THE SEC AND THE COURTS' COOPERATIVE POLICING OF RELATED PARTY TRANSACTIONS

Geeyoung Min*

A transaction between a corporation and its director or officer (a "related party transaction") presents conflicts of interest that could harm, or alternatively, could also benefit the corporation. To sort beneficial related party transactions from detrimental ones, the current legal regime relies on both ex ante screening and ex post litigation. Disclosure plays an essential role in both stages. Based on a set of hand-collected data on actual disclosures from Fortune top fifty companies, this Article casts doubt on the effectiveness of the current regulation of related party transactions. The ambiguity of the federal securities regulations leaves too much room for manipulation. An approving committee of each company exercises considerable discretion not only over which proposed transactions to approve, but also over which transactions to disclose to its shareholders and what information to include in the disclosures. In the context of state corporate law,

* Research Assistant Professor of Law, University of Virginia School of Law. I would like to thank Kerry Abrams, Norman Anderson, Michal Barzuza, Lisa Bernstein, Richard Brooks, Albert Choi, George Cohen, Anne Coughlin, Quinn Curtis, Aaron Dhir, Emma Dowell, Lisa Fairfax, George Geis, John Harrison, Andrew Hayashi, Joan Heminway, Rob Jackson, Kwon-Yong Jin, Ed Kitch, Yoon-Ho Alex Lee, Michael Livermore, David Lynn, Jonathan Macey, Paul Mahoney, Julia Mahoney, John Morley, Jennifer Nou, Blake Rohrbacher, Roberta Romano, Molly Shadel, Fred Shauer, Rip Verkerke, Andrew Vollmer, Hye Young You, and participants at the 2013 Canadian Law and Economics Association's Annual Meeting, Legal Scholarship Workshop at Chicago Law School, 2013 Doctoral Scholarship Conference at Yale Law School, 2014 C-LEAF Junior Faculty Workshop, and faculty workshops at USC Gould School of Law and Wharton School's Legal Studies and Business Ethics Department for their helpful comments on earlier drafts of this Article. Comments are welcome to geeyoung.min@gmail.com.

uncertainty exists in fiduciary duty of loyalty litigation regarding when and whether a court should bypass the fairness test and apply the business judgment rule to a related party transaction that satisfies certain safe harbor conditions, such as approval by disinterested directors. This Article proposes a fix by linking the strategic disclosure problem to the question of the applicable standard of review in fiduciary duty of loyalty litigation. To that end, the court should consider a disclosure under federal securities law as a strong signal of fairness of the disclosed transaction and be more willing to apply the business judgment rule rather than the fairness test in state duty of loyalty litigation. Potential benefits of the proposal include creating better incentives to disclose related party transactions, giving litigants more predictable rules, and allowing for richer accumulation of disclosure data over time, thus providing better guidance to companies and market participants in distinguishing between beneficial and harmful related party transactions.

I. Introduction 665
II. Related Party Transactions and the Current Regulatory Regime..673
  A. Definition of a Related Party Transaction..........674
  B. Regulations on Related Party Transactions: *Ex Ante* Versus *Ex Post* Dichotomy..........................676
  C. The SEC's Disclosure Requirements on Related Party Transactions 680
    1. An Overview of the Amendment....................681
    2. Materiality Analysis.......................................683
    3. Policies and Procedures for Review, Approval, or Ratification 685
  D. Corporate Law on Related Party Transactions ..686
  E. A Theoretical Analysis of Interactions among Regulations...691
III. Empirical Analysis of Disclosure Practices...............697
  A. An Overview of the Findings..............................699
    1. Related Party Transaction Disclosure vs. Director Independence Disclosure 699

2. Frequency, Types, and Size of Disclosed Related Party Transactions 707
B. Variation in Item 404(a) Disclosure 714
C. Analysis of "Materiality" 717
1. Material to Whom? 717
2. Identification of Related Person's Indirect Interest 719
3. Use of the "Ordinary Course of Business" Exception 721
D. Related Party Transactions Pre-Approved by Internal Policies and Procedures 725
IV. Implications 726
A. Questioning the Efficacy of the Current Regulatory Regime 727
B. Legal Policy Proposal 729
1. Proposal to the SEC: Sticks 729
2. Proposal to the Courts: Carrots 730
C. Possible Objections to the Proposal 734
1. Solicitation of More Related Party Transactions 735
2. Over-Deterrence of Beneficial Related Party Transactions 736
D. Implications for Privately Held Corporations 737
V. Conclusion 738
Appendix 739

I. INTRODUCTION

In a proxy statement for the 2012 annual shareholders' meeting,[1] Wal-Mart Stores, Inc. ("Wal-Mart") disclosed a payment of $23.5 million to a company called Cheyenne Industries, Inc. ("Cheyenne") for the purchase of home

[1] To understand how important it is that a company disclose facts about itself to its shareholders prior to those shareholders deciding how to vote in shareholders' meetings in general, see Luis A. Aguilar, *Shareholders Need Robust Disclosures to Exercise Their Voting Rights as Investors and Owners*, U.S. SEC. & EXCH. COMM'N (Feb. 20, 2013), http://perma.cc/LH65-PSUL.

furnishing products.[2] On the surface, the transaction seemed like a typical supply arrangement, especially for a giant retail company like Wal-Mart that engages in thousands of similar arrangements with numerous suppliers. What makes the transaction interesting, however, is the fact that Cheyenne's CEO, who is also a director and "an indirect equity owner" of Cheyenne, is the son of Wal-Mart's former CEO, an incumbent director. Was Wal-Mart agreeing to purchase home furnishing goods from Cheyenne because Cheyenne produced the best products at the lowest possible price? Or was Wal-Mart merely trying to help out a family member of its director? If the former, the transaction would benefit rather than harm Wal-Mart, and banning similar conflict of interest transactions would only deprive Wal-Mart of the option of securing a profitable supply arrangement. If the latter, allowing such transactions to proceed would advance the Wal-Mart director's interests at the expense of its shareholders.[3] Thus, the sensible solution seems to be to allow beneficial related party transactions while banning

[2] Wal-Mart Stores, Inc., Definitive Proxy Statement (Schedule 14A) 58 (April 16, 2012), *available at* http://perma.cc/8VTN-N4JM. ("Eric S. Scott, the son of H. Lee Scott, Jr., a director of Wal-Mart, is the CEO, a director and an indirect equity owner of Cheyenne Industries, Inc. ("Cheyenne"). Wal-Mart paid Cheyenne and its subsidiaries approximately $23.5 million during fiscal 2012 in connection with Wal-Mart's purchases of home furnishing and related products from Cheyenne and its subsidiaries. Wal-Mart expects to continue to purchase similar products from Cheyenne and its subsidiaries during fiscal 2013."). For a detailed description of the relationship between Wal-Mart and Cheyenne, see Arkansas Business Staff, *Proxy Statement Reveals Where Wal-Mart Money Goes*, ARKANSASBUSINESS.COM (Apr. 28, 2014), http://perma.cc/DWK7-8Q2T.

