Related Party Transactions

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I wish to thank András Hanák, Merritt Fox, Zohar Goshen, Michael Klausner, Georg Ringe, Chuck Whitehead, and especially Amir Licht and Alessio Pacces, for their comments on earlier drafts. Kritika Agarwal, Saurav Bhaumik, Fianna Jurdant and Nadia Zainuddin gave me useful information on Asian reforms focusing on related party transactions. Vasile Rotaru provided excellent research assistance. Usual disclaimers apply.

Abstract

This paper will be included as a chapter in the second edition of The Oxford Handbook of Corporate Law and Governance, edited by Jeffrey Gordon and Wolf-Georg Ringe (Oxford University Press: forthcoming) and is thus an updated version of the chapter appeared in its first edition (a version of which, under the title Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal), was published in 16 European Business Organization Law Review 1 (2015) and is available in working paper form at https://ssrn.com/abstract=2505188). The chapter provides a legal and policy analysis of transactions between a corporation and one of its "related parties." It first highlights the reasons why related party transactions ("RPTs") are so common around the world. Next, it better identifies the phenomenon as a specific form of potentially abusive behavior by dominant shareholders and managers, i.e. as an instrument for tunneling, asking why many jurisdictions provide for specific regulations on RPTs in addition to general rules or standards on tunneling. Then, it describes the main legal tools available to prevent corporate agents from diverting value from the corporation via RPTs. Finally, it shows that no regulation of RPTs (or tunneling) can succeed in preventing minority shareholder expropriation in the absence of sophisticated enforcement actors (specialized courts and/or active and committed securities regulators) and non-legal supporting institutions, like independent financial media and anti-tunneling social norms.

Keywords: Corporate Governance, Dominant Shareholders, Corporate Groups, Private Benefits of Control, Tunneling, Related Party Transactions, Self-Dealing, Conflict of Interests, MOM Approval, Independent Directors, Mandatory Disclosure, IAS 24, Fairness Opinions

JEL Classifications: D23, G32, G34, K22

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RELATED PARTY TRANSACTIONS

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July 2024

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1 INTRODUCTION

THIS chapter covers transactions between a corporation[2] and a "related party," a term of art that usually comprises counterparties who, thanks to their influence over corporate decision makers, may secure better terms for themselves than they would following arm's-length bargaining.

First of all, it highlights the reasons why related party transactions ("RPTs") are so common around the world (section 2). Next, it better identifies the phenomenon as a specific class of potentially value-diverting behavior by dominant shareholders and managers, i.e., as an instrument for tunneling[3] (section 3). Then, it describes the legal tools that policy makers and legal scholars commonly or increasingly consider as useful to tackle tunneling via RPTs:[4] prohibitions, procedural safeguards, mandatory disclosure, external independent advice, and ex post standard-based judicial review (section 4). Because of the focus on RPTs, this section does not include non-transaction-based, structural measures to prevent tunneling and dominant shareholders' abuse, like limits on deviations from one-share-one-vote,[5] board

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[2] Throughout this chapter, "companies" and "corporations" refer to listed companies unless it is otherwise clear from context.

[3] *See* Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000) (defining "tunneling" as "the transfer of resources out of a company to its controlling shareholder"). The term tunneling is used, as here, to refer both to dominant shareholders and managers extraction of wealth by Vladimir A. Atanasov, Bernard S. Black & Conrad S. Ciccotello, *Unbundling and Measuring Tunneling*, 2014 U. ILL. L. REV. 101, 101.

[4] Although the main focus throughout the chapter is on RPTs, mention will also be made, when relevant to our purposes, to rules with a broader or narrower scope than those on RPTs strictly defined.

[5] Most notably, that is the route taken by Israel in the last twenty years, which has culminated in a ban on pyramids. *See, e.g.*, Federico Cenzi Venezze, *The Costs of Control-Enhancing Mechanisms: How Regulatory Dualism Can Create Value in the Privatization of State-Owned Firms in Europe*, 15 EUR. BUS. ORG. L. REV. 499, 513–14 (2014). For empirical evidence that in Korea a higher degree of separation between ownership and control correlates with greater RPTs activity *see* Minjung Kang, Ho-Young Lee, Myung-Gun Lee & Jong Chool

composition requirements, or measures affecting the company's ownership (including the mandatory bid rule or oppression remedies); such tools' operation is not, whether by design or necessarily, dependent on abuse involving RPTs.

Finally, this chapter concludes that no regulation of RPTs (or tunneling) can succeed in preventing (minority) shareholder expropriation in the absence of sophisticated enforcement actors, i.e., experienced courts and/or active, committed securities regulators, operating in a social context that rejects tunneling as a business practice (section 5).

2 WELCOME TO TUNNELLAND

You are the founder and sole owner of a flourishing incorporated firm in Tunnelland, a notoriously business-unfriendly country: its punitive and inefficient tax system imposes unbearable tax rates, but leaves tax collection in the hands of unsophisticated, or selectively sophisticated (corrupt), tax officials.[6] Its politicians are strongly inclined to grabbing value from businesses by seizing corporate assets or allocating them to third parties, whether via legitimate enforcement of existing business-unfriendly laws or by exercising "raw power."[7] In addition, Tunnelland's courts are slow, unpredictable, and corrupt. Finally, its bankruptcy law is pro-creditors and liquidation-oriented and its banking system prone to liquidity crises: in the event of a credit crunch, firms face the risk of a value-destroying bankruptcy procedure due to illiquidity problems that are beyond firm owners' control.

Park, *The Association between Related-Party Transactions and Control-Ownership Wedge: Evidence from Korea*, 29 PACIFIC-BASIN FIN. J. 272 (2014).

[6] One may think of 1990s Russia as vividly described by Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731, 1758–59 (2000).

[7] *See* Curtis Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145, 1153 (1998).

If you are successful, you will soon experience how difficult it is, given the weakness of the institutional framework, to have satisfactory long-term, complex contractual relationships with business partners. You will then find it convenient to expand into adjacent industries, such as the production of materials or the supply of services you need for your initial business[8]: by governing these supply relationships by fiat within your firm, you will reduce their transactions costs.

In such a setting, a constant worry of yours will be how to minimize the risks of both government expropriation and value destruction due to creditor rights enforcement. How much wealth should you leave within your corporation? The easy answer is: as little as is strictly sufficient to keep the firm viable. How will you transfer wealth that is not strictly necessary for the corporation's viability into safer pockets? Again, there is an easy answer: in the way that makes it hardest for creditors, including the state as tax collector, and enforcement agents (public prosecutors, securities regulators, and courts) to detect and prove that you have transferred value out of the firm for nothing, which means, mainly, via transactions with yourself and/or entities you control. You will have made sure that there are plenty of these entities: in fact, your legal and tax advisors will have easily persuaded you to grant formal ownership rights over as many of the company's assets as possible to "third" parties connected to yourself, such as wholly owned companies, possibly even better if operating from a foreign jurisdiction. By doing so, you will have reduced the risk that those assets end up in the hands of tax authorities and/or creditors if things go wrong.

Your advisors will have more generally recommended that you structure your whole business as a web of connected, but formally separate, entities, each involved in a different

[8] *See, e.g.*, Randall Morck, *Finance and Governance in Developing Economies*, 3 ANN. REV. FIN. ECON. 375 (2011) (describing LG's expansion from the original cosmetic cream business to very loosely related businesses like plastics, insurance, and oil refinery).

production phase, typically with a holding company in charge of financing operations, one or more core firms in charge of production, and other satellite companies in charge of supplying the core firm(s) with components and other goods or services, like real estate or distribution. Once such a corporate group is in place,[9] RPTs will become routine and, correspondingly, it will be harder to find them suspicious, especially if businesses structured as corporate groups are a common organizational form within the economy. If RPT terms are such that the operating corporation receives less than it gives away, you can routinely transfer wealth from its coffers to your (affiliates') pockets.

Unfortunately, there are still countries around the world displaying at least some of the business-unfriendly features of Tunnelland.[10] In such countries, tunneling via RPTs is, in a way, a physiological, and possibly even social welfare enhancing, reaction to badly functioning institutions. It may be the case that, in their absence, the cost of running a business would be even higher for entrepreneurs, fewer firms would exist and those countries would be even less prosperous.[11]

An even higher number of countries have proved as business-unfriendly as Tunnelland until fairly recently.[12] There, tunneling via RPTs, or possibly RPTs without tunneling, may still be common because of path dependence, i.e., because in the past the institutional environment made it convenient for businesspeople to adopt business structures

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[9] *See* Klaus J. Hopt, *Groups of Companies*, chapter 23 in this volume.

[10] One may think of Russia or Venezuela.

[11] Yet, it goes without saying that one cannot expect capital markets to develop so long as "defensive" tunneling is pervasive. *See infra* notes 13 and 23–27 and accompanying text.

[12] One may think of Italy or South Korea.

or practices that may now be costly (for tax reasons or for the rents the dominant shareholders still extract through them) to, respectively, disentangle and abandon.[13]

Of course, the point here is not to justify business practices that are almost universally viewed as harmful to investors and financial markets. Rather, as anticipated, it is to illustrate why RPTs are so common in many countries around the globe. The fictitious example of Tunnelland also shows what the minimal quality of property rights institutions must be in any given system for RPTs to be rather a key issue for reform-minded policy makers aiming to boost domestic capital markets than a "second-worst" solution to a dysfunctional institutional environment. Finally, the Tunnellander corporate governance dystopia highlights how, in bad institutional environments, RPTs may be frequent also in closely held corporations with no distinction between controlling and non-controlling shareholders.[14] Once corporations plan for a listing and try to raise outside capital, the controlling shareholders' private costs (including the tax implications) of disentangling complex organizational structures and the related web of RPTs may be higher than the increase in the IPO price they may secure by doing so. That is especially the case if credibly committing not to engage in tunneling is costly or even impossible, for example because the legal regime is too lax and/or its enforcement institutions too weak for the them to serve as credible commitment devices.

