Procedural and Substantive Review of Related Party Transactions

The Case for Noncontrolling Shareholder-Dependent Directors

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Abstract

In publicly traded companies, related party transactions (RPTs) are an obvious vehicle for shareholder expropriation. However, they may also be efficient, particularly when they are motivated by transaction cost savings. This paper aims to identify which type of RPT review is not only effective (i.e. stops value-decreasing transactions) but also efficient (i.e. allows value-increasing transactions occur). The paper argues that there is a trade-off between these two goals (effectiveness and efficiency), and that the optimal solution is company-specific. The review of RPTs can be based on substantive or procedural fairness. Ex-post review of substantive fairness by sophisticated courts, or the credible threat thereof, can be effective in policing RPTs, as in the U.S. However, such a review may overdeter efficient RPTs because these may look unfair in hindsight, when compared with arm's length transactions. When courts review procedural fairness, the assessment is delegated to market professionals (shareholders or directors) who review the transaction ex-ante and have, in principle, good incentives to approve it only if it is efficient. However, this screen becomes ineffective if the reviewers are not well-informed or not independent. Moreover, a regime that tries to cope with this issue by empowering non-controlling shareholders in general, as in the UK, creates another problem: activist shareholders could more easily intervene with the controller's strategy, which may be inefficient for the particular company. This paper recommends a different procedural standard as the default regime. RPTs should be considered fair when they are approved by non-controlling shareholderdependent (NCS-dependent) directors. Non-controlling shareholders should have the exclusive right to nominate, appoint and remove these directors. NCS-dependent directors should account for a minority of the board and their mandate should be limited to screening related-party transactions. This regime would be as effective as those of the U.S. and the UK, and arguably more efficient. Companies that can organize themselves efficiently without RPTs may opt out of this regime, for instance by choosing a substantive court review or a broader mandate for NCS-dependent directors to advise on strategy issues.

Keywords: self-dealing, corporate governance, controlling shareholders, independent directors, Majority of Minority (MOM), Transaction Cost Economics, hedge fund activism, institutional investors

JEL Classifications: D23, G34, K22

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Alessio M. Pacces (*)

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1. Introduction

In this chapter, I discuss the review of related party transactions (henceforth RPTs) from a law and economics perspective. I focus only on the governance of listed companies. The goal of this chapter is to identify an optimal regime of RPTs, which I define in terms of effectiveness (i.e. ability to stop value-decreasing RPTs) and efficiency (i.e. allowing value-increasing RPTs to proceed).

Related parties are, broadly speaking, the persons – executives, directors or controlling shareholders[1] – who make decisions for a company, or their associates. I define these persons as corporate controllers. When a company does business with the controller's associates, there is an obvious conflict of interests, which explains why RPTs are regarded with suspicion by company law. RPTs can easily result in expropriation of non-controlling shareholders, by way of transactions that decrease the value of the company entering into them while enriching the controller and their associates. These transactions are inefficient for the particular company regardless of whether the related party gains more than the company loses.[2] The economic

* Rotterdam Institute of Law and Economics, Erasmus University Rotterdam, and European Corporate Governance Institute (ECGI). I wish to thank Marcello Bianchi, Jens Dammann, Giuseppe Dari-Mattiacci, Andreas Engert, Jill Fisch, Ed Rock, the participants in the two ECGI Oxford and Frankfurt workshops on 'The Law and Finance of Related Party Transactions' in 2017 and in the Amsterdam Centre for Law and Economics (ACLE) seminar of 18 April 2018, and particularly Luca Enriques for very helpful comments on previous versions of this chapter. Moreover, I am grateful to Luca Enriques and Tobias Tröger for having put together such a thought-provoking project. The usual disclaimers apply.

[1] A controlling shareholder is a large shareholder who exercises ultimate control on the company's decision-making, particularly by appointing its top management. A controlling shareholder may be a majority shareholder who controls the absolute majority of votes (more than 50 percent), or a dominant shareholder who controls a relative majority of the votes (for instance 30 percent). Because of minority shareholders' collective action problems, a dominant shareholder can usually control a company. However, she can be outvoted in special circumstances, whereas a majority shareholder cannot. For the purposes of this chapter, I refer to dominant shareholders as controlling shareholders, unless otherwise indicated.

[2] This chapter frames RPTs focusing exclusively on the wealth effects on the company that enters into them. As a result, RPTs which are intendedly value-decreasing (as opposed to value-increasing transactions that turned out badly) are always inefficient. When the controllers' gains from RPTs exceed the non-controlling shareholders' losses, the transaction is efficient ex-post but – as explained in the text – still generates capital market inefficiency ex-ante. As discussed in n 15, this chapter disregards the incentive effects of the distribution of transaction surplus.

inefficiency of RPTs aiming to expropriate non-controlling shareholders depends on their ex-ante effect on the cost of capital: anticipating expropriation, investors will discount the price of non-controlling stock without distinguishing between companies that expropriate or not. However, not all RPTs entail expropriation.

A textbook example of RPT is where company A purchases equipment from company B, which is fully owned by the CEO of company A. Putting a high price on equipment can be instrumental in the expropriation of investors. However, such a pricing may also compensate for special tailoring of the equipment to the buyer's needs, which might prospectively increase the buyer's profit. This stylized example reveals that RPTs do sometimes have a business purpose and can be value-increasing from the perspective of the companies entering into them. Having RPTs reviewed is instrumental in screening for value-increasing transactions of this kind.

RPT review must be backed by courts to be credible. This is important to ensure that a legal regime of RPTs can ultimately be enforced by appealing to a court if its rules are violated. Credible enforcement, however, does not require that courts determine whether RPTs are actually value-increasing or value-decreasing. Even the most sophisticated judges are not well positioned to make a verdict on this matter. As with other business decisions, RPTs are litigated only when they turn out badly. Because there are no professional standards for business decisions, these are reviewed with hindsight bias.[3] The fundamental incompetence of courts to evaluate the efficiency of RPTs stems from the same rationale behind judges' abstention from second-guessing business judgment. This incompetence has key consequences for the choice of RPT review.

Ex-post court review of RPTs can be of two types: procedural or substantive. A procedural review validates the RPT if it was approved with due process. A substantive review evaluates the RPT in comparison with a market transaction concluded at arm's length. Despite the decision-maker's conflict of interests, an RPT concluded on arm's length terms cannot be unfair, because investors lose nothing compared to market alternatives. Although this criterion is widely employed by courts, Transaction Cost Economics (TCE) reveals that it is often practically useless to evaluate RPTs.[4] In order for RPTs to have a business purpose they should be conducive to transaction cost savings, which, in turn, depend on the identity of the related parties. This makes it difficult to evaluate RPTs in comparison with arm's length transactions.[5] RPTs departing from the market price may be efficient ex-ante if transaction cost savings are taken into account. However, they may look unfair if courts cannot verify the transaction cost savings ex-post. Therefore, substantive ex-post review tends to over-deter RPTs as it leads courts to second-guess, with hindsight bias, the decision to enter into RPTs.

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[3] Holger Spamann, 'Monetary Liability for Breach of the Duty of Care' (2016) 8 JLA 337.
[4] See text to n 43-53.
[5] To be sure, RPTs may not have any meaningful business purpose and still be regarded as fair based on the arm's length criterion. Take, for instance, dealing on standard products or services with the controlling shareholder's family at market prices. Although such transactions seem innocuous for minority shareholders, they are particularly suspicious because there is arguably no economic benefit from entering into such RPTs. The screen I advocate in this chapter would be rather challenging for such transactions, although substantive court review would allow them.

Procedural review may fare better in terms of screening for value-increasing RPTs. In this regime, the assessment of an RPT is delegated to a disinterested party, with courts checking only the due process of the assessment. When the assessment is informed and independent of the corporate controller, the transaction is considered procedurally fair and is not re-evaluated ex-post. Procedural review has two advantages compared to substantive review. First, RPTs are evaluated ex-ante, not ex-post, which dramatically reduces hindsight bias. Second, RPTs are potentially evaluated by agents with incentives to maximize shareholder value (including transaction cost savings) and whose conduct may be reviewed legally and reputationally on the basis of professional standards, which are not available for business judgment. The difficulties with procedural fairness arise from the two requirements of information and independence of the assessment.

There are two techniques to implement the requirement of a disinterested screening of an RPT: approval by (non-controlling) shareholders; and approval by the board of directors. Both techniques may suffer, albeit to different degrees, from a lack of information and/or a lack of independence. Therefore, neither of them, nor a combination of the two, can guarantee that only value-increasing transactions proceed whereas all value-decreasing RPTs are stopped. As I will explain in this chapter, there is a trade-off between promoting the former and curbing the latter. Moreover, this trade-off is company-specific as the potential benefits of RPTs vary between companies and with time. The optimal RPT regime is thus a default one, which companies can opt out of.