[3] Some of the most notorious examples of such transactions come from the corporate scandals of Enron Corporation, Tyco International, Ltd., and WorldCom, Inc., which involved financial reporting fraud stemming from various related party transactions. *See* SEC Litigation Release No. 21129 on Tyco International, U.S. SEC. & EXCH. COMM'N (July 14, 2009), http://perma.cc/6834-L7FC; Art Berkowitz & Richard Rampell, *Related-Party Transactions Can Be an Investment Red Flag*, WALL ST. J. (Aug. 29, 2002), http://perma.cc/785M-WKEC; Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES (Aug. 26, 2002), http://perma.cc/L3AP-SYL8.

detrimental ones, rather than unconditionally banning related party transactions altogether.[4] But, in practice, how would a company's shareholders or regulators determine whether a related party transaction is beneficial or detrimental to the corporation?

Two important bodies of law regulate related party transactions: federal securities regulations and state corporate law. First, publicly traded corporations, such as Wal-Mart, are subject to various disclosure obligations under the federal securities laws.[5] Most notably, the Securities and Exchange Commission ("SEC") Regulation S-K Item 404(a) requires narrative disclosure of "material" related party transactions.[6] In addition to disclosure, the securities regulations impose procedural mandates for an internal review and approval of related party transactions. The federal securities regulations' disclosure and procedural requirements are designed with the goals of both informing shareholders and investors of potentially problematic transactions and weeding out transactions that are detrimental to shareholders.

In contrast, state corporate law regulation of related party transactions operates at both *ex ante* and *ex post* stages. Before commencing a transaction, an interested director or officer should disclose the transaction to

[4] Related party transactions are inevitable (e.g., executive compensation) and also often benefit the corporation. See, e.g., *Fliegler v. Lawrence*, 361 A.2d 218, 223–25 (Del. 1976), wherein Fliegler, as a shareholder of Agau Mines, brought a derivative action against defendant officers and directors of the company, including Lawrence. In deciding whether the defendants were liable for taking a corporate opportunity from Agau and whether they wrongfully benefited by causing Agau to exercise an option to buy the opportunity, the Delaware Supreme Court concluded that the option arrangement, a related party transaction between Agau and its officers and directors, was intrinsically fair. *Id.* The court found the market value of Agau's stock to be clearly inflated "largely as a result of the time and efforts expended by the individual defendants." *Id.*

[5] This Article deals only with federal securities law. The state securities laws, i.e., "blue sky laws," are beyond the scope of this Article.

[6] 17 C.F.R. § 229.404(a) (2014).

disinterested directors or shareholders to seek their approval.[7] In addition, a transaction commenced or even completed, with or without prior approval, may be subject to *ex post* duty of loyalty litigation by the corporation or its shareholders.[8] Related party transactions that are not accompanied by proper disclosure are more easily challenged in a breach of fiduciary duty of loyalty litigation.[9]

Just like the two bodies of law, two strands of academic literature have evolved largely independent of each other—one focusing on federal securities regulation[10] and the other on state corporate law aspects.[11] However, the interplay

---

7 *E.g.*, DEL. CODE ANN. tit. 8, § 144 (a)(1)–(2) (2010).

8 *See* Lewis H. Lazarus & Brett M. McCartney, *Standards of Review in Conflict Transactions on Motions to Dismiss: Lessons Learned in the Past Decade*, 36 DEL. J. CORP. L. 967 (2011) (presenting in-depth analyses of twenty court cases in which the business judgment standard of review is applied to defendants' motions to dismiss and showing that the cases cannot easily be categorized because the courts' decisions are heavily fact-dependent).

9 *See* Eric Orts, *Conflict of Interest on Corporate Boards*, *in* CONFLICT OF INTEREST IN THE PROFESSIONS 129, 134 (Michael Davis & Andrew Stark eds., Oxford University Press, 2001) ("Although courts have preserved their authority to determine that a particular transaction or conduct that involves a conflict of interest that results in 'unfairness,' they have also increasingly recognized the salience of following proper internal corporate procedures to insulate conflicts of interest from searching judicial review.").

10 *See* Simeon Djankov, et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 443–44 (2008); Elaine Henry, *et al.*, *The Role of Related Party Transactions in Fraudulent Financial Reporting*, 4 J. FORENSIC & INVESTIGATIVE ACCT. 186 (2012); Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000); Mark Kohlbeck & Brian W. Mayhew, *Valuation of Firms that Disclose Related Party Transactions*, 29 J. ACCT. & PUB. POL'Y 115, 116 (2010); Michael D. Ryngaert & Shawn E. Thomas, *Not All Related Party Transactions (RPTs) Are the Same: Ex-ante vs. Ex-post RPTs*, 50 J. ACCT. RES. 845, 846 (2012).

11 *See* Norwood P. Beveridge, *Interested Director Contracts at Common Law: Validation Under the Doctrine of Constructive Fraud*, 33 LOY. L.A. L. REV. 97 (1999); J. Robert Brown, Jr., *Disloyalty Without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53 (2007); Kenneth B. Davis, Jr., *Approval by Disinterested Directors*, 20 J. CORP. L. 215 (1995); Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997 (1988); Andrew S. Gold,

between the two bodies of regulation on related party transactions has been largely overlooked. This gap in the scholarly literature leaves a number of important questions unanswered. How effective is the combination of current disclosure regulations and *ex post* judicial review in distinguishing between beneficial and detrimental related party transactions? In the case of state corporate law-based litigation, what standard should the courts apply and how might it interact with *ex ante* disclosure? More specifically, should approval by a committee consisting of disinterested, independent directors entitle the director-defendant to business judgment protection, or should the court nevertheless apply fairness review? Could a combined regime of applying the business judgment rule in general, while applying fairness review to scrutinize potentially detrimental transactions better protect beneficial transactions? On the securities law side, given that securities law-based disclosure is subject to the "materiality" standard, how do companies actually interpret and apply the standard?[12] Is there consistency across reporting companies in applying the standard? Do companies engage in meaningful disclosure?[13] For instance, what if Wal-Mart had

The New Concept of Loyalty in Corporate Law, 43 U.C. DAVIS L. REV. 457, 511 (2009); Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1089 (1996); Lyman Johnson, *After Enron*: *Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 28–29 (2003).

[12] See Elizabeth A. Gordon, et al., *Related Party Transactions and Corporate Governance*, 9 ADVANCES IN FIN. ECON. 1 (2004) for a detailed description of 112 companies' disclosure practices. However, the article (1) analyzes disclosures only and not regulations, and, (2) refers to disclosures in proxy statements from the year 2000 that do not reflect the SEC's 2006 amendment to the disclosure requirements regarding related party transactions.

[13] The problem of nominal disclosure has been highlighted by several legal academics. *See* Vladimir Atanasov, Bernard Black, & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 12 (2011) (focusing on disclosures in financial statements and stating that, "[i]n practice, executive compensation aside, disclosure of RPT is often opaque and gives no guidance to investors as to whether the RPT was in fact on arms-length terms"); Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal*

concluded that the Cheyenne transaction was "non-material" and chose not to disclose it? Investors and regulators would face significant hurdles discovering and potentially challenging the transaction. This Article attempts to answer these important questions by more closely addressing the interaction between the two bodies of law.

