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International Corporate Governance Network

ICGN Viewpoint

Related Party Transactions: How to ensure adequate protection of minority shareholder rights

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Related Party Transactions (RPTs) are common occurrences around the globe. The underlying relationships causing parties to be related typically reflect the ability of one party to exercise, directly or indirectly, control, joint control or significant influence over another. RPTs in a business context are usually business deals or arrangements, such as the purchase or sale of assets or shares between parties who share a special relationship such as a common owner or where one corporation has a material equity interest in the other. Another example would be where the arrangement involved a transaction between a corporation and one of its directors. There are many varieties.

Many jurisdictions globally have specific rules to address RPTs because of the underlying conflicts of interest that may be involved where parties to a transaction are related.

This Viewpoint report focuses on some of the key issues involved in managing RPTs that should be considered when RPTs are being addressed. Key considerations typically include the process for approving such transactions, materiality standards and steps to ensure that proper value is established for such transactions.

Why should investors care about related party transactions?

RPTs can play an important and legitimate role in a market economy. For firms, trade and foreign investment is often facilitated by inter-company financing transactions. Lower costs of capital and tax savings provide a strong incentive for engaging in these transactions. Indeed, there are many examples of related party transactions that yield benefits for companies. Examples transactions include (1) inter-company loans or guarantees from parent to foreign subsidiary; (2) the sale of receivables to a special purpose entity, and (3) a leasing or licensing agreement between a parent and a foreign subsidiary.

A key concern about related party transactions is that they might not be undertaken at market prices, but can be influenced by the relationship between the two sides of a transaction: there is a conflict of interest for some person(s) in the company. For both inside block holders and other insiders such as management, related party transactions can be used as a mechanism for extracting private benefits of control at

the cost of other shareholders. This can range from mild to extreme degrees of expropriation.

Against this background, there are a broad array of legal strategies to regulate disclosure of related party transactions and conflicts of interests. While there is widespread agreement on the need to regulate related party transactions, there is much less convergence on what transactions should be subject to enhanced governance standards or regulation. There are also challenges, for example, the around whether and how to distinguish material from non-material related party transactions and how standards should differ as a result. The recent European Shareholder Rights Directive which covers RPTs does not address this point leaving it up to Member States to decide.

ICGN perspective on related party transactions

ICGN's Global Governance Principles recognises that RPTs have the potential to be abusive and that disclosure, review by independent directors and a shareholder vote are important ingredients to protect the interest of minority shareholders.

The board should disclose the process for approving, reviewing and monitoring related party transactions and any inherent conflicts of interest. In its policies ICGN also recommends to establish a committee of independent directors to review RPTs. This can be a separate committee or an existing committee, or subcommittee, comprised of independent directors, for example the audit committee. The committee should review significant RPTs to determine whether they are in the best interests of the company and, if so, to determine what terms are fair and reasonable. The conclusion of committee deliberations on significant RPTs should be disclosed in the company's annual report to shareholders.

In the case of RPTs that are large in scale or which could shape the company's strategic direction or capital structure, shareholders should have the right to approve RPTs. The vote can be concentrated on significant transactions above an appropriate materiality threshold, and should be based on the approval of a majority of disinterested shareholders. The board should submit the transaction for shareholder approval and disclose the following information (both before concluding the transaction and in the company's annual report):

- a) the identity of the ultimate beneficiaries including, any controlling owner and any party affiliated with the controlling owner with any direct / indirect ownership interest in the company;
- b) other businesses in which the controlling shareholder has a significant interest; and

- c) shareholder agreements (e.g. commitments to related party payments such as licence fees, service agreements and loans).

Governance and disclosure practices to mitigate the risks of abusive related party transactions

The risks of abusive RPTs can be mitigated with appropriate board oversight policies and public disclosures. Investors concerned about RPTs in investee companies should take the following points of consideration when engaging with company executives and board members.

1. Formal Board policies with regard to the monitoring of RPTs: Boards should develop and make public a formal policy in which it explains its approach to the monitoring and approval of related party transactions (either standalone or as part of a broader policy on conflicts of interest). The policy should also explain checks and balances that are being put in place to avoid abusive related party transactions and potential conflicts.

