT, although the burden of proof is shifted to the plaintiff if the RPT is approved by disinterested directors (or shareholders).[23] Thus, in Delaware, approval constitutes a part of the fairness inquiry and approval by disinterested decision makers is difficult, if not impossible, to override in practice.[24] In contrast, the courts in the UK place more weight on such approval, and do not

[21] Although formally having no binding force in most cases, the third party opinion has some deterrent effect as it is to be disclosed by the firms to the general public.

[22] Kenjiro Egashira, Laws of Stock Corporations, 448 (7th ed. 2017) (in Japanese); Kon Sik Kim et al, Corporate Law (3th ed. 2018), ?? (in Korean).

[23] See, e.g., Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994). In a recent decision, the Delaware Supreme Court held that the business judgment rule, rather than an entire fairness review, can be applied when both an independent special committee is involved and a majority of the minority shareholders approves the transaction involved. Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642-44 (Del. 2014).

[24] "[F]airness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them."191 Weinberger v. UOP, Inc., 457 A.2d 701, 709 n7 (Del. 1983).

delve into the fairness of the transaction as long as there is approval.[25]

A principal virtue of the approval requirement is helping the court to avoid, or minimize, the burden of fairness inquiry. Moreover, the approval requirement allows Firm A to block an RPT which is fair in terms of the price, but irrelevant for its core business.

5. Disclosure requirements

Recently, disclosure has been gaining more popularity as a regulatory measure against RPTs. Disclosure of RPT-related information can be made on two different fronts: disclosure of information to the firm's decision-making organs such as the board or the GMS (internal disclosure); and disclosure to investors outside the firm (external disclosure). External disclosure is found in corporate disclosure materials such as annual statements filed with the regulators or reports to stock exchanges.[26] Accounting principles also impose disclose requirements on RPTs.

Disclosure has distinct merits as a regulatory measure. It is the least intrusive in the sense that it does not directly impede RPTs in advance. Although firms must bear some cost to produce relevant information, this is affordable in most cases. If disclosure is exempted for smaller transactions, the cost can be further reduced. Ease of enforcement is another advantage. An absence of disclosure, or inadequate disclosure, may be relatively easy to identify and sanction.

Disclosure may not necessarily bring desired results, however. If directors are not truly independent, they may not be eager to delve into the information disclosed to them. If market participants such as institutional investors, analysts and business media are not aggressive enough, disclosure may fall short of generating the desired market pressure.

E. Players in enforcement

The violation of RPT rules mentioned earlier may in principle entail a variety of sanctions such as invalidation of the transaction, damages, tax, criminal punishment, and civil penalty. Such sanctions can be invoked only when enforcement mechanisms function adequately. Depending on the capacity and incentives of players involved in the enforcement, the regulation in action may vary widely. Principal players include courts, regulatory agencies, prosecutors and stock exchanges.

1. Courts

RPT regulation is ultimately enforced in courts. The quality and mindset of judges is

[25] Luca Enriques et al, Related-Party Transactions, in Reinier Kraakman et al eds. The Anatomy of Corporate Law (3rd ed. Oxford 2017) 161 n.114.

[26] Internal disclosure may be classified as *ex ante* control, while external disclosure, together with substantive constraints, as *ex post* control.

thus crucial.[27] In order to deal properly with such an abstract notion as fairness, judges need to be afforded substantial discretion as is the case in the Delaware Court of Chancery. Granting discretion can achieve desired results when the judges are equipped with competence, independence and inventiveness, which cannot necessarily be taken for granted in every jurisdiction.

2. Prosecutors

In jurisdictions where shareholder remedies are not well developed, criminal prosecution often serves as an alternative. As mentioned earlier, prosecutors play a role in restraining abusive RPTs in Korea and such a phenomenon is not confined to Korea. The criminalization of corporate misbehavior, however, is not advisable for the following reasons. First, criminal prosecution can restrain only the most egregious type of tunneling. Second, prosecutors have limited resources and often lack business expertise. Third, prosecutors may be more susceptible to political pressure, and thus often reach decisions politically palatable to those in power.

3. Regulators

Regulators may serve as an alternative to prosecutors. Indeed, capital market regulators often play a leading role. In this regard, the China Securities Regulatory Commission (CSRC) is a prime example. Regulators may prove superior to prosecutors for the following reasons. First, they tend to be technically better qualified to deal with RPTs. Second, they can move proactively and develop and implement a set of sophisticated rules. Third, as their mandate is more limited than prosecutors, they have a greater incentive to actively tackle RPTs.

Regulators may have some shortcomings though. First, they may be even more vulnerable than prosecutors to political pressure. Second, they may be susceptible to lobbying efforts of the business community.

The pros and cons of mobilizing regulators may differ depending on the country. The extent to which a country relies on regulators in dealing with RPTs can be determined by the various conditions of the particular country. For instance, a country with a low incidence of shareholder lawsuits may need to rely more on regulators.

4. Market institutions

In addition to official players discussed above, market institutions can also play a role in restraining RPTs. Stock exchanges, institutional investors, investment banks, analysts[28], accounting firms, business media[29] and proxy advisors can all play a role to

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[27] For a recent paper highlighting the importance of judges in regulating RPTs, see Ronald Gilson, A Model Company Act and a Model Company Court (Stanford Law and Economics Working Paper No. 489 2016) (http://ssrn.com/abstract=2750256).

[28] "Only firms with an audit committee on their board and firms with a large analyst following conclude

some degree. As the concept of fairness is open-ended, formal regulation alone may not be enough to bring desired results. These market institutions may be more effective in reducing unfair RPTs as they can put pressure directly on the managers involved. In a country with a sophisticated market infrastructure, formal enforcement players may perform a less conspicuous role.[30]

III. Related party transactions and their regulations

A. Ownership structure and industrial organization: two factors affecting the incidence of RPTs

The incidence of RPTs depends on a range of factors, two of which are worthy of attention: ownership structure and industrial organization. For the former, controlling shareholders may have more incentive to engage in RPTs than professional managers primarily because they are better insulated from threats from both inside and outside the firm. If the controlling shareholder, as is often the case, chooses to form a business group, the need for intra-group RPTs grows.

The incidence of RPTs is also closely related to industrial organization. As mentioned earlier, if markets are so well-developed that firms can easily procure intermediate goods and services on the market, the firms may have less reason to engage in intra-group RPTs. It is not easy, however, to collect data on these factors and the incidence of RPTs in the three jurisdictions. Before we embark on reviewing the regulation of RPTs, let us take a look at these points in each country.

1. Japan

Ownership structure: stable shareholders and employee-managers

Japan is one of the few countries in the world with a dispersed share ownership structure. As is the case in the USA and the UK, there is no controlling shareholder in most of its large listed firms. In the absence of controlling shareholders, such firms are typically run by professional managers. These managers are predominantly selected from white collar employees who have spent their whole business careers with the firm. For example, in 1997, Toyota's board was composed of 56 directors,

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related party transactions at more favorable prices." Yan-Leung Cheung et al, Buy high, sell low: How listed firms price asset transfers, 33 Journal of Banking & Finance 914, 922 (2009).

[29] For a discussion on the role of media, see Alexander Dyck et al., The Corporate Governance Role of the Media: Evidence From Russia, 63 Journal of Finance 1093, 1097 (2008).

[30] Vladimir Atanasov et al, Law and Tunneling, 37 Journal of Corporation Law 1, 24 (2011) (emphasizing the role of market infrastructure in restraining tunneling in the U.S.).

who were all “inside” directors.[31] These managers can be called “employee-managers.”

Rarely holding a sizable number of shares, these employee-managers can secure their “management independence” with the help of so-called “stable shareholders” – i.e., shareholders who hold shares primarily to maintain a trade relationship with the company. The company often serves as a stable shareholder for its own stable shareholders. According to the conventional view, this mutual shareholding structure (*kabushiki mochiai*) has been a hallmark of Japanese corporate governance and a bulwark against pressures from the capital market.[32]

This situation started to change after the bubble burst in the early 1990s. The subsequent changes in shareholder profile started with banks. In an effort to meet regulatory capital requirements, they started selling shares of borrower firms, abandoning the role as stable shareholders. Instead, the holdings of foreign investors soared, particularly in larger listed firms. As of 2016, foreign investors as a group hold 30 percent or more in 42.8 percent of the firms composing the JPX-NIKKEI Index 400.[33] In most of these firms, however, the control of employee-managers seems to have remained despite the changes in ownership structure. Most of these employee- managers lack the incentive or sufficient power to engage in RPTs.