This Article first presents a positive account of the current regulation of related party transactions under both state corporate and federal securities laws. This account is followed by a theoretical, normative framework to help analyze the regulations. The theorized framework reveals an important interplay between the SEC's disclosure requirements and state corporate law's regulation of related party transactions. If the SEC's disclosure regulations were effective, approving committees would be more careful in approving proposed related party transactions. Furthermore, if approving committees were more cautious about allowing related party transactions, such behavior would deter an interested director or an executive from proposing and entering into harmful related party transactions in the first place, due to the fear of rejection.

With the theoretical framework in place, this Article next provides empirical content on the operation of disclosure mandates under federal securities laws in order to examine whether the current disclosure regulation is effective. Based on a set of hand-collected and coded data on actual disclosures of Fortune Fifty companies, this Article examines all disclosures of related party transactions in proxy statements filed in 2012 for these large companies.[14] The

Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors, 53 DUKE L.J. 517, 567 (2003) (emphasizing that "[d]irectors continue to rely on the combination of superficial compliance with reporting, record-keeping, and other procedural requirements, and the delegation of discretionary decision making to outside experts, to satisfy their obligations.").

[14] A proxy statement is a document drafted by a company to help existing shareholders determine how to exercise their voting rights at a shareholder meeting. Since annual shareholder meetings are held in the early spring season, mostly in April and May, the disclosures in proxy

empirical strategy exploits an overlap between two distinctive sets of disclosures under federal securities regulation: one pursuant to Regulation S-K Item 404(a) (Transactions with Related Persons) and the other pursuant to Regulation S-K Item 407(a)(3) (Director Independence). To monitor conflict-of-interest transactions, Item 404(a) requires a company to disclose *material* related party transactions with all of its directors and executives.[15] On the other hand, Item 407(a)(3) requires a company to disclose *any* related party transactions with its "independent" directors to ensure those transactions do not impair the directors' exercise of independent judgment.[16] While the purposes of Item 404(a) and Item 407(a)(3) are different, there is an important overlap in the subject matter of disclosure: a company's transactions (whether material or non-material) with "independent" directors.[17] Thus, for independent directors' related party transactions, the main distinction between Item 404(a) and Item 407(a)(3) is whether the directors' interest in the transactions is material. By examining these transactions in more detail, we can gain insight into reporting companies' disclosure practices and, in particular, how they apply the "materiality" standard.

By analyzing the details of disclosed transactions, including type, size, and frequency, this Article argues that federal disclosure requirements regarding related party transactions entail several problematic practices. Such practices can be categorized into three types. First, some companies simply fail to comply with the SEC's express instructions. Second, the application of the "materiality" standard appears to vary widely across firms. Third,

materials are generally an *ex post* report of the related party transactions that occurred during the previous fiscal year.

15 17 C.F.R. § 229.404(a) (2014).

16 *Id.* at § 229.407(a)(3).

17 The fact that the current Item 407(a) (Director Independence) used to be Item 404(b) and was separated from Item 404 only after the 2006 amendment might help explain why some companies blur the distinction between the two Items in disclosing related party transactions.

companies have discretion to deem certain types of related party transactions pre-approved in their policies and procedures. Especially with respect to the second type of problem, independent directors with approval authority seem to have considerable discretion in deciding not only which transactions to approve, but also what information to disclose to investors. In many disclosures under Item 404(a), corporations often state that their related party transactions are "not material" and decline to provide more details.[18] These findings suggest that securities law-based disclosures lead to strategic and inconsistent disclosure practices, potentially undermining the signaling value of disclosures in general by creating uncertainty.

After describing the empirical findings, this Article lays out a proposal for reform. By linking disclosures under federal securities law to the standard of review in state fiduciary duty of loyalty litigation, this proposal could alleviate the uncertainties currently associated with both the federal securities disclosure regime and *ex post* judicial review. Specifically, courts should consider disclosure under the SEC regulations as a factor in support of applying business judgment protection when a transaction is challenged in state court. The fact that a company disclosed the details of a related party transaction in its proxy statement shows its strong confidence in the transaction and its willingness to inform its shareholders. Thus, federal disclosure should be treated as a factor in support of the director-friendly business judgment protection.

This proposal offers several potential benefits. First, the proposed regime incentivizes the approving committees to reconsider the "materiality" criteria and provide more transparent disclosure of related party transactions. Second, it can help litigants predict which standard of review courts will apply and reduce uncertainty in *ex post* duty of loyalty litigation. Third, in the long run, this regime can provide both directors and market participants with better guidance in distinguishing between beneficial and detrimental related

18 For further discussion on this issue, see *infra* Part III.B.

party transactions through accumulation of disclosure data on related party transactions.

This Article is the first to closely examine the interplay between federal securities regulations and state corporate law on related party transactions. It is also the first to provide a detailed description of related party transaction disclosure practices. It proceeds as follows. Part II defines related party transactions and describes the current regulatory regime, focusing on corporate law's fiduciary duty obligations and federal securities laws' disclosure requirements. This part also analyzes theoretically the ways in which those regulations interact with each other and affect related parties' and approving committees' behavior. Part III presents an analysis of the hand-collected data and explores the extent to which the current regulations on related party transactions accomplish the goal of deterring harmful related party transactions while allowing beneficial ones. Part IV discusses the possible role that disclosures could play in making the applicable standard of review in fiduciary duty of loyalty cases more predictable. Part V concludes.

II. RELATED PARTY TRANSACTIONS AND THE CURRENT REGULATORY REGIME

This Part provides an overview of the existing regulatory framework under both corporate and securities regulations, and develops a theoretical framework to analyze the existing regulatory regime. It identifies some definitional issues (how the meaning of "related party transaction" differs depending on the context) and the changing views on related party transactions. It also briefly summarizes the different bodies of public and private regulatory law. This Part then examines corporate and securities law regulations in more depth, focusing particularly on the uncertainty surrounding the choice of standard of review in corporate law and the 2006 amendments to the disclosure requirements under the securities laws. The last section provides a theoretical analysis explaining the interaction between the applicable regulatory regimes.

A. Definition of a Related Party Transaction

There is no universal definition of a "related party transaction." The terms "related party" and "transaction" carry different meanings depending on the regulation. As compared in Table 1, SEC Regulation S-K and the common law of duty of loyalty cover much broader definitions of "related party transaction" than Delaware General Corporate Law Section 144 does. Similarly, while the SEC regulations and the common law of duty of loyalty define "related party" to include not only a corporation's directors and officers, but also shareholders with significant ownership, DGCL Section 144 focuses only on directors and officers. Since the goal of this Article is to examine the intersection and interplay between the SEC regulations and state corporate law (particularly safe harbor provisions such as DGCL Section 144), I use "related party transactions" to refer to the transactions between a company and its directors and officers.[19]

At the theoretical level, a related party transaction triggers the agency problem—a corporate director's self-dealing is a clear example. In a typical self-dealing transaction, a director extracts a private benefit at the expense of a company's shareholders.[20] Corporate law attempts to minimize the agency problem by imposing the fiduciary duty of loyalty and allowing the corporation and its shareholders to challenge the transaction through litigation. Accordingly, legal scholars have focused on regulating potentially harmful related party transactions through duty

---

[19] This Article does not cover fraud, appropriation of corporate opportunity, executive compensation, or insider trading. Although these topics all implicate similar elements of conflicts of interest, each of them has been treated separately by policymakers, courts, and academics.