Eventually, in countries with better functioning institutions, RPTs are not just the remnants of darker ages. Whenever an agency relationship exists, as is the case between shareholders as a class and creditors, between controlling and minority shareholders, and between managers and shareholders in dispersed ownership companies, the party with de

[13] *See* generally Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 55 STAN. L. REV. 127 (1999).

[14] To be sure, that may also be true in jurisdictions with a good institutional environment, if there are tax advantages to organizing the firm as an integrated group of companies.

facto residual rights of control over corporate assets, i.e., the agents, will appropriate as much value as they can expect to get away with, after factoring in the probability of detection and punishment,[15] on the one hand, and, on the other, any negative feelings they might anticipate for breaking rules or social norms, if any such rules and norms exist. RPTs are, again, an effective technology to appropriate value, because of the same attractive features highlighted above: first, they are easier to disguise as legitimate business transactions; second, thus disguised, they are not taxed as corporate distributions.[16]

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[15] Scholars tend to associate RPT-based tunneling more with dominant shareholders than with managers, who are said to appropriate private benefits via excessive compensation (*see* Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1304–05 (2009)). However, there is no reason why, other things being equal, managers should prefer excessive compensation to RPTs as a tunneling technique. As a matter of fact, in jurisdictions where tunneling is widespread and unchecked for by legal and non-legal institutions, not only do manager-controlled companies often enter into RPTs (*See, e.g.*, Merritt B. Fox & Michael A. Heller, *What Is Good Corporate Governance?*, *in* CORPORATE GOVERNANCE LESSONS FROM TRANSITION ECONOMY REFORMS 3, 18 (Merritt B. Fox & Michael Heller eds., 2006)), but it is also the case that such companies soon become shareholder-controlled, whether because managers themselves succeed in securing a controlling ownership stake (usually via "equity tunneling:" *see* Atanasov et al., *supra* note 2, at 110–111) or because someone else acquires control in their stead. Control is simply too valuable to remain "up for grabs" for long. *See* Lucian A. Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (National Bureau of Economic Research Working Paper No. w7203, 1999), http://www.nber.org/papers/w7203. Hence, even in such jurisdictions we observe no managerial tunneling in equilibrium: dominant shareholders themselves will keep managers on a tight leash. It is where institutions effectively address tunneling that one can observe dispersed ownership in equilibrium and, possibly, excessive managerial compensation. This form of tunneling is more common than others in such an environment, because it is hard to detect: executive pay is inevitable and determining what is reasonable compensation highly subjective.

[16] Of course, the same is usually true of excessive compensation. See supra note 15. Hwang and Kim report that in Korea RPTs are also used to transfer wealth to heirs so as to avoid estate and gift taxes. *See* Sunwoo Hwang

At the same time, RPTs exist that in fact create value for all parties involved.[17] That may more easily be the case in closely held companies incurring higher transaction costs when dealing with unconnected market participants, due to higher information costs on both sides.[18] But listed companies may enter into entirely fair RPTs as well.

For instance, a company's labs may start developing a new product, but the finance department may later find that it is impossible to bring it to market, e.g. due to financial constraints and the need to concentrate R&D investment in other, more promising areas. The dominant shareholder may be in the best position to buy the project from the company and have a wholly owned company work on it. Selling to a third party may be worse as an alternative, if the project is better developed with the dominant shareholder's unique entrepreneurial input and/or if it is hard for any third party to understand the project's chances of success: any offer from such third party will discount the higher perceived risk of failure. If the dominant shareholder buys the project for no less than its value to the company, then the transaction is both fair and efficient.

& Woochan Kim, *When Heirs Become Major Shareholders. Evidence on Pyramiding Financed by Related-Party Sales*, 41 J. CORP. FIN. 23 (2016).

[17] RPTs may even be entered into at favorable terms for the corporation and correspondingly unfavorable ones for the related party, whenever the latter has an interest in supporting the former (so-called propping), if only to keep extracting private benefits of control from it in the future. *See, e.g.*, Curtis J. Milhaupt & Mariana Pargendler, *Related Party Transactions in State-Owned Enterprises, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 245, 248 (Luca Enriques & Tobias Tröger eds., 2019). (Of course, if the related party in the propping transaction is itself a controlled entity with minority shareholders, the cost of propping up the other subsidiary are borne, in part, by those shareholders in what may well be just another instance of tunnelling.)

[18] *See, e.g.*, Luca Enriques et al., *Related Party Transactions, in* THE ANATOMY OF CORPORATE LAW 145, 146 (Reinier Kraakman et al. eds., 3d ed. 2017). Savings in transaction costs may be such that a below-market rate or price for a given RPT may be justified (i.e., involve no harm to the corporation). *See, e.g.*, DAVID KERSHAW, COMPANY LAW IN CONTEXT 478 (2d ed. 2012).

This stylized example also shows how difficult it will be for third parties, be they minority shareholders, financial analysts, the company's auditor, enforcement agents, or the public at large, to understand whether a RPT is in the best interests of the company: to do so, they would not only need to gauge what the right value of the project to the company would be if it realized it internally, but also assess whether it would be possible to find a third party willing to offer a price higher than the sum of (1) the price offered by the controlling shareholder and (2) the transaction costs that finding another buyer and negotiating with them would involve.

More debatable is whether even RPTs harmful to the company and/or its minority shareholders, and tunneling more broadly, may be efficiency-justified as the quid pro quo for the "public" (or shared) benefits minority shareholders enjoy as a consequence of the monitoring/entrepreneurial effort undertaken by dominant shareholders.[19] Note that there is no reason why minority shareholders themselves should a priori dislike a system thus designed. Provided ways are found for the dominant shareholder to pre-commit to a given level of private benefits extraction,[20] minority shareholders may in fact understand the virtues

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[19] For this proposition *see* María Gutiérrez Urtiaga & Maria I. Sáez Lacave, *A Carrot and Stick Approach to Discipline Self-Dealing by Controlling Shareholders* 7 (ECGI—Law Working Paper No. 138, 2010), http://ssrn.com/abstract=1549403; Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, 169 J. INST. & THEORETICAL ECON. 160, 162 (2013). Both models crucially rely on the verifiability of tunneling levels whether by markets via disclosure (Gutiérrez Urtiaga and Sáez Lacave) or courts (Gilson and Schwartz). *See also* Jens Dammann, *Corporate Ostracism: Freezing Out Controlling Shareholders*, 33 J. CORP. L. 681, 705–25 (2008) (a system allowing for unfair related party transactions coupled with a structural ex post remedy may be more efficient for some companies than a transaction-based approach to tunneling control). But *see contra* ALESSIO M. PACCES, RETHINKING CORPORATE GOVERNANCE 96–97, 151–52 (2012) ("[s]tealing is always inefficient ex ante.").

[20] That may well be the crux of the matter. *Cf.* ANTHONY TROLLOPE, THE WAY WE LIVE NOW Ch. CXVI (1875) ("'What we ought to do . . . is to get some fellow like Vossner, and make him tell us how much he wants to steal

of a regime that maximizes the sum of their (direct and indirect) losses from private benefits of control and of their gains from public benefits of control. In other words, they may be ready to tolerate private benefits extraction, so long as the contribution to the company's value by the dominant shareholder compensates for that.

The main problem with this idea is that, again, private benefits extraction is hard to verify by a third party like a court or even an arbitrator. Even a comprehensive system of mandatory disclosure may be insufficient for the purpose: no disclosure regime can be expected to succeed in forcing dominant shareholders to confess how much they are stealing from their controlled company.[21]

No legal regime explicitly subscribes to the "quid pro quo" view of private benefits extraction.[22] But laxity in regulation and enforcement of anti-tunneling provisions has traditionally been common around the world.[23] That is tantamount to an implicit legalization of pecuniary private benefits extraction.[24] It also provides a strong incentive for parties to devise contractual or, better, non-legal (and especially reputation-based) constraints on tunneling. A credible device to commit to moderate tunneling is family ownership itself: so

above his regular pay. Then we could subscribe that among us. I really think that might be done.' . . . But Mr. Lupton was of opinion that the new Vossner might perhaps not know, when thus consulted, the extent of his own cupidity.").

[21] *Cf.* Alessio M. Pacces, *Controlling the Corporate Controller's Misbehaviour*, 11 J. CORP. L. STUD. 177, 193 (2011) (highlighting the unattainable conditions for ex post mandatory disclosure to work effectively in this area).

[22] What comes closest to that are rules allowing for individual unfair transactions to go through in the context of corporate groups. *See infra* note 107 and accompanying text.

[23] *See, e.g.*, Sang Y. Kang, *'Generous Thieves': The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions*, 21 STAN. J.L. BUS. & FIN. 57, 85–95 (2015).

[24] *See* Gutiérrez Urtiaga & Sáez Lacave, *supra* note 19, at 14; Gilson & Schwartz, *supra* note 19, at 162.

long as the dominant family member has descendants who may be at the company's helm some day, the dominant family member can be expected to stop short of subtracting so much value as to make the company no longer profitable in the long run.[25]

Finally, tunneling not only raises distributional concerns in the relationship between insiders (managers or controlling shareholders) and (minority) shareholders,[26] but has an intuitively negative effect on capital markets as a whole and their dynamic efficiency. First, pervasive tunneling may have chilling effects on the IPO market: if a prospective listed company is unable to signal its controllers' intention not to engage in tunneling and/or to credibly commit to higher standards, it may desert the IPO market, leaving it to tunneling-prone issuers.[27] Second, a high level of tunneling (actually, of private benefits of control more generally) may lead to distortions in the market for corporate control (the highest-value user may be unable to buy control from the incumbent controlling shareholder, if the former is unable to extract private benefits as high as the latter)[28] and in ownership structures more generally (no one will relinquish control to the market if the private benefits of control one

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[25] *See* Kang, *supra* note 23.

