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Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal)

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Luca Enriques
University of Oxford and ECGI

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Abstract

This paper 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 behaviour 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. Further, it provides a (partially) critical assessment of the measures put forth by the European Commission to harmonize rules on RPTs within the EU, based on the previous analysis of individual legal tools. 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.

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Luca Enriques*
Allen & Overy Professor of Corporate Law
University of Oxford, Faculty of Law
St Cross Building, St Cross Road
Oxford, OX1 3UL, United Kingdom
e-mail: luca@enriques.eu

*Corresponding Author

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I. Introduction

This article focuses on transactions between a corporation 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 obtain following arm's-length bargaining.

Related party transactions (hereinafter: RPTs) are an effective and, in some jurisdictions, common instrument to divert value from a corporation by those in control, i.e. dominant shareholders and, where ownership is sufficiently dispersed, managers. They are effective in the sense that they are *per se* legitimate business transactions, *i.e.* something is given in exchange for the company's value: determining whether what the company receives is worth to it no less than what it gives requires a possibly complex assessment of the transactions' merits from the company's viewpoint, a task any third party, including a court, is ill-equipped to make.

Because RPTs are commonly observed around the globe, a number of jurisdictions have provided for specific rules to address them, in spite of the fact that they are but one of the many techniques that controllers can use to enrich themselves at the expense of their company, its minority shareholders, and other stakeholders. For instance, in the UK, the UKLA Listing Rules have since long imposed procedural safeguards and disclosure requirements on companies with a premium listing that are to engage in substantial RPTs: in short, transactions above a certain size and not entered into "in the ordinary course of business"[1] require: (a) full disclosure before they are finalized, in the form of a circular to shareholders;[2] (b) "a statement by the board that the transaction or arrangement is fair and reasonable as far as the security holders of the company are concerned and that the directors have been so advised by a sponsor";[3] and (c) approval by the shareholder meeting, the company having to ensure that the related party (1) does not vote in the relevant resolution and (2) takes all reasonable steps to ensure that its associates do not vote either.[4] These rules, which have recently been strengthened following misbehaviour by dominant shareholders at foreign listed companies listed on the London Stock Exchange,[5] apply in addition to the general Companies Act 2006 obligations for conflicted directors (and shadow directors)[6] and are

[1] UKLA Listing Rule 11.1.5.
[2] *Id*., 11.1.7(2).
[3] *Id*., 13.6.1.(5).
[4] *Id*., 11.1.7(4).
[5] *See infra* note 65. For an in-depth analysis of these amendments to the Listing Rules *see* Roger Barker & Iris H-Y Chiu, *Protecting Minority Shareholders in Blockholder-Controlled Companies - Critically Evaluating the UK's Enhanced Listing Regime*, CAPITAL MARKETS L.J. (forthcoming).
[6] *See* Companies Act, Part 10, Chapters 2-5. *See e.g.* DAVID KERSHAW, COMPANY LAW IN CONTEXT 476-504 (2d ed. 2012).

complemented by periodic disclosure requirements on RPTs in accordance with International Financial Reporting Standards.[7]

Most recently, the European Commission (EC) has issued a proposal to amend the Shareholder Rights Directive, *inter alia* harmonizing the rules on RPTs throughout the EU, chiefly relying on ad hoc disclosures and shareholder meeting approval.[8]

This article provides a critical assessment of the EC's proposal based on a functional analysis of the most commonly used legal techniques to prevent value diversion via RPTs.[9] It first highlights the reasons why related party transactions ("RPTs") are so common around the world (Section II). Next, it better identifies the phenomenon as a specific class of potentially value-diverting behaviour by dominant shareholders and managers, *i.e.* as an instrument for *tunnelling*,[10] and asks why many jurisdictions provide for specific regulations on RPTs in addition to general rules or standards against controllers' abuse (Section III). Then, it describes the legal tools that policymakers and legal scholars commonly or increasingly consider as useful to tackle tunneling via RPTs:[11] prohibitions, procedural safeguards, mandatory disclosure, expert opinions, and ex post standard-based judicial review (Section IV). Because of the focus on RPTs, Section IV does not include non-transaction-based, structural measures to prevent tunneling and dominant shareholders' abuse, like limits on deviations from one-share-one-vote,[12] board 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.

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[7] *See* INTERNATIONAL ACCOUNTING STANDARDS BOARD, International Accounting Standard 24 (EC Staff Consolidated version of 18 Feb. 2011, *available at* http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias1_en.pdf).

[8] *See* European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, Article 9c, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2014:213:FIN).

[9] The word "functional" is used in this context to mean that legal tools are here analysed as instruments to attain the overall objective of an "efficient corporate governance framework for European undertakings, investors and employees" (*see id.*, at 2), *i.e.*, as we view it, a corporate governance framework in which no relevant constituency can be made better off without making another worse off. *See generally* John Armour, Henry Hansmann and Reinier Kraakman, *What Is Corporate Law?*, in REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 1, 2-4 (2d ed. 2009).

[10] *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.

[11] 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.

[12] 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. (forthcoming 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 Park, *The Association*

Section V contains the critical assessment of the measures put forth by the European Commission to harmonize rules on RPTs within the EU, based on the previous analysis of individual legal tools. In short, the main criticism that we address to the European Commission Proposal is that it puts forth a regime at the same time too loose and too harsh, its looseness and harshness reinforcing, instead of offsetting, each other to increase the likelihood that member states will adopt suboptimal rules on related party transactions and that the European Union itself will later intervene in company law to provide for even looser rules on relationships between companies within the same group. Finally, this article 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 tunnelling as a business practice (Section VI).

II. 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.[13] 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."[14] 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.

If you are successful, you will soon experiment 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:[15] by governing these supply relationships by fiat within your firm, you will reduce the transactions costs thereof.

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

[13] 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).

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

[15] *See e.g.* Randall Morck, Finance and governance in developing economies 4 (2011), Working Paper No. w16870. National Bureau of Economic Research, *available at* http://www.nber.org/papers/w16870 (describing LG's

In such a setting, a constant worry of yours will be how to minimize the risk of government expropriation and of 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 a 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: the best way to do that is transactions with yourself and/or entities you control. And you will have made sure that there are plenty of these: in fact, your legal and tax advisers 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, 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 advisers 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 production phase, typically with a holding company in charge of financing operations, one or more operating companies producing the goods or providing the services (the core firm(s)), 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,[16] 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.[17] 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.[18]

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expansion to very loosely related businesses like plastics, insurance, and oil refinery from the original cosmetic cream business).

[16] *See* Klaus J. Hopt, *Groups of Companies*, *in* OXFORD HANDBOOK OF CORPORATE GOVERNANCE (Jeffrey N. Gordon & Georg-Wolf Ringe eds., forthcoming).

[17] One may think of Russia or Venezuela.

[18] A parallel could be drawn between tunneling and corruption. Like there is no worse business environment than one where politicians have residual control rights over businesses and not even corruption is available as a Coasian tool

An even higher number of countries have proved as business-unfriendly as Tunnelland until fairly recently.[19] 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 businessmen to adopt business structures (practices) that may now be costly (for tax reasons or for the rents the dominant shareholders still extract through them) to disentangle (abandon).[20]

Of course, the point here is not to justify business practices that are almost universally viewed as harmful to investors and financial markets. Rather, it is to illustrate why RPTs are so common in many countries around the globe. The Tunnelland story 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 policymakers aiming to boost domestic capital markets than a "second-worst" solution to a dysfunctional institutional environment.[21] Finally, the story highlights how, at least in institutional environments like Tunnelland's, RPTs may be an important feature of closely-held corporations with no distinction between controlling and non-controlling shareholders. 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, *e.g.* because the legal regime is too lax to serve as a credible commitment device.

Eventually, in countries with better functioning institutions, RPTs are not just the remnants of darker ages. Whenever an agency relationship exists, as it 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 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.[22] RPTs are, again, an effective

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to reallocate such rights to private parties (*see* Milhaupt, *supra* note 14, at 1168-69), there is similarly no worse business environment than one in which politicians have the upper hand and entrepreneurs cannot hide money from them by taking it out of firms in a seemingly legitimate (and, in a non-sophisticated tax regime, untaxed) way. Note, however, that both theory and the empirical evidence challenge the idea that corruption is the lesser evil in the long run (*see e.g.* Toke S. Aidt, *Corruption, Institutions, and Economic Development*, 25 OXFORD J. ECON. POL'Y 271 (2009)). Similarly, one cannot expect capital markets to develop so long as "defensive" tunneling is pervasive. *See infra* notes 21 and 32-36 and accompanying text.