Looking at two effective RPT regimes – those of the U.S. and the UK – this chapter will argue that the efficiency of both models can be improved at the margin. In particular, a procedural review, which is part of the UK tradition, is preferable to a substantive review, which can always be invoked in the U.S., particularly in Delaware, because the mere threat of ex-post judicial review tends to over-deter RPTs.[6] On the other hand, applying a procedural standard without additional safeguards may under-deter RPTs, especially in the presence of a controlling shareholder, which may undermine directors' independence and, hence, the quality of the screen. To cope with this problem, the UK model has traditionally relied upon the power of institutional investors to constrain independent directors reputationally, as a majority of UK shareholders have the power to remove directors at will.[7] This approach achieves both too little and too much. Recently, the inflow in the UK market of majority shareholders, who cannot be outvoted, has made this approach ineffective to police RPTs in particular cases.[8] More generally, in the age of hedge fund activism, such broad powers of non-controlling shareholders may become excessive. Short of the presence of majority shareholders, which are rare and may

[6] As I explain below, text to n 73-77, this outcome depends on the assumption of credible enforcement of the RPT regime – as in the U.S. – and on the burden of proof. In the absence of meaningful reference to an arm's length transaction, the burden of proving substantive fairness is very high. Failing procedural fairness, or whenever Delaware courts put on the defendant the burden of proving substantive fairness, the controller is unlikely to win the trial. See also Rock (2018) in this volume.
[7] Alessio M Pacces, 'Controlling the Corporate Controller's Misbehaviour' (2011) 11 JCLS 177, 206-207.
[8] Bobby Reddy, 'The Fat Controller - Slimming Down the Excesses of Controlling Shareholders in UK Listed Companies' (2017) University of Cambridge Faculty of Law Research Paper No. 47/2017 <http://dx.doi.org/10.2139/ssrn.3056999> accessed 19 April 2108.

have other reasons to self-police RPTs,[9] a general outsider's influence on the appointment and removal of board members is not limited to policing RPTs, and potentially provides activists with the leverage to oppose the controller's strategic choices. This may or may not be efficient for a particular company.[10]

To deal with RPTs, I suggest introducing a new category of players in the boardroom: the non-controlling shareholders-dependent (NCS-dependent) directors. Non-controlling shareholders should have the exclusive right to nominate, appoint, and remove such directors. By default, NCS-dependent directors should account for a minority of the board, and their mandate should be limited to screening RPTs. The assessment of RPTs by NCS-dependent directors would be final and courts would only review due process. Moreover, only NCS-dependent directors would be exclusively accountable to non-controlling shareholders. Controllers would continue to appoint the majority of the board, unless the appointments were contested. These rules would aim to foster independence and information in the RPT review, without generating potential inefficiencies. Yet, companies should be free to depart from the default regime and opt into a more governance-intensive role of NCS-dependent directors to include, for instance, a mandate to represent non-controlling shareholders in strategic decisions. By the same token, companies should be free to opt into a regime with or without NCS-dependent directors, in which RPTs are subject to substantive court review or must be approved by non-controlling shareholders.

The remainder of this chapter is arranged as follows. The next section (Section 2) explains why RPTs may be efficient and illustrates the trade-off between effective and efficient review of RPTs. Section 3 discusses the substantive and procedural standards of review, including their shortcomings. Section 4 presents the NCS-dependent directors proposal, contrasting it with the regimes of the U.S. and the UK. Section 5 addresses potential criticisms of the proposal, while Section 6 provides a conclusion.

2. Putting RPT Review in Context

2.1. What are RPTs and how can they be efficient?

RPTs are not undesirable per se, but they are undesirable when they are instrumental to tunnelling.[11] Tunnelling is a term used to describe several techniques

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[9] Sang Yop Kang, '"Generous thieves": The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions' (2015) 21 Stan J L Bus Fin 57.

[10] In Alessio M Pacces, 'Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance' (2016) 2016/4 Erasmus Law Review 199, 214-215, I argue that companies for which this outcome is inefficient should be able to opt out of one-share-one-vote. One-share-one-vote is currently mandatory for companies in the premium listing of the UK market. See Davies (2018) in this volume. In this chapter, I focus on the legal techniques to achieve efficient RPT control independently of the distribution of governance rights between controllers and non-controlling shareholders.

[11] Simon Johnson and others, 'Tunneling' (2000) 90 Am Ec Rev 22, first used tunnelling to describe investor expropriation.

applied to expropriate investors, typically – but not exclusively – non-controlling shareholders.[12] Investors are expropriated by way of transferring resources, or claims thereon, from the company to its management, controlling shareholders (if they exist) or their affiliates, which may be individuals or corporate entities in which the corporate controllers have an interest. One straightforward way to engage in tunnelling is to allow the company to deal with the controller's related parties. RPTs can be instrumental in *cash-flow tunnelling*, where the company – and investors, pro-rata – are deprived of profit, or *asset tunnelling*, where the company is deprived of productive assets and investors lose the pro-rata value of their claim to such assets.[13]

In this chapter, I do not deal with other forms of tunnelling, such as direct dilution of the investors' claims (*equity tunnelling*). On the one hand, equity tunnelling does not necessarily involve RPTs because dilution may be implemented unilaterally by the corporate controllers, for instance by trading controlling stock on terms other than non-controlling stock. On the other hand, corporate control transactions sometimes involve RPTs and the risk of equity tunnelling.[14] Control transactions, however, differ from RPTs because the distribution of the gains between the controller and non-controlling shareholders determines whether an efficient control transaction goes through, whereas an RPT's efficiency does not depend on the distribution of the surplus. RPTs are both viable and efficient if the company entering into them lose nothing.[15]

Not all RPTs entail tunnelling. A controlling shareholder may decide that the company purchases equipment from a sister company, which is fully owned by the controller, as the sister company owns the machinery to produce the equipment at the lowest cost. The conflict of interests would make investors suspicious that the purchase price is too high. Assume, however, that although there are cheaper products on the market, no equipment is really comparable to the one being sold by the sister company. One possible reason for this is that the equipment in question, for instance automotive engines, is highly specialized for the group's production. Under these assumptions, purchasing the related party's equipment may be efficient because it enables the company to exploit unique synergies. Such synergies are common in corporate practice, particularly in corporate groups. The complication here is that corporate groups feature minority shareholders that may be disadvantaged by the operations with the controller's company. Minority

[12] Tunnelling can expropriate creditors, too, although I am not looking at this problem in this chapter. See John Armour, Luca Enriques and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, OUP 2017) 105.
[13] Vladimir Atanasov, Bernard Black and Conrad Ciccotello, 'Law and Tunnelling' (2011) 37 J Corp L 1, 5-9.
[14] See Rock (2018) in this volume, in the context of freeze-out transactions.
[15] In previous work I discussed why, provided that non-controlling shareholder lose nothing from the control transaction, fostering efficient changes in control requires excluding non-controlling shareholders from the transaction surplus. The latter are supposed to reward the acquirer's investment as well as the incumbent controller's idiosyncratic private benefits of control (in the form of control premiums and golden parachutes). See Alessio M Pacces, *Rethinking Corporate Governance: The Law and Economics of Control Power* (Routledge 2012) 127-140.
Goshen & Hamdani (2018) in this volume take a similar approach to RPTs, arguing that they can reflect efficient idiosyncratic choices of the controller so long as non-controlling shareholders lose nothing. However, they do not allow the controller to grab the transaction surplus to compensate idiosyncratic private benefits of control.

shareholders are, in principle, not needed to exploit group synergies, which raises the question of why they are there at all if not to be expropriated.

The existence of minority shareholders in corporate groups suggests that they make economic sense. Investors purchase the stock of companies belonging to business groups at a discount accounting for the risk of tunnelling. If corporate controllers choose to have minority shareholders that price the tunnelling risk, which is higher the higher the size and the complexity of corporate groups, there must be some countervailing benefit. I posit that this benefit, which applies to RPTs more generally, is transaction cost savings.

According to Ronald Coase's definition, transaction cost is the cost of using the price mechanism.[16] This does not simply include the cost of negotiating, drafting and enforcing contracts. In addition, and more importantly, there is the cost of adapting contracts to unforeseen circumstances, which is crucial in the uncertain world of business. According to TCE, markets and hierarchies are two polar opposite ways of organizing transactions, with spot market exchange at one end of the spectrum and vertically integrated firms at the other.[17] The advantage of spot market exchange is the presence of prices, which prompt firms to adapt quickly but undermine their incentives to specialize. If firm A specializes in supplying firm B, the investment of firm A becomes worthless the moment firm B terminates the supply contract. In other words, transaction costs undermine asset specificity. Integrated firms support asset specificity by coordinating, instead of negotiating, adaptation to new circumstances. However, the shortcoming of coordinated exchange is that incentives are much weaker than in market exchange. Sometimes, firms need a moderate degree of asset specificity, but still require some incentive intensity to perform. As shown by Professor Williamson[18], the optimal organization in these situations is a hybrid between impersonal markets and vertical integration. Examples of hybrid organizations are franchising and other long-term contracts.

RPTs, too, support hybrid organizational structures motivated by transaction cost savings. Compared to arm's length transactions, RPTs allow for negotiation and renegotiation cost savings, relationship-specific investments in supply and service contracts, and even for funding that would not be available on regular capital markets (so-called internal capital markets).[19] All of this would, likewise, be available to a large, multidivisional firm, but with a fundamental difference. Multidivisional firms face no limits regarding the size of transfers between divisions because they all belong to the same firm with the same owners. Because, on the contrary, RPTs occur between legally separated entities with different owners, the size of transfers within corporate groups, or even family networks, is constrained by law. Leaving creditor protection aside, the presence of minority shareholders limits the controller's ability to overpay for tailored supplies insofar as the RPT regime effectively curbs

[16] Ronald H Coase, 'The Nature of the Firm' (1937) 4 Economica 386, 390-392.
[17] Oliver E Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (Free Press 1975).
[18] Oliver E Williamson, 'Comparative Economic Organization: The Analysis of Discrete Structural Alternatives' (1991) 36 Admin Sci Q 269.
[19] On internal capital markets as economic justification of business groups, see Ronald W Masulis, Peter Kien Pham and Jason Zein, 'Family business groups around the world: Financing advantages, control motivations, and organizational choices' (2011) 24 Review of Financial Studies 3556.

tunnelling. On the one hand, this harnesses the controller's incentive to manage the company efficiently. On the other hand, this enables asset specificity to the extent that rewarding it is acceptable to minority shareholders.

From a TCE perspective, non-controlling shareholders are a commitment device for RPTs to support a hybrid governance structure, whenever it would be efficient to do so. Imagine for a moment a 'no-tunnelling' regime.[20] In such a regime, an RPT may result in no loss for non-controlling shareholders, although a favourable allocation of the transaction surplus to the related party may be necessary to support relationship-specific investments. The question for hybrid organizations, and hence of efficient RPTs, is whether they can generate a sufficient surplus to reward relationship-specific investments. Going back to the automotive engine example, the price of a tailor-made engine could depart from the price of a standard engine up to a point (the 'no-tunnelling' point) in which non-controlling shareholders expect to receive at least as much in terms of return from asset specificity. Beyond that point, the only solution is vertical integration. In the TCE framework, the choice between hybrids and vertical integration depends on the frequency of disturbances to the status quo. In the previous example, this would refer to how often the engine would have to be adapted for the vehicle's production. Frequent adaptation of relationship-specific investments is too costly for hybrids to support.[21]

RPTs that, in principle, have the business purpose of economizing on transaction cost, give rise to two problems. One is the question of how the transaction gains should be divided between the parties. Although this is a crucial question in terms of incentives, I omit it from the scope of this chapter and instead focus on a second issue, namely the risk of tunnelling. The economic function of RPTs would be undermined if they could be used for investor expropriation, as non-controlling shareholders could no longer play their role as a commitment device. To avoid this problem, the law should prevent value-decreasing RPTs. Implementing such a restriction is not straightforward in the absence of references to market prices. In particular, a 'no-tunnelling' regime may result in forgoing value-increasing transactions – i.e. transactions with expected returns offsetting the difference from market prices – and create other inefficiencies in corporate decision-making.