[20] *See* Sanford J. Grossman & Oliver D. Hart, *One-Share-One-Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175, 177 (1988); Michael C. Jenson & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

TABLE 1: COMPARISON OF DEFINITIONS OF "RELATED PARTY TRANSACTION"

Source of Regulation	"Related Party"	"Transaction"
SEC Regulation S-K Item 404(a)	Directors/ Officers/ Beneficial Owner of more than 5% of stock and their immediate family members	Any financial transaction, arrangement, or relationship
DGCL Section 144	Directors/ Officers	Contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers, are directors or officers, or have a financial interest
Common Law of Duty of Loyalty	Directors/ Officers/ Controlling Shareholders	Any conflicts of interest

of loyalty lawsuits and procedural safeguards—in particular, *ex ante* review and approval by disinterested directors.[21]

[21] *Cf.* Paul G. Mahoney, *Mandatory Disclosure As A Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048 (1995) (arguing that the SEC's mandatory disclosure requirement was initially designed to reduce the agency costs created by promoters of companies and that the 1934 Exchange Act's expansion of mandatory disclosures towards forward-looking statements for enhancing the accuracy of stock prices is

Finance and accounting scholars have viewed related party transactions in a more neutral light. Their literature looks at the possible costs and benefits of a related party transaction, analyzing how regulations affect firm value and whether certain regulations of related party transactions are in the best interest of the shareholders.[22] Some of the literature focus on comparative analyses, examining the determinants of the regulatory regime for related party transactions in different countries.[23]

B. Regulations on Related Party Transactions: *Ex Ante* Versus *Ex Post* Dichotomy

As shown in Table 2, in addition to the traditional common law regulation on related party transactions,[24] currently there are several bodies of regulation dealing with related party transactions. But it is not always clear how they influence or interact with one another.

undesirable). Item 404(a) disclosures are mostly "backward-looking" and are directly relevant for controlling the agency problems of interested directors.

22 *See* Michael D. Ryngaert & Shawn E. Thomas, *Not All Related Party Transactions (RPTs) Are the Same: Ex-ante vs. Ex-post RPTs*, 50 J. ACCT. RES. 845 (2012); Elaine Henry et al., *The Role of Related Party Transactions in Fraudulent Financial Reporting*, 4 J. FORENSIC & INVESTIGATIVE ACCT. 186 (2012); Mark Kohlbeck & Brian W. Mayhew, *Valuation of Firms that Disclose Related Party Transactions*, 29 J. ACCT. & PUB. POL'Y 115 (2010); Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000).

23 *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. OF FIN. ECON. 430 (2008); Luca Enriques, *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, 2 INT'L & COMP. CORP. L.J. 297, 331 (2000).

24 *See* Eric Orts, *Conflict of Interest on Corporate Boards*, *in* CONFLICT OF INTEREST IN THE PROFESSIONS, 129 (Michael Davis & Andrew Stark eds., 2001) ("Traditional conflicts-of-interest rules include requirements of disclosure, procedural approval and ratification by disinterested superiors, and judicial review for substantive fairness in situations in which financial or personal interests may compromise a director's objectivity or loyalty to the organization.").

These various bodies of regulation can be categorized into two groups depending on the stage of intervention.[25] The first group consists of *ex ante* regulations (or rules) that attempt to screen related party transactions before they take place. The SEC, for instance, recently established an amended regulation requiring companies to describe their general procedural guidelines for the review and approval of related party transactions.[26] Another important *ex ante* regulation consists of laws passed by state legislatures requiring disclosure of related party transactions in order to receive approval from disinterested directors or shareholders before the transactions take effect.[27] Major stock exchanges have also amended their listing standards to require listed companies to have appropriate board committees, consisting exclusively of independent directors, review related party transactions.[28]

The second group consists of *ex post* regulations that monitor the related party transactions after they have occurred. *Ex post* disclosure is one example. In addition to the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 850, which requires disclosure of material related party transactions in financial statements, SEC Regulation S-K Item 404(a) requires publicly traded corporations to disclose any transaction over $120,000 that has occurred since the last fiscal year, or any currently-proposed transaction in which the company is a participant and a related party has a direct or indirect material interest.[29] That disclosure must be made in both the company's annual filing (10-K) and its proxy statements.[30]

---

[25] For a detailed taxonomy of the regulations, see Vladimir Atanasov et al., *Law and Tunneling*, 37 J. CORP. L. 1 (2011).

[26] 17 C.F.R. § 229.404(b) (2012).

[27] *E.g.*, DEL. CODE ANN. tit. 8, §144 (a)(1)–(2) (2010).

[28] *See, e.g.*, NYSE Listed Company Manual 314.00, *available at* http://perma.cc/Y3VA-SAG9?type=image.

[29] 17 C.F.R. § 229.404(a) (2014).

[30] 17 C.F.R. § 229.10(a)(2) (2014).

TABLE 2: REGULATIONS ON RELATED PARTY TRANSACTIONS

Authority	Statute/Reg.	Requirements
Federal SEC Regulations	SEC Reg. S-K Item 404	Mandatory disclosure, implementation of policies & procedures on transactions
State Corporate Statute (Safe Harbor Provision)	DGCL Section 144	Disclosure & approval (by disinterested directors or shareholders), or approval & transactions' fairness
FASB[31]	FASB ASC Topic 850	Disclosure of material related party transactions
Exchange Listing Standards	NYSE Listed Company Manual 314.00, NASDAQ Listing Rule 5630	Review by appropriate committee
Charter Provisions	—	Deviation from state safe harbor provision
Common Law	Fiduciary Duty of Loyalty	Fairness test
PCAOB[32] Standards[33]	PCAOB Standard No. 18[34]	Accounting firm's duty to review transactions as Outside Auditor

[31] Financial Accounting Standards Board.

[32] Public Company Accounting Oversight Board.

[33] According to the SEC, "[t]he Public Company Accounting Oversight Board . . . is a private-sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee accounting of professionals who provide independent audit reports for publicly traded companies." SEC, *Public Company Accounting Oversight Board (PCAOB)*, SEC.GOV, http://perma.cc/UMS5-L6GP.

[34] On June 10, 2014, the PCAOB released an amendment of the standards for related party transactions, which requires auditors to "obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements." Auditing Standard No. 18: Amendment to Certain PCAOB

In addition to the corporate and securities regulations that directly impose disclosure obligations on corporations, the Sarbanes-Oxley Act requires accounting firms that audit public companies to register with the PCAOB and adhere to professional standards established by that Board.[35] According to those standards, an accounting firm, as an outside auditor, has a duty to *ex post* review the related party transactions of the companies it audits. These reviews are in addition to the company audit committee's *ex ante* review of the transactions.

