Optimal Review of Related Party Transactions: The Case for NCS-dependent Directors

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Related Party Transactions (RPTs) are transactions between a company and the executives, directors or the controlling shareholder of that company, or their associates (eg a company the related party owns fully or partly). In publicly held companies, RPTs are an obvious vehicle for tunnelling, which is inefficient. RPTs, however, are not generally prohibited. Moreover, several companies around the world enter into RPTs as a matter of routine. For instance, manufacturing companies sometimes purchase equipment from a related party instead of an independent supplier. This operation can be efficient when it leads to transaction cost savings.

In my chapter in the book The Law and Finance of Related Party Transactions, I aim to identify the legal regime of RPTs that can best screen for efficient transactions. In particular, I look at the standards of judicial review of RPTs, which can be based on substantive or procedural fairness. Unfortunately, no standard of RPT review is sufficiently accurate to stop all value-decreasing transactions (eg, tunnelling to family members) and simultaneously let all value-increasing transaction (eg, the supply of tailor-made equipment in a long-term relationship) go through. Living in such an imperfect world, I argue that a procedural review, in which courts sanction RPTs based on due process, is preferable to a substantive review, in which

courts re-assess the merits of RPTs typically in comparison with an arm's length transaction. However, to be effective at countering expropriation of non-controlling shareholders, a procedural review should be accompanied by additional safeguards.

A substantive ex-post review, or the credible threat thereof, can be effective in policing RPTs when it is performed by sophisticated courts, as is the case in the U.S. and particularly in Delaware. However, such a review over-deters efficient RPTs because these too may go sour, and then will look unfair in hindsight when compared with arm's length transactions. The arm's length benchmark is in fact incompatible with the transaction cost saving justification of RPTs, according to which the counterparty identity can justify a consideration departing from market prices.

On the contrary, when courts only review due process, the assessment of RPTs is delegated to market professionals (institutional shareholders or independent directors) who review the transaction ex-ante and have, in principle, good incentives to approve it only if it is efficient. This screen becomes ineffective, however, if the assessors are not well-informed or are not really independent, which is often the case. An effective procedural review regime, such as the UK regime of RPTs, may cope with this issue by empowering non-controlling shareholders to fire directors at will – for instance, when they reveal that they are not effectively independent. This approach, however, creates another problem: empowered activist shareholders could more easily intervene with the controller's strategy, which may be inefficient for certain companies at some point in their lifecycle (as I have argued here).

Therefore, I recommend a different approach to the procedural review of RPTs. RPTs should be considered conclusively fair when they are approved by non-controlling shareholder-dependent (NCS-dependent) directors. Courts would only review information and independence of NCS-dependent directors, respectively based on the prevailing professional standards for these directors and on the compliance with the following rules. Non-controlling shareholders should have the exclusive right to nominate, appoint and remove NCS-dependent directors. These directors should account for a minority of the board and their mandate should be limited to screening RPTs only. I contend that this proposed regime would be as effective as those of the U.S. and the UK in countering investor expropriation, but better at screening for efficient transactions.

NCS-dependent directors should be a default regime. Companies that can organize themselves efficiently without RPTs may opt out of this proposed regime, for instance by choosing a substantive court review of RPTs or a broader mandate for NCS-dependent directors to advise on strategy issues.

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