2.2. The Trade-off between Effective and Efficient Review of RPTs

An effective RPT regime implements the prohibition of stealing in corporate governance. Virtually every company law system includes such a prohibition by stating that distributions to shareholders must be done pro-rata.[22] Because RPTs are a way to execute non-pro-rata distributions, it might be tempting to prohibit them altogether. Although prohibiting RPTs altogether would not be a good idea, as

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[20] The next section, text to n 39, explains why this is practically unattainable.
[21] Sharon Belenzon, Patrick Bolton and Ulya Tsolmon, 'The Organization of Innovation across Countries and Industries' (2013) Unpublished Working Paper Duke University <https://pdfs.semanticscholar.org/e389/d660ab42a1a7415105c5c44ea25d5a3c5ed3.pdf> accessed 19 April 2018.
[22] 'But there are a million and one ways to evade such a rule.' Edward B Rock and Michael L Wachter, 'Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation' (2001) 149 U Pa L Rev 1619, 1661.

reflected by the fact that company law jurisdictions feature only selective prohibitions,[23] this option is worth considering to illustrate how it simplifies the problem.

There is no need to review RPTs if they are prohibited. Rather, one would need to screen the company's operations to identify an RPT. This represents an enforcement problem. To reduce the cost of enforcement, law can mandate the disclosure of clues to identify suspicious transactions, such as a list of the corporate controller's related parties and of material transactions with them. If well designed, such disclosure obligations must be breached in order to carry out unlawful RPTs. Thus, an effective prohibition of RPTs would require only aggressive enforcement of disclosure obligations. This could be an attractive option for countries with weak enforcement institutions, particularly incompetent or corrupt courts, which cannot be trusted to review RPTs substantively or procedurally.[24]

The prohibition of RPTs, however, would not deliver significant progress. As noted by Professor Enriques[25], even if enforced effectively, such a prohibition would not accomplish much in terms of policing expropriation. Because RPTs are only one way of expropriating investors, an effective prohibition of RPTs would shift tunnelling to other techniques. A broad prohibition of tunnelling would be costly to enforce because tunnelling techniques are virtually infinite. Moreover, a prohibition of RPTs would be self-defeating in the long run because judges may not be comfortable with the outcome of individual cases, leading to exceptions. Aside from judges, interest groups would lobby for relaxation of the prohibition in order to allow value-increasing RPTs, especially if the latter were permitted by other jurisdictions.[26] Therefore, an effective regulation of RPTs must also include a screen for value-increasing transactions. An efficient standard of RPT review should allow value-increasing RPTs while remaining effective at preventing value-decreasing RPTs.

Techniques to review RPTs differ in terms of effectiveness and efficiency. An ineffective review of RPTs is always inefficient. This is not because tunnelling reduces the value of the company entering into RPTs as the related parties will most often gain as much as the company loses, which is a merely distributional issue. Allowing for value-decreasing RPTs is inefficient because, fearing such transactions, investors would be reluctant to finance companies to start with. Preventing (or capping)[27] tunnelling ex-post is efficient ex-ante because it lowers the cost of capital for firms willing to go public, all else being equal.

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[23] Armour, Enriques and others, *The Anatomy* (n 12) 158-161.

[24] However, this solution would only work temporarily. See below, text to n 26, the self-defeating character of prohibitions.

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

[26] See Davies (2018) in this volume illustrating the evolution if the common law prohibition of self-dealing through the companies' articles of association. See also the more recent evolution of case law in Israel, to relax the RPT regime (Licht 2018 in this volume).

[27] A few law and economics scholars have argued that value-decreasing RPTs should be allowed to an extent limited by contract. See María Gutiérrez and Maribel Sáez, 'A Contractual Approach to Discipline Self-Dealing by Controlling Shareholders' (2014) ECGI-Law Working Paper 138/2010 <http://dx.doi.org/10.2139/ssrn.2440663> last accessed 19 April 2018; and Ronald J Gilson and Alan Schwartz, 'Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review' (2013) 169 JITE 160. The problem with this approach is that a cap on tunnelling

An effective review of RPTs is thus necessary for efficiency. However, the costs of an effective RPT review could offset its benefits. RPT review entails direct and indirect costs. Direct costs are akin to the administrative cost of any legal discipline such as the costs stemming from shareholder voting if shareholders have to validate an RPT, or from adjudication by courts if the latter have to determine whether RPTs are fair. Although these costs can be substantial, they are relatively small compared to the values at stake in RPTs. Moreover, since the seminal work of Gary Becker,[28] the point that efficient enforcement (e.g. hiring the optimal amount of police) is lower than effective enforcement (e.g. hiring as much police as necessary to bring crime to zero) has been well acknowledged by the legal scholarship. Because minimizing the direct costs of RPT review is quite straightforward,[29] here I focus on the indirect costs, which are particularly problematic in terms of efficiency.

RPT review generates indirect costs by causing inefficient corporate governance behaviour. An intuitive source of inefficiency is forgoing value-increasing RPTs. This, as we have seen, is why a prohibition of RPTs would not be sustainable, even if it were effective. Likewise, RPTs may be over-deterred if the standard of review is too strict, for instance because courts, in the presence of a conflict of interests, require controllers to prove that RPTs are concluded on arm's length terms – a test that, as I will explain, most business-minded RPTs are bound to fail. In practice, this situation may revert to a quasi-prohibition, which is effective in the presence of aggressive enforcement of instrumental disclosure rules, but is not efficient.[30]

RPT review can lead to corporate governance inefficiency in another, less intuitive way. When the effectiveness of the regime is dependent on far-reaching governance rights of non-controlling shareholders, the latter may end up being overly empowered compared to what is optimal for a particular company. In previous work, I have argued that it is efficient for certain companies to opt into a temporary governance regime in which non-controlling shareholders, particularly activist hedge funds, cannot interfere with the strategic choices of the corporate controller, be that the management of a dispersed ownership company or a dominant shareholder.[31] Companies for which fending off hedge fund activism may make economic sense are often the same companies that benefit from RPTs. These companies operate in industries (such as pharmaceuticals and transportation) where innovation is often discrete (i.e. requires moderate asset specificity) and disturbances are infrequent (i.e. innovation is long-cycle).[32] Therefore, while these companies benefit from a commitment not to expropriate minority shareholders via RPTs, making hybrid organizations viable, they also suffer from pressure from activist hedge funds to generate short-term results.[33] When effective RPT control is achieved via far-

may not be enforceable by courts. See Pacces, *Rethinking* (n 15) 97 and 150-152, and Enriques, *Related Party* (n 25) 7.

[28] Gary S Becker, 'Crime and Punishment: An Economic Approach' (1968) 76 J Pol Econ 169.

[29] The approach to RPT review recommended by this chapter – NCS-dependent directors – also reduces direct administrative costs compared to existing regimes. See n 96.

[30] This is the situation in the U.S., as explained in text to n 77.

[31] This is a regime based on dual-class shares. See Pacces, *Exit, Voice and Loyalty* (n 10) 214-215.

[32] Belenzon, Bolton and Tsolmon (n 21) 20-22.

[33] As shown by Belenzon, Bolton and Tsolmon (n 21) in Figure 3, such companies are frequently organized as groups with minority shareholders in continental Europe. In the U.S. and the UK, however, companies in the same industries are organized as multidivisional companies or groups of

reaching powers of non-controlling shareholders, the efficient governance of such companies may be undermined.[34]

This proposition may sound counterintuitive from a law and economics perspective, which has long considered minority shareholder approval the most effective way to curb tunnelling.[35] How could a system of RPT control, which is seemingly a self-contained matter, lead to a general over-empowerment of non-controlling shareholders? The reason is that it is very difficult to limit the powers of non-controlling shareholders to RPT review. If approving RPTs is all that shareholders can do, this screen would likely be ineffective due to a lack of information. If shareholders can do more to obtain information on RPTs, in practice they would be able to use this power to influence strategy as well.[36]

To frame the indirect cost of RPT review, I look at the errors in the enforcement of the RPT regime. In law and economics, errors in law enforcement are defined as false positives and false negatives, borrowing from a paradigm of statistical inference.[37] For example, a false positive is the conviction of an innocent person, while a false negative is the acquittal of a guilty person. Efficient enforcement requires that the joint cost of these errors be minimized.[38] In the RPT domain, false negatives are value-decreasing transactions that proceed because the RPT review is ineffective. False positives are of two kinds, namely value-increasing RPTs that fail to proceedand arguably efficient strategic choices that fail to be implemented because of opposition from powerful non-controlling shareholders. Although such inefficiencies are not necessarily related to RPTs, they would not occur if the RPT regime did not rely on far-reaching governance rights to be effective.

The false negatives/false positives framework is useful when analysing the relationship between the effectiveness and efficiency of RPT review. To reduce false positives, the standard of review could be relaxed. Courts could, for instance, put on the plaintiff the burden of proving that RPTs were value-decreasing. Similarly, courts could assume that shareholder approval is sufficient to validate an RPT, unless the plaintiff demonstrates that shareholders lacked sufficient information to decide. While this approach would reduce the indirect cost of RPT review, it would most likely undermine its effectiveness and let some value-decreasing RPTs through, which is also inefficient. These examples reveal that there is a trade-off between the false negatives and false positives of RPT review. Although in general reducing the risk of

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wholly owned subsidiaries. One of the possible explanations of this outcome is that the RPT regimes in the U.S. and in the UK are too strict. See text to n 72-88.