Judicial review, through litigation, is another form of *ex post* control over related party transactions. It is distinct from other regulations because it applies only when a shareholder brings suit, most often alleging breach of the fiduciary duty of loyalty. In most cases, judicial review in litigation is the formal check on the related party transactions.[36] Once a shareholder-plaintiff demonstrates a conflict of interest, the director-defendant bears the burden of proof in showing the fairness of the transaction. This fairness test is one of the highest standards limiting directors' discretion. The following table categorizes various regulations of related party transactions depending on the stage of the intervention. This Article's principal focus is on the federal securities regulations and state corporate laws.

Auditing Standards Regarding Significant Unusual Transactions, PCAOB Release No. 2014-002, app. at A1-1, *available at* http://perma.cc/BE5X-D732.

[35] Public Company Accounting Oversight Board; Order Approving Proposed Technical Amendments to Interim Standards Rules, 69 Fed. Reg. 24,199 (Apr. 28, 2004); Order Regarding Section 101(d) of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 23,336 (Apr. 25, 2003).

[36] Although not as effective as litigation as the formal check, reputation functions as an informal check on related party transactions. A company that undertakes a harmful related party transaction can face adverse consequences in the capital markets when such a transaction is disclosed to the investors even if it is not challenged in court. This kind of informal mechanism may result in serious consequences, and enhancing disclosure regulations can facilitate such informal mechanisms.

TABLE 3: *EX ANTE* AND *EX POST* REGULATIONS ON RELATED PARTY TRANSACTIONS

Ex Ante	*Ex Post*
Related Party Transaction Policy and Procedures (Item 404(b)(1))	—
Internal Disclosure by Related Party[37] (State Safe Harbor Provision)	External Disclosure by Approving Committee (Item 404(a)(1))
Approval by Disinterested Directors (State Safe Harbor Provision)	Ratification by Shareholders (State Safe Harbor Provision)
Review by Appropriate Committee (Stock Exchange Listing Standards)	Review by Outside Auditors (PCAOB Standard)
—	Judicial Review (Litigation) (Common Law)

C. The SEC's Disclosure Requirements on Related Party Transactions

On January 27, 2006, the SEC proposed amendments regarding disclosure to Item 404 (related party transactions) of Regulation S-K. The amendment to Item 404, according to the SEC, "significantly modified" the disclosure requirement for related party transactions promulgated in 1982.[38] After

[37] See *infra* Part II.E for a more detailed discussion on internal disclosures and external disclosures.

[38] Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,197 (Sept. 8, 2006). Many law firms issued Memos on this amendment, but not all of them agreed on whether it is a fundamental change to the disclosure of related party transactions. Regardless of the significance of the change, however, practitioners agreed that the amended regulations caused companies to incur higher compliance costs. *See* Ning Chiu & Richard Truesdell, *Disclosure and Approval of Related Person Transactions: Examining the Revised Regulations*, 17 CORP. GOVERNANCE ADVISOR 18, 22 (2009) ("[T]he combination of the expansion of defined terms used, more reliance on materiality judgments and board-level

receiving over 20,000 comment letters, the Commission released the final rule on August 29, 2006.[39]

1. An Overview of the Amendment

The SEC sought to modernize and streamline the disclosure requirement with the amendment.[40] Its goals were to "enhance investors' understanding of how corporate resources are used in related party transactions, and provide improved information to shareholders for purposes of better evaluating the actions of the board of directors and executive officers in fulfilling their responsibilities to the company and its shareholders."[41] According to the SEC's final release, the amendment was not, at least expressly, triggered by any specific corporate scandal or specific concern over the existing reporting practice. Rather, it was mainly the result of an effort to bring the standard up to date without changing the bottom-line effect.[42]

Under the amended Item 404(a), companies must disclose any transaction[43] between themselves and a related person[44] exceeding $120,000 in which the related person "had or will have a direct or indirect material interest."[45] Notable changes to Item 404 in 2006 are to (1) expand the scope of

---

approvals pursuant to written policies and procedures has resulted in a closer examination and review of transactions with related persons.").

39 Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,159 (Sept. 8, 2006).

40 *Id.* at 53,197.

41 *Id.* at 53,224.

42 *See id.*

43 "[A] transaction includes, but is not limited to, any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships." 17 C.F.R. § 229.404 (2014).

44 "Related person" includes any director, nominee for director, executive officer or five percent shareholders of the company (primary reporting person) and their immediate family members. *See id.*

45 17 C.F.R. § 229.404 (2014). In the SEC's final release, a related party transaction requiring disclosure under Item 404(a) is called a "reportable" transaction. And a related party transaction that need not be disclosed is termed an "excludable" transaction.

"immediate family members,"[46] (2) increase the dollar threshold of reportable transactions from $60,000 to $120,000, (3) eliminate instructions on "materiality,"[47] and (4) require "policies and procedures for the review, approval or ratification" of any reportable transaction.[48]

---

46 The amended definition of "immediate family members" was expanded to cover stepchildren, stepparents, and any person (other than a tenant or employee) sharing the household. For the purpose of the disclosure of related party transactions, this broader definition of immediate family member is a natural reflection of changing social norms. The SEC clarified that a company should disclose policies for the review, approval, or ratification of related person transactions under Item 404(b)(1) even when the company does not have to report any transactions under Item 404(a). SEC Compliance and Disclosure Interpretations, Question 130.06 (May 17, 2013), *available at* http://perma.cc/9UCN-ML3U; *see also* 17 C.F.R. § 229.404 (2014).

47 Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,197 (Sept. 8, 2006). This disclosure explained:

> The revisions retain the principles for disclosure of related person transactions that were previously specified in Item 404(a), but no longer include all of the instructions that served to delineate what transactions are reportable or excludable from disclosure based on bright lines that can depart from a more appropriate materiality analysis. Instead, Item 404(a) as amended consists of a general statement of the principle for disclosure, followed by specific disclosure requirements and instructions.

Id. See also id. at 53,176 ("[W]e are concerned that sole reliance on a bright line definition in our rules might provide an incentive to characterize perquisites or personal benefits in ways that would attempt to circumvent the bright lines.").

48 Item 404(b)(2) requires a company to identify any transactions required to be reported where such policies and procedures did not require review, approval, or ratification or where such policies and procedures were not followed. Based on its language, it only refers to a related party transaction that meets the criteria for disclosure obligations: the value of the related party transaction exceeds $120,000 "and" the related person has a direct or indirect material interest in it. Among those transactions, in cases where (i) the corporation's internal policy and procedures exclude the transaction from review, approval, or ratification or (ii) for any reason, the transaction was excluded from application of the policies and procedures, a company should disclose as much. 17 C.F.R. § 229.404 (2014).

2. Materiality Analysis

In order to minimize the problems caused by the clear but inflexible dollar threshold, the SEC combined the dollar threshold with a flexible but ambiguous standard of "materiality." Whenever the dollar amount of a related party transaction exceeds $120,000, a company should evaluate whether a related person had or will have a direct or indirect material interest in the transaction. Only when the transaction is determined to be material is disclosure required. Unlike other requirements for Item 404(a), the term "materiality" is neither defined nor accompanied by any instructions in the Item.