Although share ownership is dispersed in most listed firms, there are controlling shareholders in some firms. As of 2016, 17.9 percent of the firms listed in the Tokyo Stock Exchange had controlling shareholders, the majority of whom were listed firms themselves.[34] The pyramidal ownership structure commonly found in Korean groups is relatively rare in the Japanese economy.[35]

Industrial organization: long-term relationships with suppliers

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[31] Takuji Saito, Determinative Factors in Introducing Outside Directors in Japanese Firms and its Effect, in Corporate Governance in Japan (Hideaki Miyajima ed. 2011) 181, 184 (in Japanese). Except for one former bureaucrat from the Ministry of Trade and Industry, all of them joined the firm straight out of college.

[32] This kind of mutual shareholding structure is supposed to help cement a stable long-term trading relationship. Recent studies by Japanese scholars find that Japanese firms are now much less interested in holding shares of their trading partners. See, e.g., Zenichi Shishido, Reality and transformation of “Japanese trade practices”, Shojihomu No. 2142(August 25, 2017) 4, 10 (in Japanese). For a paper which disputed the conventional view, see Yoshiro Miwa & J. Mark Ramseyer, Rethinking Relationship-Specific Investments: Subcontracting in the Japanese Automobile Industry, 98 Michigan Law Review 2636, 2655 (2000).

[33] Tokyo Stock Exchange, White Paper on Corporate Governance of Firms Listed on Tokyo Stock Exchange (2017) at 5 (in Japanese).

[34] Seven percent of those firms have individual controlling shareholders. Id. at 8.

[35] Takahito Kato, A memorandum on agency problems between controlling and minority shareholders, Tokyo University Law School Law Review Vol. 11 (2016) 222, 224 (in Japanese).

As mentioned earlier, Japanese firms tend to trade with outside suppliers, rather than engage in intra-group RPTs. To secure stable supply and cooperative behavior, they maintain long-term trading relationships with these suppliers.[36] Such business arrangements generate little risk of tunneling, as the firms are trading with outsiders.[37]

Incidence of RPTs

It is difficult to find reliable data on the frequency of RPTs in Japan. Professor Takahito Kato of the University of Tokyo argues that the risk of tunneling arising from RPTs may be negligible.[38] He cites an empirical study showing that a subsidiary does not necessarily suffer loss when both the parent and the subsidiary are listed.[39] He further states that as a matter of theory, the management of a listed parent will have less incentive to exploit its subsidiary as they may not achieve any personal gain from such exploitation.[40] This lower risk of tunneling may be a reason why Japan has been hesitant about directly regulating RPTs.

2. Korea

Ownership structure: *chaebol and controlling minority shareholders*

Corporate governance in Korea centers on *chaebols*, which are family-controlled business conglomerates that dominate the national economy. The ownership structure of a *chaebol* is often characterized as a controlling minority shareholder (CMS) structure.[41] The CMS is a patriarch with the title of “chairman”, who effectively controls all the member firms by means of extensive inter-company

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[36] For a short account of the long-term trading relationship in Japan, see Motoshige Ito, Interfirm Relations and Long-Term Continuous Trading, in Kenichi Imai & Ryutaro Komiya eds., Business Enterprises in Japan (MIT Press, Cambridge, 1994) 105-115. This kind of long term trading relationship emerged since Japanese firms had been forced to abandon the holding company structure after the Second World War.

[37] This type of industrial organization is made possible probably because markets in Japan are relatively better developed than in Korea and China.

[38] Kato, supra note 35, 226-228.

[39] Hideaki Miyajima et al, An Economic Analysis of the Listing of Parent and Subsidiary – Is the conflict of interest really serious?, in Hideaki Miyajima ed., Corporate Governance in Japan (2011) 332-333 (in Japanese).

[40] Kato, supra note 35, 228. He adds that as an individual controlling shareholder is generally presumed to serve as director, his or her conduct can be restrained by the exiting fiduciary duty regime.

[41] Kon Sik Kim, Dynamics of shareholder power in Korea, in Research Handbook on Shareholder Power, 535, 536-537, in Randall S. Thomas & Jennifer G. Hill eds. (Edward Elgar 2015).

shareholdings. Composed of numerous pyramidal and circular holdings, a *chaebol*'s actual ownership structure used to be extremely complicated. Under the tacit encouragement of the government, many *chaebols* have been converted into a holding company structure. As most of these holding companies hold only about 30 percent of the shares of their subsidiaries, the dominance of CMS remains intact even in a simplified ownership structure.

Korea's CMS structure exhibits three principal features. First, the CMS's cash-flow rights are extremely low in larger groups, although the figure for smaller business groups is substantially higher.[42] Second, the CMS can still secure absolute control by means of acquiring holdings of other member firms. In other words, these member firms are a functional equivalent of stable shareholders in Japan. Third, despite recurring criticism on the growing disparity between the CMS's cash-flow right and the control right, the CMS structure has remained stable over the last two decades.

Industrial organization: prevalence of corporate groups and RPTs

In the 1960s, Korean firms started expanding by exporting low-tech manufacturing goods to developed countries. As domestic markets were woefully underdeveloped, the exporting manufacturers had to set up new firms and have them supply core parts for their end products.[43] By means of vertical integration, the export industry was able to avoid inefficiency from the "hold-up" problem and enhance competitiveness in the global market.[44] Leading exporters soon grew into giant conglomerates while intra-group RPTs have been commonly undertaken for purely business purposes and, sometimes, for tunneling purposes.[45]

The prevalence of RPTs may be attributable, at least partly, to the backward state of markets. Or, viewed from a different angle, pervasive intra-group RPTs may have been a factor impeding market development in Korea, taking away business opportunities for small- and medium-sized firms including start-ups. This is a reason why, as discussed later, RPTs have been subject to regulation under the Act relating to Monopoly Regulation and Fair Trade (Fair Trade Act or FTA) in Korea.

Incidence of RPTs

Chaebol firms actively engage in intra-group RPTs. As of 2015, RPTs on average

[42] In an extreme case, the founder-controlling shareholder of Lotte Group controls the whole group with only 0.1 percent of the cash-flow right. Kang, supra note 7, 123.

[43] Setting up a new firm, the controlling shareholder made relatively lucrative affiliates invest their surplus funds, leading to a complicated ownership structure.

[44] For a view emphasizing the counter-productiveness of vertical integration in Korean chaebol, see, e.g., Sea-Jin Chang, Financial Crisis and Transformation of Korean Business Groups : The Rise and Fall of Chaebols (Cambridge 2003) 112-117.

[45] Cross-subsidization among group firms may be regarded as a mixture of the two purposes.

accounted for 11.7 percent of the total sales in 47 large business groups, down from 13.2 percent in 2011.[46] In 36.7 percent of the firms, the figure amounted to 30 percent or higher.[47]

Tables 1 and 2 reveal that as the share ownership of the CMS family (heirs of the CMS in particular) goes up, the percentage of intra-group RPTs in the firm's sales figure rises.[48] It is generally believed that these intra-group RPTs are often abused for tunneling purposes.[49] In a typical scenario, Firm A routinely purchases goods and services from Firm B, paying above-market prices. For example, Hyundai Motors funneled all its car delivery service contracts to an affiliate called Hyundai Glovis, almost wholly owned by Chung Mong-koo, Chairman of the Hyundai Motor Group, and his son.[50] This is a prime example of RPTs being beneficial only to a firm owned by the heirs of the controlling family.[51] RPTs have been a well-known means of transferring wealth to *chaebol* heirs to help them inherit their family business.

Table 1: Percentage of intra-group RPTs by CMS family holdings as of 2015

CMS family holdings	0~20%	20~30%	30~50%	50~100%	100%
Intra-group RPTs	12.2%	9.0%	11.3%	16.5%	34.6%

Table 2: Percentage of intra-group RPTs by holdings of the heirs of CMS as of 2015

Holdings of the heirs of CMS	0~20%	20~30%	30~50%	50~100%	100%
Intra-group RPTs	11.7%	12.5%	23.1%	25.5%	59.4%

46 Korea Fair Trade Commission, Analysis of internal transactions in large corporate groups in 2015 (September 2016)(https://www.ftc.go.kr/solution/skin/doc.html?fn=bf82cc5fdc843c725c6b7c1d88eab7c6fd0b397bce01aa307d6dccb5c78b8e6f&rs=/fileupload/data/result//news/report/2016/) (visited on January 7, 2018) at 6 (in Korean).