[34] Ineffective RPT control would likewise fail to support hybrid governance structures. As explained in text to n 21-22, if RPTs can be instrumental to tunneling, the controller cannot take any credible commitment towards minority shareholders, which undermines the purpose of a hybrid structure. Because there is a tradeoff between effectiveness and efficiency of RPT control and neither extreme supports hybrid governance structures, perhaps there is an optimal combination of effectiveness and efficiency. Unfortunately, the analytical framework of this chapter (false positives/false negatives, discussed below) is too coarse to identify this optimum.

[35] Simeon Djankov and others, 'The Law and Economics of Self-Dealing' (2008) 88 J Fin Econ 430.

[36] For instance, activists claiming board representation to dig deeper into RPTs may use their representatives to put pressure on the target company towards changing innovation strategy altogether. See text to n 60-71.

[37] Robert Cooter and Bradley J Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 NYU L Rev 1045, 1070.

[38] I am not considering direct administrative costs here. But see n 29.

false positives increases the risk of false negatives, and vice versa, the balance between the two types of errors can be improved.

Marginal analysis is helpful in this exercise. When two inputs are perfect substitutes for each other and have different marginal costs, switching from an input with high marginal cost to an input with low marginal cost is an obvious strategy to minimize cost. This is attributable to the law of diminishing marginal returns to input.[39] Because false negatives and false positives of RPT review are not homogeneous inputs and their costs are company-specific, the joint cost of these errors cannot be minimized with precision. However, in jurisdictions where the marginal cost of false negatives is likely to be significantly higher than the marginal cost of false positives – reflecting a situation in which RPTs are vehicles for substantial investor expropriation – the balance can be improved by adopting a stricter standard of review. On the contrary, where the marginal cost of false positives is likely to be significantly higher than the marginal cost of false negatives – reflecting a situation in which RPTs can hardly be entered into – the balance can be improved by relaxing the existing standard of review. Finally, in both cases, the cost of RPT review can be reduced by letting individual companies opt out of the default regime, if it does not suit them.

In the following sections, I will first discuss the main types of RPT review. Secondly, I will carry out a functional analysis of the two most effective models of RPT control – those of the U.S. and the UK – and discuss how their efficiency can be improved.

3. Standards of Review: Substantive versus Procedural

The review of RPT does not operate in a vacuum. Functionally, a standard of review needs to be combined with disclosure obligations and effective enforcement. As revealed by the previous example of RPT prohibition, an RPT regime requires disclosure to enable knowledge of violations and enforcement to deter nondisclosure.[40] In the presence of a more nuanced standard of review, the requirements of disclosure and enforcement become more sophisticated, but the same principle stands. For instance, even the most efficient standard of review would become useless if conflicts of interest could be hidden by obscure beneficial ownership, or if investors had no access to reliable courts. In this chapter, I assume away such issues in order to focus on the standard of review.[41]

A standard of review is a technique for courts to determine whether certain behaviour is legal or not. From a law and economics standpoint, a standard of review should distinguish between value-increasing and value-decreasing RPTs from the perspective of the individual company. Judges, however, tend to regard this matter differently. Courts are generally willing to determine ex-post whether RPTs were or were not 'fair', namely in breach of the duties of the person(s) who decided to enter into them. Because controllers have duties to act in the best interest of the company,

[39] Robert S Pindyck and Daniel L Rubinfeld, *Microeconomics* (7th edn Pearson International 2009) 202-203.
[40] Ronald J Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119 Harv L Rev 1641, 1653.
[41] See Pacces, *Controlling* (n 7) 192-201 for how these functional requirements interact.

functionally this implies that actions which are intendedly value-decreasing are unfair. Not knowing which RPTs are actually value-increasing or value-decreasing, courts test the fairness of RPTs indirectly.[42]

There are two standards for reviewing the fairness of RPTs. One is substantive fairness, which implies that the terms of the transaction were not harmful to (non-controlling) shareholders. The other is procedural fairness, which infers the non-harmfulness of the transaction from the procedure through which it was decided. The question is whether a standard exists allowing a judge to make a substantive assessment of the transaction, particularly whether dealing with a related party has any business purpose at all. The answer, as I am going to show, is negative, which explains why the most sophisticated courts rely on procedural fairness, albeit to different extents.

3.1. The pointlessness of the arm's length criterion of substantive fairness

A seemingly promising standard of substantive fairness – often incorporated by legislation – considers RPTs fair if they are carried out at arm's length. Under such a standard, courts would sanction an RPT if the price did not depart from market conditions. Theoretically, non-controlling shareholders cannot be worse off if they get as much as the best available market alternative to the RPT in question. However, if the RPT is truly identical to an arm's length transaction, one may wonder why the company would not rather deal with an unrelated party. Because the identities of the parties are crucial for transaction cost savings[43], RPTs that have a business purpose cannot be identical to an arm's length transaction. Once transaction costs are taken into account, an RPT concluded on worse terms than arm's length may be unharmful to non-controlling shareholders. The problem here is that although courts *can* verify market prices they *cannot* always verify transaction cost savings.

According to TCE, defining whether an RPT has a business purpose depends on the transaction characteristics such as asset specificity, uncertainty, and low frequency.[44] Assume a business with a related party characterized by relationship-specific assets, for instance electronics for a particular carmaker. Assume furthermore a relatively infrequent interaction, for instance only when a new car model is introduced. Finally, assume that the business is facing uncertainty at discrete intervals, for instance regarding whether the sales of the new car model would be sufficient to repay the relationship-specific investments. This is a stylized business case for a hybrid governance structure, in between impersonal markets and vertical integration, which supports RPTs.

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[42] In company law, the standards of review of corporate decision-making, such as substantive or procedural fairness, may depart from the standards of conduct governing it, such as the director's fiduciary duties of care and loyalty. Melvin A. Eisenberg, 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993) 62 Fordham L Rev 437. This is because corporate decision-making is undertaken under conditions of fundamental uncertainty. Frank H Knight, *Risk Uncertainty and Profit* (first published 1921, Augustus M Kelley 1964) 310-312. Uncertainty ex-ante makes it very difficult for courts review the conduct of business decisions ex-post.
[43] Williamson (n 18) 282.
[44] Text to n 16-21.

The transaction between parties to a hybrid governance structure cannot be meaningfully compared with a transaction at arm's length. For example, purchasing navigation equipment from the related party makes sense if it can be tailored to idiosyncratic features, such as the automatic driving software of the carmaker. The purchase price would be higher than a standard navigation system, although this difference may be more than compensated by synergy gains. When the supplier must deliver certain qualities, which cannot be spelt out in a contract, the price must be high enough to support asset specificity. If the corporate controller has a substantial interest in the supplier, applying the arm's length criterion may not allow such an RPT to proceed even though the expected value of the RPT is positive for the company entering into it. On the contrary, the arm's length criterion would allow the purchase of standard navigation systems from the related party at the market price, even if the cost of tailoring them vastly exceeded the synergy gains expected from the previous RPT. Purchasing standard equipment from a related party must then conceal subtler forms of tunnelling, as this can hardly have a business purpose.[45]

Because the decision to enter into RPTs is ultimately a business decision, courts should not review their merits. But, since the arm's length criterion is not really useful, judges seeking to determine the substantive fairness of an RPT must form an idea about the relevance of transaction cost savings. This is equivalent to reviewing an RPT's business purpose. Judges, however competent and informed, are ill-equipped to do this. The standard argument is that judges are not business experts, but this is not the real reason. Judges are not experts in many behaviours and areas, and yet they review them. For instance, judges are not medical experts, but they review cases of medical malpractice. The key difference here is the presence of professional standards.[46]

Courts can review doctors' conduct based on existing professional standards. Such standards do not exist for business decisions, because they are idiosyncratic and are made under conditions of uncertainty.[47] As a result, the review of business decisions is intrinsically prone to hindsight bias.[48] Such decisions, including the decision whether or not to enter an RPT, are only challenged when they turn out badly. Because, unlike medical cases, there is no objective standard of conduct to determine whether a business decision made sense ex-ante, courts would be less inclined to detect any business purpose of an RPT when they observe the company's poor performance ex-post. This, however, does not necessarily mean that RPTs were not expected to be value-increasing when they were entered into. It only implies that their expected benefits have not materialized ex-post, be it because of misjudgement, bad luck, or because indeed tunnelling was the only purpose of the RPT.

These arguments against courts second-guessing business decisions are usually deployed to support the Business Judgment Rule (BJR). The BJR is a doctrine

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[45] The procedural review advocated by this chapter would subject such transactions to an arguably tougher scrutiny by NCS-dependent directors. See also n 5.
[46] Spamann (n 3) 357.
[47] Pacces, *Rethinking* (n 15) 250-251.
[48] G Mitu Gulati, Jeffrey J Rachlinski and Donald C Langevoort, 'Fraud by Hindsight' (2004) 98 Northwest U L Rev 773.

developed by U.S. state courts. Under a number of conditions, including the absence of conflicts of interest, courts will abstain from reviewing the merit of a business decision in a company. Functionally, the goal of the BJR is to avoid making directors and officers overly risk-averse in their decision-making, which explains why this rule is applied functionally in both U.S. jurisdictions and beyond.[49] Although, formally, the BJR does not apply to RPTs[50], the limitations of a substantive review of RPTs by courts stem from the same rationale behind the BJR. Being unable to step into the shoes of the management or controlling shareholders when they decided to enter an RPT, judges would be reluctant to consider them fair when they are litigated ex-post. Knowing this, controllers would enter fewer value-increasing RPTs in the first place.