[26] The ability of relatively efficient markets to discount tunneling risk makes distributional concerns less troublesome anyway: a company's share price should reflect information about known (uncompensated for) past tunneling and expectations about (uncompensated for) tunneling yet to come (or to detect). Thus, shareholders buy shares at a price that discounts the predictable harm resulting from tunneling. They may miscalculate the amount of undetected and future tunneling, but that is no different from miscalculating future earnings. Incidentally, the tunneling discount makes tunneling more socially acceptable even when detected: minority shareholders deserve no particular sympathy if the price they paid compensated them ex ante for taking that risk. But see immediately *infra* notes 27–30 and accompanying text for the various inefficiencies arising from tunneling.

[27] *See, e.g.*, Fox & Heller, *supra* note 15, at 19.

[28] *See, e.g.*, Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957 (1994).

can extract are high).[29] Finally, tunneling may well lead to distortion in managerial and strategic choices within individual companies, as controlling shareholders will choose transactions and strategies allowing them to extract more value via tunneling than those that maximize overall firm value.[30]

3 RELATED PARTY TRANSACTIONS: *DE JURE* NOT A SYNECDOCHE

RPTs are a usual suspect, if not *the* usual suspect, as a tunneling tool. Yet, it should already be clear by now that, on the one hand, RPTs do not necessarily involve tunneling, while, on the other, tunneling itself can be the outcome of corporate action (or inaction) not involving RPTs.[31] That is important for two reasons. First, at the risk of stating the obvious, the fact that some RPTs create value for all parties involved should not be a reason for playing down the negative effects of tunneling for corporate governance and capital markets development. Second, enlightened corporate governance reformers would better not just focus on RPTs if their goal is to create an environment conducive to the development of equity markets.

And yet the focus of policymakers aiming to improve investor protection in controlled companies has mainly focused on RPTs.[32] For instance, in the aftermath of the Parmalat

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[29] *See, e.g.*, Bebchuk & Roe, *supra* note 13. *See also supra* note 15.

[30] *See, e.g.*, Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 301–03 (Randall K. Morck ed., 2000).

[31] *See* Luca Enriques & Tobias H. Tröger, *The Law and (Some) Finance of Related Party Transactions, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 1, 2–4.

[32] *See* Luca Enriques, *Related party transactions: policy options and real-world challenges (with a critique of the European Commission proposal)*, 16 EUR. BUS. ORG. L. REV. 1, 12-13 (2015) (for an attempt to explain the focus on RPTs).

scandal, Italy introduced new rules on RPTs in 2010.[33] Seven years later, the EU required member states to do the same.[34] And under the influence of international economic organizations such as the OECD and the World Bank,[35] many Asian countries,[36] including India,[37] broadened the scope of RPT rules and tightened their content in the first two decades of this century.

Given their prominence across jurisdictions, identifying the scope of rules on RPTs becomes particularly important.[38] Let us do so by making reference to their accounting

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[33] *See* Regulations Containing Provisions Relating to Transactions with Related Parties (adopted by CONSOB with Resolution no. 17221 of 12 March 2010, later amended by Resolution no. 17389 of 23 June 2010, available at http://www.consob.it/mainen/documenti/english/laws/reg17221e.htm).

[34] *See* Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, O.J. (L 132), [hereinafter *Second Shareholder Rights Directive*], 1, and more precisely Art. 1(4) thereof, which inserts a new Article 9c in Directive 2007/36/EC. For a report on how EU member states implemented Article 9c, *see* Paul L. Davies et al., *Implementation of the SRD II Provisions on Related Party Transactions* (European Corporate Governance Institute—Law Working Paper No. 543/2020, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3697257.

[35] The now defunct World Bank's Doing Business Report has been instrumental in focusing lawmakers' minds on improving RPTs laws by ranking countries, inter alia, according to how strictly (according to a methodology derived from Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008)) they regulate them. *See* World Bank Group, Doing Business 2020, 18 (2020), https://www.worldbank.org/en/programs/business-enabling-environment/doing-business-legacy.

[36] *See, e.g.*, OECD, GUIDE ON FIGHTING ABUSIVE RELATED TRANSACTIONS IN ASIA 25–31 (2009).

[37] *See* Companies Act 2013, § 188 (India).

[38] More important still, but outside the scope of this chapter, is the question of which business decisions, whether explicit or implicit, should be subject to enhanced scrutiny because they are tainted by a conflict of

definition, taking the one in the International Financial Reporting Standards as an example. According to International Accounting Standard 24,[39] "[a] related party transaction is a transfer of resources, services or obligations between a [corporation] and a related party, regardless of whether a price is charged."[40] Who qualifies as a related party is, in turn, defined very analytically in the same Standard so as to include all entities and persons, such as directors and controlling shareholders, that may presumptively have a significant influence on a corporation's decision on whether to enter into a transaction and under what terms, together with their (again broadly and analytically identified) affiliates.[41]

A key component of the RPT definition is in the preposition "between:" technically, no RPT exists if the transaction does not have the corporation (or an affiliate of its) on one side and a related party on the other. Hence, various transactions with tunneling potential entered into directly between the controller and shareholders do not qualify as RPTs because the company is not a party to the transaction. Such is, for example, the case of: (1) "internal tender offers," by which controlling shareholders aim to take the company private via a bid for all of the shares they do not already own;[42] (2) sales of the controlling block at a premium

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interests. *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and the Regulation of Controlling Shareholders*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 23, 44–50.

[39] International Financial Reporting Standards were previously known as International Accounting Standards. Confusingly, standards adopted prior to renaming, like the one dealing with related party transactions, have kept their previous name of International Accounting Standards (IAS) followed by the relevant number.

[40] *See* International Accounting Standards Board, International Accounting Standard No. 24 (EC Staff Consolidated version of 1 January 2023, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02008R1126-20230101).

[41] *Id.* at 2–4 (using 857 words to define related parties).

[42] *Cf.* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 817 (2003).

incorporating the present value of future private benefits;[43] and (3) share purchases other than from the company itself on the basis of inside information.[44]

Other tunneling transactions often do not qualify as RPTs strictly defined because the counterparty to the corporation is not a related party, although a related party, such as the dominant shareholder, may indirectly gain from the transaction to the detriment of minority shareholders.[45] Such may be the case when a side deal exists between the controller and the company's counterparty. For example, the counterparty pays a kickback to the controller in exchange for an above-market discount from the controlled entity: these transactions would clearly qualify as conflict-of-interest transactions, but they are not between the company and a related party.

No RPT is entered into in the following case either: suppose a company is controlled by a parent also active in the same business. For antitrust or regulatory reasons, the latter has to divest part of its business. Instead of selling directly owned assets, it may force the subsidiary to sell its own and even to select a buyer that will not challenge the parent's dominant position in the market, when possibly another competitor would have done so and paid more for the assets (assuming the subsidiary will no longer be active in that market after

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[43] *Id*. at 793–96.

[44] *See* Vladimir Atanasov, Bernard S. Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 16 (share sales on the basis of inside information are at the expense of prospective shareholders. *Id*. at 23).

[45] To be sure, under the UK Listing Authority Listing Rules, RPTs are defined more broadly to include also transactions (other than in the ordinary course of business) "between a listed company and any person the purpose and effect of which is to benefit a related party" (UK Listing Authority Listing Rules, LR 8.1.7.R(3)). Similarly, in France the rules on "regulated transactions" extend to transactions in which related parties are only indirectly interested. *Code de Commerce* (C. Com.) Art. L. 225-38 and Art. L. 225-86. For Belgium *see similarly Code des sociétés et des associations*, Art. 7:97 (extending procedural rules to all board resolutions concerning related parties).

the sale, selling to an aggressive competitor would harm the parent's profitability, but not necessarily the subsidiary's).

Another example may be that of a secondary offering at a discount over the market price, but the price of which is still inflated because of negative information that has not yet been disclosed or because of false or misleading statements that keep market prices artificially high. If (some of the) minority shareholders subscribe to the newly issued shares and the controller does not, the former, together with any other new shareholder, will lose and the controller will correspondingly gain (to be sure, together with other non-subscribing shareholders).[46]

Transactions by which minority shareholders are forced to sell their shares to the company or the controlling shareholder, when executed outside the framework of a merger with a related party (as can be the case in Europe following a takeover bid,[47] where they are known as squeeze-outs) are also ones in which the interest of the controller is clear and equity tunneling may take place, but they would not qualify as RPTs because no transaction between the company and a related party occurs.

Of course, it is possible to make sense of the fact that RPTs are subject to specific rules not applying to other tunneling techniques, and vice versa. There might be tunneling transactions falling under a category of transactions normally displaying no potential for abuse, which yet happen to transfer value to the related party due to some idiosyncratic features of theirs. As an example, consider the case of an undercapitalized two-layer pyramidal group which operates at both layers in an industry (e.g., banking) where capital

[46] *See* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L.J. 1554, 1604–06 (2015). For empirical evidence from Chile on this form of tunneling *see* Borja Larrain & Francisco Urzúa, *Controlling Shareholders and Market Timing in Share Issuance*, 109 J. FIN. ECON. 661 (2013).

[47] *See, e.g.*, Edward Rock et al., *Fundamental Changes*, *in* THE ANATOMY OF CORPORATE LAW, *supra* note 18, at 171, 190–91.

ratios are required at a consolidated level. Suppose that the higher-layer company is undercapitalized while the lower-layer company is well capitalized. The dominant shareholder at the top of the group will have an interest in raising new capital at the lower level of the pyramid, so as to minimize their burden in the recapitalization. That may, however, come at the expense of the lower-layer company's profitability. Yet applying the special rules on RPTs to all new share issues to prevent idiosyncratic tunneling transactions such as the one just described may lead to burdensome, over-inclusive regulation: other things being equal, in such a case ex post judicial review would sound like a better solution.