2. The board should follow a formalized process to evaluate the alignment of the RPT with the company's interests and disclose it. This should among others include an overview of the factors they take into consideration when determining whether to approve a RTP or not, including:

- Are there strong business reasons for the Company to enter into the proposed RTP;
- A statement from the board of directors and / or independent board committee that the terms of the Related Party Transaction are fair to the Company and its shareholders;
- A confirmation that the terms and conditions of the transactions are established on an arm length basis and that similar conditions would have been applied for a transaction with an unrelated party;
- Whether the Related Party Transaction is expected to have an impact on the independence on corporate directors that are involved in the transaction.

3. Policy on conflicts of interest: it should be mandatory for companies to have a policy in place in which it is explicitly outlined how conflicts of interest, including those related to RPTs, are being dealt with. This policy should be publicly available. Companies should also fully disclose ALL RPTs where conflicts of interest are involved.

4. It should be mandatory for companies to disclose their definition of what constitutes a material related party transaction: companies should make available their definition for material related party transactions and disclose all RPTs that meet the set criteria. There is no existing bright line test for materiality.

Companies should give a public notification of the transaction that qualify as a material RPT.

5. Formal valuation of related party transactions: an issuer shall obtain a formal valuation for a related party transaction. Any formal valuation would need to come from an independent third party. This should at least apply for all material RPTs and any RPT where a conflict of interest is identified. A summary of the formal valuation should be made available to company's shareholders.

6. Role of the Board: RPT's should be approved by the Board of Directors or committee of the board. In many countries special committees are formed for the purpose reviewing RPTs often with these committees and reporting into the board for final approval. This is to be encouraged as it ensures that the committee can consist only of independent directors and can also comprise independent directors that have the time to devote to these kinds of transactions which can often take considerable time to review. Independent advisors are often also typically retain by the board or such a committee as a part of the oversight of the conflict of interest elements that can be part of RPTs

7. Role of shareholders in the approval of material RPTs: whereas it is recognized that adequate safeguards at board level can protect the interests of minority shareholders, ICGN is of the view that shareholders should have the right to approve related party transactions. The vote can be concentrated on material related party transactions or for related party transactions with an important governance impact. The vote should be based on the approval of a majority of disinterested shareholders.

8. Advice from independent experts: An Independent experts should be consulted by the Board in the process analyzing a material RPT. Any concerns as highlighted by the independent expert should be included in the communication to shareholders about the proposed transaction.

9. Companies should disclose their procedures to ensure that interested shareholders in a related party transaction cannot exercise their voting rights on the respective transaction.

Members of the board with an interest in the transaction under discussion should abstain or not vote on the approval of the RPTs. They should also refrain from participation in the board's discussions about the RPT.

10. Companies should provide shareholders with full disclosure on the details of each new RPT (not only material RPTs). This should include among others the following:

Global information:

- The date of authorization of the agreement;
- The business purpose of the transaction;
- The duration of the service.

More specific information:

- The rationale for the conclusion / the continuation of the transaction;
- A complete description of the field of the provided services;
- A confirmation that terms and conditions are market proof;
- The benefits to the Company and to the relevant Related Party;
- The process followed to choose the service provider (rationale on the selection of the company over peers);
- The approval rate of the board.

Conclusion

RPTs are neither intrinsically good or bad. They can have legitimate purposes in promoting the company's own long-term value creation and success. But they can also be subject to abuse, by executive management or controlling owners, in a way that can negatively affect the company and its minority shareholders and its creditors. This Viewpoint highlights these risks, but it also suggests potential steps that corporate boards could take to ensure that RPTs are legitimate and fair and are done in the best interests of the company and all providers of capital. Investors can use the recommended practice points as a guide for engaging with companies on their approach to RPTs.

About ICGN Viewpoints

This ICGN Viewpoint was prepared by ICGN's Shareholder Rights Committee, with Bram Hendriks and Michael Herskovich as lead authors. ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate. While not defining a formal ICGN position on the subject, ICGN Viewpoints are produced by our member-led Policy Committees and we encourage dialogue by contacting Committee chairs directly or the ICGN Secretariat as follows:

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