The 2006 changes regarding "materiality" analysis can be divided into three parts. First, the SEC eliminated the former Instruction 1 to Item 404(a), which had listed various factors that could be considered in determining materiality. Second, the SEC removed the former Instruction 9 to Item 404(a), which had emphasized that the dollar threshold was not a bright-line rule for materiality. The removal implies that even if a transaction exceeds the dollar threshold, it still can be deemed non-material and need not be disclosed. Third, the SEC deleted the former Item 404(b) regarding certain business relationships, which allowed non-disclosure of transactions between a company for which a person was serving as a director and another company she managed or

owned,[49] as long as the amount involved was no more than five percent of the gross revenue of either company.[50]

The reason for removing all "materiality" related instructions and the bright-line rule also stems from the SEC's intent to make disclosure more principle-based.[51] Consistent with this, the SEC deleted "all of the instructions that served to delineate what transactions are reportable or excludable from disclosure based on bright lines that can

---

[49] On the other hand, related party transactions between two companies for which the same person serves only as directors are often outside the scope of concern:

> A person who has a position or relationship with a firm, corporation, or other entity that engages in a transaction with the registrant shall not be deemed to have an indirect material interest within the meaning of paragraph (a) of this Item where: a. The interest arises only: i. From such person's position as a director of another corporation or organization that is a party to the transaction.

Instruction to 17 C.F.R. § 229.404(a) 6.a.i. (2014).

[50] Although the SEC did not emphasize it in its release of the final 2006 rules, the other source informing materiality was the former Item 404(b) covering certain business relationships. The former Item 404(b) contained a "five percent rule" which required directors or nominees for director to disclose any related party transaction when the dollar amount of the transaction exceeded five percent of either the registrant's or the other entity's consolidated gross revenue for its last full fiscal year. *See* 17 C.F.R. § 229.404 (2005). This numerical formula functioned as a practical threshold on what to report and what to exclude. The SEC's decision in the 2006 final rules then can be understood as an effort to pursue more case-specific fairness. *See generally* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,176 (Sept. 8, 2006). Since the regulations already contain a clear $120,000 threshold, the Commission might have thought that another rigid criterion was unnecessary. Rather, the Commission could have sought to have a more flexible standard to complement the bright-line dollar threshold.

[51] This principle-based interpretation of materiality is not new. It is consistent with what the SEC staff did in Staff Accounting Bulletin (SAB) No. 99 back in 1999. Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150, 45153 (Aug. 19, 1999) (codified at 17 C.F.R. pt. 211). In the context of a misstatement in financial statements, the SEC stated, "as with materiality generally, this analysis requires consideration of both quantitative and qualitative factors" and indicated quantitatively small, but qualitatively material, examples.

depart from a more appropriate materiality analysis."[52] However, based on the SEC's final release, the SEC made clear that the omission of former instructions was not intended to change the standards applicable to those items. In its final 2006 release, all the former instructions to the rule retained almost the exact same language. Thus, when a company evaluates the materiality of its related party transactions, it still needs to consider the same factors, although the source of legal support is different.

3. Policies and Procedures for Review, Approval, or Ratification

Newly added Item 404(b)(1) requires companies to "[d]escribe the registrant's policies and procedures for the review, approval, or ratification of any transaction required to be reported under paragraph (a) of this Item."[53] The intention of the new addition is to correspond with the fact that the "[s]tate corporate law and increasingly robust corporate governance practices support or provide for such procedures in connection with transactions involving conflicts of interest."[54] As a result, the SEC requires disclosure of procedural information on related party transactions based on the belief that "this type of information may be material to investors."[55] Even before 2006, some companies included policies on conflict of interest transactions in their corporate governance documents.[56]

52 Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,197 (Sept. 8, 2006).

53 17 C.F.R. § 229.404(b)(1) (2014).

54 Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,202 (Sept. 8, 2006).

55 *Id.*

56 These documents include codes of ethics, corporate governance guidelines, and committee charters, as required by Sarbanes-Oxley Act. *See generally* Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7201, 7261–7265 (2002).

D. Corporate Law on Related Party Transactions

Under the traditional common law, at least until the early twentieth century, a related party transaction between a company and its director was generally deemed *per se* voidable by the company regardless of whether the transaction was beneficial or harmful to the company.[57] This doctrinal stance came from the fact that a relationship between a director and shareholders was treated the same as the relationship between a trustee and its beneficiaries under the trust law.[58] Starting in the early twentieth century, however, courts and state legislatures began moving away from *per se* voidability.[59] For instance, in some Delaware cases, which were decided before the adoption of the safe harbor provision, conflict of interest transactions were determined voidable only after an examination of whether the transactions were fair to non-participating shareholders and whether the transactions were approved by a disinterested majority of directors or stockholders.[60]

Moreover, the adoption of the safe harbor provision significantly mitigated the common law *per se* voidability rule. California first adopted a provision validating related

57 Not everyone agrees that *per se* voidability was the dominant view in the nineteenth century. *Compare* Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36, 39–40 (1966) (arguing that as late as the end of the nineteenth century the rule appeared settled that corporations had the power to avoid all such transactions without regard to the fairness of the transaction or the manner in which it was originally approved by the corporation) *with* Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 659–60 (1992) (claiming that even in the nineteenth century, courts allowed a conflict-of-interest transaction if it was deemed fair).

58 *See* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 958–59 (2005).

59 Potter v. Sanitary Co. of Am., 194 A. 87, 90–92 (Del. Ch. 1937).

60 *See, e.g.*, Keenan v. Eshleman, 2 A.2d 904, 908 (Del. 1938); *Blish v. Thompson Automatic Arms Corp.*, 64 A.2d 581, 602 (Del. 1948); and *Kerbs v. Cal. E. Airways*, 90 A.2d 652, 658 (Del. 1952).

party transactions under certain conditions in 1931.[61] Delaware enacted a similar provision in 1967.[62] Legislators recognized that in many cases, such as executive compensation, related party transactions are inevitable[63] and that it may be undesirable to put all such transactions in danger of being voided.

Under current law, directors and officers who are involved in a related party transaction are subject to the fiduciary duty of loyalty.[64] The duty "mandates that the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[65] In general, shareholders' derivative suits[66] alleging a breach of the duty of loyalty proceed as follows: once a shareholder-plaintiff proves the existence of a conflict of interest between a company and a director, the presumption of business judgment is rebutted

---

61 *See* HENRY W. BALLANTINE & GRAHAM L. STERLING, JR., CALIFORNIA CORPORATION LAWS, 98–102 (1938).

62 *See* Blake Rohrbacher, et al., *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719, 719 (2008).

63 *See* Jonathan Macey, *The Nature of Conflicts of Interest Within the Firm*, 31 J. CORP. L. 613, 614 (2006) ("[E]thical theory only guides us to the extent that we can avoid conflicts, which is to say, hardly ever as a practical matter. Some way of *managing* conflicts is necessary in the real world, and that is through the contracting process.").

64 For the purposes of this Article, I focus on Delaware's statutory duty of loyalty, as developed through case law. DEL. CODE ANN. tit. 8, § 144 (2010). With regards to related party transactions, I focus specifically on related party transactions where a controlling shareholder is not involved so as to analyze the interplay between federal securities regulations and state corporate law.