In terms of my earlier classification of error costs, substantive review of RPTs structurally generates false positives. On the other hand, substantive review performed by competent courts and backed by credible enforcement mechanisms leads to few false negatives, particularly if the burden of proving substantive fairness is on the controller.[51] Proving that an RPT was carried out at arm's length would be hard if the RPT was instrumental in tunnelling. Under these assumptions, a controller seeking to expropriate investors via an RPT would be deterred by the prospect of a lawsuit, not so much because of the risk of liability, but rather because of its shaming effect.[52]

3.2. Procedural fairness and its limits

In the context of companies benefiting from RPTs, the balance between false negatives and false positives can be improved by moving from substantive to procedural fairness. Procedural fairness requires due process, which in turn implies that the RPT is knowledgably approved by directors or shareholders who do not have the same conflict of interests as the corporate controller. When reviewing procedural fairness, courts only check whether the approval was informed and independent from the controller, effectively delegating the review to a third party.

So long as the two assumptions of the information and independence of the reviewers hold true, moving from a substantive to a procedural review of RPTs is efficient. This is an informal way to express the condition that the marginal cost of false positives is higher than the marginal cost of false negatives. In jurisdictions where the RPT regime is enforced by competent courts, the latter would be able to verify the information and independence requirement as opposed to transaction cost savings, which are not verifiable. Hence, courts stepping away from substantive

[49] The BJR is actually not a rule, but a standard to review directors' conduct. See Armour, Enriques and others, *The Anatomy* (n 12) 68-70.
[50] This normally holds true unless the RPT is emancipated from the underlying conflict of interest by way of due process, which is the procedural standard of review discussed in the next section.
[51] This is the RPT regime in the U.S., if the RPT fail the procedural fairness test. See text to n 73.
[52] As shown by the empirical literature, directors do not face any meaningful risk of out-of-pocket liability, not even in jurisdictions – such as the U.S. – where litigation of RPTs is a credible threat. Bernard S Black, Brian R Cheffins and Michael Klausner, 'Outside Director Liability: A Policy Analysis' (2006) 162 JITE 5. What deters directors' misbehaviour is rather shaming in the professional community they belong to. See the discussion of deterrence along these lines in Pacces, *Controlling* (n 7) 196-198.

review would likely lead to a more significant decrease of false positives compared to the increase of false negatives.

Procedural review is preferable to substantive review for two reasons. First, the assessment of an RPT takes place ex-ante, not ex-post. Because an independent and informed approval by directors or the shareholders is necessary and sufficient for the validity of an RPT, the hindsight bias problem becomes less severe. In an RPT trial, judges observing unsuccessful transactions may still doubt the quality of the approval, particularly the decision of directors to recommend it. However, unlike strategic business decisions, such as whether or not to set up a hybrid governance structure, the monitoring functions of the board of directors are increasingly standardized. There are professional standards to review a director's conduct in the domain of RPTs, comparable to the standards applying to medical doctors. Courts could thus be persuaded that overlooking a particular bit of information, which ex-post turned out to be crucial, was justified by the professional standards for RPT screening. To avoid hindsight bias, courts should be disallowed from re-assessing the merits of RPTs. If the approval does not meet the prevailing independence and information standards, courts should simply consider the RPT invalid.[53]

The second advantage of a procedural review of RPTs is the identity of the reviewers. To qualify for procedural fairness, RPTs have to be reviewed by independent directors, independent shareholders, or both. These categories of people are arguably better placed than judges at screening for value-increasing RPTs. Directors are usually more knowledgeable about business transactions, whereas shareholders have better incentives to stop tunnelling to their disadvantage. Therefore, combining the review by independent directors with the approval of independent shareholders could be an interesting option for companies that want to commit to efficient RPTs.[54] RPTs would be reviewed by the constituency with the strongest interest in getting them right, relying on information from skilled businesspersons, with courts checking only whether the review meets the prevailing standards for directors' monitoring. However, the matter is complicated by the fact that directors may not actually be independent and shareholders may not be informed.

Given that a procedural standard reduces the false positives of an RPT review, its ability to keep false negatives at bay strictly depends on the independence and information of the reviewers. Opportunistic managers or controlling shareholders may keep crucial information from non-controlling shareholders or appoint their representatives as independent directors. To be sure, courts can evaluate ex-post directors' independence and information much better than the business purpose of an RPT. However, courts can secure directors' independence and information only to a limited extent. On the one hand, courts may be not very knowledgeable about corporate governance.[55] On the other hand, ex-post court review could lead directors

[53] The shaming effect stemming from this outcome would be sufficient for deterrence. See text to n 111.
[54] See Enriques, *Related Party* (n 25) 20-21, noting that no main jurisdiction features such a rule, although Delaware comes close to it. See text to n 75. As hinted above (n 29), I am not considering the direct administrative cost of this solution here.
[55] Incompetent judges will tend to assess independence and information requirements in a formalistic way. As a result, even the combined screen by independent directors and non-controlling

to become defensive in reviewing RPTs to avoid the shame of a lawsuit. Finally, the lack of independence may be subtler: directors nominated, if not appointed, by the corporate controllers may not be truly independent in their judgment.

The law and economics literature,[56] along with the most sophisticated courts,[57] acknowledges that the review by independent directors cannot be assumed to be entirely independent. Short of plain opportunism, there is a structural 'there but for the grace of God go I' bias in boardrooms, which prompts directors – whether executive or independent – to side with one another.[58] There are several ways to address this bias. One way is to reintroduce the substantive court review in dubious cases. However, this may over-deter efficient RPTs that fail the arm's length test. Alternatively, the RPT regime may rely on shareholder approval to compensate for the lack of directors' independence. As I am going to show, this solution is illusory.

3.3. Shareholder Approval in the Age of Hedge Fund Activism

At least in theory, independence is not a significant problem for shareholder approval. It is sufficient to exclude the controllers' interest from the approval of RPTs by way of rules prescribing Majority of Minority (MOM) approval. A MOM vote effectively confers a veto right upon non-controlling shareholders. However, shareholders are dependent on directors for information regarding any conflicts of interest and the business purpose of an RPT. Shareholder approval of RPTs is only as good as the information underlying it. Although I am assuming that disclosure rules are enforced effectively, a lack of directors' independence can give bias to the information disclosed in ways that are not always verifiable by courts, unless they review the merits of the transaction. Due to collective action problems, both individual and institutional shareholders are unlikely to question the information provided by directors, unless they are prompted by someone to do so. So long as not entirely independent directors are the only source of shareholder information, adding shareholder approval to the RPT regime is unlikely to reduce the amount of false negatives.[59]

Recently, however, hedge fund activism has reduced shareholders' dependence on directors for information. By way of providing independent information to shareholders, hedge funds have become a tremendous agent for reducing the amount of false negatives in the review of RPTs. The business models of activist

shareholders could lead to false negatives. Independent directors could recommend the approval of RPTs geared towards expropriation because of undisclosed ties with the corporate controller. Not having alternative sources of information, shareholders would rubberstamp. Even worse, formalistic legislation might not even require shareholder approval to exclude the votes of the controlling shareholder (Majority of Minority). See Luca Enriques, 'Do Corporate Law Judges Matter? Some Evidence from Milan' (2002) 3 EBOR 765.

[56] Johnathan R Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2008) 90-104; Pacces, *Controlling* (n 7) 200-201; and María Gutiérrez and Maribel Sáez, 'Deconstructing Independent Directors' (2013) 13 JCLS 63.

[57] See text to n 73.

[58] Macey (n 56) 66-69. See also Zapata Corp v Macdonaldo, 430 A 2d 779, 787 (Del 1981).

[59] Pacces, *Rethinking* (n 15) 263. One may object that shareholders who doubt directors' independence may be inclined to say no to any RPT. This is unlikely for institutional shareholders who have decided to invest in a company engaging in RPTs in the first place. Shareholders unhappy with RPTs would rather seek to steer the management away from them, or exit the investment.

hedge funds clearly provide them with the incentive to uncover value siphoned-off via RPTs. The question is whether this may go too far, leading to false positives as well.

Hedge funds are agents for change, which has created opportunities and challenges for corporate governance. The challenges mainly stem from the fact that hedge funds are opportunistic, so their interest may not always align with what is best for a particular company.[60] Moreover, hedge funds do not exclusively focus on stopping value-decreasing RPTs, but have a broader interest in influencing the company's strategy in order to make it more profitable in the short term.

An RPT regime relying on activist hedge funds to be effective would lead to false positives of two kinds. Hedge funds may stop potentially value-increasing RPTs that are not profitable in the short run (e.g. an intra-group supply contract whose surplus has not yet materialized). Moreover, they could use their powers to intervene with the company's strategy (e.g. to break up corporate groups).

One obvious way for hedge funds to obtain a 'say on strategy' from shareholder approval of RPTs is blackmail. However, there is a more fundamental way to leverage a shareholder's right to approve RPTs. Like other shareholders, hedge funds need company-specific information to screen RPTs effectively. The most effective way to obtain this information is to appoint a representative to the board. Indeed, seeking board representation is what hedge funds typically do when they engage with a company.[61] Applied to RPTs, this is a very effective strategy to review them thoroughly. However, a hedge fund representative sitting on the board would do much more than review RPTs, unless he or she is constrained from doing so.[62] Moreover, the profits from stopping value-decreasing RPTs are probably too insignificant to motivate a hedge fund's engagement. Activist hedge funds seek to alter the strategy of the companies with which they engage, which may include changing the hybrid organization that motivates efficient RPTs. Experience has shown that activist hedge funds use whichever power the law confers upon (minority) shareholders to induce the board, or even a dominant shareholder,[63] to implement changes from which they can profit.[64] Whether these changes are always for the good of the company is debated.[65]

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[60] Pacces, *Exit, Voice and Loyalty* (n 10) 204-207 (flagging that identifying best choices in this context is far from obvious, and thus individual companies should ultimately decide who decides).
[61] If hedge funds stop short of board appointments, it is because they have obtained from the management the information and the concessions they want under the credible threat to seek board representation. See Alessio M Pacces, 'Shareholder Activism in the CMU' in Emilios Avgouelas, Danny Busch and Guido Ferrarini (eds), *Capital Markets Union in Europe* (OUP 2018) 513-514.
[62] See text to n 98-99 and 114-115 for a discussion of how NCS-dependent directors are committed not to interfere with strategic choices.
[63] Kobi Kastiel, 'Against All Odds: Hedge Fund Activism in Controlled Companies' (2016) 2016 Colum Bus L Rev 60.
[64] This is especially the case in Europe. See Pascal Bine and others 'Activist Investing in Europe: A Special Report 2017' (*Activist Insight*, October 2017) < https://www.skadden.com/insights/publications/2017/10/activist-investing-in-europe-a-special-report-2017> accessed 22 April 2018.
[65] Cf Lucian A Bebchuk, Alon Brav, and Wei Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 Colum L Rev 1085 with John C. Coffee and Darius Palia (2016), 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 1 Annals of Corporate

Although fending off hedge funds' 'say on strategy' could be desirable for particular companies, limiting the powers of non-controlling shareholders to RPT approval is practically difficult. Having only the power to approve RPTs, shareholders would not have access to independent information. Because activist hedge funds would not even consider being involved in such an arrangement, the effectiveness of RPT review would be undermined. The arrangement becomes interesting, however, when activists can claim more power qua shareholders to obtain information independently. At this point, however, the power can also be used to stop efficient RPTs and, more fundamentally, to discourage long-term strategies that are efficient for some companies.