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

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

[21] Needless to say, only a fool would accept to become a minority shareholder in a corporation operating in such a business environment.

[22] 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*

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.[23]

At the same time, no one denies that RPTs exist that create value for all parties involved.[24] 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.[25] But listed companies may enter into entirely fair RPTs as well.

For example, 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 company wholly owned by himself 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

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Elusive Quest for Global Governance Standards, 157 U. PA. L. REV. 1263, 1304-05 (2009). However, there is no reason why, other things 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., *Unbundling*, *supra* note 1, at 110-11) 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 (1999), National Bureau of Economic Research Working Paper No. w7203, *available at* 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. Such 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.

[23] Of course, the same is usually true of excessive compensation. *See* note 22. 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 & Woochan Kim, When Heirs Become Major Shareholders. Evidence on Tunneling and Succession Through Related Party Transactions, ECGI Working Paper in Finance No. 413/2014, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2411412.

[24] RPTs may even be entered into at favourable terms for the corporation and correspondingly unfavourable 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* Atanasov et al., *Unbundling*, *supra* note 1, at 108. Graphically, we can think of tunneling, propping, and RPTs as three partially overlapping circles: two different overlapping areas identify tunneling and propping via RPTs. Fair RPTs cover the remaining area of the RPT circle (fair for both parties); non-overlapping parts of the tunneling and propping circles are tunneling and propping activities via technologies other than via RPTs. The three circles all overlap where propping is done via tunneling from another entity in the form of a related party transaction.

[25] *See e.g.* Luca Enriques, Gérard Hertig & Hideki Kanda, *Related Party Transactions*, *in* KRAAKMAN ET AL., *supra* note 9, at 154. 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, *supra* note 6, at 478.

party will discount the higher perceived risk of failure. If the dominant shareholder buys the project for more than its net present value to the company, then the transaction is both fair and efficient.

This stylized example also clarifies how difficult it will be for third parties, be they minority shareholders, financial analysts, the company's audit firm, 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 the price offered by the controlling shareholder and the transaction costs that finding another buyer and negotiating with him 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.[26] 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, minority shareholders may in fact understand the virtues 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 problem with this idea is, again, that private benefits extraction is hard to observe, let alone verify, by a third party like a court or even an arbitrator. Even a comprehensive system of

[26] 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), *available at* 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. INSTITUTIONAL & 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). *But see contra* ALESSIO M. PACCES, RETHINKING CORPORATE GOVERNANCE 96-97, 151-52 (2012): "[s]tealing is always inefficient ex ante." The problem with that statement is that defining stealing in the context of conflicted transactions is easy in theory, but identifying instances thereof can be difficult in practice. Hence, a "zero tolerance" policy may in practice rule out transactions that would create value for all parties (a false positives problem). A more tolerant regulation will of course have the opposite problem (false negatives). But if the level of tunneling in the long run at an individual company is such as not to considerably affect a company's profits, growth opportunities and pro-rata distribution policies (the ultimate proxies for a sustainable and tolerable level of tunneling), a loose regime may be acceptable as a second best for all parties involved. At the end of the day, dominant shareholders can only credibly commit to moderation in tunneling via reputation-building, which in turn may crucially have to build upon time consistency-compatible family values. *Cf.* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 425 (2003) (highlighting that effective reputation-building cannot be based on the threat of economic sanctions). *See also infra* text preceding note 31.

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.[27]

No legal regime explicitly subscribes to the "quid-pro-quo" view of private benefits extraction.[28] But laxity in regulation and enforcement of anti-tunneling provisions has traditionally been common around the world.[29] That is tantamount to an implicit legalization of pecuniary private benefits extraction.[30] 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 long as the dominant family member has descendants who may be at the company's helm someday, he can be expected to stop short of subtracting so much value as to make the company no longer profitable in the long run.[31]

Finally, tunneling not only raises distributional concerns in the relationship between insiders (managers or controlling shareholders) and (minority) shareholders,[32] 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 tunnelling and/or to credibly commit to higher standards, it may desert the IPO market, leaving it to tunneling-prone issuers.[33] 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 as high private benefits)[34] and in ownership structures more generally (no one will relinquish control to the market if the private

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[27] *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).

[28] What comes closest to that are rules allowing for individual unfair transactions to go through in the context of corporate groups. *See infra* note 118 and accompanying text.

[29] *See e.g.* Sang Y. Kang, Controlling Shareholders: Benevolent "King" or Ruthless "Pirate" 17 (2014) (*available at* http://works.bepress.com/sangyop_kang/2/).

[30] *See* Gutiérrez Urtiaga & Sáez Lacave, *supra* note 26, at 14; Gilson & Schwartz, *supra* note 26, at 162.

[31] *See* Sang Y. Kang, The Puzzle of Controlling Shareholder Arrangement in Bad-Law Jurisdictions: Analysis on "Roving" and "Stationary" Controllers 30-48 (unpublished manuscript, on file with the author).

[32] 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 to come (or to detect). Thus, shareholders buy shares at a price that discounts the predicable 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 infra* notes 33-36 and accompanying text for the various inefficiencies arising from tunneling.

[33] *See e.g.* Fox & Heller, *supra* note 22, at 19.

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

benefits of control to be extracted are high).[35] 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.[36]

III. Related Party Transactions Versus Tunneling Versus Conflicted Transactions

Because RPTs are a usual suspect as a vehicle for tunnelling, a number of jurisdictions provide for specific provisions addressing RPTs as such. For instance, accounting standards, including the US GAAP and the International Financial Reporting Standards (IFRS) applicable throughout the EU, provide for disclosures on (material) related party (relationships and) transactions.[37] Similarly, the UK has since long provided for procedural safeguards and immediate disclosure of larger RPTs.[38] Italy has followed the UK example in 2010.[39] Under the influence of international economic organizations such as the OECD and the World Bank,[40] many Asian countries,[41] including India,[42] have recently broadened the scope of RPTs rules and tightened their content.

If RPTs do not necessarily involve tunneling and tunneling itself can be the outcome of behavior not involving RPTs, why do those jurisdictions single out RPTs for specific regulation

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[35] *See e.g.* Lucian A.Bebchuk, & Mark J. Roe, *A theory of path dependence in corporate ownership and governance*, 52 STAN. L.REV. 127 (1999). *See also supra* note 22.

[36] *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).

[37] *See* RESEARCH AND DEV. ARRANGEMENTS, Statement of Fin. Accounting Standards No. 57 (Fin. Accounting Standards Bd. 1982); INTERNATIONAL ACCOUNTING STANDARDS BOARD, International Accounting Standard No. 24. No mention of materiality is made in the International Accounting Standard 24. However, it is an overarching principle of IFRS that disclosure is only to be made when it is material. *See Id.*, International Accounting Standard No. 1, para. 31 (EC Staff Consolidated version of 18 Feb. 2011, *available at* http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias1_en.pdf): "An entity need not provide a specific disclosure required by an IFRS if the information is not material."

[38] *See* PAUL L. DAVIES & SARAH WORTHINGTON, GOWER & DAVIES PRINCIPLES OF MODERN COMPANY LAW 689-90 (9th edition, 2012). Note, however, that the UK's definition of RPT is different from the IAS 24's. Similar rules are also in place in Hong Kong since the 1980s.

[39] *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).

[40] The 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* INTERNATIONAL FINANCE CORPORATION, DOING BUSINESS 2014 96-97 (11th ed. 2013), *available at* http://www.doingbusiness.org.

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

[42] *See e.g.* Ernst & Young, India Inc. – Companies Act 2013. An overview 42-43 (2013), *available at* www.ey.com/Publication/vwLUAssets/India_Inc_Companies_Act_2013/$FILE/India_Inc_Companies_Act_2013.pdf.

rather than dealing, more broadly, with conflict-of-interest transactions or, even better, any kind of tunneling?