47 Id. at 3. The percentage is higher in firms in service industries. In the business facilities management and business support services, the percentage is as high as 51.9 percent. Id. at 12.

48 Id. at 18, 20.

49 For a short description of some high-profile instances of tunneling, see Sang Yop Kang, "Generous Thieves": The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions, 21 Stanford Journal of Law & Finance 57, 77-80 (2015). For a paper showing an adverse effect of routine RPTs on firm market value in poorly governed firms, see Bernard Black et.al., "How corporate governance affect firm value? Evidence on a self-dealing channel from a natural experiment in Korea," Journal of Banking and Finance, Vol. 51, at 131-150 (2015).

50 Black et al, supra note 49, at 144.

51 Sunwoo Hwang & Woochan Kim, When Heirs Become Major Shareholders: Evidence on Pyramiding Financed by Related-Party Sales (January 2016)(unpublished paper)(demonstrating that "related-party sales are used as a means to financially support the firms in which heirs become major shareholders, and allow them to control other member firms in the group through pyramiding").

3. China

Ownership structure: corporatization and the rise of corporate groups

Until the late 1970s, when China started to embrace market elements into its economy, all business activities were undertaken by the State. In 1993, the State decided to turn these state-run enterprises into corporations, called state-owned enterprises (SOEs). This policy measure was taken to enhance the performance of SOEs by preventing bureaucrats from interfering with operational decisions. After this process called "corporatization", distinct from "privatization", a number of large SOEs in the form of joint stock company under the Company Act were listed in the newly-established Shanghai and Shenzhen stock exchanges. Although the number of privately-owned enterprises (POEs) has grown during the last four decades, SOEs still dominate the national economy and account for the majority of large listed firms.[52]

Ownership in the listed firms generally remains concentrated. As of 2008, more than 95 percent of the listed firms had "ultimate controlling shareholders" holding at least 10 percent of shares.[53] Another conspicuous feature of the ownership structure in China is the prevalence of the pyramidal structure.[54] Based on pyramidal holdings, Chinese firms generally operate in group structures. As corporatization progressed, the number of corporate groups grew exponentially. Like corporatization, corporate groups are a product of government policy. It was in the mid-1980s that the Chinese government decided to start fostering business groups: a decision based on an expectation that these would contribute to new technology, stable financial performance, and international competitiveness.[55] As few POEs were in operation at that time, SOEs were chosen to be transformed into groups. In 1991, 57 large SOEs were converted into corporate groups and the number of corporate groups exceeded 7,000 in the early 1990s.[56]

The rise of corporate groups was also partly due to a peculiar feature of the IPO of SOEs in the 1990s. The Chinese government encouraged cash-stricken SOEs to

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[52] Qiao Liu, Corporate China 2.0 (palgrave 2016), at 7 ("Out of 98 mainland companies on the 2015 *Fortune* Global 500 list, only 10 companies are private.")

[53] Id. at 118.

[54] Id. at 121.

[55] Jia He et al, "Business Groups in China", 22 Journal of Corporate Finance 166, 168 (2013). It was also partly due to the fact that Japanese and Korean economies, which served as role models for China, had grown based on the group structure. Benjamin L. Liebman & Curtis J. Milhaupt, "Introduction: The Institutional Implications of China's Economic Development", in Liebman & Milhaupt eds., Regulating the Visible Hand? (Oxford, 2016), xvi-xvii.

[56] Jia He et al, supra note 55, 168.

undertake IPOs in overseas capital markets.[57] In order to whet the appetite of foreign investors, these SOEs often set up a subsidiary with attractive assets separated from the original firm and listed this subsidiary only. This kind of SOE split-up took place in domestic stock markets as well in order to meet the strict listing requirements of the Shanghai or Shenzhen stock exchanges. The resulting parent and subsidiary firms naturally kept on operating as one enterprise in the form of a corporate group and as a consequence engaged in intra-group RPTs to manufacture end products.

Group structures are not confined to SOEs alone, however. Many POEs including household names such as *Alibaba*, *Wanda* and *Wahaha* now also operate as corporate group. Given the external financial constraints, they voluntarily adopted a group structure to foster internal capital markets.[58]

Industrial organization

Vertical integration was pervasive in China even before the reform and opening-up policy started in the late 1970s. "Chinese managers often preferred to make, rather than buy, inputs because they wanted to reduce the dependence on potentially unreliable suppliers."[59] Attempts were made to reverse this tendency even in the 1950s, but these largely failed. Vertical disintegration started only in the late 1970s with the growth of market forces resulting from market reforms.[60] As SOEs "purchased more and more intermediate inputs through markets," vertical disintegration occurred in 27 out of 31 industrial sectors.[61]

Incidence of RPTs

Despite the increasing specialization of Chinese firms, it is generally believed that RPTs are still widespread even among listed firms. Table 3 shows that more than 80 percent of listed firms engage in RPTs and this proportion has been rapidly

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[57] The Chinese government no longer encourages overseas listing. Instead, in recent years, re-listing on Chinese exchanges of overseas listed firms is in vogue.

[58] Liu, supra note 52, at 121.

[59] Yifan Zhang, Essays on Industrial Organization in China's Manufacturing Sector (Ph.D. dissertation University of Pittsburgh 2005) at 16. SOEs even founded their own schools and hospitals.

[60] Id. at 4.

[61] Id. at 16-17. Zhang argues that "[t]he comparative advantage of vertical integration declined gradually and almost disappeared in the 1980s". Id. at 17. A recent study shows that vertical integration has a negative impact on productivity, in contrast to recent studies based on U.S. firms. Hongyi Li et al, Vertical integration and firm productivity, 26 Journal of Economics & Management Strategy, 403 (Summer 2017).

increasing.[62]

Table 3: Popularity of RPTs in listed firms

	Percentage of listed firms	Total amount of RPTs (100M yuan)
2002	85.2	5846
2003	89.5	9073
2004	92.9	28976
2005	90.3	37006
2006	98.2	45907
2007	82.0	120808

Although Chinese firms engage in various types of RPTs, three types are particularly noteworthy: the provision of security; the sale of goods; and the extension of credit.[63] In terms of percentage, the provision of security is by far the largest, ranging from 55 to 62 percent during the period of 2007 to 2010. Prior to 2006, however, credit extension took up the largest portion as low or no interest lending between affiliate firms was commonplace.[64] In 2003, the CSRC decided to prohibit listed firms from lending to affiliates and ordered them to get rid of existing credits.[65]

RPTs between parent and subsidiary firms account for the largest percentage of RPTs: 41.4 percent on average. Meanwhile, RPTs between affiliate firms under the common control come next at 24.41 percent on average.[66] Unlike in Korea, RPTs involving individual shareholders and managers are believed to be negligible.[67]

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[62] Kai Zhong, A study of legal issues of related party transactions under the company act (Chinese University of Politics and Law Press 2015)(in Chinese) at 29. According to a more recent survey, the percentage of listed firms engaging in RPTs is 81.15 percent in 2013, 92.69 percent in 2014, and 91.90 percent in 2015. Bin Wang et al, On the regulation of disclosure of RPTs in listed firms, Chinese securities (2016, Issue 8) at 32 (in Chinese).

[63] Id. at 30-31.

[64] As of the end of 2005, 374 firms among 1,308 listed firms were engaging in financial transactions with their affiliates, and loans to their affiliates accounted for 8.6 percent of the total assets. Guohua Jiang et al, "Tunneling through Non-Operational Fund Occupancy: An investigation based on officially identified activities", 32 Journal of Corporate Finance 295, 296 (2015).

[65] Notice relating to some issues on financial transactions between listed firms and their affiliates and listed firms' provision of security. For a short account of this notice, see, e.g., Nicholas Calcina Howson, "Quack Corporate Governance' as Traditional Chinese Medicine – the Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle Against State Political Economic Power, 2 Seattle University Law Review 667, 681-682 (2014).

[66] Zhong, supra note 62, at 31.

[67] RPTs between listed firms and individual shareholders (and their family) amount to 0.01 percent on average. Ibid.