One may doubt that hedge funds can achieve so much. After all, activist hedge funds are few in number, control limited resources, and depend on the support of (large) institutional investors. As has been authoritatively argued, institutional investors are ultimately decisive and have incentives to make only value-increasing decisions.[66] This argument overlooks the agency problems of the main category of institutional investors, namely index funds. These funds rely on low-cost voting policies and thus are ignorant about idiosyncratic choices.[67] In a world in which index funds often 'call the shots'[68], this has a positive and a negative consequence. The positive consequence is that institutional investors would likely support a hedge fund's call to stop value-decreasing RPTs.[69] The negative consequence is that index funds are also likely to side with hedge funds seeking to reorganize companies away from hybrid structures supporting RPTs, without knowing whether this is efficient. While individual portfolio companies are not worth the effort to screen for efficient RPT-based strategies, because all other investors would free-ride, index funds suffer from the short-term underperformance of the companies that they, as opposed to active investors, cannot exit.[70] Moreover, once hedge funds have obtained institutional investors' support in curbing RPTs, they can use this support to extract concessions from management on bigger issues.[71]

In the next section, I propose a different approach to the procedural approval of RPTs, which aims to commit non-controlling shareholders to reviewing RPTs rather than strategy as well.

Governance 1. See also Martijn KJ Cremers, Lubomir P Litov, and Simone M Sepe, 'Staggered Boards and Long-Term Firm Value, Revisited' (2017) 126 Journal of Financial Economics 422.

[66] Ronald J Gilson and Jeffrey N Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights' (2013) 113 Colum L Rev 863.

[67] Pacces, *Exit Voice and Loyalty* (n 10) 210.

[68] Stephen J Choi, Jill E Fisch and Marcel Kahan, 'Who Calls the Shots?: How Mutual Funds Vote on Director Elections' (2013) 3 Harv Bus L Rev 35.

[69] Paraphrasing Gilson and Gordon (n 66), index funds have strong incentive to stop tunnelling in their portfolio companies, while hedge funds make the cost of doing so negligible.

[70] Jill E Fisch, Assaf Hamdani, Steven Davidoff Solomon, 'Passive Investors' (2018) Unpublished Manuscript (on file with the author).

[71] See, in this perspective, the studies on the signalling function of voting support on seemingly minor issues. Marcel Kahan and Edward B Rock, 'Symbolic Corporate Governance Politics' (2014) 94 B U L Rev 1997; and Jill E Fisch, Darius Palia and Steven Davidoff Solomon, 'Is Say on Pay All About Pay? The Impact of Firm Performance' (2018) 8 Harv Bus L Rev, forthcoming.

4. Strategies to Police RPTs

This section aims to identify a regime coping more efficiently with the false negatives of a procedural review of RPTs. For this purpose, I will look at two jurisdictions that traditionally succeed in curbing expropriation, namely the U.S. and the UK.
The modest goal of this functional analysis is to determine whether the balance between false negatives and false positives in these jurisdictions could be improved.[72] I will argue that, given the effectiveness of both regimes, they should relax their standards. On the one hand, the U.S. should scrap the option for courts to review RPTs substantively. On the other hand, the UK should scrap far-reaching shareholder rights in uncontested board elections. These marginal changes would not lead to an increase in the number of false negatives that is larger than the increase in the number of false positives. In other words, both the U.S. and the UK would continue to do a good job at policing value-decreasing RPTs if they relied exclusively on procedural review. To support this outcome, I suggest strengthening the procedural review through a default regime of NCS-dependent directors.

4.1. The U.S. litigation-based regime

In the U.S., Delaware's courts have traditionally coped with the false negative problem by supplementing a procedural review with a substantive review. Being aware that the judgment of independent directors is not fully trustworthy, Delaware's courts have been willing to review the substantive fairness of RPTs in dubious circumstances. Unlike other U.S. state jurisdictions, the BJR does not fully protect RPTs in Delaware, even though they are approved by independent and informed directors.[73] Such an approval may exempt the controller from having to prove the arm's length character of an RPT (i.e. shifting the burden of proof). However, RPTs may fail the procedural fairness test. Moreover, Delaware's courts will always review directors' good faith. When either procedural fairness or directors' good faith is lacking, judges may look into the merits of the transaction.

Delaware's courts have been more demanding in the presence of a controlling shareholder. They previously reviewed substantive fairness even though RPTs were approved by a special committee of independent directors or by a MOM, either of which would only shift the burden of proof.[74] Recent case-law, however, has afforded BJR protection to RPTs passing both procedural tests.[75] This is not a dramatic change from a regime in which approval by a special committee of independent

[72] The following discussion cannot do justice to the complexities of the U.S. and the UK regimes. See, respectively, Rock (2018) and Davies (2018) in this volume.
[73] Delaware case law is ambiguous on the extent to which procedural fairness immunizes RPTs from substantive review. Differently from the Model Business Corporation Act (Subchapter F), Delaware General Corporation Law (s 144) does not provide a 'broad immunity'. See Fliegler v. Lawrence, 361 A 2d 218, 222 (Del 1976). Moreover, as explained by Eisenberg (n 42) 455, the duty of directors to act in good faith (which 'can be given an objective as well as a subjective content') allow courts to apply a '"smell test" that is more rigorous than the business judgment rule'.
[74] See Weinberger v UOP, Inc, 457 A 2d 701 (Del 1983) and Kahn v Lynch Communications, 638 A 2d 1110 (Del 1994).
[75] See In re MFW Shareholders Litigation, 67 A 3d 496, 503 (Del Ch 2013) and Kahn v M&F Worldwide Corp, 88 A 3d 635, 644 (Del 2014) (affirming MFW).

directors already shifts to the plaintiff the burden of proving substantive unfairness, although, arguably, a MOM vote confers more leverage on activist hedge funds.[76]

The strategy of Delaware to screen RPTs is consistent with an overall litigation-based approach to curbing tunnelling in the U.S.[77] In this context, securities litigation is even more effective against tunnelling than corporate litigation. When the company is doing poorly in terms of stock price, RPTs can also be attacked by alleging a violation of the federal disclosure rules. Functionally, this is a natural consequence of Delaware's courts being strict in reviewing RPTs, which makes elusive disclosures perhaps the only way to carry out RPTs. However, while aggressive enforcement of corporate and securities law copes well with the false negatives of RPT review, it also creates false positives. When the company is doing poorly, RPTs and their disclosure may be litigated whether or not there has been investor expropriation. This over-deters RPTs.

While the U.S. regime could benefit from scrapping the substantive review, this would eliminate an important remedy to the false negatives stemming from a lack of directors' independence. As the UK experience reveals, empowering non-controlling shareholders is not a good solution to this problem.

4.2. The UK governance-based regime

UK courts traditionally do not review substantive fairness. However, the UK is rather strict about the procedural fairness of RPTs. Company law mandates ex-ante disclosure and approval by the board, as well as by shareholders for certain classes of RPTs. The listing rules are stricter, requiring in addition an informed shareholder approval for all RPTs above a materiality threshold. In the presence of a controlling shareholder, such an approval is governed by a MOM rule.[78] After the inflow of companies with controlling shareholders in the UK market, the listing rules have become stricter.[79] They now also include an obligation for controlling shareholders to sign an enforceable independence agreement with the company, in the absence of which all RPTs would have to be submitted to a MOM vote. Moreover, the independence agreement must be approved every year by independent directors, who, in principle, should be appointed with the consent of minority shareholders, although a majority shareholder can override a negative MOM vote.[80]

Corporate governance in the UK is not litigation-intensive and the strategy to police RPTs reflects this. Enforcement actions in UK corporate governance are

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[76] See the discussion of this issue by Rock (2018) in this volume. Individual companies do not have to choose for MOM approval, however. They may prefer to deal with Delaware courts' substantive review after all, particularly given that the burden of proving the unfairness of RPTs shifts to the plaintiff after the approval by the independent special committee.
[77] Pacces, *Controlling* (n 7), 201-205.
[78] In the absence of independence agreement, also non-material RPTs are subject to MOM approval. See Davies (2018) in this volume.
[79] See Brian R Cheffins, 'The Undermining of UK Corporate Governance (?)' (2013) 33 Oxford Journal of Legal Studies 503, 505-509.
[80] Currently, the UK listing rules (LR 9.2.2a) require a MOM approval of independent directors. However, failing that, a majority vote becomes sufficient after 90 days. See Davies (2018) in this volume.

conspicuous by their absence.[81] The procedural fairness of RPTs is achieved differently in the UK, in particular by way of the company law right of shareholders to remove directors at will.[82] Because this is a credible threat from institutional investors, they hardly need to use it.[83] According to this threat, UK directors enter into RPTs only under conditions of procedural fairness for fear of being shamed and/or ousted from the London financial community.[84]