To answer this question, let us first identify RPTs by reference to their accounting definition, taking the one in the *International Financial Reporting Standards* as an example. According to International Accounting Standard 24,[43] "[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*."[44] 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 a transaction and under what terms, together with their (again broadly and analytically identified) affiliates.[45]

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 *e.g.* the case of: (1) "internal tender offers," by which a controlling shareholder aims to take the company private via a bid for all of the shares he does not already own; (2) sales of the controlling block at a premium incorporating the present value of future private benefits; and (3) share purchases on the basis of inside information other than from the company itself.[46]

Other tunneling transactions do not qualify as RPTs because the counterparty to the corporation is not a related party, although the dominant shareholder may indirectly gain from the transaction to the detriment of (some of the) minority shareholders.[47] Such may be the case when a side deal exists between the controller and the company's counterparty (*e.g.* a supplier). For example, the latter pays a kickback to the former 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*.

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[43] 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 followed by the relevant number.

[44] *See* International Accounting Standard 24, *supra* note 37.

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

[46] *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).

[47] To be sure, under the UK Listing Rules for Premium listed companies 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*" (FCA Listing Rules, LR 11.1.5.R(3)).

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 its own assets, it may force the subsidiary to do so and even to select a buyer who will not challenge the parent's dominant position in the market, when possibly another competitor would have done so and possibly paid more for the assets (assuming the subsidiary will no longer be active in that market after the sale, selling to an aggressive competitor would have harmed the parent's profitability, but not 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 other new shareholders, will lose and the controller will correspondingly gain (to be sure, together with other non-subscribing shareholders).[48]

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,[49] where they are known as squeeze-outs) are also transactions in which the interest of the controller is clear, equity tunneling may take place, but no transaction between the company and a related party would take place.

Finally, according to its accounting notion, a RPT involves a transfer of *resources*. When value is transferred between the company and the related party that does not qualify as a resource, no RPT is involved. Such is for example the case where the controller appropriates a mere business idea (or a corporate opportunity).[50]

Of course, the fact that RPTs are subject to specific rules not applying to other tunneling techniques, and vice versa, can be fully justified. So, there might be tunneling transactions falling under a category of transactions normally displaying no potential for abuse (e.g. an issue of new

[48] *See* Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders* 49-59 (2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2227080. For empirical evidence from Chile on this form of tunneling *see* Borja Larrain & Francisco Urzúa I. *Controlling Shareholders and Market timing in Share Issuance*, 109 J. FIN. ECON. 661 (2013).

[49] *See e.g.* Edward Rock et al., *Fundamental Changes*, in KRAAKMAN ET AL., *supra* note 9, at 183, 205.

[50] The point is tricky, however, because there is no doubt that a RPT is entered into if the controller indeed pays a price for the business idea. In the absence of a formal deal, there is a transfer of value between the company and the controller, but what is transferred would arguably not qualify as a "resource," because there is no evidence thereof in the company's books. This makes sense from an accounting perspective, because in the absence of a resource (*i.e.* asset), there can be no entry for the tacit transaction in the company's accounts. It makes much less sense if RPTs are the subject of procedural rules or other mandatory disclosure rules. This example shows how the automatic transplant of accounting concepts into regimes aimed to substantially or procedurally regulate behavior may be problematic. Examples of regulations or proposed regulations transplanting the accounting definitions of RPTs to define the scope of

shares with pre-emption rights for all shareholders), 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 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 his 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, especially in the presence of pre-emption rights for shareholders, to prevent idiosyncratic tunneling transactions such as the one just described may lead to burdensome, over-inclusive regulation: other things 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.[51] For instance, should a system provide that the procedural safeguards for RPTs have to be followed in the case of parent-subsidiary mergers, while much looser rules apply to tender offers initiated by the dominant shareholder and followed by a squeeze-out (again executed other than via a merger), the latter will be the preferred avenue to freeze out minorities.[52]

So, why do reform efforts in various jurisdictions in recent years focus on RPTs as opposed to, for example, the broader (and, in many jurisdictions, more traditional) category of conflict-of-interest transactions?[53] One plausible explanation (in addition to the more prosaic one that the international policy debate is framed in terms of RPTs and domestic policymakers are just receptive

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procedural safeguards include Italy's Consob Regulation on RPTs (*supra* note 39) and the European Commission's proposal for a European regulatory framework for RPTs (*see infra* note 136 and accompanying text).

[51] *See* Atanasov et al., *Law and Tunneling*, *supra* note 46, at 40.

[52] This has been the case in Delaware with reference to parent-subsidiary mergers, on the one hand, and tender offers launched by an already dominant shareholder, 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 the Delaware's bifurcated approach to such pair of transactions was instrumental to the Court's acknowledgment of their functional equivalence. *See especially* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003); 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 to ensure that the law in action works effectively to protect minority shareholders.

[53] Conflict-of interest (or self-interested) transactions are a traditional focus of corporate law rules in many jurisdictions and are still the target of antitunneling provisions in some of them. Such is the case in France (special rules for transactions in which either directors or controlling shareholders have a direct or indirect interest: CODE DE COMMERCE (C. COM.) art. L225-38) and in Belgium (for transactions in which directors have a conflicting interest: CODE DES SOCIÉTÉS art. 523).

of that language) is that that rules applying to RPTs are more easily complied with and enforced than rules on conflicts of interest. Intuitively, the question of whether a "conflict of interest" exists in a given transaction is much more subjective and uncertain than the question of whether someone is a related party (although there is room for discretion in that respect as well). More precisely, it would be harder for companies as well as for regulators, to set up, respectively, an effective compliance program or supervisory policies for conflict of interest transactions than for RPTs, especially if the special procedure has to apply (and enforcement powers are to be used) as soon as negotiations of a RPT start. Detecting a RPT is easier than deciding on a case by case basis whether on a given issue a director or a dominant shareholder may have a direct or indirect interest. In the case of the former, a "map" of related parties is relatively easy to draw and update, of course with the collaboration of "direct" related parties such as directors and dominant shareholders. Identifying "interests," especially indirect ones, equally implies the collaboration of directors and dominant shareholders, but, first, their discretion will be wider because of the subjective call that is needed to decide whether an interest has arisen with regard to a specific transaction; second, the identification exercise would have to be undertaken for each and any individual transaction, which makes a properly formalized procedure or supervisory policy necessarily over-inclusive, and therefore burdensome. For the company, it would in fact imply asking directors and dominant shareholders to self-scrutinize each corporate transaction as opposed to providing an updated list of their affiliated persons and entities. True, this issue is less serious when the applicable rules provide for no special safeguards already to be complied with ahead of a formal resolution *e.g.* by the board. And yet, even when legal rules only pertain to the final stages of a transaction (for example requiring the additional approval by the shareholder meeting and detailed disclosure over the transaction), the risk remains higher of failing to apply the relevant rules to a conflicted transaction than to a RPT.

IV. Legal Tools Against Tunneling Via RPTs

So far, we have seen that RPTs can be pervasive in a given jurisdiction due to its present or past political conditions, that RPTs per se are not detrimental to the corporation or its (minority) shareholders, and that RPTs are just one of a number of tunneling techniques that dominant shareholders and managers may use to extract value from the corporation or its (minority) shareholders. Turning to the question of how legal systems can prevent RPTs from being used for tunneling purposes, the key issue is how to minimize that risk (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 excessively high costs.[54] Because a number of context-specific factors and variables will determine what the best solution is for any given jurisdiction,[55] no attempt is made here to rank the legal tools described below, let alone recommend any of them as suitable. Rather, the conditions for them to be effective and their limits will be sketched out in very general terms. The focus here is on prohibitions, procedural safeguards, disclosure, external independent advice, and ex post standard-based review.