At the same time, when the law treats differently two tunneling techniques allowing a controller to reach exactly the same expropriation outcome, the controller may engage in "tunneling arbitrage" and choose the more loosely regulated technique.[48] For instance, were a legal system to provide that the procedural safeguards for RPTs have to be followed in the case of parent-subsidiary mergers, while looser rules apply to internal tender offers followed by a squeeze-out (again executed other than via a merger), the latter will be the preferred avenue to freeze out minorities.[49]

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[48] *See* Atanasov et al., *supra* note 44, at 40.

[49] This used to be the case in Delaware with reference to parent-subsidiary mergers, on the one hand, and internal tender offers, on the other: courts treated internal tender offers more leniently than mergers, until they recognized that the two transaction forms are functionally equivalent. *See, e.g.*, Suneela Jain et al., *Examining Data Points in Minority Buy-Outs: A Practitioners' Report*, 36 DEL. J. CORP. L. 939, 941–48 (2011). Legal scholars' criticism of Delaware's bifurcated approach to such pairs of transactions was instrumental to the Court's acknowledgment of their functional equivalence. *See especially* Gilson & Gordon, *supra* note 42, at 827–40; Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2 (2005). The role legal academics had in such evolution in Delaware case law illustrates how sophisticated, functionally minded legal scholars may sometimes be as important as sophisticated courts in ensuring that the law in action works effectively to protect minority shareholders.

4 THE LAW AGAINST TUNNELING VIA RPTS

Turning to the question of how legal systems can prevent RPTs from being used for tunneling purposes, the key issue is how to minimize the risk of tunneling (i.e., to have rules that are effective enough to give rise to few "false negatives") without stifling value-creating transactions (i.e., avoiding "false positives" as much as possible) and more generally without imposing costs higher than the benefits stemming from the same rules.[50] Because a number of context-specific factors and variables will determine what the best solution is for any given jurisdiction,[51] no attempt is made here to rank the legal tools described below, let alone single out any of them as more suitable than the other. Rather, the conditions for them to be effective and their limits will be sketched out in very general terms.

4.1 Prohibitions

The seemingly most draconian way to address tunneling via RPTs is a simple prohibition. Straightforward as it may seem, that strategy has two main drawbacks: first, it would also rule out value-creating RPTs that insiders may otherwise enter into on fair terms for the corporation and, second and more importantly, a prohibition "may not accomplish much":[52] unless an equally well enforced prohibition on any form of tunneling is in place,[53] insiders would just avoid RPTs as an expropriation technique and use functionally equivalent substitutes. In other words, a prohibition on RPTs is only effective if the enforcement system can tackle tunneling more broadly. That requires enforcement actors to use open-ended

[50] *See, e.g.*, Pacces, *supra* note 21, at 191.

[51] *See* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 414–25 (2003).

[52] Enriques et al., *supra* note 18, at 146.

[53] *See* Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing US Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1149–51 (2003).

standards to respond to insiders' ingenuity in devising seemingly legitimate value-diverting transactions. However, if an enforcement system is so sophisticated as to be capable of dealing with tunneling in all its forms, then there is no reason for using such a raw technique to prevent corporate theft. Conversely, and for the same reasons, a prohibition on RPTs would ineffectively tackle tunneling exactly where, on its face, it would be most justified to protect minority shareholders, i.e., in countries with bad enforcement institutions.

One may counter that a prohibition will be better than nothing and that, however little, it will raise the costs of tunneling, making it less profitable. Yet it remains true that if enforcement institutions are bad enough, the costs of evading the prohibition on RPTs will still be low: for instance, a counterparty is related to the corporation if it is in turn controlled by a related party. Assessing whether a *control* relationship exists can often require sophistication on the part of courts, especially as clever lawyers may find effective ways to disguise it.

True, it might be the case that in countries which have neither excessively bad nor particularly good enforcement institutions, a RPT prohibition may indeed lower the amount of tunneling in the economy. But even there, prohibitions may be self-defeating in the long-term: because individual RPTs can be entirely fair for the company, and sometimes even necessary (as in crisis situations in which outsiders may be unwilling to do business with the company), value-creating transactions may be entered into in violation of the prohibition. As it happens, one of the parties to the RPT may ex post find it convenient to renege on it. It may then opportunistically use the prohibition to free itself from its obligations. In those cases, the pressure for judges to come up with doctrines or interpretations eroding the automatism of

RPT prohibitions will be strong. With time, prohibitions "in action" may end up looking ever more similar to ex post standards.[54]

Prohibitions selectively targeting a specific category of RPTs, namely loans to related parties such as directors and executives, have traditionally been more common in Europe[55] and gained traction in the US and China in the first half of the 2000s. In the US, Congress banned loans to officers and directors[56] after WorldCom and other corporate scandals highlighted both the magnitude of the phenomenon and how loans could be used to circumvent executive compensation disclosure rules or delay compliance therewith.[57] In the wake of widespread abuse, China banned debt guarantees to shareholders from companies and their affiliates.[58]

4.2 Procedural Safeguards

Most jurisdictions provide for rules on how to enter into RPTs. Procedural rules may apply to RPTs as such (as is the case in India[59] and the European Union[60]), to a broader set of

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[54] This may be part of the explanation for how, back in the nineteenth century, an ex post fairness review of RPTs prevailed on a (seeming) prohibition thereon in the United States. For an in-depth analysis of the relevant case law and for the doctrinal basis for such an outcome in Delaware, New Jersey, and New York, *see* DAVID KERSHAW, THE FOUNDATIONS OF ANGLO-AMERICAN CORPORATE FIDUCIARY LAW 322–68 (2018).

[55] *See* Luca Enriques, *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, 2 INT'L. & COMP. CORP. L.J. 297, 303–07 (2000).

[56] 15 U.S.C. 78m (k).

[57] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 115–17 (2004).

[58] *See, e.g.*, Henk Berkman, Rebel A. Cole & Lawrence J. Fu, *Expropriation Through Loan Guarantees to Related Parties: Evidence from China*, 33 J. BANK. FIN. 141, 144 (2009).

[59] *See supra* note 37.

[60] *See supra* note 34.

transactions that include some or all RPTs (as is the case in France, where procedural rules apply to all non-routine transactions in which a related party has a direct or indirect interest[61]), or to a subset of RPTs (as used to be the case in Germany until the implementation of the Second Shareholder Rights Directive[62]). Sometimes, quantitative thresholds or qualitative features are used to define the scope of procedural rules (e.g., in most European Union member states).

In general, procedural rules can be defined as more or less strict, depending on how effectively insulated corporate decision makers are from the related party and on the extent to which they put such "independent" decision makers in control over the negotiating process. Relatedly, a crucial element for the rules effectiveness is decision makers access to relevant information and their ability to process it as disinterested executives would.

The focus in this section is on two of the main procedural safeguards that jurisdictions currently deploy: approval by a majority of independent shareholders and approval by disinterested/independent directors.

4.2.1 MOM Approval

A popular idea in academia as well as among policy makers is that the most effective procedural safeguard against tunneling is a veto power over RPTs for a majority of the shareholders other than the related party itself (a majority of the minority, or MOM, in companies with a dominant shareholder).[63] An increasing number of countries (including

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[61] *Code de Commerce* (C. Com.) Art. L. 225-38 and Art. L. 225-86. For the UK, *see supra* note 45.

[62] AktG § 112. BGB § 181.

[63] *See* Assaf Hamdani & Yishai Yafeh, *Institutional Investors As Minority Shareholders*, 17 REV. FIN. 691, 692 (2013) ("Financial economists, legal scholars, the Organisation for Economic Co-Operation and Development, and others have urged lawmakers to subject certain self-dealing transactions to a vote by 'disinterested' shareholders").

Israel, and some major East Asian countries,[64] with the notable exceptions of Japan, China and South Korea[65]) provide for such a requirement, albeit, usually, with respect to material, non-routine RPTs only.[66]

A MOM requirement acts as an effective screen for fair RPTs, provided at least four conditions are met:

(a) Minority shareholders have a real opportunity to cast their vote.

(b) Voting is sincere (i.e., non-conflicted), for example as an outcome of counting only the votes of shareholders that are truly unrelated to the related party and have not been paid a bribe to vote in favor or threatened with some greater evil in case the resolution is rejected.

(c) MOM approval is the outcome of a well-informed decision-making process, which entails full disclosure of all material information about the RPT.

(d) Shareholder voting takes place at a moment in time when vetoing the RPT is still a viable choice for the corporation.

Condition (a) would seem to always apply and hence not be even worth mentioning. However, the Russian experience reminds us that where enforcement institutions are

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[64] *See* ASIAN ROUNDTABLE ON CORPORATE GOVERNANCE, REFORM PRIORITIES IN ASIA. TAKING CORPORATE GOVERNANCE TO A HIGHER LEVEL 66 (2011).

[65] *See* Kon Sik Kim, *Related Party Transactions in East Asia, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 311-16.