Nevertheless, tunneling is still perceived as a serious problem in China.[68] A Chinese legal scholar asserts that although tunneling in unlisted firms remains widespread due to inadequate regulation, tunneling in listed firms is in decline.[69] Anecdotal evidence showing otherwise abounds, however.[70]

B. Substantive constraints

1. Japan

The Japanese Company Code (JCC) has no special provision directly targeting controlling shareholders. It is generally accepted in Japan that a controlling shareholder does not owe fiduciary duties to the firm or its fellow shareholders.[71] Although no provision directly addresses the behavior of controlling shareholders, they may still be held liable as a *de facto* director or based on the general tort provision in the Civil Code (Art. 709).[72] In practice, however, it is difficult to hold a controlling firm liable for damages to the firm based on the theory of *de facto* director.[73]

As for the substance of an RPT, the fairness standard is applicable. Fairness is generally deemed to have been established when an RPT meets the so-called arm's length test.[74] The scope of transaction that is governed by the arm's length test, however, is not clearly delineated.[75] Taking a strict view, fairness is to be established on an individual basis even when the firm engages in a range of RPTs with its affiliates. So, in principle, even when the RPTs as a whole are deemed to be fair, a particular RPT may still be held to be unfair. The opposite conclusion may come about if a more flexible view is taken, which would allow the establishment of

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68 Id. at 56.

69 Id. at 57.

70 For example, Jian Gang He, Profit shifting, media monitoring and corporate governance: a study of the *wuliangye* case, Management world (2008, Issue 10) 141; CSRC strengthens the sanction on information disclosure violation by listed firms (July 31, 2015) (in Chinese). (http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201507/t20150731_282052.html) (visited on Feb. 8, 2018).

71 Kato, supra note 35, at 233. In the process of the 2014 amendment of the JCC, a proposal was made to provide for the fiduciary duty of a controlling shareholder, but was rejected, partly due to the criticism that the concept is too ambiguous to be applicable in a court decision. Id. at 225.

72 Id. at 224, 228. According to him, however, it will be difficult to regard a corporate controller as *de facto* director because a legal person is not allowed to serve as director under the JCC (Art. 331(1)(i)).

73 Id. at 228 n.25.

74 Egashira, supra note 22, 447-448.

75 Koji Funatsu, Pursuit of the Group Interest and the Provision on "the Parent's Liability", Shojihomu No. 1959 (March 5, 2012) 4, 5-6 (in Japanese).

fairness to be verified on an overall basis.

In the process of preparing an amendment to the JCC in 2014, a proposal was made to introduce the duty of the parent corporation to compensate for the "disadvantage" arising from a transaction between the parent and the subsidiary.[76] The proposal purported to adopt a global, rather than an individual, approach in calculating the amount of disadvantage.[77] Faced with opposition from the business community, however, the Japanese government dropped the proposed provision when it submitted the bill to the Diet.

At around the same time, adopting a rather broad approach, a district court decided in favor of the director of a subsidiary which participated in the Cash Management System run by its parent. Acknowledging the possibility of the subsidiary benefiting from the CMS on a long-term basis, the court stated that the decision of the director to participate in the CMS was not to be regarded as unreasonable even when the subsidiary was not likely to borrow funds from the CMS in the near future.[78] This decision may be construed as a sign of the rising popularity of the flexible view in Japan. Taking a conventional view, however, directors of a controlled firm are still not allowed to sacrifice the firm's interest for the interest of the controlling firm or the group as a whole.[79]

2. Korea

Controlling shareholders

As is the case in Japan, the majority of commentators are of the opinion that a controlling shareholder does not owe fiduciary duties to the firm or its fellow shareholders in Korea. Corporate law rules are contained in the Commercial Code (KCC). The KCC has a few provisions applicable to controlling shareholders. The most relevant of these is Article 401-2, which holds a person with "influence over the firm" liable to the company if they give "an order" to its directors as a result of which the firm suffers loss (Art. 401-2(i)). There is no dispute that this provision was put in place primarily as a means to hold controlling shareholders liable. Although only a few relevant cases have been reported so far, the court seems to have been quite cautious in acknowledging the existence of an order. As yet, no court has held a controlling shareholder liable under this special provision.

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[76] Kato, supra note 35, at 225.

[77] Id. at 230-231.

[78] Yokohama District Court, February 28, 2012, Judgment 2010Wa1651. For a comment on this decision, see Yoh Ohta & Daisuke Morimoto, An Analysis of the Yokohama District Court Decision in the Shareholder Derivative Suit involving Nissan Car Body (I, II) Shojihomu No. 1977 (September 25, 2012) 16; No. 1978 (Oct. 5, 2012) 73 (in Japanese)

[79] Egashira, supra note 22, at 54.

Group context

Both the fairness standard and the arm's length test are generally accepted in Korea as well. Court decisions elaborating on the arm's length test are rare, however. Most commentators are of the opinion that directors of a controlled firm are not allowed to sacrifice the firm's interest for the interest of the controlling firm or the group as a whole. Group-oriented behavior, however, still remains prevalent in Korea, generating myriads of intra-group RPTs. An individual RPT which is inconsistent with a firm's immediate interest may serve the long-term interest of the group as a whole. Particularly relevant in this context are RPTs entered into to prop up an ailing affiliate. The Supreme Court acknowledges the possibility of allowing such an RPT, but takes a highly cautious attitude toward propping up transactions.[80]

Fair Trade Act

A set of idiosyncratic provisions targeting RPTs are laid out in the Fair Trade Act. The first provision adopted in 1996 is Article 23(1)(vii), which aims to regulate acts of "unfair assistance" by preventing business firms from dealing with their affiliates or other firms on "fairly preferential terms". Whether a price involved in an RPT is preferential or not is to be determined in comparison with the so-called "normal price", which is a price that would be reached in an arm's length transaction.[81] The Supreme Court holds that the burden of proving the normal price falls on the Fair Trade Commission (FTC), and applies a strict evidentiary requirement, which the FTC has often failed to satisfy.[82] Due to this heavy evidentiary burden, the provision has been ineffective in restraining intra-group RPTs. It has been particularly inadequate in dealing with the so-called "funneling of business" (*ilgam molajugi*) to a related party, a practice met with severe public disapproval. Business funneling involves

[80] In a case on the criminal liability for a series of RPTs conducted to prop up its ailing affiliates, the Supreme Court held those managers including the controlling shareholder liable, pointing to such factors as lack of reasonable and objective standard in selecting supporting firms among the group firms and lack of countervailing benefits to those supporting firms who bore a substantial financial burden as a result of the propping up transactions. Supreme Court Decision No. 2013Do5214 (September 26, 2013) In a more recent case on the same issue, however, the Supreme Court held the defendants not guilty for breach of trust, stating that the defendants are lacking in criminal intent when certain requirements are satisfied. Supreme Court Decision No. 2015Do12633 (November 9, 2017). The requirements mentioned in the decision are hard to meet. They include the following factors: the existence of the common interest among affiliate firms; propping up transactions undertaken to promote the common interest; reasonableness of the size of propping up transactions and the selection of the firm benefitting from propping up transactions; propriety and lawfulness of propping up transactions; and, objective possibility of the supporting firm receiving commensurate compensation.

[81] Supreme Court Decision, No. 2009Du20366 (November 13, 2014).

[82] In addition, the Fair Trade Commission is required to prove "a potential harm to the fair trade."

awarding contracts to a related party, normally a firm owned by an heir apparent of the controlling shareholder. In 2013, a new provision was included in the FTA to specifically address business funneling (Art. 23-2(1)(iv)). A virtuous feature of the new provision lies in the fact that it can be applicable even when the terms are not "fairly preferential" to the related party**.** The provision is based on the premise that funneling a substantial amount of business can by itself be beneficial to the related party even when the terms do not deviate from the market price. The Korean government, however, included a number of exceptions to this rule, presumably taking into consideration the reality that many business groups depend heavily on intra-group RPTs.[83]

3. China

Article 21 of the Company Act

The Company Act of China (CCA) contains certain provisions potentially applicable to RPTs. The most relevant example may be Article 21, which provides that the controlling shareholder, *de facto* controller, directors, supervisors and senior officers of a company may not cause damage to the company by taking advantage of their "affiliation relation" with the company, and that those who cause damage to the company shall be liable for compensation of the damage.[84] "Affiliation relation" is broadly defined to include relations with firms under the direct or indirect control of the controlling shareholder or *de facto* controller (Art. 216(iv)). The judicial interpretation of the Supreme Court proclaims that the court will support a lawsuit filed by a company or its shareholders against a shareholder who damaged the corporate interest by using RPTs (Judicial Interpretation (3), Art. 12).

It appears that shareholders, in theory, can file a derivative lawsuit against those involved in abusive RPTs under Article 21. Shareholder derivative suits, however, are rare and almost all of them involve limited liability companies, rather than stock corporations.[85] Even when a derivative suit is filed, Chinese courts are extremely reluctant to interfere with the substance of a board decision.[86]

[83] For example, the FTA exempts RPTs with a related listed firm if the controlling family holds less than 30 percent of the shares of the firm or if the RPTs account for less than 30 percent of the listed firm's revenue. In most *chaebol* firms, the controlling family managed to avoid this provision by lowering their holdings below the 30 percent line.