A. Prohibitions. The seemingly most draconian way to address tunneling via RPTs is a simple prohibition of RPTs as such. Straightforward as it may seem, that strategy has two main drawbacks: it would also rule out value-creating RPTs that insiders may otherwise have entered into on fair terms for the corporation and, more importantly, it "may not [even] accomplish much:"[56] unless an equally well-enforced prohibition on any form of tunneling is in place,[57] insiders would just avoid RPTs as an expropriation technique and use functionally equivalent substitutes. In other words, a prohibition is only effective if the enforcement system can effectively tackle tunneling more broadly. That requires enforcement actors to use open-ended 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 as a per se prohibition 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 will be related to the corporation if it is in turn controlled by a related party. Assessing whether a corporate control relationship exists inevitably leaves much room for discretion and for clever lawyers' tricks 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

[54] *See e.g.* Pacces, *supra* note 27, at 191.
[55] *See* Goshen, *supra* note 26, at 414-425.
[56] Enriques et al., *supra* note 25, at 155.
[57] *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).

which no outsider is willing to do business with the company), violations of the prohibition will not only involve tunneling, but also value-creating transactions. 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 (if not from the outset), prohibitions "in action" will look ever more similar to ex post standards.[58]

Prohibitions selectively targeting a specific category of RPTs, i.e. loans to related parties such as directors and executives, have traditionally been more common in Europe[59] and gained traction in the US and China in the first half of the 2000s. In the U.S., Congress banned loans to officers and directors[60] 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.[61] In the wake of widespread abuse, China banned debt guarantees to shareholders from companies and their affiliates.[62]

B. 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 and Italy), to a broader set of transactions that include some or all RPTs (as is the case in France, where procedural rules apply to all transactions in which a director has a direct or indirect interest[63]), or to a subset of RPTs (as is the case in Germany, with its very narrow rules applying to transactions in which the director is himself the counterparty or acts in his or her name[64]). Often, jurisdictions provide for different procedural rules depending on whether the related party is a director or a controlling shareholder (*e.g.* Belgium). Sometimes, quantitative thresholds or qualitative features are used to define the

[58] 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 Path of Corporate Fiduciary Law*, 8 N.Y.U.J.L. & BUS. 395, 444-483 (2012).

[59] *See* Luca Enriques, *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, 2 INT'L & COMP. CORP. L.J. 297, 303-07 (2000). *But see* Enriques et al., *supra* note 25, at 169 (UK and Italy removed the ban in the 2000s).

[60] 15 U.S.C. 78m (k).

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

[62] *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).

[63] CODE DE COMMERCE (C. COM.) art. L225-38. For the UK, *see supra* note 47.

[64] AktG § 112. BGB § 181. A recent trend, especially in scholarship, toward extending the scope of § 112 has not gone very far yet. *See* Mathias Habersack, § 112, 2 MÜNCHENER KOMMENTAR ZUM AKTG 1371, Rn. 10 & 16 (Wulf Goette, Mathias Habersack & Susanne Kalss eds., 4th ed., 2014), *available at* Beck-online (§ 112 does not extend to shadow management board members, but does extend to family members of the board member in very specific circumstances).

scope of procedural rules on RPTs (*e.g.* in the UK, both for substantial property transactions and, other than in special circumstances, for related party transactions[65]).

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

The focus here is on two of the main procedural safeguards that at least some jurisdictions currently deploy: approval by a majority of independent shareholders and approval by disinterested/independent directors.

1. MOM approval. A popular idea in academia as well as among policymakers 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).[66] An increasing number of countries (including the UK, Israel, and all major East Asian countries, with the notable exceptions of Japan and South Korea[67]) provide for such a requirement with respect to larger, non-routine transactions.

A MOM requirement does ensure that only fair RPTs are entered into, provided at least four conditions are met:

1. minority shareholders have a real opportunity to cast their vote;
2. voting shareholders do so sincerely, e.g. being truly unrelated themselves to the related party and having been paid no bribe to vote in favor;
3. the MOM approval is the outcome of a well-informed decision-making process, following full disclosure of all material information about the RPT;
4. shareholder voting takes place at a moment in time when vetoing the RPT is still a viable choice for the corporation.

Condition 1 would seem to always apply and hence not be even worth mentioning. However, the Russian experience in the 1990s reminds us that when enforcement institutions are

[65] *See* Section 191, Companies Act 2006, and UK FCA Listing Rules 11.1.6 and 11.1.10. Neither thresholds nor qualitative features apply, however, with regard to transactions with dominant shareholders, in case of failure to comply with the FCA Listing Rules aimed to ensure the independence of the listed company from the dominant shareholder or refusal by an independent director to support the statement declaring compliance therewith. *See id.*, 11.1.1A.

[66] *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").

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

dysfunctional enough, even MOM clauses are deprived of their "self-enforcing" appeal.[68] A famous account of asset stripping after privatization 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.[69]

That was also a case in which condition 2 (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 directors"[70] may easily lead to routine general meeting approval of RPTs.[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 smaller countries with a small presence of international institutional investors specializing in asset management, shareholders of that kind may well ensure that RPTs are routinely passed.[73]

Condition 3 presupposes rules ensuring that full disclosure is made of information shareholders need to make an informed decision about the transaction.[74] In addition, it presupposes that shareholders, possibly with the help of proxy advisors, are able to make good decisions on individual business transactions as opposed to decisions on how to invest.[75]

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

[69] Black et al., *Privatization*, *supra* note 13, at 1771.

[70] *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).

[71] *Ibid*. Disqualification from voting equally fails to extend to a related party's affiliates in France (CODE DE COMMERCE [C. COM.] art. L225-40).

[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 66, at 706-08, 711-13 (analyzing Israeli companies' shareholder votes on RPTs in 2006).

[74] 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.

[75] *See* Rock et al., *supra* note 49, at 184 n3.

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 lead to false negatives does not mean that shareholders would be better off without it.

Finally, disinterested shareholders may well approve a less than fair RPT when the alternative unconnected transaction would be less convenient to the company, once incurred and prospective transaction costs are taken into account. Suppose the shareholder meeting is convened to approve the sale of an asset to a related party for a price of 100$, the company having incurred 5$ in transaction costs in the process (*e.g.* in lawyers' and investment bankers' fees). Suppose also that the consensus is that the asset is worth between 95$ and 100$. Once the proposed transaction is disclosed, an unrelated party credibly declares that it would buy the same asset for 105$. If the company has to spend more than 5$ in transaction costs to negotiate with the unrelated party, disinterested shareholders will vote for the RPT even if, by now, they are aware that the company, on the one hand, would have gained more by searching for another buyer on the market and, on the other, loses some money from the RPT once transaction costs are factored in.[76]

Of course, a MOM requirement also makes it more likely that a *fair* RPT (i.e., a transaction in the best interest of the company itself) 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), thinking it is worth less (more) than the related party offers;
2. one or more shareholders have the power to hold out and no agreement is (or can be) reached on the side payment that they request to vote in favour of the transaction;[77]
3. the marginal transaction costs of obtaining MOM approval, including the longer time and the publicity needed to finalize it, are such as to make the transaction no longer worth entering into or practicable.

The transaction cost issue is the reason why jurisdictions that provide for MOM approval (*e.g.*, the UK, Hong Kong, 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,[78] because the

[76] Because the company has already spent those 5$ in transaction costs, it is better for the shareholders to sell for 100$ and recover those costs in all or in part than to retain an asset that is worth even less than the price paid for it by the related party.

[77] *Compare* Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* OXFORD HANDBOOK OF CORPORATE GOVERNANCE, *supra* note 16 (cautioning against extensive use of MOM clauses in the presence of hedge fund activism).

[78] Another conditional exception is provided for in the UK FCA Listing Rules for Premium-listed companies with a controlling shareholder. They provide that: (1) the controlling shareholder has to commit to respect the independence of the listed company by signing a mandatory agreement with the company; (2) in case of failure to do so, or to comply with the agreement in the view of even one independent director, each and any RPT with the controlling shareholder will have to be MOM-approved. For a more detailed description of the new regime see Roger Barker & Iris

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.[79]

2. Disinterested or independent directors' approval. Jurisdictions may require involvement of independent directors in the approval process, as is the case in Belgium (for intra-group transactions specifically[80]) and Italy,[81] or make it strongly advisable, as under Delaware case law with regard to some transactions with controlling shareholders.[82] Within or across jurisdictions, however, approval merely by disinterested directors is sometimes sufficient: such is the case in Belgium and Delaware for transactions with directors and 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 this qualification. Even when a director is nominated and appointed with the involvement of minority shareholders (like in jurisdictions, such as Israel, Italy, and Spain[83]) substantial independence is not guaranteed, as that is mainly a function of an individual's assertiveness, ability not to succumb to boardroom biases,[84] and reputational and career concerns.[85]

Even assuming that an independent director has such personal qualities and concerns, a handicap he still faces is his inferior knowledge of a company's business.[86] The presence of what

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H-Y Chiu, *Protecting Minority Shareholders in Blockholder-Controlled Companies – Critically Evaluating the UK's Enhanced Listing Regime*, CAPITAL MARKETS L.J. (forthcoming).