[66] The model for this requirement was the RPT regime contained in the UK Listing Rules for Premium Companies. When the distinction between Premium-listed and Standard-listed companies was abandoned in 2024, the Financial Conduct Authority watered down the rules on RPTs and failed to confirm the MOM approval requirement for large, non-routine RPTs that had applied for decades to Premium-listed firms. See Financial Conduct Authority, Primary Markets Effectiveness Review: Feedback to CP23/31 and Final UK Listing Rules Policy, Statement PS 24/6 (2024), Ch. 8 (available at https://www.fca.org.uk/publications/policy-statements/ps24-6-primary-markets-effectiveness-review-feedback-cp23-31-final-uk-listing-rules).

dysfunctional enough, even MOM clauses are deprived of their "self-enforcing" appeal.[67] A famous account of asset stripping in Russia includes an anecdote of how Mikhail Khodorkovski, then the dominant shareholder at Yukos, managed to obtain the legally required shareholder vote for a number of tunneling transactions involving its subsidiaries:

> Yukos owned only 51% of the shares in the subsidiaries, and needed 75% of the votes of the shareholders who participated in a shareholder meeting to authorize the share issuance (plus a majority of the votes of noninterested shareholders). Khodorkovski's solution was bold, if not exactly legal: The day before the subsidiaries' shareholder meetings, Yukos arranged for a compliant judge to declare that the minority shareholders were acting in concert, in violation of the Antimonopoly Law. The judge disqualified everyone but Yukos and its affiliated shareholders from voting. When minority shareholders arrived at the meetings, they were greeted by armed guards; most were barred from voting or attending on the basis of this court order. Yukos' shares were voted and were counted as noninterested; the proposals all passed.[68]

That was also a case in which condition (b) (sincere voting) was not met. In the absence of broad-scope rules on who is disqualified from voting, MOM approval may just pay lip service to minority shareholder protection. In countries where families often control listed companies, like Hong Kong, excluding the related party but counting votes from "relatives, such as cousins, nephews, and uncles, as well as friends and other members of the board of directors"[69] may easily lead to routine general meeting approval of RPTs.[70] And even in the

[67] *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1959–60 (1996).

[68] Black et al., Privatization, *supra* note 6, at 1771.

[69] *See* Yan-Leung Cheung, P. Raghavendra Rau & Aris Stouraitis, *Tunneling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong*, 82 J. FIN. ECON. 343, 350 (2006).

[70] *Id*.

U.S. the mechanics of voting may stand in the way of making sure that the majority of the minority indeed comprises only disinterested shareholders.[71]

Less blatant cases of conflicted voting are those where shareholders are (controlled by) current or potential providers of financial services to the company (and/or its dominant shareholder):[72] in countries with small capital markets and a secondary presence of international institutional investors and/or independent asset managers, shareholders of that kind may well ensure that RPTs are routinely passed.[73]

Condition (c) presupposes rules ensuring that full disclosure is made of information shareholders need in order to make an informed decision about the transaction.[74] In addition, it presupposes that shareholders are willing to become informed about individual

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[71] *See* Amir N. Licht, *Farewell to Fairness: Towards Retiring Delaware's Entire Fairness Review*, 44 DEL. J. CORP. L. 1, 47 (2020).

[72] The Delaware case *Hewlett v. Hewlett Packard Co*., 2002 Del. Ch. LEXIS 35, while not dealing with a tunneling transaction, aptly shows how difficult it is for a plaintiff to prove that an institutional investor's vote may have been tainted by conflict of interest.

[73] For Israeli evidence of that *see* Hamdani & Yafeh, *supra* note 63, at 706–08, 711–13 (analyzing Israeli companies' shareholder votes on RPTs in 2006), and Efrat Dressler, *Voice and power: Do Institutional Shareholders Make Use of Their Voting Power?*, J. CORP. FIN. 65 (2020). The most blatant example of "friendly" institutional investor voting on a RPT comes from South Korea: in August 2017, Samsung's then vice-chairman and *de facto* group head, Lee Jae-yong, was convicted for making payments to foundations close to South Korea's president in exchange for state pension funds' favorable vote in a merger between two Samsung affiliates that cemented the CEO's control over the *chaebol*. *See, e.g.,* Jong-sung You, *The changing dynamics of state–business relations and the politics of reform and capture in South Korea*, 28 REV. INT'L POL. ECON. 81, 81-82 (2021).

[74] *See* Licht, *supra* note 71, at 46. For a more general analysis of why shareholder voting outcomes may deviate from efficient ones *see* Michael C. Schouten, *The Mechanisms of Voting Efficiency*, 2010 COLUM. BUS. L. REV. 763, 780–808.

transactions[75] as well as able to make good decisions on individual business transactions as opposed to decisions on how to invest.[76]

To be sure, a disinterested, albeit less well-informed, decision maker may generally be preferable to one with the relevant knowledge but a clear conflict of interest: that MOM approval may also lead to false negatives does not mean that shareholders would be better off without it.

Finally, disinterested shareholders may well approve a RPT which appears not to be the best deal for the company, when the alternative unconnected transaction would now be less convenient to the company after taking prospective transaction costs into account. Suppose the shareholder meeting is convened to approve the sale of an asset to a related party for a (fair) price of $100 and that the transaction costs borne to enter that transaction are $1.5. Once the proposed transaction is disclosed, an unrelated party credibly declares that it would buy the same asset for $102, subject to due diligence etc. If the company has to spend, say, $3 in transaction costs to negotiate with the unrelated party, disinterested shareholders will vote in favor of the RPT even if, by now, they are aware that the company would have gained more if it had searched for another buyer on the market.[77]

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[75] For a skeptical account of institutional investors' incentives to become informed on RPT resolutions *see* Alperen A. Gözlügöl, *Majority of the Minority Approval of Related Party Transactions: The Analysis of Institutional Shareholder Voting*, 18 EUR. COMP. & FIN. L. REV., 820, 824-58 (2021).

[76] *See* Rock et al., *supra* note 47, at 174.

[77] So long as the transaction costs of doing do would have been lower than $3.5. Note, incidentally, that a scenario in which the company starts negotiations both with an outsider and a related party will be infrequent. Even assuming that the negotiation process itself can be shaped in such a way as to rule out favoritism and hence persuade the outsider to compete with the related party, the outsider should know that the related party will have better information about the value of the asset than the outsider and anticipate that either the related

Of course, a MOM requirement also makes it more likely that a fair RPT (i.e., a transaction in the best interests of the company) will not be entered into. That may be the case when:

1 Shareholders are ill-informed about the real value to their corporation of the asset to be bought (sold), wrongly assessing it is as worth less (more) than the related party offers.

2 One or more shareholders have the power to hold out and no agreement is (or may be) reached on the side payment that they demand in exchange of a favorable vote on the transaction.[78]

3 The marginal transaction costs of obtaining MOM approval, including those stemming from the longer time and the publicity needed to finalize it, are such as to make the transaction no longer worth entering into.[79]

The transaction cost issue is the reason why jurisdictions that provide for MOM approval (e.g., Hong Kong and Singapore) do so only for RPTs above a given size, typically when their value is above 5% of the company's market capitalization. France is an exception,

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party will outbid the outsider or the outsider will have paid too much for the asset. Ex ante, this is likely to discourage the outsider from even starting negotiations. (I am grateful to Luigi Zingales for this insight.)

[78] *Cf.* Edward B. Rock, *Majority of the Minority Approval in a World of Active Shareholders*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 105, *passim* & 130 (addressing the question of whether any instance of shareholder opportunism of the kind indicated in the text had occurred in the U.S. and concluding (*id*. at 130): "I have been unable to find any examples in the United States of the MOM condition being exploited by opportunistic shareholders.").

[79] *Cf.* Alessio M. Pacces, *Procedural and Substantive Review of Related Party Transactions*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 181, 192 & 202–204 (arguing that the extended disclosures that typically have to precede MOM approval may have the indirect effect of empowering activist investors, potentially to the detriment of long-term shareholder value creation).

because the exemption is only for routine self-interested transactions (i.e., those the company itself assesses to be entered into in the ordinary course of business and at market conditions). However, MOM approval in France is only ex post, at the annual meeting, and denial of approval of a properly board-approved transaction has very little practical impact, if any.[80]

4.2.2 Disinterested or Independent Directors' Approval

Jurisdictions may require involvement of independent directors in the approval process, as is the case in Belgium[81] and Italy,[82] or make it strongly advisable, as under Delaware case law with regard to some transactions with controlling shareholders.[83] Within or across jurisdictions, however, approval merely by disinterested directors is sometimes sufficient: such is the case in France generally for transactions in which a director or a substantial shareholder have an interest.

For independent directors (and a fortiori for merely disinterested ones) to play an effective role in the protection of minority shareholders, the key issue is of course how truly independently from controllers one can expect them to act. In part, that will depend on how "independence" is defined and, primarily, on whether being nominated by the controlling shareholder precludes that qualification.[84] Even for directors nominated and appointed with

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[80] *See* Geneviève Helleringer, *Related Party Transactions in France. A Critical Assessment, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 400, 408.

[81] *Code des Sociétés et des Associations* Art. 7 :97, § 1 & 2.

[82] CONSOB Regulation on Related Party Transactions, *supra* note 33, Art. 7 & 8.

[83] In Delaware, approval of the transaction by a special committee of independent directors reverses the burden of proof that the transaction is entirely fair upon the plaintiff. *See, e.g.*, Claire Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903, 922–23 (2011).

[84] *See* Lucian A. Bebchuk & Assaf Hamdani, *Independent directors and controlling shareholders*, 165 U. PENN. L. REV. 1271, 1287 (2017).

the involvement of minority shareholders (like in Israel, Italy, and Spain[85]) substantial independence is not guaranteed, as that is mainly a function of an individual's assertiveness, ability not to succumb to boardroom biases,[86] and reputational and career concerns.[87] Even assuming that the involved independent directors have such personal qualities and concerns, a handicap they face is their inferior knowledge of a company's business.[88] The presence of what are to them unknown unknowns may well allow insiders opportunistically to filter the pieces of information based upon which independent directors' decision will be made.