This approach achieves too little and too much. It achieves too little because it is ineffective against a majority shareholder. As the latter cannot be prevented from appointing formally independent directors, who can in turn approve the independence agreement, inefficient RPTs below the listing rules' materiality threshold can proceed with board approval notwithstanding the lack of independence from the controlling shareholder.[85] Conversely, this approach achieves too much because both the company's management and a dominant shareholder who does not control a majority of the votes, facing an effective veto by non-controlling shareholders, can fail to control the majority of the board. The UK corporate governance code establishes, on a comply-or-explain basis, that a majority of the board should be independent from the corporate controller.[86] Institutional investors make this default rule practically impossible to opt out of due to their statutory right to remove any director at will, possibly by forming a coalition against the dominant shareholder.[87] On the one hand, this makes the review of RPTs by the board of directors very effective. On the other hand, this creates false positives because, as explained above, such far-reaching governance rights of non-controlling shareholders can be used by hedge funds to summon institutional investors to veto efficient RPTs and the hybrid organizations supporting them.[88]

The UK regime for RPTs could be improved by turning the right of non-controlling shareholders to remove all directors at will into an optional rule. By default, non-controlling shareholders could only replace the incumbent directors in a contested election. This would align the regime of the UK with that of the U.S., where shareholders – including hedge funds – need a proxy contest (or the threat thereof) to take control of the board.[89] When directors cannot be fired at all times, it is somewhat harder for hedge funds to challenge their strategic choices. Apart from

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[81] Armour and others 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States' (2009) 6 JELS 687.
[82] UK Company Act 2006, s 168.
[83] Armour, Enriques and others, *The Anatomy* (n 12) 55.
[84] Pacces, *Controlling* (n 7) 206-207.
[85] Reddy (n 8) 17-19.
[86] UK Corporate Governance Code B.1.2.
[87] See Pacces, *Controlling* (n 7) 208-209 with a description of the EasyJet case, in which the controlling shareholder failed to gain control the majority of the board due to the opposition by institutional investors. The overhaul of the listing rules has only marginally weakened the position of dominant shareholders. See Cheffins (n 79) 516-531.
[88] According to Julian Franks and Colin Mayer, 'Evolution of Ownership and Control around the World: The Changing Face of Capitalism' in Benjamin Hermalin and Michael Weisbach (eds), *The Handbook of the Economics of Corporate Governance* (Vol 1, North Holland 2018) 722-729, minority shareholder empowerment in the UK has created an environment unfavourable to controlling shareholders (unless they retain a majority of the votes on a one-share-one-vote basis).
[89] See Lucian A Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 Harv L Rev 833 (arguing for a move towards the UK regime). Cf Marcel Kahan and Edward B Rock, 'The Insignificance of Proxy Access' (2011) 97 Va L Rev 1347.

cases of majority shareholders, this move would thus likely reduce false positives by a larger extent than it would increase false negatives so long as there is another effective check on directors' independence. I posit that NCS-dependent directors could act as such a check, which would also be effective in the presence of a majority shareholder.

4.3. NCS-Dependent Directors: A proposal

Both the U.S. regime and the UK regime seek to remedy the shortcomings of a procedural review of RPTs – directors' lack of independence and information – supplementing it with other screens. Neither the UK nor the U.S. address the problem of directors' independence and information at its core. As the law and economics literature has shown, there is a trade-off between information and independence.[90] Independent directors cannot be simultaneously good monitors and good advisors of corporate management. If they are good monitors, they will never become sufficiently informed to be good advisors. If they are good advisors, over time they will lose the independence necessary to be good monitors. Focusing on RPTs, it would be desirable for independent directors to be good monitors and review RPTs with sufficient information and effective independence. However, this requires that directors be entirely separated from the management and those controlling it, while having the necessary incentives and the resources to gather information to screen the management's conflicts of interest.

For this reason, I propose to introduce a new player in the boardroom: the NCS-dependent director. Such a director should be able to gather information separately from the management while not being involved in managerial decision-making in any manner.[91] To achieve this result, NCS-dependent directors should be nominated by a different constituency than the one nominating the executive and independent directors, should have no authority about management decisions other than those involving RPTs, and have unlimited access to company information. As the name suggests, the gist of this proposal is to turn a subset of *independent* directors into directors who are actually *dependent* on non-controlling shareholders.[92] This proposal consists of three interrelated aspects.

Firstly, in order to guarantee effective independence from the management, NCS-dependent directors should be nominated by shareholders, not by the board as is normally the case for independent directors. When present, the controlling shareholder should be disqualified from both the nominations and from voting on them. In this particular case, the NCS-dependent directors would effectively be

[90] Arnoud Boot and Johnathan R Macey, 'Monitoring, Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance' (2004) 89 Cornell Law Review 356; Renée B. Adams and Daniel Ferreira, 'A Theory of Friendly Boards' (2007) 62 J Fin 217.
[91] See Kobi Kastiel and Yaron Nili, '"Captured Boards": The Rise of "Super Directors" and the Case for a Board Suite (2017), 2017 Wisconsin Law Review 101, 132-136 (not imposing restrictions on involvement with management).
[92] See Gutiérrez and Sáez (n 56) 90-94 for a similar proposal, although not based on private ordering. See also Wolf-Georg Ringe 'Independent Directors: After the Crisis', 13 EBOR 401, 421-424. None of these proposals considers restricting the function of non-controlling shareholder dependent directors to particular problems, as I do. For a pre-hedge fund version of this proposal, see Pacces, *Controlling* (n 7) 209-213.

minority-elected directors, as is currently seen in some countries including Italy, Spain, and Israel.[93]

Secondly, NCS-dependent directors would have exclusive authority to review RPTs. This brings the legitimate question of whether NCS-dependent directors would have incentives to gather enough information to review RPTs effectively. Recent experience with the board nominees of activist investors suggests that this may well be the case.[94] Although controllers normally control the information flow, answering to a different investor constituency would give NCS-dependent directors the incentive to become independently informed about RPTs. Moreover, professional standards would likely develop around this new kind of 'constituency director' to support accountability to institutional investors.[95] Finally, the right of NCS-dependent directors to access all relevant information and to use company resources to process it, including obtaining expert opinions, would be enforced by courts.

As a default rule, approval by NCS-dependent directors would be sufficient to validate RPTs.[96] In order to avoid false positives, courts would not review substantive fairness, but only the procedural safeguards of NCS-dependent directors' review. For instance, courts would review whether their election was effectively independent, whether they had sufficient information to review an RPT, but not whether they did a good job in screening an RPT. This would reduce hindsight bias. As hinted above, the director's conduct in screening RPTs can be reviewed by courts on the basis of professional standards, which are not available to review business judgment. The company's articles of association could allow it to opt into a different regime, for instance substantive court review.[97] Similarly, the default regime would not require shareholder approval, or MOM in the presence of a controlling shareholder, unless the articles of association so provide.

Thirdly, by default, NCS-dependent directors should account for a minority of the board members.[98] Moreover, their mandate should be limited to the review of RPTs. This solution aims to commit NCS-dependent directors to refraining from strategic decision-making. NCS-dependent directors should monitor RPT decisions, not participate in choosing the strategy underlying them. Because assessing individual RPTs requires understanding this strategy, they will attend the board meetings without, however, having the possibility to influence their outcome. Although these

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[93] See Enriques, *Related Party* (n 15) 19, noting that independent nomination and appointment do not eliminate per se the tendency of directors to side with other board members. The restriction on the mandate of NCS-dependent director aims to cope with this problem, among others.

[94] Kastiel and Nili (n 91) 114-120.

[95] This is an idea dating back to Ronald J Gilson and Reinier Kraakman, 'Reinventing the Outside Director: An Agenda for Institutional Investors' (1991) 43 Stan L Rev 863. Their proposal of minority professional directors representing institutional investors never took off in practice, perhaps because they did not recommend any change in the default rules, as I do here.

[96] This implies that, compared to existing regimes, NCS-dependent directors reduce not only the (indirect) error cost of RPT review, but also the (direct) administrative cost. An obvious cost advantage is that shareholder approval is not needed. Moreover, courts only review due process, which is less burdensome than a substantive review.

[97] This would be a stricter regime in jurisdictions where enforcement is aggressive and courts are knowledgeable about RPTs. In all other cases, substantive court review will likely be laxer than NCS-dependent directors.

[98] Again, this reflects the proposal by Gilson and Kraakman (n 95), 888-889. The difference from that proposal, is that the mandate of NCS-dependent directors is limited to reviewing RPTs as default rule.

limitations may reduce the quality of information that NCS-dependent directors receive from the rest of the board, they are crucial to ensure independence.[99] Individual companies should be free to depart from such a default regime and opt into a more governance-intensive role for NCS-dependent directors to include, for instance, a mandate to represent non-controlling shareholders in strategic decisions. However, the proximity of NCS-dependent directors to the executive directors may undermine their independence over time.

This default regime is chosen in such a way that it is easy to opt out of when it is inefficient, while it would be hard to opt into when it is efficient.[100] Investors enjoying far-reaching governance rights – such as a veto on the entire board, as is the case in most UK listed companies – would be reluctant to limit those to NCS-dependent directors. Likewise, managers or dominant shareholders controlling all board appointments – as is the case in the uncontested elections of most U.S. listed companies – would be reluctant to admit non-controlling shareholder representatives to the boardroom. If the proposed regime were not default, companies that benefit from committing non-controlling shareholders to screening RPTs only via NCS-dependent directors could not get this regime. Conversely, companies can easily opt out of the proposed RPT regime when their organization does not need RPTs. Controllers who consider NCS-dependent directors unnecessary would propose to opt out of NCS-dependent directors. Being content with a tougher RPT screening, either by courts (as in the U.S.) or by the general meeting (as in the UK), investors would most likely agree to this proposal. A MOM vote should be enough to prevent opportunistic opt-into laxer regimes – for instance one in which board approval of RPTs is sufficient – unless investors consider such regimes more efficient for the company.

5. Potential Criticism

In this section, I address potential criticism of the NCS-dependent directors proposal.