[79] *See e.g.* Enriques, *The Law*, *supra* note 59, at 327-28.

[80] CODE DES SOCIÉTÉS art. 524.

[81] Consob Regulation on Related Party Transactions, *supra* note 39, art. 7 & 8.

[82] In Delaware, approval of freezeout transactions 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).

[83] *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 66, 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).

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

[85] *Cf.* Luca Enriques, Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure: The Interests of Shareholders As a Class*, in KRAAKMAN ET AL., *supra* note 9, 55, 64.

[86] Keay, *supra* note 84, at 152.

are to him unknown unknowns may well allow insiders to filter the pieces of information based upon which his decision will be made.

Independent director involvement may also vary in intensity. The weakest involvement requirement is for an independent director non-binding advice on RPTs, like in Belgium and, limited to smaller 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, a non-binding negative advice can serve shareholder interests by giving them a persuasive piece of evidence of tunneling before the court. Further, the market may use it as a signal of the dominant shareholder's inclination for tunneling, although that will be of little consequence if control is incontestable and the company has no prospect of raising more equity. Finally, especially when the negative advice is to become public, boards will tend not deviate from the independent directors' advice.[87]

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 a 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.

Yet stronger is an 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[88]), 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 a favorable advice a forgone conclusion.

The strongest form of involvement is finally the "independent negotiating committee" (or "special committee") Delaware courts have since long nudged boards into using when a parent-subsidiary merger or an MBO is on the agenda:[89] the board delegates a small number of

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

[88] *See* Consob Regulation on Related Party Transactions, *supra* note 39, art. 7-8 (for larger transactions, independent directors may hire advisors of their choice at the company's expense).

[89] *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." *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 (Del. 1983)).

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,[90] and the procedural costs should be lower. The crucial point is always whether one can expect independent directors to make decisions in the best interest of the company rather than the related party's.[91]

3. Independent directors and *MOM approval?* All in all, neither MOM approval nor independent directors' role ensure that tunneling via RPTs will not occur. To lower that risk, a jurisdiction may think of combining the two procedural safeguards discussed above. 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."[92] They may thus screen RPTs and ensure that their terms are better for the shareholders: the risk that shareholders approve unfair transactions because it is too late for alternative solutions to be considered[93] should go down 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."[94] Ex ante, it will prompt independent directors to negotiate harder.[95]

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 not only be more inclined to vote for the proposed RPT, but also less likely to side with opportunistic activist investors who, by holding out, may aim to extract value from the company.

No main jurisdiction has so far addressed RPTs by combining independent and MOM approval. The one which has come closest to it is Delaware: for end-of-game transactions such as MBOs and freeze-outs, 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

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

[91] For a negative assessment *see* Gutierrez & Sáez, *Deconstructing*, *supra* note 83, at 81.

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

[93] *See supra* note 76 and accompanying text.

[94] *In re Cox Communications, Inc.*, *supra* note 92, at 606.

rule, and therefore virtually insulates the transaction from judicial review.[96]

C. Disclosure. One of the core functions of mandatory disclosure has traditionally been to cast light on self-interested transactions.[97] 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.[98] Its importance is more in supporting internal decision-makers' independence (they will act more assertively if they know the RPT they may approve will be subject to public scrutiny) and in facilitating private and public enforcement against tunneling.

Financial reporting standards nowadays require disclosure (and therefore the audit)[99] of information relating to material RPTs almost everywhere.[100] 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.[101] In Europe as elsewhere, companies going public have to provide detailed information of material relations with related parties in their prospectuses.[102]

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, embarrassing RPTs may well remain hidden from the public's view.[103] And even independent directors may not always be in the best position to make that call: if they approve the transaction themselves, given a choice on whether their judgment should be subject to public scrutiny, they will naturally tend to favor opacity.

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

[96] *In re MFW* S'holders Litig., 67 A.3d 496 (Del. Ch. 2013). Because a special committee is sufficient to reverse the burden of proof that the transaction is entirely fair, which also means some degree of insulation from judicial review, it is unclear how worthy it is for a company (and its controlling shareholder) to go through the hassle of MOM approval and the ensuing risk of activist investor holdouts. *See* Viktor Lewkow et al., *Going Private Transactions – MFW's Bumpy Road to Business Judgment Review*, CLEARY GOTTLIEB MERGERS & ACQUISITIONS AND CORPORATE GOVERNANCE REPORT 7, 7-8 (May 2014).

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

[98] 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).

[99] Reliability and completeness of RPT-related information in financial statements is usually supported by auditors' review thereof. *See e.g.* KERSHAW, *supra* note 25, at 507.

[100] For the US and the EU, *see supra* note 37.

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

[102] For the EU, *see* Commission Regulation (EC) No 809/2004, April 29, 2004, implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, as amended, Annex 1, No. 19 (OJ L149, April 30, 2004, 3, 31).

[103] *Cf.* Geeyoung Min, The SEC and the Courts' Cooperative Policing of Related Party Transactions 16-17, Virginia Law and Economics Research Paper No. 2013-06, *available at* http://ssrn.com/abstract=2319138.

Some jurisdictions also provide for *ad hoc*, immediate disclosure of larger RPTs, whether as a step in the process leading to MOM approval (UK) or as an independent requirement once the transaction has been entered into (Italy; the UK for "smaller transactions"). 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 may pressure the company into obtaining better terms for (minority) shareholders or even into abandoning the transaction altogether.[104]

Even when 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."[105] The wording, again, grants a company (its audit firm) discretion in the choice of whether to aggregate RPTs (in monitoring that choice).

Given the discretion in disclosing RPTs, rules allowing investors to know who is in the position to engage in RPTs with the corporation can also help detect tunneling. Ownership disclosure rules allow the market to have updated information about who has or may have an influence over the company's management.[106]

D. 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,[107] 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.[108] Such advice usually includes (when it is not confined to) a

[104] 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 highly unlikely, if, like in the UK, the applicable rules allow for the transaction to be finalized before it, with the only proviso that it be approved by shareholders.

[105] IAS 24, *supra* 37, at 6 (§24). David Buchuk et al., *The Internal Capital Markets of Business Groups: Evidence from Intra-Group Loans*, 112 J. FIN. ECON. 190, 208-210 (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).

[106] *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").

[107] Such is for example the case in Belgium (for intra-group transactions: CODE DES SOCIÉTÉS art. 524(2)) and Singapore (*see* Rule 921, Singapore Exchange Mainboard Rules).

[108] 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*

fairness opinion, which the law may then require to disclose.[109]

Because fairness valuations imply a high degree of discretion,[110] the value of the independent experts' fairness opinions ultimately rests upon their reputation. Their effectiveness as a tool to protect investors is thus as doubtful as that of gatekeepers more generally,[111] the main concern being, as usual, that outside experts, even when chosen by independent directors, may be less independent than they look, as they usually stand to gain much more from other advisory and investment banking roles than from providing fairness opinions.[112]

In addition, as a piece of information instrumental to shareholder voting on the transaction, the fairness opinion *per se* is not particularly helpful.[113] 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.[114] Delaware is the only main jurisdiction that has developed a wide body of case law on the scope of required disclosure on fairness opinions,[115] while Italy's Consob Regulation on RPTs requires information about fairness opinions' contents roughly equivalent to Delaware case law.[116] Other countries appear to be less detailed in their requirement for fairness opinion disclosure.

E. Ex post, standard-based review. Jurisdictions usually rely also on ex post judicial enforcement of one form or another of a "don't tunnel" standard to tackle RPTs. 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 strictly identified) therefrom.[117]

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).

[109] That is the case in Italy: *see* Consob Regulation on Related Party Transactions, *supra* note 39, art. 5(5) (if a fairness opinion is released, it has to be disclosed).

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

[111] *See generally* JOHN C. COFFEE JR., GATEKEEPERS. THE PROFESSIONS AND CORPORATE GOVERNANCE 2-10 (2006) (defining gatekeepers as agents acting as "reputational intermediary[ies] to assure investors as to the quality of the 'signal' sent by the corporate issuer," including investment bankers providing fairness opinions in parent-subsidiary mergers among gatekeepers, and outlining reasons for the failure of gatekeepers in the early 2000s).

[112] *See e.g.* Davidoff, *supra* note 110, 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).

[113] *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").