65 Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

66 BLACK'S LAW DICTIONARY 475 (8th ed. 2004) (defining a shareholder derivative action as "a suit asserted by a shareholder on the corporation's behalf against a third party . . . because of the corporation's failure to take some action against the third party"). Most fiduciary duty cases are brought as derivative suits with the directors or officers as the defendants.

and fairness review is applied.[67] Under entire fairness review, the director-defendant bears the burden of proving intrinsic fairness both in the process (fair dealing) and in the substance (fair price or fair terms) of the transaction at issue.[68] If the director-defendant succeeds in proving both conditions, the shareholder-plaintiff can neither enjoin the related party transaction nor seek any damages. The applicable standard of review is often the key to success in a given case because it is often quite difficult and costly for directors to meet the fairness test or, on the other side, for shareholders to rebut the presumption of business judgment review.

In addition to the common law duty of loyalty, a director or officer's self-dealing is also subject to statutory safe harbor provisions.[69] The most important example is Delaware

---

67 In actual cases, the test to decide whether to use a fairness standard instead of the business judgment rule is not entirely clear. *See* Lazarus & McCartney, *supra* note 8, at 1010.

68 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (holding in the context of parent-subsidiary mergers that, "[w]hen directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.") (internal citations omitted).

69 As of October 2014, fifty-one jurisdictions (including the District of Columbia and Puerto Rico) have a safe harbor provision regarding related party transactions: ALA. CODE §§ 10A-2-8.60–8.63 (2011); ALASKA STAT. § 10.06.478 (2013); ARIZ. REV. STAT. ANN. § 10-860 (1996); ARK. CODE ANN. § 4-27-831 (2014); CAL. CORP. CODE § 310 (1977); COLO. REV. STAT. § 7-108-501 (2004); CONN. GEN. STAT. ANN. § 33-781 (West 2006); DEL. CODE ANN. tit. 8, § 144 (2010); D.C. CODE § 29-306.70 (2011); FLA. STAT. ANN. § 607.0832 (West 1997); GA. CODE ANN. § 14-2-860 (1989); HAW. REV. STAT. § 414-261 (2000); IDAHO CODE § 30-1-860 (1997); 805 ILL. COMP. STAT. 5/8.60 (1998); IND. CODE ANN. §§ 23-1-35-2–3 (West 1987); IOWA CODE ANN. §§ 490.860-63 (West 2014); KAN. STAT. ANN. § 17-6304 (1972); KY. REV. STAT. ANN. § 271B.8-310 (West 1989); LA. REV. STAT. ANN. § 12:84 (1968); MASS. GEN. LAWS ANN. ch. 156D, §§ 8.31–32 (LexisNexis 2004);MD. CODE ANN., CORPS. & ASS'NS § 2-419 (West 1983); ME. REV. STAT. tit. 13-C, § 871 (2007); MICH. COMP. LAWS ANN. § 450.1545a (2009); MINN. STAT. § 302A.255 (2008); MISS. CODE ANN. § 79-4-8.60 (2013); MO. ANN. STAT. §

General Corporation Law Section 144.[70] This provision rescues related party transactions from *per se* voidability: if an interested transaction satisfies certain conditions (disclosure and approval of disinterested directors or shareholders[71] or fairness), the transaction shall not be voided solely because of the conflicts of interest. Although the provision's language is clear on the issue of validity, it is still silent on how far the safe harbor reaches. More specifically, the question remains as to whether a related party transaction that satisfies the safe harbor provision (particularly the first condition of disinterested directors' approval) becomes subject to the business judgment rule or merely shifts the burden of proof to the shareholder-plaintiff while remaining under fairness review.[72] The courts'

351.327 (West 1998); MONT. CODE ANN. § 35-1-461 (2009); N.D. CENT. CODE § 10-19.1-51 (2011); N.J. STAT. ANN. § 14A:6-8 (West 1988); N.M. STAT. ANN. § 53-1140.1 (LexisNexis 1987); N.Y. BUS. CORP. LAW § 713 (McKinney 1998); N.C. GEN. STAT. § 55-8-31 (2005); NEB. REV. STAT. ANN. § 21-20,112 (LexisNexis 1995); NEV. REV. STAT. § 78.140 (2007); OHIO REV. CODE ANN. § 1701.60 (LexisNexis 1986); OKLA. STAT. ANN. tit. 18, § 1030 (West 2014); OR. REV. STAT. § 60.361 (1987); 15 PA. CONS. STAT. ANN. § 1728 (West 1989); P.R. LAWS ANN. tit. 14, §§ 3564–66 (2009); R.I. GEN. LAWS § 7-1.2-807 (2005); S.C. CODE ANN. § 33-8-310 (1990); S.D. CODIFIED LAWS § 47-1A-860 (2005); TENN. CODE ANN. § 48-18-701 (2012); TEX. BUS. ORGS. CODE ANN. § 21.418 (West 2011); UTAH CODE ANN. § 16-10a-850 (West 1992); VA. CODE ANN. § 13.1-691 (2005); VT. STAT. ANN. tit. 11A, §§ 8.60–63 (2008); WASH. REV. CODE ANN. § 23B.08.700 (LexisNexis 2009); W. VA. CODE § 31D-8-860 (2002); WIS. STAT. § 180.0831 (1989); WYO. STAT. ANN. § 17-16-860 (2009).

[70] DEL. CODE ANN. tit. 8, § 144 (2010).

[71] In re Wheelabrator Technologies, Inc., 663 A.2d 1194, 1203 (Del. Ch. 1995) ("[T]he operative effect of shareholder ratification in duty of loyalty cases has been either to change the standard of review to business judgment rule, with the burden of proof resting upon the plaintiff, *or* to leave 'entire fairness' as the review standard, but shift the burden of proof to the plaintiff.").

[72] *See* Eric Orts, *Conflict of Interest on Corporate Boards*, *in* CONFLICT OF INTEREST IN THE PROFESSIONS, 149 n.40 (Michael Davis & Andrew Stark eds. 2001) ("The trouble is that neither the model statute nor various state versions specify what standard applies to review self-dealing transactions that are 'not voidable' for any of these reasons"). Some scholars argue that, even with a disinterested board's approval, fairness review should still be

answers have not been consistent, and the issue has been controversial among practitioners and legal scholars.[73] Given that shifting the burden of proof or applying a different standard of review will have serious consequences for determining liability, providing a predictable answer would have an important impact on the regulation of related party transactions.

---

applied to related party transactions because directors' collegial relationships make it difficult for approving directors to effectively police their colleagues in an unbiased way. *See also* J. Robert Brown, Jr., *Disloyalty Without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 103–04 (2007); Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 1002–03 (1988).