Independent director involvement may also vary in intensity. The weakest involvement requirement is for independent directors to give non-binding advice on RPTs, like in Belgium and, limited to smaller material transactions, in Italy. Such a requirement does not prevent the dominant shareholder, or at least non-independent directors, from being part of the internal decision-making process. Yet, provided that the negative advice is to be disclosed and private enforcement tools are available to shareholders, non-binding negative advice can serve shareholder interests by giving them a persuasive piece of circumstantial evidence of tunneling before the court. Further, the market may use it as a signal of the

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[85] *See* María Gutierrez & Maribel Sáez, *Deconstructing Independent Directors*, 13 J. CORP. L. STUD. 63, 86 (2013). In Israel, "[e]ach public company has to appoint at least two outside directors, who must be independent from both the controlling shareholder and the management and whose candidacy must be approved not only by a majority of shareholders but also by a third of minority shareholders." Hamdani & Yafeh, *supra* note 63, at 698. Cumulative voting, which allows for minority shareholder representation in the board, is mandatory in Argentina, the Philippines, Russia, and Poland. *See* Tatiana Nenova, *A Corporate Governance Agenda for Developing Countries*, 217 CONTADURÍA Y ADMINISTRACIÓN 181, 201 (2005).

[86] Andrew Keay, *The Authorizing of Directors' Conflicts of Interest: Getting a Balance?*, 12 J. CORP. L. STUD. 129, 143–46 (2012).

[87] *Cf.* Luca Enriques et al., *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies, in* THE ANATOMY OF CORPORATE LAW, *supra* note 18, 79, 85.

[88] Keay, *supra* note 86, at 152.

dominant shareholder's inclination for tunneling, although that will be of little consequence if control is uncontestable and the company has no prospect of raising more equity. Finally, especially when the negative advice is to become public, boards will hesitate to deviate from the independent directors' advice.[89]

Involvement is stronger with a requirement that the transaction be approved not only by the board as a whole but also by a majority of the independent directors. Here, it makes an intuitive difference whether their decision is made in the same room and at the same time as the board's decision, and whether interested directors, and especially the CEO or the dominant shareholder, are present.

Still stronger is the independent directors' binding advice, in which case they do have a veto power over the RPT. Whether that power is effective (will be exercised as often as necessary to protect shareholders' interests) depends not only on the directors' substantial independence and on whether they have full access to information but also on whether they can be assisted by experts (lawyers, investment bankers, etc.) of their own choice at the company's expense (like in Italy[90]), and on how late in the negotiation process they are involved: the later they are to express themselves on the RPT, the more likely that a number of alternatives will no longer be practically available, so that the RPT may have become the only viable way ahead for the corporation and the independent directors' favorable advice a forgone conclusion.[91]

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[89] That is reported to be the case in Belgium at least. *See* Koen Geens, *Corporate Boards in Belgium, in* CORPORATE BOARDS IN LAW AND PRACTICE 120, 142 (Paul Davies & Klaus Hopt eds., 2013).

[90] *See* CONSOB Regulation on Related Party Transactions, *supra* note 33, Art. 7–8 (for larger transactions, independent directors may hire advisors of their choice at the company's expense).

[91] *See supra* text preceding note 77.

The strongest form of involvement is the “independent negotiating committee” (or “special committee”) Delaware courts have since long nudged boards into using[92] for self-interested transactions: the board delegates a small number of independent directors to conduct negotiations on the transaction and to decide upon it, usually having freedom to search for alternative counterparties. Because of their total control over the process, special committees have various advantages over shareholder MOM approval: their involvement is more timely, their (access to) information better, no serious holdout risk exists,[93] and the procedural costs should be lower. The crucial point is always whether one can expect independent directors to make decisions in the best interests of the company rather than in the related party’s.[94]

4.2.3 Independent Directors and *MOM Approval?*

All in all, neither MOM approval nor the independent directors’ involvement separately ensure that tunneling via RPTs will not occur. To further lower that risk, one may combine the two procedural safeguards. There are obvious synergies between the two: as then Vice-Chancellor Strine put it, the independent directors’ role “is important because the directors have the capability to act as effective and active bargaining agents, which disaggregated stockholders do not;”[95] they may thus screen RPTs and ensure that their terms are better for the shareholders: the risk that shareholders approve unfair transactions just because it is too

[92] *See, e.g.*, Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1026 (1997) (“language in Weinberger led to the near universal use of ‘special committees’ of independent directors in MBOs.” The reference is to Weinberger v. UOP, Inc., 457 A.2d 701, 709 (Del. 1983)).

[93] Unless they may be held liable for damages in case of a negligent decision, in which case, other things being equal, they may have a preference for vetoing the transaction.

[94] For a negative assessment *see* Gutierrez & Sáez, *supra* note 85, at 81.

[95] In re Cox Communications, Inc. S’holders Litig., 879 A.2d 604, 606 (Del. Ch. 2005).

late for alternative solutions to be considered[96] should decrease considerably. But, again in Chancellor Strine's words, "because bargaining agents are not always effective or faithful, [MOM approval] is critical, because it gives the minority stockholders the opportunity to reject their agents' work."[97] Ex ante, it will prompt independent directors to negotiate harder.[98]

Net of the higher direct transaction costs, compared to MOM approval alone, the combination of independent directors and MOM approval may also lower the risk that value-creating transactions will not be entered into. In fact, approval by well-reputed independent directors may act as a credible signal of a transaction's fairness to minority shareholders. These, in turn, may be more inclined to vote for the proposed RPT rather than assuming the worst and/or hold out to obtain better terms.

No main jurisdiction has so far addressed RPTs by combining independent directors and MOM approval. The one which has come closest is Delaware: its courts have held that combining both a special committee and MOM approval grants a company and its dominant shareholder the protection of the business judgment rule, and therefore virtually insulates a self-interested transaction from judicial review.[99] U.S. listed companies commonly approve RPTs and other conflicted transactions accordingly.[100]

4.3 Disclosure

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[96] *See supra* text preceding note 77.

[97] *In re Cox Communications, Inc.*, *supra* note 95, at 606.

[98] Richard Booth, *Majority-of-the-Minority Voting and Fairness in Freezeout Mergers*, 59 VILL. L. REV. TOLLE LEGE 87, 93 (2014).

[99] In re MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013).

[100] Licht, *supra* note 71, at 27–30.

One of the core functions of mandatory disclosure has traditionally been to cast light on self-interested transactions.[101] Mandatory disclosure is still today a widely used technique to address RPTs. In isolation, mandatory disclosure may be insufficient to prevent tunneling, which is well documented even via transactions that are publicly disclosed.[102] Its function is no less significantly to support internal decision makers' independent conduct (they will act more assertively if they know the RPT under consideration will be subject to public scrutiny) and to facilitate private and public enforcement against tunneling.

Financial reporting standards nowadays require disclosure (and therefore the audit)[103] of information relating to material RPTs in all the main jurisdictions.[104] In addition to accounting standards' requirement for periodic information about RPTs, the US SEC requires companies to annually disclose RPTs above $120,000 so long as the related party has a material interest in the transaction.[105] In Europe, as elsewhere, companies going public have

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[101] *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1066–73 (1995).

[102] For empirical evidence relating to China between 1996 and 2006 *see* Guohua Jiang et al., *Tunneling Through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1 (2010); Yan-Leung Cheung et al., *Buy High, Sell Low: How Listed Firms Price Asset Transfers in Related Party Transactions*, 33 J. BANK. & FIN. 914 (2009).

[103] Reliability and completeness of RPT-related information in financial statements is usually supported by auditors' review thereof. *See, e.g.*, KERSHAW, *supra* note 18, at 507.

[104] For evidence that mere adoption of IFRS is not sufficient to achieve high levels of disclosure and transparency, effective enforcement institutions being a necessary complement to it, *see* Edilene Santana Santos, Rafael F. Schiozer & Vera Maria Rodrigues Ponte, *Disclosure of Related Party Transactions Under IFRS: Does Cross-Listing Reduce the Legal Origin Disclosure Gap*, 57 INT'L J. ACC'T. 2250018-1 (2022).

[105] Securities and Exchange Commission, Regulation S-K, Item 404.

to provide detailed information of material transactions with related parties in their prospectuses.[106]

All of these rules and standards rely on a company's necessarily discretionary assessment of whether a transaction (or a related party's interest) is material for disclosure purposes. Especially if that assessment is not itself made by independent directors, dubious RPTs may well remain hidden from the public's view.[107] And even independent directors may not always be in the best position to make that call: if they supinely approve the transaction themselves, given a choice on whether their judgment should be subject to public scrutiny, they will naturally tend to favor opacity.

Some jurisdictions also provide for ad hoc, immediate disclosure of large and/or non-routine RPTs, whether as a step in the process leading to MOM approval (as was the case in the UK for Premium-listed companies until 2024 and is still the case in India[108]) or as an independent requirement once the transaction has been entered into (the EU and the UK; France for all non-routine transactions[109]). In the former case, because disclosure is made well in advance of the shareholder meeting where MOM approval is scheduled, there is the additional advantage that attention from the media, financial analysts, and activist investors

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[106] *See* Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC, Annex 1, Item VIII (O.J. L168, 12, 70, 30 June 2017).

[107] *Cf.* Geeyoung Min, *The SEC and the Courts' Cooperative Policing of Related Party Transactions*, 2014 COLUM. BUS. L. REV. 663, 698.

[108] See Securities and Exchange Board of India, Circular No.: SEBI/HO/CFD/CMD1/CIR/P/2021/662 (2021), available at https://www.sebi.gov.in/legal/circulars/nov-2021/disclosure-obligations-of-listed-entities-in-relation-to-related-party-transactions_54113.html.

[109] *Code de Commerce* (C. Comm.) Art. L22-10-13.

may pressure the company into obtaining better terms for (minority) shareholders or even abandoning the transaction altogether.[110]

Even when only ex post, ad hoc disclosure has an additional advantage over periodic disclosure in IFRS-compiled financial statements: while in the former case details about the individual transaction are normally to be provided, according to International Financial Reporting Standards, RPTs "of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity."[111] The wording, again, grants a company and its audit firm discretion in the choice of whether, respectively, to aggregate RPTs and objecting to that choice.