[84] The controlling shareholder and de facto controller are defined in Article 216. The concept of controlling shareholder is based on either of the two elements: ownership of a majority of shares or influence on the resolutions of the GMS (Art. 216(ii)). The "de facto controller" is defined as a person who despite her non-shareholder status is capable of actually controlling the conduct of the company "through investment relations, agreements or other arrangements"(Art. 216(iii)).

[85] Donald C. Clarke & Nicholas Howson, "Pathway to minority shareholder protection: derivative actions in the People's Republic of China", in The Derivative Action in Asia (Dan W. Puchniack et al eds., Cambridge) 243, 275-278 (2012).

[86] Jianbo Lou, "Ordinary Corporate Conduct Standard vs. Business Judgment Rule", in German and Asian

Other CCA provisions

Another general provision potentially applicable to RPTs is Article 20(1), which provides that shareholders shall not harm "the interest of the firm or other shareholders" by abusing their so-called "shareholder rights". Shareholders who have violated this provision shall be liable to the firm or other shareholders in accordance with the law (Art. 20(2)). A critical defect of this provision is that it requires the abuse of "shareholder rights". The shareholder rights most likely to be involved in an RPT may be voting rights. It is difficult to establish an abuse of voting rights, however. For an RPT not involving a shareholder resolution, it would be even more difficult to prove an abuse of shareholder rights, unless the concept of shareholder rights is liberally construed.

The CCA includes a provision on general concepts equivalent to fiduciary duties in the USA. Article 147(1) provides that "directors, statutory auditors and senior executives" owe the duty of loyalty and the duty of diligence to the company. These duties are generally regarded as a functional equivalent of fiduciary duties under American law. Although this provision does not explicitly mention controlling shareholders, a growing number of leading scholars are of the opinion that controlling shareholders owe fiduciary duties to general shareholders as well as to the firm.[87]

Administrative rules

A regulation issued by the CSRC contains some provisions on the fairness of RPTs. The "Administrative Rules on IPO and Listing of Shares" requires that the issuer firm does not engage in RPTs that are "conspicuously unfair" (Art. 19).[88]

C. Procedural constraints

1. Japan

Narrow scope of the basic self-dealing rule

Under the JCC, a director of a company with a board of directors[89] who desires to

Perspectives on Company Law (Holger Fleischer et.al. eds., 2016) 83, 103; Zhong, supra note 61, at 185.

[87] Junhai Liu, Modern Company Law(I)(third ed. 2015) at 340-343 (in Chinese); Xudong Zhao ed., Corporate Law (4th ed. Higher Education Publishing Company, 2015), 235-236 (in Chinese).

[88] CSRC Regulation No. 32 (May 17, 2006). It further requires the issuer firm to conduct RPTs at fair prices and not to manipulate its profits by means of RPTs (Art. 32).

[89] The JCC allows a stock corporation to choose among a wide range of governance structures. Larger firms tend to have the board of directors.

enter into a transaction with the company is required to obtain approval of the board of directors in advance (Art. 365(1)). As this provision is aimed at directors only, it is generally regarded as inapplicable, in principle, to related parties such as controlling shareholders who do not formally serve as a director. If the size of an RPT is substantial, however, the board of directors may be required to approve the RPT based on its general statutory power (JCC Art. 362(4)(i)). Even in such a case, securing board approval itself may not necessarily be an onerous hurdle as there are relatively fewer independent directors in Japan.[90]

Role of directors, statutory auditors and disinterested parties

Prior to reform in 2014, there was no special regulation on RPTs other than the disclosure provision under the Company Accounting Rules, which requires an RPT between the controlling shareholder and the controlled firm to be disclosed in the notes of non-consolidated financial statements of the controlled firm (Company Accounting Rules Arts. 98(1)(xv), 112(1)). The 2014 reform strengthened procedural constraints as well as disclosure by introducing provisions making it more difficult for a related party to engage in tunneling activities. First, the directors of the controlled company are required to state in the business report that they have taken precautions to ensure that RPTs disclosed in the notes of non-consolidated financial statements do not damage the controlled company's interest (Company Code Enforcement Rules Art. 118(v)). Second, the statutory auditor is required to audit the business report and to state in the audit report his or her opinion on the RPTs covered by the business report (Enforcement Rules Art. 129(1)(ii)).[91] Third, the Listing Rules of the Tokyo Stock Exchange require the executive organ to seek the opinion of a disinterested party when entering into a material RPT (Rules 441-2(1)).

A recent Supreme Court decision on a management buyout transaction

Like their American counterparts, Japanese courts are now paying more attention to procedural aspects of RPTs. This phenomenon is conspicuous in court decisions on management buyout (MBO) transactions, a prime example of conflict of interest transactions. In a recent decision on a two-step MBO composed of a tender offer and an ensuing squeeze out, the Supreme Court of Japan stated that it would not delve into the fairness of the price in the squeeze out transaction as long as the tender offer is undertaken "in accordance with a procedure that is generally accepted as fair," and the squeeze out price is equal to the tender offer price.[92]

[90] As of 2016, in about 80 percent of the overall listed firms, the portion of independent outside directors accounts for less than one third of the board members. Tokyo Stock Exchange, supra note 33, at 77.

[91] The same provision applies to the audit and supervisory committee and the audit committee (Enforcement Rules Arts. 130-2(1)(ii), 131(1)(i)).

[92] Supreme Court Decision, Kinyu-shoji hanrei No. 1497 (July 1, 2016) 8 (in Japanese).

Undertaking the MBO transaction, the majority shareholders, in an effort to neutralize the conflict of interest involved, took such measures as appointing an independent third party committee and obtaining an expert opinion. The Court accepted the procedure as fair without scrutinizing the actual effect of those measures in detail.[93]

2. Korea

Expansion of the scope of the basic self-dealing rule

In terms of corporate statutes, Korea's approval requirements appear to be the most extensive of the three countries. Under the pre-2011 KCC, the basic self-dealing rule was similar to its Japanese counterpart, requiring board approval only for transactions between the firm and a director. The 2011 amendment substantially expanded the scope of related parties to include "major shareholders" and firms in which the "majority" of shares were under the control of major shareholders (KCC Art. 398).[94] This latter category is not as comprehensive as it first appears because the majority test is too high to cover large affiliated firms in reality. As the controlling shareholder often holds less than 50 percent of shares of the firms in his or her business empire, many significant intra-group RPTs remain outside the reach of the revised provision. This defect is somewhat remedied by a special provision applicable to listed firms (KCC Art. 542-9), which expands the scope of affiliates to include all the member firms of a business group under the FTA (KCC Enforcement Decree 35(5), 35(4)(ii)(B)). This provision may potentially cover even routine intra-group RPTs conducted by a listed firm. In order to minimize the burden of listed firms, the KCC allows a special exception, according to which the firm does not have to obtain board approval for each and every RPT, as long as it has obtained a comprehensive approval for routine RPTs, normally on an annual basis (Art. 542-9(5)). This exception is widely utilized in the business community, and the general practice thereof goes like this: The listed firm prepares a document which indicates the monetary sum total of RPTs with each affiliate and submits this document to the board of directors for approval, normally at the beginning of the business year. The document typically indicates only the sum total of RPTs, and does not contain details of their trade terms. In practice, the board of directors almost invariably gives a comprehensive approval without considering the fairness of the terms. As yet, no case of rejection has been reported.

[93] For a critical comment on this decision, see, e.g., Manabu Matsunaka, The supreme court decision on JCOM and the fair price in a two-step acquisition involving a structural conflict of interest, Shojihomu No. 2114 (Oct. 25, 2016) 4 (in Japanese).

[94] A major shareholder is broadly defined to include shareholders with ten percent shares or with influence over material business matters. KCC Art. 542-8(2)(vi). The 2011 amendment heightened the voting requirement to a two-thirds majority.