[114] *See* Blake Rohrbacher & Mark Zeberkiewitz, *Fair Summary: Delaware's Framework for Disclosing Fairness Opinions*, 63 BUS. LAW. 881, 891-91 & 900-05 (2008).

[115] For surveys of such case law *see id.*, *passim*; *id.*, *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).

[116] *See* Consob Regulation, *supra* note 39, Annex 4.

[117] Matters are more complicated in the U.S., where ex post review looks not only into a transaction's substantial fairness, but also to 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).

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.[118] 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 will make both the parent *and* its subsidiaries better off in the longer run.[119]

Ex post standard review can be an alternative to the legal safeguards analyzed so far, in which case a jurisdiction comes closest to a pure liability rule on RPTs.[120] The country which is closest to a pure liability rule model among the main ones is Germany: leaving aside a very specific provision on purchases from some related parties in the two years following the company's formation[121] and management board members' duty to inform their fellow members and the supervisory board of their conflicts of interests,[122] its procedural rules only apply to RPTs in which the director is formally on both sides of the transaction.[123] There, ex post enforcement relies on the prohibition of concealed distributions,[124] on directors' and controlling shareholders' duty of loyalty,[125] on group law provisions allowing for ex-post compensation of individually harmful transactions,[126] and on the very broad domain of the criminal provision on breach of trust (*Untreue*).[127]

In form, Delaware is similar to Germany, because no remedy can be successfully obtained if the RPT is entered into on fair terms. However, as a matter of practice if not of substance, 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 themselves are substantially unfair.

When ex post standard-based review goes together with procedural (ex ante) safeguards, the two legal tools can interact in at least three ways. First, ex post review may strengthen (minority)

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[118] *See* Hopt, *supra*, note 16.

[119] *Cf.* Dammann, *supra* note 26, at 706-09 (although with no explicit reference to group law).

[120] *See* Goshen, *supra* note 26, at 408.

[121] AktG § 52.

[122] *See* Holger Fleischer, *Related Party Transactions bei börsennotierten Gesellschaften: Deutsches Aktien(konzern)recht und Europäische Reformvorschläge*, 45 BETRIEBS-BERATER 2691, 2696 (2014).

[123] *See supra* note 64 and accompanying text.

[124] *See e.g.* Wolfgang Schön, *Transfer Pricing–Business Incentives, International Taxation and Corporate Law*, *in* FUNDAMENTALS OF INTERNATIONAL TRANSFER PRICING IN LAW AND ECONOMICS 47, 58 (Wolfgang Schön & Kai A. Konrad eds., 2012) (clarifying that, however, "these rules only bite when asset diversion either leads to insolvency of the company or when the assets of the company do not fully cover the subscribed capital").

[125] *See* Fleischer, *supra* note 122, at 2696-97.

[126] *See* Hopt, *supra*, note 16.

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 available if the transaction is judged to be unfair, proof of compliance with ex ante safeguards having no bearing on the outcome of the case. Examples of standard-based remedies that thus 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."[128] In bankruptcy, actions to recover money for the benefit of creditors, such as the *actio pauliana*, can also be used to tackle tunneling ex post.[129] 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).[130]

Ex post review may, on the contrary, weaken shareholder protection when a remedy for violations of ex ante safeguards is *only* available if the transaction is also judged to be unfair, in which case ex post standard-based review effectively weakens ex ante safeguards.[131] 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 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.[132]

Finally, procedural safeguards may, so to speak, 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, prejudicial to the corporation.[133]

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[127] *See* 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, 500, 520-21 (2007).

[128] *Id*. at 518-20, 523.

[129] *See e.g.* Irit Mevorach, *Transaction Avoidance in Bankruptcy of Corporate Groups*, 11 EUR. COMP. FIN. L. REV. 235, 242 (2011).

[130] *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., *Law and Tunneling*, *supra* note 46, at 12, for a negative assessment of tax law as an anti-tunneling device (in the US, but with arguments of more general import).

[131] For instance, in France RPTs that have not been approved by the board are void only if they harm the corporation. *See* CODE DE COMMERCE (C. COM.) art. L225-42.

[132] *See* Goshen, *supra* note 26, at 409. On the distinction between property and liability rules *see generally* Guido Calabresi & A. Douglas Malamed, *Property Rules, Liability Rules, and Inalienability*, 85 HARV. L. REV. 1089 (1972).

[133] For practical purposes, such is the case in Delaware in the event of approval by disinterested directors of a transaction in which a director has an interest, because in that case the business judgment rule applies. *See e.g.* Enriques, *supra* note 59, at 322-23. *See also supra* note 96 and accompanying text (for the similar consequences of special committee *and* MOM approval of freeze-out transactions).

V. The European Commission Proposal on RPTs: A Critical Assessment

In April 2014, the European Commission issued a proposal for a harmonized regulatory framework for RPTs entered into by listed companies.[134] According to the Explanatory Memorandum, "[c]urrently, shareholders do not have access to sufficient information ahead of the planned [related party] transaction and do not have adequate tools to oppose to abusive transactions."[135] Hence, the proposal to insert an article 9c in the Shareholder Rights Directive which would rely on three of the tools analyzed in the previous Section: disclosure, a third party independent opinion, and (MOM) shareholder approval of larger transactions.

More in detail, the proposal defines RPTs by reference to IAS 24[136] and provides for three different regimes depending on the size of transactions.

(1) RPTs "that represent [less] than 1% of [a company's] assets" are left totally unregulated, unless they are entered into with the same related party and represent more than 5% of the assets if aggregated in a period of 12 months, in which case rules under (3) below apply.[137] In general, member state rules will exclusively apply to such transactions, unless other EU rules, such as those on IFRS disclosure on RPTs, apply.[138]

(2) For RPTs "that represent more than 1% of their assets," companies have an obligation to publicly announce them

> "at the time of the conclusion of the transaction, and accompany the announcement by a report from an independent third party assessing whether or not it is on market terms and confirming that the transaction is fair and reasonable from the perspective of the shareholders, including minority shareholders. The announcement shall contain information on the nature of the related party relationship, the name of the related party, the amount of the transaction and any other information necessary to assess the transaction."[139]

Member states may allow for an exemption from the independent third party opinion requirement if shareholders (excluding the relevant related party from the vote) so resolve with regard to "clearly defined types of recurrent transactions with an identified related party in a period of not longer than 12 months after granting the exemption."[140]

(3) Finally, RPTs "representing more than 5% of their assets" or "which can have a significant impact on profits or turnover are submitted to a vote by the shareholders in a general

[134] *See* Proposal for a Directive, *supra* note 8.
[135] *Id*. at 5.
[136] *Id*. at 18 (*sub* art. 2(j)).
[137] *Id*. at 24-25 (*sub* art. 9c).
[138] *See supra* note 37 and accompanying text.
[139] *Id*. at 24 (sub art. 9c para. 1).
[140] *Id*.

meeting." The related party will be excluded from voting. The vote will have to take place before the transaction is concluded, but conclusion under the condition of shareholder approval is also permitted. Again, an exemption can be obtained from shareholders other than the related party for "clearly defined types of recurrent transactions with an identified related party in a period of not longer than 12 months after granting the exemption."[141] Aggregation of transactions with the same related party in a 12-month period implies that if the 5% threshold is crossed, "any subsequent transactions with the same related party shall be submitted to a shareholder vote and may only be unconditionally concluded after shareholder approval."[142]

Member States may provide for a general exemption from all such requirements, but only in case of "transactions entered into between the company and one or more members of its group" and "provided that those members of the group are wholly owned by the company."

Finally, a newly proposed article 14b would generally provide that member states "lay down the rules on penalties applicable to infringements of the national provisions adopted pursuant to this Directive and shall take all measures necessary to ensure that they are implemented. The penalties provided for must be effective, proportionate and dissuasive." Hence, a public enforcement toolkit, likely including administrative fines, will also support rules on RPTs.

While the proposal will certainly undergo some changes before it finally becomes law (if it ever does), it is worth assessing its contents in the light of the previous analysis in Sections III and IV.

Even leaving aside the uncertainties that arise from the lack of coordination of the proposed disclosure and approval rules both with those on executive compensation (which are RPTs according to IFRSs, but would have their own disclosure and approval rules according to the same Proposal[143]) and with each other (the timing of disclosures for RPTs that are to be approved by the shareholder meeting is unspecified), the proposed rules appear to be loose in some respects and excessively strict in others. Unfortunately, as argued below, laxity and strictness, rather than balancing each other to produce a workable and reasonable solution, will exacerbate the negative effects of each and likely lead to overall weakened investor protection.