Finally, given the discretion as to whether disclose RPTs, rules requiring public disclosure on ownership stakes can also help detect tunneling. From this perspective, ownership disclosure rules allow the market to have updated information about who has an influence over the company's management and hence may force it to enable tunneling.[112]

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[110] For the same reason, disclosure as an independent requirement would be more effective if it were to be made before the transaction is finalized. Notice, however, that even with disclosure to the market prior to MOM approval, renegotiation is unlikely if, like in the UK regime in force until 2024, the applicable rules allow for the transaction to be entered into before its disclosure, so long as it is conditional upon shareholder approval.

[111] IAS 24, *supra* note 40, at 6 (§ 24). David Buchuk et al., *The Internal Capital Markets of Business Groups: Evidence from Intra-Group Loans*, 112 J. FIN. ECON. 190, 208–10 (2014) (connecting evidence of absence of tunneling via related lending transactions in Chile to reforms providing for disclosure of all such loans individually in the financial statements).

[112] *See, e.g.*, Luca Enriques, Matteo Gargantini & Valerio Novembre, *Mandatory and Contract-based Shareholding Disclosure*, 15 UNIFORM L. REV. 713, 720 & 735 (2010) (describing ownership disclosure as "mainly a tool for ensuring better corporate governance by guaranteeing that the market knows who has an influence over management").

4.4 Third Party Advice and Fairness Opinions

To tackle the issue of insufficient (independent director and/or) shareholder information, some jurisdictions require that companies make an independent financial advisor's opinion available to shareholders,[113] whether in anticipation of their vote on the transaction or as a supplement to information on the transaction itself. Voluntary use of independent third parties as advisors in the negotiation process, be they lawyers or investment banks, is also common practice.[114] Such advice usually includes (when it is not confined to) a fairness opinion, which the law may then require to disclose.[115]

Because fairness valuations imply a high degree of discretion,[116] the value of the independent experts' fairness opinions ultimately rests upon the experts' reputation. Their effectiveness as a tool to protect investors is thus as doubtful as that of gatekeepers more generally,[117] the main concern being, as usual, that outside experts, even when chosen by independent directors, may be less independent than they look, because they usually stand to

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[113] Such is, among others, the case in Singapore (*see* Rule 921, Singapore Exchange Mainboard Rules).

[114] Also nudged by statutes and/or case law providing that directors may reasonably rely on experts' reports. *See, e.g.*, Del. Code Ann. tit. 8, § 141(e). For Germany *see* Holger Fleischer, *Directors' Liability and Financial Crisis: The German Perspective*, 88 IL DIRITTO FALLIMENTARE E DELLE SOCIETÀ COMMERCIALI 454, 463–64 (2013) (describing the case law outlining the conditions under which directors can rely on independent experts' opinions).

[115] That is the case in Italy. *See* CONSOB Regulation on Related Party Transactions, *supra* note 33, Art. 5(5) (if a fairness opinion is released, it has to be disclosed).

[116] *See, e.g.*, Steven M. Davidoff, *Fairness Opinions*, 55 AM. U.L. REV. 1557, 1573–80 (2005).

[117] *See generally* JOHN C. COFFEE JR., GATEKEEPERS. THE PROFESSIONS AND CORPORATE GOVERNANCE 2-10 (2006).

gain much more from other advisory and investment banking roles than from providing fairness opinions.[118]

In addition, as a piece of information instrumental to shareholder voting on the transaction, the fairness assessment per se is not particularly informative.[119] What can be helpful is information the fairness opinion is based upon, like management's projections of future cash flows, and the assumptions and methods the advisor has used.[120] Delaware is the only main jurisdiction that has developed a wide body of case law on the scope of the required disclosure of fairness opinions,[121] while Italy's CONSOB Regulation on RPTs requires information about fairness opinion contents roughly equivalent to Delaware case law.[122]

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118 *See, e.g.*, Davidoff, *supra* note 116, at 1586–88; Wai Yee Wan, *Independent Financial Advisers' Opinions for Public Takeovers and Related Party Transactions in Singapore*, 30 CORP. & SEC. L.J. 32, 33 (2012).

119 *See* In re Pure Res., Inc., S'holders Litig., 808 A.2d 421, 449 (Del. Ch. 2002) ("the disclosure of the banker's 'fairness opinion' alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability").

120 *See* Blake Rohrbacher & Mark Zeberkiewitz, *Fair Summary: Delaware's Framework for Disclosing Fairness Opinions*, 63 BUS. LAW. 881, 891, & 900–05 (2008).

121 For surveys of such case law *see id*., *passim*; Blake Rohrbacher & Mark Zeberkiewitz, *Fair Summary II: An Update on Delaware's Disclosure Regime Regarding Fairness Opinions*, 66 BUS. LAW. 943 *passim* (2011) (focusing especially on cases dealing with investment bankers' conflicts of interest).

122 *See* CONSOB Regulation, *supra* note 33, Annex 4.

4.5 Ex Post Standard-Based Review

Jurisdictions often rely on ex post judicial enforcement of one form or another of a "thou shalt not steal" standard to tackle RPTs.[123] Generally, what the various manifestations of ex post standard-based review have in common is that courts look into the merits of a RPT to find out whether its terms were "fair" to the corporation, i.e., whether it suffered any prejudice (broadly or narrowly defined) therefrom.[124]

Different standards of review may apply to different RPTs within the same jurisdiction. Notably, corporate law in many countries, including France and Italy, provide for more lenient standards when RPTs also qualify as intra-group transactions.[125]

Ex post review can be a negative condition for the enforcement of violations of the legal safeguards analyzed so far, in the sense that consequences follow from such violations

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[123] One prominent exception is the UK, where courts do not involve themselves into substantive fairness review of self-dealing transactions. *See* Paul Davies, *Related Party Transactions: UK Model*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 361, 364.

[124] Matters are more intertwined with procedural safeguards in the US, where ex post review looks not only into a transaction's substantial fairness, but also its procedural fairness. *See, e.g.*, Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 451–57 (1993).

[125] *See* Hopt, *supra* note 8. The justification for a looser approach on such transactions is that these are routine, repeat transactions, the individual review of which by courts would be practically incompatible with the very group business form; in addition, no matter whether the individual transaction is fair to the individual group entity, synergies arising from repeated intra-group RPTs or lower transaction costs may make both the parent and its subsidiaries better off in the longer run. *Cf.* Jens Dammann, *Related Party Transactions and Intragroup Transactions*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 218, 232–33. For a critique of European-style laxer regimes, *see* Luca Enriques & Sergio Gilotta, *The Case Against a Special Regime for Intragroup Transactions*, EUR. BUS. ORG. L. REV. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4101546.

only if courts assess that the transaction was prejudicial to the corporation. In that case, a jurisdiction comes closest to a pure liability rule on RPTs:[126] even MOM approval, on its face a property rule (i.e., a rule that requires consent of the relevant party, in our case minority shareholders), proves to be very much akin to a liability rule if defendants may prove that a RPT that has not been MOM-approved is still valid because it has caused no damage to the corporation.[127] *Prima facie*, Delaware is a case in point, because, at least formally, no remedy can be successfully obtained if the RPT is judged to have been entered into on substantively fair terms. However, as a matter of practice, Delaware case law nudges corporations into subjecting RPTs to procedural safeguards: the more rigorously these safeguards are complied with, in form as well as in substance, the less the judges will be inclined to rule for the plaintiffs by finding that its terms were substantially unfair under the entire fairness test.[128]

When ex post standard-based review goes together with procedural (ex ante) safeguards, the two legal tools can interact in at least two ways. First, ex post review may strengthen (minority) shareholder protection by working as *an additional safeguard* to procedural ones. That is the case if a remedy (such as damages and/or nullification) is

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[126] *See* Goshen, *supra* note 51, at 408. *See also* Alperen A. Gözlügöl, *Blinded by 'Fairness': Why We Need (Strong) Procedural Safeguards in Screening Self-Dealing and Obtaining a Fair Price Is Not the Answer*, 23 EUR. BUS. ORG. L. REV. 633, 644, 647-653 (2022) (noting that a pure ex post review regime leads not only to under-deterrence but also is also unlikely to provide the intrinsic motivation not to engage in predatory behavior that procedural requirements may instead instill).

[127] *See* Goshen, *supra* note 51, at 409; *see also* Licht, *supra* note 71, at 9-10, 15.

[128] The scope of such test has extended well beyond freeze-out mergers. *See* Licht, *supra* note 71, at 6-7 ("Entire fairness review . . . applies to all instances in which the shadow of a controlling shareholder's interest hangs over corporate action . . . [and] similarly (indeed, originally) governs self-interested actions by nonemployee directors").

available if the transaction is judged to be unfair, regardless of whether ex ante safeguards had been complied with. Examples of standard-based remedies that help police tunneling via RPTs are often found in criminal, bankruptcy, and tax law. In France prosecution for abuse of corporate assets (*abus de biens sociaux*) complements procedural safeguards relying on shareholder meeting ratification of RPTs, while in Italy criminal penalties for tunneling are only relevant, for practical purposes, in the event of bankruptcy, on a count of "fraudulent bankruptcy."[129] In bankruptcy, actions to recover assets for the benefit of creditors, such as the actio pauliana, can be used to tackle tunneling.[130] Ex post review is finally the technique tax laws use to deal with RPTs aimed to minimize a company's tax burden (so-called transfer pricing).[131]

Second, procedural safeguards may trump ex post standard-based review: such is the case when compliance with ex ante safeguards immunizes the transaction, i.e., prevents judges from declaring a transaction void or even from finding for the plaintiff in a liability suit despite evidence that the transaction is, in fact, harmful to the corporation.[132]

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[129] Pierre-Henri Conac, Luca Enriques & Martin Gelter, *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4 EUR. COMP. & FIN. L. REV. 491, 518–20, 523 (2007).