Independence of directors approving RPTs

The independence of directors is an essential condition for effective board monitoring. In this regard, the situation in Korea does not warrant much optimism. According to the dominant view, even an executive director is entitled to vote on an RPT with his or her boss as long as the former has no personal interest in the RPT involved. This weakness may be somewhat ameliorated by the involvement of outside directors. In Korea, a large listed firm is required to fill a majority of board seats with outsiders (KCC Art. 542-8). Many firms, however, manage to fill these seats with nominally independent, but actually pliant, directors. It is thus not surprising that examples of outside directors voting "no" are extremely rare.[95]

3. China

The CCA prohibits directors and senior executive officers from dealing with a firm without obtaining approval of the GMS (Art. 148(1)(iv)). The provision does not cover other related parties such as the controlling shareholder or affiliate firms.[96] RPTs are thus rather thinly regulated under the CCA. This regulatory lacuna is filled by government regulations and exchange rules. As exchange rules are tightly controlled by the CSRC, they are functionally indistinguishable from government regulations.

Perhaps the most prominent feature of the CSRC's regulation of RPTs is the veto power granted to independent directors.[97] The CSRC requires a listed firm to fill more than one-third of seats (two at least) on the board with independent directors, one of whom needs to be an accounting professional[98] and to approve certain large RPTs before board approval is secured.[99] At times, these independent

[95] A low objection rate does not necessarily mean inaction on the part of the outside directors as they are customarily given an opportunity to let management know their negative view informally in advance. Kyung-Hoon Chun, Korea's Mandatory Independent Directors: Expected and Unexpected Roles, in Dan W. Puchniak et al, Independent Directors in Asia: A Historical, Contextual and Comparative Approach (2017 Cambridge University Press) 176, 200-201.

[96] There are other provisions applicable to RPTs. The CCA, for example, requires approval of the GMS for providing security for shareholders or *de facto* controllers (Art. 16(1)). This special rule for provision of security may be justified by the fact that the transaction was so widespread.

[97] In addition, the CSRC, together with the State Economy and Trade Commission, promulgated in 2002 "the Principles of Corporate Governance for Listed Firms", which provide for general rules on RPTs.

[98] Guiding Opinions on the Establishment of Independent Directors System in Listed Companies (2001) (available at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69191.html). On the enforcement of this requirement, see Donald C. Clarke, The Independent Director in Chinese Corporate Governance, 31 Delaware Journal of Corporate Law, 126, 197-201 (2006).

[99] Id. at Para. 5(1). Moreover, independent directors have power to issue an independent opinion report on material corporate matters including "events that the independent directors consider to be detrimental to the interests of minority shareholders." Para. 6(1).

directors may hesitate to block an RPT involving the controlling shareholder as they are normally appointed at the behest of the controlling shareholder. There is some empirical evidence, however, suggesting that a positive role is played by these independent directors.[100]

This procedural requirement is further specified in the stock exchange listing rules and the guidelines promulgated under the listing rules. The Listing Rules of the Shanghai Stock Exchange, for example, contain a chapter on RPTs (Ch. 10). More systematic and detailed is a special guideline for RPTs (the RPT Guideline)[101] enacted by the Shanghai Stock Exchange. The RPT Guideline is composed of 63 provisions, which include comprehensive rules on every aspect of RPTs, covering substance, procedure and disclosure. For example, the RPT Guideline has a set of detailed rules on the definition of a related party (Arts. 7-11). The related party is broadly defined to include a natural or legal person or other organization "that has such a special relationship with the listed company as would make the listed company tilted towards her or its interests in accordance with the principle that essence is more important than form" (Arts. 8(v), 10(v)).

The RPT Guideline divides RPTs into three groups and applies different regulations for each category of RPT. Regulations on the largest RPTs amounting to RMB 30 million or more and 5 percent or more of the net assets of the firm ("the largest RPTs") are strictest and include procedural rules (Art. 20). For the largest RPTs, both prior approval of independent directors and approval of the board of directors are required (Art. 25(1)).[102] Reports or opinions to be submitted to the board of directors include: an audit or appraisal report prepared by a securities firm (Art. 20(i)); and the opinion of the audit committee or a special RPT committee (Art. 25(2)). The largest RPTs need to be approved by the GMS as well (Art. 20).[103] In addition, the board of statutory auditors[104] is required to monitor the process of deliberation, voting, disclosure and implementation regarding RPTs and to present its opinion in the annual report (Art. 28). The RPT Guideline has a separate chapter for routine RPTs to minimize the compliance burden on firms (Chapter 8, Arts. 42-

100 Agnes W. Y. Lo et al., Can Corporate Governance Deter Management from Manipulating Earnings? Evidence from Related-Party Sales Transactions in China, 16 Journal of Corporate Finance 225, 226 (2010) (finding that firms with high percentages of independent directors tend to "have a smaller magnitude of manipulated transfer prices"); Juan Ma and Tarun Khanna, Independent Directors' Dissent on Boards: Evidence from Listed Companies in China (Harvard Business School Working Paper 13-089 (October 24, 2013). On the role of minority-appointed directors to control RPTs, see Alessio M. Pacces, 'Controlling the Corporate Controller's Misbehaviour', 11 Journal of Corporate Law Studies 177 (2011).

101 Guidelines on the implementation of RPTs of Firms listed on the Shanghai Stock Exchange.

102 The related directors are not allowed to vote at the board meeting (Art. 26(1)).

103 As the controlling shareholder involved is excluded from voting, the RPT may not be approved if the remaining

104 This should be distinguished from the audit committee composed of directors.

47).[105]

Finally, caution is advised regarding the efficacy of the approval requirement. The approval requirement can take effect only when the proposal to engage in an RPT is submitted to the board or the GMS for approval. There is no guarantee, however, that such a formal procedure is adopted in reality. Indeed, a recent study on fraud cases involving firms listed in Hong Kong and Singapore seems to support this suspicion.[106] Although potentially applicable to Japan and Korea as well, this statement is presumably more relevant to China.[107]

D. Disclosure

1. Japan

Accounting rules

Regarding the disclosure of RPTs, basic rules are contained in the Company Accounting Rules promulgated under the JCC. The Accounting Rules require certain larger firms to disclose substantial RPTs with their controlling shareholders in the notes of their non-consolidated financial statements (Company Accounting Rules 98(1)(xv), 112(1)). In reality, however, the disclosure of RPTs is often implemented inadequately, such as by not including contract terms.[108]

Company Code Enforcement Rules

The rules related to RPTs were substantially strengthened in 2014. According to the revised Company Code Enforcement Rules (Art. 118(v)), matters to be disclosed in the business report include the following: directors' opinion as to whether the RPTs involved adversely affect the interest of the controlled firm; and the opinion of outside directors if it contradicts the board's judgment. The Enforcement Rules (Art. 129(1)(vi)) further require the statutory auditors (and other equivalent organs) to audit the business report, and to state their opinion on the RPTs with its controlling

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105 The Guideline allows the firm to get a comprehensive approval for multiple routine RPTs on an annual basis.

106 Wai Yee Wan et al, Managing the Risks of Corporate Fraud: the Evidence from Hong Kong And Singapore (working paper 2017) at ("almost half (45.2%) of the fraud cases in the sample involve either misappropriation of assets or problematic RPTs which were not disclosed to the boards and/or shareholders nor properly approved by the boards and/or shareholders").

107 Id. at 7 ("a significant proportion of fraud firms in each of Hong Kong and Singapore are overseas mainland Chinese enterprises").

108 Masao Yanaga, Related party transactions and procedural safeguards, in A Path of Enterprise Law (Festschrift for commemorating Professor Kenjiro Egashira's seventieth birthday) 319-323 (2017) (in Japanese).

shareholders in the audit report.

Exchange Rules

As is the case in China, stock exchanges, and particularly the Tokyo Stock Exchange (TSE), play an increasingly conspicuous role in regulating RPTs. The TSE has recently enacted a set of detailed rules on RPTs with controlling shareholders.[109] First, a listed firm with a controlling shareholder is required to adopt its own special guideline on RPTs: "the guideline on measures to protect minority shareholders in conducting transactions with controlling shareholders" (RPT Guideline)(Listing Rules Art. 204(12)(i), Implementation Rules Art. 211(4)(1)). Second, the board of directors is required to obtain an opinion from an independent third party before reaching its decision on a material RPT (Listing Rules Art. 441-2(1)). Third, the firm is required to make the necessary and sufficient disclosure for a material RPT (Listing Rules Art. 441-2(2)). Fourth, the firm is required to disclose its compliance with the RPT Guideline, as well as the measures it has taken to ensure fairness and to avoid a conflict of interest (Listing Rules Art. 411(1), Implementation Rules Art. 412(6)).

Actual RPT guidelines announced by listed firms often adopt an arm's length test as the standard to be applied to an RPT.[110] They also provide for procedures to be adopted. In some cases, they require an opinion of an outside director or outside expert independent from the parent company. The approval of a majority of minority shareholders (MOM), however, is rarely, if ever, required in reality. In addition, although RPTs are disclosed, detailed information on their terms is generally not disclosed.[111] Thus, even the enhanced disclosure under the Listing Rules falls short of equipping a potential plaintiff shareholder with adequate information.