Of course, striking the right balance could never be easy, given that the new rules would have to apply both in countries with almost no specific rules on RPTs, such as Germany, and in ones with well-developed rules on RPTs, like the UK. However, for that very reason, one would have expected more leeway for member states to adapt the new framework of rules to their own legal

[141] *Id*. at 24-25 (*sub* art. 9c para. 2).
[142] *Id*. at 25 (*sub* art. 9c para. 3).
[143] *See* IAS 24 (*supra* 37, at 2) and Articles 9a and 9b of the Proposal, *supra* note 134, at 22-24.

systems and specifically to their idiosyncratic regimes in the same or in adjacent areas (think, again, of Germany with its corporate groups laws) and more caution and care in devising solutions.

Let us start with the reasons why the proposed regime will prove lax: the new rules, first, are under-inclusive and, second, rely on weak safeguards.

A. Under-inclusiveness. To be effective, rules on RPTs should reasonably extend disclosure and approval requirements to those transactions that presumptively create a sufficiently high risk of non-trivial amounts of tunneling. Of course, legal rules are necessarily blunt tools to screen RPTs so as to always avoid inclusion of tunneling risk-free transactions and always to include those that positively create that risk. A standard, like the notion of materiality, will give corporate decision-makers wide discretion in determining what to include and, if the rationale is the risk of tunneling, may prove self-defeating, because no insider will be happy to confess that the company is doing something that may indeed be judged as tunneling-prone. Therefore, despite their bluntness, quantitative criteria, albeit imperfect themselves, are generally preferable and, up to a point, the more articulated they are, the better.

The proposed rules are anything but well-articulated and fine-tuned. For both disclosure and approval purposes, they rely on one quantitative criterion based exclusively on assets. For approval purposes only, a qualitative criterion complements the asset-based ratio: when the RPT has a "significant impact on profits or turnover". Incidentally, no aggregation of transactions with the same related party is provided for in that case, although they may well cumulatively have such an impact.

The qualitative criterion leaves ample room for maneuvering. Because such transactions may well be below the asset-based threshold for disclosure as well and they may be aggregated in financial statements according to IAS 24 or even left undisclosed as immaterial according to IFRS 1,[144] public enforcers may even fail to detect such transactions. Hence, the new rules will likely fail to catch a lot of cash-flow tunneling (i.e., affecting a company's income statement as opposed to its balance sheet).[145]

Further, as we have seen in section III, RPTs are but one category of transactions in which dominant shareholders may have a financial interest. That is the reason why many legal systems, like the UK, apply procedural safeguards and/or disclosure requirements to a broader set of transactions, that includes, in addition to transaction *with* a related party, those in which a related party has an interest.[146] The choice of using the accounting definition of RPTs will make it easy for

[144] *See supra* notes 37 and 105.
[145] *See* Atanasov et al., *supra* note 46, at 6-7.
[146] *See supra* note 47.

bad-intentioned dominant shareholders to circumvent the new rules. They may adapt to the new regime by reinventing themselves as corrupt go-betweens that facilitate transactions with third parties on preferential terms in exchange for kickbacks.

Finally, as Tobias Tröger has noticed, the proposed rules appear only to apply to transactions between *the listed company* and a related party.[147] They should not extend to transactions entered into by subsidiaries of the listed company with the listed company's related parties. That leaves badly intentioned dominant shareholders with ample room for maneuvering, especially if member states exempt transactions with wholly owned subsidiaries, because they may then have the company move assets (and production phases) at the level of a wholly owned subsidiary and then freely transact with it.[148]

B. Weak safeguards. While the legal tools the proposed rules rely on are widely used across jurisdictions, their effectiveness crucially depends on their details. In the proposed rules, when the details are not lacking, they are often bound to undermine investor protection.

The contents of disclosure for transactions representing more than one percent of assets are only cursorily sketched out: disclosure does not have to go further than "the nature of the related party relationship, the name of the related party, the amount of the transaction and any other information necessary to assess the transaction." Of course, "any other information necessary" is a catch-all phrase, but again one would expect policymakers not to entrust interested insiders with wide discretion when deciding what details to provide of a RPT. By comparison, the contents of the UK Listing Rules circular (for Premium listed companies) and of Italy's statement for RPTs are more comprehensively outlined.[149]

In addition to disclosure, the proposed rules require companies to obtain a fairness opinion for all transactions above the one percent threshold, unless an exemption is granted by the shareholder meeting for recurrent transactions with a specific counterparty. Legal commentators have long been doubtful about the value of fairness opinions.[150] If they have any, it is the information value of the data, methods, and assumptions they are based on.[151] However, the proposed rules only require disclosure of the independent expert's report, without indicating what its minimum content should be other than by stating that it has to "assess[] whether or not [the RPT] is on market terms and confirm[] that the transaction is fair and reasonable from the perspective of the shareholders,

[147] Tobias Tröger, Corporate Groups 28, SAFE Working Paper No. 66 (2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2500101.

[148] *Id.*

[149] See UK FCA Listing Rules 13.6 and Consob Regulation on Related Party Transactions, Annex 4.

[150] *See supra* notes 110-112 and accompanying text. *See also* Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27, *passim.*

[151] *See supra* note 114 and accompanying text.

including minority shareholders:" apparently, the report may well omit information of what data management has provided the expert with, what assumptions the expert has made and what methods it has used. Finally, even assuming that indeed repeat providers of fairness opinions can act as proper gatekeepers and care more about their reputation than about an individual client relationship, according to the proposed rules, the third party expert could be anyone, as opposed to someone, like the company's sponsor for listing purposes, a primary audit firm or more generally a repeat player in capital markets, with a decent reputational stake in the matter. To conclude, the expert's report informative value and the assurance it provides about the transaction's fairness may well tend to zero; incidentally, its costs, however calculated,[152] will be real.

Shareholder approval as conceived of in the proposed rules raises three main issues from the standpoint of ensuring effectiveness: first, there is the general question of how effective and disinterested shareholders can be in screening individual RPTs for fairness.[153] Especially in smaller markets and generally in smaller companies, given the scarcity of international (independent) institutional investors, it may be easy to obtain shareholder approval, and even more so if active minority shareholders are mainly local financial institutions with actual or prospective ties with the company and its controlling shareholder. Second, approval will be granted at the end of a negotiation process, which member states are free to leave in the hands of interested agents: no involvement whatsoever of disinterested, let alone independent, directors is required. As hinted before, it may well be that when the time has come for the shareholder meeting to approve the transaction any other alternative will be worth less than the transaction itself, no matter whether ex ante the company should have gone in a different direction.[154] Finally, the proposed rule does not prevent affiliates of the related party from voting in favor of the transaction, so that the approval screen may work much less effectively than it looks, especially after controlling shareholders will have adjusted their ownership arrangements accordingly.

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[152] Proposals for legislative instruments are preceded by impact assessments. In the Proposal, the only quantitative element that the Proposal's Explanatory Memorandum mentions from the Impact Assessment is about the independent report costs (*see* Proposal, *supra* note 134, at 9). It is worth reporting it without a comment:

> According to the Impact assessment, the most significant costs would be linked to the fairness opinion by an independent advisor. However, depending on the complexity of the transaction, an experienced advisor should be able to assess the fairness of the given transaction within between approximately 5 and 10 hours. This could result in a cost of maximum 2,500-5,000 € in case the opinion is made by an auditor.

[153] Unless one expects proxy advisors to be biased in favour of dominant shareholders, the point of how well-informed shareholders can be (*see critically* Tröger, *supra* note 147, at 33) should in theory cut the opposite way. When in doubt (and independent), they should lean on the side of voting against approval of RPT. In practice, however, institutional investors tend to vote in favour of management. *See* Therese Strand, Re-Thinking Short-Termism and the Role of Patient Capital in Europe: Perspectives on the New Shareholder Rights Directive 41 (2014), *available at* http://ssrn.com/abstract=2516844.

[154] *See supra* note 76 and accompanying text.