One may question whether this proposal would fare better than existing regimes based on independent directors, such as (de facto) the UK. First of all, it is a default regime, which may revert to any of the existing regimes if companies so decide. Second, NCS-dependent directors would not replace independent directors. Regular directors would continue to do their jobs, namely selecting and advising the management on strategy, including on whether RPTs are suitable. NCS-dependent directors would, however, take over the monitoring role of independent directors on RPTs and deal with nothing else. The limited mandate would commit NCS-dependent directors to reviewing RPTs only. Moreover, NCS-dependent directors would always be exclusively accountable to non-controlling shareholders who select

[99] See Boot and Macey (n 90). As argued in the previous paragraphs, NCS-dependent director will likely develop professional standards of conduct prompting them to acquire information independently from the corporate controller. Constituency directors certainly have a right (if not a duty) to do so. See Kastiel and Nili (n 91) 126 and text to n 104.

[100] This is based on a recent law and economics theory of default rules, according to which optimal defaults can be derived from the ease of altering them. See Ian Ayres 'Regulating Opt-Out: An Economic Theory of Altering Rules' (2012) 121 Yale L J 2032. See also Lucian A Bebchuk and Assaf Hamdani, 'Optimal Defaults for Corporate Law Evolution' (2002) 96 Northwest U L Rev 489.

and fire them. While this excludes management and controlling shareholders from tampering with the RPT screen, the default regime for appointing and removing the majority of the board should be less favourable to non-controlling shareholders: shareholders unhappy with the board's nominees could not simply veto them, but would have to wage a proxy contest.[101]

Another potential objection to separating monitoring from the advisory role of the board is that NCS-dependent directors would not have sufficient information to screen RPTs. After all, more independent directors are necessarily less informed about idiosyncratic matters.[102] This shortcoming is unavoidable to support the independent screening of RPTs. Such an independent screening is, in turn, necessary to make hybrid organizational structures viable. The alternative – substantive court review – would fare no better in terms of information. Moreover, regular directors would have an incentive to reduce the information imbalance of NCS-dependent directors in order to promote the business case for RPTs. Because the limited mandate of NCS-dependent directors commits them to approving RPTs only, regular directors would be arguably less reluctant to share idiosyncratic information that a 'dissident director' could normally use to challenge their strategic choices.[103] NCS-dependent directors are effectively constituency directors for non-controlling shareholders.[104] They would operate as independent negotiating agents in RPTs, claiming enough of the expected transaction cost savings to make sure that non-controlling shareholders are no worse-off. This is similar to Delaware's approach to independent special committees, apart from the fact that the independence of NCS-dependent directors is stronger, which makes substantive court review unnecessary.[105]

A third potential objection is that NCS-dependent directors would not have strong incentives to screen RPTs. In particular, they could do nothing and/or be defensive to avoid being ashamed, or sued, if RPTs turn out badly. So long as judges are knowledgeable about business cases, there is no reason to expect that the procedural review by courts would give bias to the incentives. As far as monitoring is concerned, a good process can discharge directors from liability even in the presence of a bad outcome. This is because RPT screening, unlike business judgment, can be reviewed based on professional standards on information acquisition and processing. Fostering a reputation for such professional standards would provide positive incentives to screen RPTs thoroughly, once a market for NCS-dependent directors is in place. NCS-dependent directors would be accountable to institutional investors collectively, having an interest in efficient RPTs, but individually would be lacking the incentive to acquire idiosyncratic knowledge to screen for them. Therefore, the market for NCS-dependent directors would likely

[101] The purpose of this regime, which is in line with the U.S. default rules, is to make institutional investors focus on selecting NCS-dependent directors. See a discussion of the two ways to remove directors in the U.S. and the UK in Armour, Enriques and others, *The Anatomy* (n 12) 55-56.
[102] Boot and Macey (n 90).
[103] Macey (n 56) 90-92.
[104] I thank Jill Fisch and Ed Rock for making me notice this. See Kastiel and Nili (n 91) 122-126 for illustration.
[105] Remember that courts cannot verify transaction cost savings in RPTs. See text to n 43-44.

reward the acquisition of such idiosyncratic knowledge as opposed to doing nothing or just saying 'no.'[106]

A fourth potential criticism is whether institutional investors would actually select NCS-dependent directors. Although they have, in principle, both the powers and the incentives to perform this task, institutional investors have been traditionally reluctant to nominate even a minority of directors.[107] There are, to be sure, legal risks in doing so. Particularly in the U.S., institutional investors that are deemed to exercise control would face burdensome disclosure obligations and trading restrictions.[108] In the default regime, however, NCS-dependent directors would have to refrain from exercising control.[109] Moreover, institutional investors would be explicitly summoned to select NCS-dependent directors and would have the exclusive right to remove them at will, which implies they should be active at least behind the scenes.[110] Finally, there is a risk that hedge funds would take over the appointment of NCS-dependent directors. But, as I will explain, this risk is not high because of the limitation of mandate.

Professor Rock in this volume disagrees with a few points underlying this proposal. His arguments are as follows. First, market prices are a good reference point for ex-post court review of RPTs. Second, such a review is unavoidable when RPTs fail the procedural test. Third, he asserts that my concern for hedge fund veto is overstated. While our views clearly differ on the first point, the second requires some clarification. It is true that courts need to re-evaluate unfair RPTs ex-post to award compensation for damages. However, liability is not necessary for deterrence, which is how a procedural RPT regime affects incentives. Because directors are not deterred by liability, but by the shaming implication of a lawsuit[111], an RPT regime could work without substantive court review. Regarding the third criticism, Professor Rock's point is that a MOM vote on RPTs is not so harmful in the U.S. I could not agree more. What my proposal tries to remedy is not simply a veto right on RPTs – the effectiveness of which indeed depends on voting thresholds and outside options, varying across situations and jurisdictions[112] – but rather the dependence of RPT

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[106] Despite a rather strict regulation of RPTs in Chile, which includes approval by directors not appointed by the controlling shareholder, there is empirical evidence of efficient RPTs going through. See David Buchuk, Borja Larrain, Francisco Muñoz and Francisco Urzúa, 'The internal capital market of business groups: Evidence from intra-group loans' (2014) 112 J Pol Econ 190.
[107] Bernard S Black and John C Coffee, 'Hail Britannia: Institutional Investor Behavior under Limited Regulation' (1994) 92 Michigan Law Review 1997, 2034-2055. Cf Gilson and Kraakman (n 95) 892-894.
[108] See the discussion of Sections 13(d) and 16(b) of the U.S. Securities Exchange Act in John Morley, 'Too Big to Be Activist' (2018) Working Paper <https://law.ucla.edu/centers/business-law/center-for-law-and-economics/events/law-and-economics-workshop/> accessed 22 April 2018.
[109] Even without such a restriction, Gilson and Kraakman (n 95) 894-903 have long argued that the appointment of a minority of professional directors is not to be deemed exercise of control for the purposes of U.S. securities regulation.
[110] Massimo Belcredi, Stefano Bozzi and Carmine Di Noia, 'Board Elections and Shareholder Activism: The Italian Experiment' in Massimo Belcredi and Guido Ferrarini (eds), *Boards and Shareholders in European Listed Companies. Facts, Context and Post-Crisis Reforms* (Cambridge University 2013) 408-416 provides evidence that in jurisdictions featuring minority slates of directors (such as Italy) institutional investors are active in the nomination process.
[111] See Pacces, *Controlling* (n 7) 196-198. In this perspective, the amount of damage compensation is inessential and could be set separately from the actual harm stemming from unfair RPTs.
[112] Rock (2018) in this volume.

control on far-reaching governance rights, which activist hedge funds could use for other purposes.

A final objection – aired orally by Professor Enriques – is that NCS-dependent directors could effectively veto a strategy by vetoing individual RPTs. Because activist hedge funds cannot be excluded from appointing NCS-dependent directors, this would undermine the goal of the proposal. I agree that RPTs are ultimately undistinguishable from the strategy that supports them.[113] That said, separating investor protection from strategic decision-making has two advantages. First, although NCS-dependent directors would be free to share information with the hedge funds appointing them, they would still owe fiduciary duties to all shareholders.[114] This constrains straight blackmail: NCS-dependent directors would have to show a business purpose of saying 'no.'[115] Still, the business purpose could reflect a different strategy favoured by hedge funds. The second advantage here is that NCS-dependent directors would be committed to screening RPTs only. Unlike regular directors, NCS-dependent directors would not be able to collect information to support an alternative strategy and 'sell it' to institutional investors. Therefore, hedge funds would be unlikely to use NCS-dependent directors to challenge strategy.

6. Conclusion

In this chapter, I have discussed the review of related party transactions (RPTs). RPTs need to be reviewed because, on the one hand, they may result in expropriation of non-controlling shareholders but, on the other hand, they can lead to transaction cost savings. RPT review can be of two types. Courts performing a substantive review re-evaluate RPTs ex-post while courts performing a procedural review check whether RPTs were approved by way of an independent and informed process ex-ante. The goal of the review is to stop value-decreasing RPTs (effective review) while allowing value-increasing RPTs (efficient review) as much as possible.

This chapter finds that there is a trade-off between the effectiveness and efficiency of RPT review. This trade-off is company-specific, as it depends on how much the company's organizational structure benefits from transaction cost savings. Nevertheless, I argue that the efficiency of RPT review can be improved at the margin by moving from substantive to procedural review. This requires securing the information and the independence of RPT approval. For this purpose, I recommend that RPTs be approved by NCS-dependent directors. NCS-dependent directors should be selected and removed exclusively by non-controlling shareholders, account for a minority of the board, and have a mandate limited to RPT review. This default regime would commit non-controlling shareholders to reviewing RPTs only, as opposed to the strategic choices motivating them. A company would be able to

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[113] This is the reason why it is hard to limit the power of non-controlling shareholders to the review of RPTs. See text to n 35-36 and 65-66.

[114] See Kalisman v Friedman, CA No 8477-VCL (Del Ch 2013). (Constituency directors can share information with the shareholders who appointed them so long as they do not breach their fiduciary duties).

[115] In reviewing NIC-directors compliance with their fiduciary duties, courts should apply a procedural, not a substantive standard. In other words, courts should determine whether the decision to veto one or more RPTs was rational and justified by professional standards of conduct, not whether RPTs should have been approved on their merits.

opt out of this regime, particularly if it prefers non-controlling shareholders to have a broader influence on its strategy.

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