The task of controlling RPTs is largely assigned to internal corporate organs such as directors and statutory auditors. In that sense, one can say that the primary purpose of the TSE rules is not so much to provide investors with detailed information on RPTs but rather to ensure the fairness of the terms.

2. Korea

KCC and the Capital Market Act

As mentioned earlier, the KCC requires material RPTs to be approved by the board of directors and to be reported to the GMS (Art. 542-9(3), (4), Enforcement Decree Art. 35(8)). A more detailed disclosure rule exists in the Capital Market Act[112], which

[109] Kato, supra note 35, at 230.

[110] Ibid.

[111] Yanaga, supra note 108, at 320.

[112] Its full title is "the Act regarding Financial Investment and Capital Market."

requires the annual report to include “contents of transactions with large shareholders or directors and employees” (Enforcement Decree Art. 168(3)(vi)). This rule, however, is not particularly effective in reality. Disclosure under this rule is to be made only when the annual report is prepared. Moreover, details of RPTs which should form the basis of the fairness decision are often not fully disclosed. These defects may in theory be remedied by the rules of the stock exchange. The Korea Exchange, the country’s only stock exchange, however, has no specific rules on RPTs.

Fair Trade Act

What is expected to fill this regulatory vacuum is the FTA, which requires firms belonging to large business groups to disclose large RPTs following the board decision (Art. 11-2(1)). As such, disclosure is to be made within one day of the board decision (FTC Rules on Board Decision and Disclosure of Large RPTs Art. 6(1)), so this can be a source of timely information. The FTC Rules do require the terms of the RPT to be disclosed, but the level of required disclosure is not specified (FTC Rules Art. 6(1)). In practice, disclosure is often neglected[113] or when it is made, the scope of disclosed information is generally quite limited.

3. China

Administrative regulations

For the disclosure of RPTs of a listed firm, China has a set of detailed rules. First of all, the Code of Corporate Governance for Listed Companies proclaimed by the CSRC and National Economic and Trade Commission in 2002 encompasses basic provisions on consultation in writing and disclosure (Arts. 12 to 14). More concrete rules are scattered across several regulations issued by the CSRC. For example, the Rules on Implementing Disclosure at Listed Firms contain a set of rules on the disclosure of RPTs for the secondary market (Arts. 48, 59, 63 and 71(3)).[114]

In practice, however, RPT-related disclosure is often inadequate or delayed.[115] The CSRC, from time to time, imposes sanctions for violation of disclosure rules.[116] The extent of sanctions seems relatively mild, especially when imposed on controlling shareholders and managers involved.[117]

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[113] The sanction for non-compliance is only an administrative fine (FTC Rules Art. 11).

[114] Disclosure rules applicable to RPTs relating to the primary market are contained in the Administrative Rules on the Issuance of Securities by Listed Companies (Arts. 44 and 53).

[115] Bin Wang et al, supra note 62, at 32.

[116] Sanctions are imposed in accordance with the Securities Act Arts. 192, 193 and 223. As of 2014, out of 24 cases of the CSRC’s disclosure-related administrative sanctions, seven cases relate to RPTs. Ibid.

[117] Id. at 34. Since 2015, the CSRC is imposing higher civil penalties for violation of RPT disclosure rules.

Stock exchange rules and the RPT Guideline

More comprehensive disclosure rules on RPTs, however, are found in the listing rules of stock exchanges. The RPT Guideline, mentioned earlier, includes detailed rules on disclosure of RPTs. It divides RPTs into three groups and deals with each type differently. For example, in the case of an RPT with a related natural person, a timely disclosure is required if the amount involved reaches or exceeds RMB 300,000 (Art. 18). In the case of an RPT with a related firm, disclosure is required only when it reaches or exceeds RMB 3 million and accounts for 0.5 percent or more of the net assets (Art. 19). For an RPT which satisfies the size requirement of RMB 30 million and 5 percent of the net assets, the listed firm must also provide an audit and appraisal report prepared by a securities firm, and shall acquire GMS approval (Art. 20). These requirements do not apply to routine RPTs, however. Instead, the RPT Guideline prescribes the firm to disclose certain matters including pricing policy regarding RPTs and the reasons behind conducting RPTs (Art. 38).

Sanctions for violating RPT-related disclosure rules appear lenient, however. According to an unofficial hand count, only eleven cases of sanctions for such a violation were reported by the Shanghai Stock Exchange during the period between 2016 and February 2018.[118] The harshest sanction imposed by the Exchange was public censure, and this was imposed only once in that period.

IV. General observations

It is admittedly an ambitious task to discuss in one chapter the law and realities of RPTs in these three jurisdictions. Given the paucity of available data, it may be premature to embark on a comparative analysis of the three different RPT systems. Nevertheless, dispensing altogether with a comparative analysis would render this chapter insipid. We will thus attempt a comparative analysis of sorts, focusing on three aspects of RPT regulation, albeit in a highly subjective and cursory manner.

A. Evolution of RPT regulations

Hypothetical framework

The three jurisdictions all have a basic self-dealing provision in their corporate statutes. Primarily aimed at directors and officers, the self-dealing provision falls short of dealing with intra-group RPTs properly. In all three countries, various reform measures have been taken to improve control of RPTs. The initiation of such reform is presumed to depend on the balance between two conflicting forces: the pressure for reform on the one hand, and the powerful resistance from the business

118 (http://www.sse.com.cn/disclosure/credibility/supervision/measures/) (visited on Feb. 8, 2017).

community on the other.

The driving force behind reform may comprise various factors, two of which will be addressed here: (1) prevalence of tunneling; and (2) pressure from the capital market. It is indisputable that the prevalence of tunneling will intensify pressure for reform. The role of the capital market here may need some explanation, however. Widespread intra-group RPTs with the potential for tunneling do not fit well with a vibrant capital market. Foreign investors, in particular, will view RPTs with suspicion.

A countervailing force against reform may vary depending on: (1) the power of controlling shareholders as a whole; and (2) the importance of intra-group RPTs as a way of organizing business activity.[119]

Japan

In view of the hypothetical framework described above, the recent reforms of RPT regulation in Japan are puzzling to explain. Regarding the pressure for reform, RPTs were not so widespread nor was tunneling regarded as a serious issue in Japan, in contrast to Korea and China. On the other hand, the resistance does not appear to be strong either. As mentioned earlier, most of the controlling shareholders are publicly held firms, who presumably have less incentive to engage in tunneling in comparison with individual controllers. Moreover, intra-group, routine RPTs are less significant in the Japanese industrial organization than in Korea and China. An additional relevant factor is pressure from the capital market. Since the late 1990s, foreign investors have been steadily expanding their holdings to such a level that, as of 2016, 30 percent or more of the shares in 42.8 percent of the firms composing the JPX-NIKKEI 400 were owned by foreign investors.[120] In recent years, Japan has been under pressure from foreign investors to improve its corporate governance.[121] Nevertheless, faced with opposition from the business community in the process of the 2014 revision of the JCC, Japan decided not to adopt a mandatory outside director requirement.[122] Viewed cynically, it was presumably easier for the business community to accept RPT reform focusing on disclosure rather than a mandatory outside director requirement.

Korea

Korea's current RPT regulatory regime may be regarded as a product of compromise between a loosely knit group of reformers and the business community

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[119] This will again depends on the feasibility of market transactions.

[120] Tokyo Stock Exchange, supra note 33, at 6.

[121] Gen Goto et al, Japan's Gradual Reception of Independent Directors, in in Dan W. Puchniak et al, Independent Directors in Asia: A Historical, Contextual and Comparative Approach (2017 Cambridge University Press) 135, 147-150.

[122] Id. at 160-171.

dominated by *chaebols*. A public outcry over rampant tunneling was a factor driving reform measures on intra-group RPTs. On the other hand, as many *chaebol* firms were heavily dependent on intra-group RPTs, they made strenuous efforts to tone down reforms. As a consequence, Korea has ended up with a set of seemingly rigorous rules, which are porous in reality. Unsurprisingly, scandals involving abusive RPTs continue to emerge.

Increasingly concerned about dwindling market opportunities for smaller firms, the general public is putting pressure on the newly installed reformist government to implement further reform. The road to successful reform, however, is not without obstacles. As long as an alternative way of industrial organization (such as Japanese-style long-term trading relationships or pure market exchange) remains unacceptable to *chaebol* firms, even the reformist government may hesitate to further strengthen restrictions (entailing costs and uncertainty) on routine intra-group RPTs.