C. Inflexibility. The proposed rules are unduly inflexible in various respects. First of all, the Proposal rules out alternative arrangements that could well work more effectively where the proposed rules may for example be unduly costly due to a specific legal system's anti-synergic features. Think of Germany, where shareholder strike suits against any kind of shareholder meeting resolutions are extremely common:[155] there, one could at least conceive that approval by (truly) independent supervisory board members may provide for a better regime than one involving the shareholder meeting.[156] Similarly, in countries, like Italy and Spain, where minority shareholders are given a chance to appoint (independent) directors, a well-designed system relying on both disclosure and approval by (minority-elected) independent directors may be as good as mere shareholder approval at ensuring investor protection, and possibly at lower cost.[157]

Further, the proposed rules leave very little flexibility when it comes to exemptions: while it is wise not to let boards the discretion that is implied in a judgment on whether a transaction is recurrent or, worse, entered into on market terms in the ordinary course of business unless (minority) shareholders authorize them to do so, the one and only exemption (for transactions with wholly owned subsidiaries) is overly narrow. If not member states, individual companies should be able to exempt also transaction with non-wholly owned subsidiaries, when the subsidiary minority shareholders are not themselves related parties of the parent listed company (or other subsidiaries thereof).

Without such an exemption, transactions displaying no potential whatsoever for tunneling[158] will have to be disclosed, assessed by an independent third party, and possibly approved by shareholders.[159] In other words, the proposed rules would then apply in a number of settings in which they add no value in terms of investor protection, while raising the costs of companies' management, especially where groups of companies are common. This will make existing plans at the EU level to loosen up protections for minority shareholders within groups even more likely to succeed.[160]

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[155] *See* Tröger, *supra* note 147, at 30-31.

[156] *See* Fleischer, *supra* note 122, at 2699.

[157] *See* Pacces, *supra* note 27, at 209-13.

[158] Provided that rules on RPTs, as they should, also apply to transactions with related parties entered into by a company's subsidiaries, because otherwise they may just be a first step in the direction of further tunneling at the subsidiary's level: *see supra* text preceding note 148.

[159] Of course, *recurrent* transactions will not have to be subject to the independent expert's opinion and shareholder approval, if the shareholder meeting so resolves (and approval, to be sure, should be a foregone conclusion, because the dominant shareholder may exercise its voting rights with regard to that resolution: the related party that should abstain would in fact be the subsidiary itself): see supra text accompanying notes 140-141. However, non-recurrent transactions with subsidiaries may well be relatively frequent.

[160] *See e.g.* Pierre-Henri Conac, *Director's Duties in Groups of Companies: Legitimizing the Interest of the Group at the European Level*, 2013 EUR. COMP. & FIN. L. REV. 194 (also for a report of the Commission's initiatives). More critically, *see* Tröger, *supra* note 147, at 35-37.

Further, once they are passed, the proposed rules' inflexibility will make it harder for member states to experiment with more stringent rules in addition to them: if the EU rules are unnecessarily burdensome, it will be much easier for powerful dominant shareholders to convince policymakers that they should not make issuers' life even harsher with rules that the EU itself does not even impose and hence competitors in other member states will likely not be subject to. Similarly, member states that already have more stringent rules in at least some respects will be under greater pressure to loosen up their regime and avoid any goldplating on the EU minimum harmonization rules. In short, unduly burdensome rules increase the risk that the EU regime will become one of *de facto* maximum harmonization.

That is why it matters that, as shown above, the proposed rules are lax. Harmonization rules provide a focal point for member states: when interest group pressures are strong enough, it will be hard to impose stricter rules.

To conclude, the new proposed rules may improve on the status quo in at least some of the member states, but may well end up having many European jurisdictions stuck with a both weak and inflexible regime, which may more likely lead to further watering down of investor protections (especially within groups) rather than to their ratcheting up in the near future. While the legislation process will allow for plenty of opportunities for improving on the proposed rules, the initial steps of this EU attempt to provide for uniform rules in such a core area of corporate law as tunneling are further evidence of how harmonization is a two-edged sword to be handled with extreme care.

VI. The Challenges of Enacting Effective and Enduring Reforms

Reform-minded policymakers aiming to improve domestic capital markets' attractiveness in various continents have recently singled them out among tunneling techniques and designed special prophylactic rules, relying mainly on procedural safeguards 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;[161] second, the new legal environment must be either supported by relevant market players or in tune with social perceptions about tunneling.

[161] For empirical evidence showing that securities law reforms are ineffective where no tradition of effective law enforcement exists *see* Hans B. Christensen, Luzi Hail & Christian Leuz, Capital-Market Effects of Securities Laws: Prior Conditions, Implementation, and Enforcement (ECGI Finance Working Paper No. 407, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1745105.

Good enforcement institutions are key because, first, in this area there is no such thing as an effective bright line rule,[162] and even self-enforcing provisions can prove illusory.[163] Second, substantial fairness is intuitively hard to evaluate, as the convenience of a transaction to a corporation is known only, if at all, to corporate insiders.[164] 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 no much easier than when substantial fairness review is required. Enforcers will have to resolve such questions 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 (disinterestedness) was just formal (ostensible) rather than 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"[165] that is needed to discern bad RPTs from good. This is why the ease by which private and public enforcement actors can start a case and collect evidence is not only key in assessing a jurisdiction's anti-tunneling regime,[166] but also relevant to predict whether the law in action is likely to evolve over time.

The problem is that even reform-minded policymakers 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, e.g., of Italy or Brazil) it is often securities regulators who take the lead in enforcing antitunneling 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 tunneling" is not,

[162] *See supra* notes 56-57 and accompanying text.

[163] *See supra* text preceding note 69 (while the Yukos case is extreme, we have shown throughout this paper that there is generally ample room for manoeuvring to avoid the application of RPT rules).

[164] *See supra* text following note 25.

[165] *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").

[166] Goshen, *supra* note 26, at 409.

broadly speaking, a specification of the prohibition on theft)[167] or market players do not themselves effectively demand high compliance rates and strict enforcement.

Unless social norms themselves evolve in unison with the new stricter rules and thus make tunneling socially unacceptable,[168] the social perception may soon become one of over-zealous bureaucrats harassing successful entrepreneurs/employers for the benefit 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."[169]

Social norms can switch to antitunneling mode in two ways. The easier one is when "obey the law" is a social norm itself: antitunneling rules will almost automatically convert into social norms. Unfortunately, even "obey the law" is far from a universal social norm.[170]

When no such norm exists, a "tunneling shock" will be necessary[171] (and perhaps not even sufficient). Think of spectacular instances of tunneling at an individual company (think of Italy's Parmalat) or across the market (think of Russia or the Czech Republic after privatization or East Asian countries at the time of 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. is not just an ephemeral outbreak of moralism with no roots in deeply-felt social convictions about loyalty bonds.[172]

Finally, there might be situations in which market players themselves may not only pressure politicians to enact stricter antitunneling provisions, but also keep that pressure high on enforcement

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[167] *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).

[168] On the relationship between corporate governance and social norms *see generally* Amir N. Licht, *Culture and Law in Corporate Governance*, in OXFORD HANDBOOK OF CORPORATE GOVERNANCE, *supra* note 16.

[169] 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 would was making it impossible to manage corporate groups. *See* LUCIEN SIMONT, *Conflits d'Intérêt: Les Implications des Nouveaux Articles 60 et 60*bis, 1996 REVUE PRATIQUE DES SOCIÉTÉS 369, 372.

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

[171] 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).

[172] *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 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").

agents and the government, so that there are no second thoughts. Large international institutional investors and independent financial media are the best candidates for that job, while global law firms and leading issuers may set the right tone at the top of the legal and business elites.[173] But that kind of dynamics is rarely observed: independent institutional investors may have too little at stake in an individual domestic equity market to maintain the pressure high. Further, in many jurisdictions independent financial media, when they exist, find it hard to retain their independence for long. On the side of issuers (and by implication their advisors) it is usually more convenient, at least in the short term, to keep doing things the old way.

VII. Summary

This article has provided 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 way to create synergies or better allocate resources between connected businesses. Next, it has clarified the distinction between tunneling and RPTs and shown why it can make sense to have specific rules on the latter. Then, it has analysed 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. Finally, it has provided a critical assessment of the measures put forth by the European Commission to harmonize rules on RPTs within the EU, based on the pros and cons of individual legal tools highlighted in Section IV. As a conclusion, it has sketched out the conditions for antitunneling law reforms to be effective.

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

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