[130] *See, e.g.*, Kristin van Zwieten, *Related Party Transactions in Insolvency*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 260, 262–65.

[131] *See, e.g.*, Wolfgang Schön, *Transfer Pricing, the Arm's Length Standard and European Union Law*, *in* ALLOCATING TAXING POWERS WITHIN THE EUROPEAN UNION 73, 73–74 (Isabelle Richelle, Wolfgang Schön & Edoardo Traversa eds., 2013). According to some, an effective and sophisticated tax system may itself contribute to preventing tunneling. *See* Mihir A. Desai et al., *Theft and Taxes*, 84 J. FIN. ECON. 591 (2007). *But see* Atanasov et al., *supra* note 44, at 12, for a negative assessment of tax law as an anti-tunneling device (in the US, but with arguments of more general import).

[132] For practical purposes, such is the case in Delaware in the event of approval by a special committee of independent directors and MOM approval by uncoerced shareholders. *See supra* note 99 and accompanying text.

5 The Challenges of Enacting Effective and Enduring Antitunneling Reforms

Reform-minded policy makers aiming to improve domestic capital markets' attractiveness have recently singled out RPTs among tunneling techniques and designed special prophylactic rules, relying mainly on procedural and disclosure requirements.

For such reforms to be effective in the long run two elements are crucial: first, the law in action has to follow through on the reformed law on the books; second, the new legal environment must be either supported by relevant market players or in tune with social perceptions about tunneling.

Good enforcement institutions are key because, first, there is no such thing as an effective bright line rule against tunneling[133] and even self-enforcing provisions prove illusory.[134] Second, substantial fairness is intuitively hard to evaluate, as the convenience of a transaction to a corporation is known only, at most, to corporate insiders.[135] Third, even procedural rules will require difficult judgment calls on the part of enforcers (be they prosecutors, lawyers, judges, or supervisory authorities officials). Such rules may indeed better screen tunneling (as they do introduce a filter). But when, for whatever reason, the filter does not work, ex post enforcement will often be not much easier than when substantial fairness review is required. Enforcers will have to resolve questions such as whether a control relationship exists (a key component of the notion of related party), disclosure has been complete, pivotal votes were sincere, and/or independence (or disinterestedness) was just

[133] *See supra* notes 52–53 and accompanying text.

[134] *See supra* text preceding note 68 (while the Yukos case is extreme, we have shown throughout this chapter that there is generally ample room for maneuvering to avoid the application of RPT rules).

[135] *See supra* text following note 18.

formal (ostensible) or substantial (real) as well. Most of the times, none of these questions will have a straightforward answer.

Only by seeing more and more cases can enforcers develop the "smell"[136] that is needed to discern bad RPTs from good. That is why the ease by which private and public enforcement actors can start a case and collect evidence is not only key to assessing a jurisdiction's anti-tunneling regime[137] but also relevant to predicting how likely it is that the law in action will evolve in the right direction.

The problem is that even reform-minded policy makers will hesitate to unleash incompetent judges by easing shareholder access to justice. Unpredictability of outcomes and outright wrong decisions, no matter whether in favor of plaintiff shareholders or defendant insiders, may well harm an equity market's reputation no less than the absence of avenues for judicial redress.

That may explain why in countries with traditionally weak enforcement institutions (think, for example, of Italy or Brazil) it is often securities regulators who have taken the lead in enforcing anti-tunneling rules. Not only can securities regulators hire experienced professionals from the market, but, given their investor protection mission, they may also perform their enforcement tasks zealously.

But even fervent enforcement by a committed securities regulator, backed, as it may, by law reforms tightening RPT rules, can reveal itself to be no more than a flash in the pan in countries where either no social norm against tunneling exists (i.e., where "don't engage in

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[136] *Cf.* Charles M. Yablon, *On the Allocation of Burdens of Proof in Corporate Law: An Essay on Fairness and Fuzzy Sets*, 13 CARDOZO L. REV. 497, 502 n.16 (1991) (reporting how Delaware practitioners used to refer to fairness review as the "smell test[:] . . . if the terms of the underlying transaction stink badly enough, the courts will find a way to abrogate any procedural protections supplied by the business judgment rule").

[137] Goshen, *supra* note 51, at 409.

tunneling" is not a specification of the prohibition on theft)[138] or market players do not themselves effectively demand high compliance rates and strict enforcement.[139]

Unless social norms evolve in unison with the new stricter rules and thus make tunneling socially unacceptable,[140] the social perception may soon become one of overzealous bureaucrats harassing successful entrepreneurs/employers for the benefit, if at all, of anonymous and often foreign investors, at which point it will be easy for the powerful business elite to obtain laxer enforcement and/or a "reparation law."[141]

Social norms can switch to anti-tunneling mode in two ways. The easier one is when "obey the law" is a social norm itself and anti-tunneling rules are introduced: the latter will

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[138] *Cf.* Sviatoslav Moskalev & Seung C. Park, *South Korean Chaebols and Value-Based Management*, 92 J. BUS. ETHICS 49, 57–59 (2010) (discussing the reasons why "the South Korean public has [long] tolerated the unethical practice of tunneling"); Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, 3 EUR. BUS. ORG. L. REV. 765, 781–82 (2002) (suggesting that in the past tunneling by dominant shareholders was socially accepted in Italy).

[139] Marcello Bianchi, Luca Enriques & Mateja Miliĉ, *Enforcing Rules on Related Party Transactions in Italy, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 477, 486–99 (reporting how zeal in the enforcement of its RPT Regulation by the Italian securities regulator, Consob, declined considerably after a few years since the regulation was passed, and speculating that this outcome may also depend on market players' failure "to internalize legal constraints on tunneling as social norms").

[140] On the relationship between corporate governance and social norms *see generally* Amir N. Licht, *Culture and Law in Corporate Governance*, chapter 6 in this volume.

[141] In 1995 Belgian lawmakers enacted a "*loi de réparation*" to replace a 1991 law requiring a shareholder vote for all transactions in which a majority of directors had an interest, following large companies' and financial media's accusation that the 1991 law was making it impossible to manage corporate groups. *See* Lucien Simont, *Conflits d'Intérêt: Les Implications des Nouveaux Articles 60 et 60bis*, 1996 REVUE PRATIQUE DES SOCIETES 369, 372. For similar examples involving Malaysia's and India's RPT regimes *see* Dan W. Puchniak & Umakanth Varottil, *Related Party Transactions in Commonwealth Asia: Complexity Revealed, in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 17, 327, 354–55.

almost automatically become social norms as well. Unfortunately, the "obey the law" norm is far from universal.[142]

When no such norm exists, a "tunneling shock" will be necessary[143] (and perhaps not even sufficient). Think of spectacular instances of tunneling at an individual company (e.g. at Italy's Parmalat) or across the market (e.g. in Russia or the Czech Republic after privatization or in East Asian countries in the run-up to the 1990s East Asian crisis) affecting one or more large firms' viability and therefore harming wider constituencies than investors, such as employees, suppliers, and entire communities. When that happens, a backlash may ensue and tolerance for tunneling may fall. That will be fertile ground for effective corporate governance reforms, so long as, of course, intolerance for tunneling stabilizes as well, i.e., it is not just an ephemeral outbreak of moralism with no roots in deeply felt social convictions about loyalty bonds.[144]

Finally, there might be situations where market players themselves may not only pressure politicians to enact stricter anti-tunneling provisions, but also keep the pressure high on enforcement agents and the government, so that there are no second thoughts. Large international institutional investors and independent financial media are the best candidates

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[142] *See* Amir. N. Licht, *Social Norms and the Law: Why Peoples Obey the Law*, 4 REV. L. & ECON. 715, 736–42 (2008).

[143] Leaving aside even more serious shocks, like wars (of state formation), which are arguably the most effective drivers of cultural change. *See, e.g.*, Jordan I. Siegel, Amir N. Licht & Shalom H. Schwartz, *Egalitarianism and International Investment*, 102 J. FIN. ECON 621, 625 (2011).

[144] *Cf.* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 671 (1974) ("the Ambassador from a South American country . . . came to seek [my] advice because he wanted to encourage the investment of outside capital into private firms in his country . . . I asked first, 'Are your stock exchange facilities adequate?' And he replied, 'No, that really isn't the question . . . . The trouble with management in my country is that their only loyalty is to their relatives.'").

for that job, while global law firms and leading issuers may set the right tone at the top of the legal and business elites.[145] But that kind of dynamics is rarely observed: independent institutional investors may have too little at stake in an individual jurisdiction's equity market to keep the pressure high. Further, in many jurisdictions independent financial media, when they exist, find it hard to retain their independence for long.

6 SUMMARY

This chapter has given an overview of related party transaction regulation from a comparative perspective. It has first shown how RPTs are a common phenomenon in many jurisdictions, whether as a political risk management tool in countries with bad quality institutions, as a more elegant way than outright theft to misappropriate corporate value by dominant shareholders, or as a tool to create synergies or better allocate resources between connected businesses. Next, it clarified the distinction between tunneling and RPTs. Subsequently, it analyzed some of the most common legal tools to regulate RPTs: prohibitions, procedural safeguards (independent director and majority-of-the-minority approval), disclosure, external independent advice, and ex post standard-based review. As a conclusion, it sketched out the conditions for anti-tunneling law reforms to be effective.

[145] *See generally* CURTIS J. MILHAUPT & KATHARINA PISTOR, LAW AND CAPITALISM 203–04 (2008).

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