China

From an early stage, the Chinese government was mindful of the risk of tunneling accompanied with RPTs. On the other hand, there has been little resistance from controlling shareholders. Many large listed firms are SOEs and those who run them on a daily basis are bureaucrat-managers who commonly rotate between their positions in the Chinese government (including the Chinese Communist Party) and the SOE. As their terms of office are limited, they have less incentive to resist reform measures initiated by the Government. Although the controlling shareholders of POEs are private individuals by definition, they may not be nearly as influential as their counterparts in countries like Korea when it comes to opposing a government.

From the perspective of industrial organization, intra-group RPTs are becoming less important as it is now increasingly possible for firms to trade with external firms on the market.

Summary

Table 4 below encapsulates the relative importance of various factors at work in each of the three jurisdictions.

Table 4: Pressure for reform and strength of resistance in the three countries

	Japan	Korea	China
Prevalence of RPTs	weak	strong	moderate
Capital market pressure	strong	moderate	weak
Power of controlling SHs	weak	strong	weak
Importance of RPTs	weak	strong	moderate

B. Features of the regulation of RPTs

Japan

As discussed above, substantial differences exist in RPT regulations between the three countries. For Japan, RPTs have been much less prevalent compared to the other two jurisdictions. Significant RPTs are mostly those between parents and subsidiaries, i.e. vertical RPTs. Having started to pay more attention to RPTs only recently, Japan has chosen to focus on strengthening procedural and disclosure requirements. As substantive constraints remain largely unchanged, courts are not likely to play a significant role. This may have been due to the persistent concern on the part of Japanese policy makers (as well as the business community) about proliferating shareholder lawsuits. Instead, the reformers chose to rely more on outside directors, statutory auditors and third-party experts in ensuring the fairness of an RPT. The majority of minority (MOM) approach, which is gaining support from policymakers as well as scholars in many jurisdictions, has not yet been seriously considered.

As for enforcement, Japan relies heavily on the stock exchanges in actually regulating RPTs. This is in line with an approach taken by the UK, Hong Kong and, more relevantly, China.

Korea

Of the three jurisdictions, it is probably in Korea that RPTs are most common and where RPTs attract most attention from the policy makers and the public. As far as statutory law is concerned, Korean regulation may appear to be the strictest. In addition to the fairly broad RPT provisions under the KCC, there are further provisions in the FTA as well. These rules, however, have largely failed to eradicate abusive RPTs in Korea’s economy due to the shortcomings in enforcement mentioned earlier. This regulatory gap is being filled by criminal prosecution. Prosecutors often bring criminal charges against *chaebol* chairmen involved in egregious RPTs, asserting a breach of trust under criminal statutes. The criminal sanction approach may bring immediate results, but it should not be heavily depended upon because it has many limitations.

In theory, a more active role could be expected of the Korea Exchange, which is equipped with the necessary expertise and resources. The Korea Exchange, however, has failed entirely to respond to such expectations, unlike its counterparts in China and Japan. The Korea Exchange’s inaction is presumably due to its relatively subordinate political status when it comes to dealing with big business.

China

The Chinese government brought in RPT regulations to prevent bureaucrat-managers stealing from SOEs. The basic approaches taken by China are similar to those in Japan. China tends to focus on procedure and disclosure. This may be partly attributable to the fact that courts still play a relatively passive role in China. Like Japan, China has also chosen to rely more on stock exchanges than on courts. Some differences exist, however. In China, the CSRC, the capital market regulator, is actively involved in matters of general corporate governance.[123]

Overall evaluation

Table 5 below summarizes our initial evaluation of the three features of RPT regulation in each jurisdiction according to law in action as well as in the books.

Table 5: Evaluation of the three features of RPT regulation

	Japan	Korea	China
substance	moderate	moderate	weak
procedure	strong	moderate	moderate
disclosure	moderate	weak	moderate

Table 5 is largely consistent with the evaluation prepared by the World Bank in its Doing Business Report (DBR) of 2018.[124] The DBR evaluates the quality of the RPT regulation of 190 countries, employing the so-called "extent of conflict of interest regulation index", which is in essence equivalent to the "RPT Index."[125] The RPT Index is composed of three categories: (1) disclosure; (2) director liability; and (3) shareholder lawsuits.[126] Although similar in substance, these categories do not exactly correspond to those adopted in this chapter. (1) is meant to cover "procedure" as well, and (2) and (3) together are functionally the same as "substantive constraints."

Table 6 below presents the RPT Index scores for the three jurisdictions. China's scores should be given particular attention, as it scores very low on substantive constraints, and director liability in particular. This is in line with the evaluation shown in Table 5. On the other hand, China scores 10, the highest possible score, for disclosure. Although China admittedly applies a set of strict procedural and disclosure rules to listed firms, this score appears too high especially when compared with the corresponding score for Japan.

[123] For a view in favor of the proactive role of the CSRC, see, e.g., Howson, supra note 65.

[124] The World Bank report is available at http://www.doingbusiness.org/%7E/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB2018-Full-Report.pdf.

[125] Dan W. Puchniak and Umakanth Varottil, Related Party Transactions in Commonwealth Asia: Complexity Revealed, in this book, at ??.

[126] DBR 91-94.

Table 6: RPT Index scores in the DBR

DBR 2018	This chapter	Japan	Korea	China
Director liability	Substantive constraints	6	6	1
Ease of shareholder suits		8	8	4
Disclosure	Procedure	7	7	10
	Disclosure			
RPT Index score		7	7	5

C. Potential consequences of strengthening RPT regulations

If RPTs are more tightly regulated, it will become more costly for business groups to continue to engage in intra-group RPTs. Business groups would then have to change their mode of business activity. This is not a serious issue in Japan as firms rely primarily on long-term trading relationships on the market. In China, firms have already started expanding their market transactions. The challenge will likely be most daunting for Korean *chaebols*. In principle, they will be left with four options. The first option is to deal more with outside firms on the market. Firms already depend increasingly on external firms, called “cooperative firms”. If they cannot find appropriate firms on the market, they may choose to turn their affiliate trading partners into wholly-owned subsidiaries to eliminate any room for dispute. This is their second option. It will require an enormous amount of funds, however. They will then likely be forced to sell some member firms to secure funds for maintaining control over their core firms, ending up with a less sprawling business empire. The third option is not an easy one either: instead of giving up some of their non-core firms, they may let the holding company (in a statutory or functional sense) issue new shares or bonds or secure bank loans to secure funds for turning the member firms into wholly-owned subsidiaries. This option will inevitably lead to a weakening of control on the part of controlling families. None of these three options would be easy to swallow from their perspective. Accordingly, they may opt for the fourth option, which is to block or dilute any attempts at reform.

If any of the first three options are pursued, any room for tunneling will largely evaporate. This would further decrease the incentive of controlling shareholders to keep control of their business empires within the family, especially when they are not sure about their superior business acumen. Will they eventually part with control as their counterparts did in the past in the USA or the UK? This will be one of the most fascinating developments for corporate governance scholars to monitor.

Table 7 below outlines the potential impact of further RPT reforms on business firms in each jurisdiction.

Table 7: Potential impact of further RPT reforms on business firms

	Japan	Korea	China
Potential impact	weak	strong	moderate

V. Concluding remarks

The incidence of RPTs may be affected by the existing share ownership structure and industrial organization. Indeed, it will be difficult to strengthen regulations on RPTs as long as this economic environment remains unchanged. Reining in RPTs alone may lead to counter-productive results. Current as well as past attempts to revamp RPT regulations in most jurisdictions aim or have aimed to minimize tunneling without impeding legitimate transactions.

As we have seen, considerable differences exist in RPT regulation between the three East Asian countries under review. Such disparity is attributable to differences in the salience of RPTs, in the economic and political environment, and in the institutional infrastructure of each jurisdiction. Another relevant factor may be the extent of each country’s need to develop capital markets. A country’s need to promote its capital market may vary depending, partly at least, on the type of its principal industries. The three countries all started their economic development with relatively low-tech, and thus low-risk, manufacturing industries. They could all safely depend heavily on bank loans for business capital. The three countries, and certainly their leading firms, have been moving into higher-tech and higher-risk industries, requiring risk capital in the capital market. It will still take more time, however, to clarify whether the financing behavior of leading firms can be changed and the impact such change would have on the extent to which each country relies on RPTs.

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