[73] *Compare* HMG/Courtland Properties, Inc. v. Gray, 749 A.2d 94, 114 (Del. Ch. 1999) (ruling that Section 144 does not play any role in determining which standard of review applies), *and* Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) ("[Compliance with Section 144] merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved."), *with* Cooke v. Oolie, No. CIV. A. 11134, 2000 WL 710199, at *13 (Del. Ch. May 24, 2000) ("The disinterested directors' ratification cleanses the taint of interest because the disinterested directors have no incentive to act disloyally and should be only concerned with advancing the interests of the corporation. The Court will presume, therefore, that the vote of a disinterested director signals that the interested transaction furthers the best interests of the corporation despite the interest of one or more directors."); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction."); *and* Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 120 (Del. 2006) ("After approval by disinterested directors, courts review the interested transaction under the business judgment rule . . . ."). The Courts' variant interpretation of the effect of Section 144 is well described in Blake Rohrbacher et al., *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719, 736–37 (2008) and Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals*, 60 FLA. L. REV. 589, 603–04 (2008).

E. A Theoretical Analysis of Interactions Among Regulations

It is important to note that an approving entity's disclosure to shareholders and the market under SEC regulations is distinct from a related party's disclosure solely to the approving entity for the sake of receiving the valid approval under state corporate law. Under state corporate laws, disclosure is made by a related party to an approving entity in order to enjoy the safe harbor protection. Since these disclosures are made solely within the company, they can be thought of as "Internal Disclosures." There is no specific format required for these disclosures. By comparison, under the SEC regulations, the approving committee is responsible for disclosing related party transactions to shareholders in that company's proxy statements.[74] Such "External Disclosures" have an audience beyond the company's shareholders and are publicly available to all market participants through SEC EDGAR filers. External Disclosures are influential because they reach a much broader audience, yet are less powerful than Internal Disclosures in the sense that they do not directly affect the validity of the transaction.[75]

In terms of timing, External Disclosures are mostly backward-looking while Internal Disclosures are more forward-looking. Even though External Disclosures are made after related party transactions have already taken place, the purpose of the SEC regulations is not necessarily for *ex post* regulation. Rather, by mandating disclosure, the SEC

---

[74] Regulation S-K Item 404(a) does not specify in which filing corporations should disclose related party transactions. 17 C.F.R. § 229.404(a) (2014). Of the fifty sample companies I reviewed, forty-nine companies disclosed details of related party transactions only in their proxy statements. Although each company's 10-K has a section for disclosing related party transactions, it merely refers to proxy statements without providing specific details about the transactions.

[75] Luca Enriques, *The Law on Company Directors' Self-Dealing: A Comparative Analysis*, 2 INT'L & COMP. CORP. L. J. 297, 307–11 (2000) (distinguishing "disclosure *per se*" from "disclosure as a procedural requirement").

asks companies to be more discerning when determining which related party transactions to approve *ex ante*, before they enter into transactions with a related party. For instance, most related party transactions are recurrent and appear in proxy statements for several consecutive years, unless the related party leaves the company. Hence, if shareholders find a certain related party transaction problematic, the transaction can still be halted through a legal challenge even though the related entities have already begun their business dealing. Table 4 below summarizes the differences between Internal Disclosures and External Disclosures.

TABLE 4: COMPARISON OF
TWO DIFFERENT KINDS OF DISCLOSURES

	Internal Disclosures	External Disclosures
Governing Law	State Corporate Laws	SEC Regulation S-K Item 404
Disclosing Entity	(By) Related Person	(By) Approving Entity
Audience of Disclosure	(To) Approving Entity	(To) (Existing/Potential) Investors
Subject of Disclosure	All Related Party Transactions	Material Related Party Transactions
Timing of Disclosure	Mostly *ex ante*	Mostly *ex post*

External disclosure can have an important effect on director elections. Shareholders often rely on proxy statements, which contain information on related party transactions, when asked to vote on director nominees for the upcoming year. Those two sets of information, one regarding related party transactions and the other regarding director nominees, can inform shareholders which director nominees have previously engaged in related party

transactions.[76] The shareholders can therefore refuse to elect a nominee who engaged in a problematic transaction with the corporation in the previous year.[77]

More importantly, External Disclosures can affect both the approving committee's and the related party's behaviors, both in terms of disclosure and approval. With respect to approval, once an approving committee blesses a proposed related party transaction and the details of the transaction are released through the company's proxy statement, the information becomes accessible to all market participants. If a seemingly problematic related party transaction is disclosed, that transaction may not only provide a basis for shareholders' duty of loyalty litigation, but it also may harm the reputations of both the directors and the companies involved. Awareness of such potential consequences would make an approving committee more cautious when making

76 The 2006 amendment, as reflected in 17 C.F.R. § 229.404(a) (2014), added a forward-looking feature by requiring "proposed" related party transactions to be disclosed. In practice, however, companies rarely specify whether the transactions will be continuing for the next fiscal year.

77 In fact, by comparing disclosures in 2012 proxy statements and 2013 proxy statements, I found at least two cases in which a non-employee director who was heavily involved in complicated related party transactions was not nominated for director re-election in the following year. Even companies with annual elections of directors are likely to re-elect the same directors, and changing the nominee is not common. The interested director's involvement in a related party transaction, however, may not be the only reason for the nominee's exclusion from the ballot. But the departure of a conflicted director can improve a firm's corporate governance. The SEC disclosure is a source of corporate governance rating by independent rating agencies. For instance, when Institutional Shareholder Services, Inc. (ISS) screens corporations for governance risks for the purposes of making proxy recommendations, it asks a series of questions to rate the related party transactions in each company: "(1) What percent of the directors were involved in material RPTs? (2) Do the directors with RPTs sit on key board committees? (3) Are there material related party transactions involving the CEO?" INSTITUTIONAL SHAREHOLDER SERVICES, INC., ISS GOVERNANCE QUICKSCORE 2.0: OVERVIEW AND UPDATES 54 (2014).

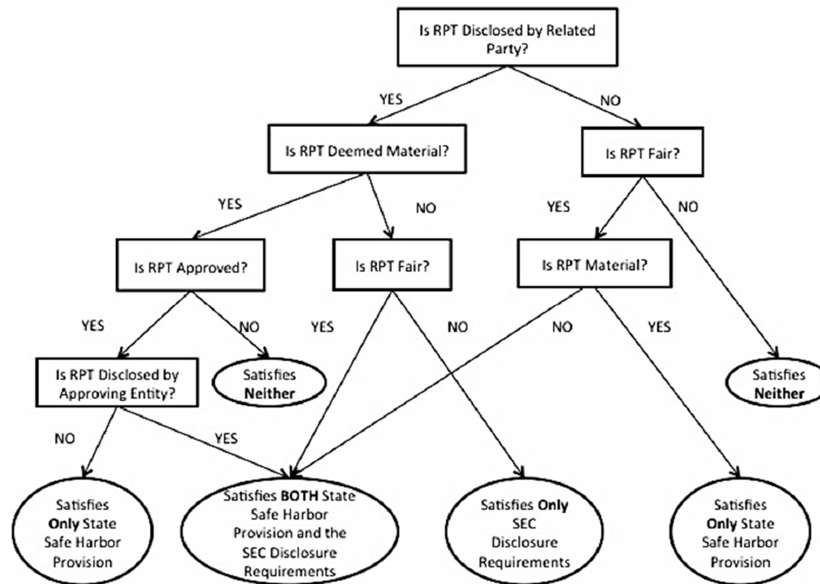
such decisions and could, for instance, result in the application of a stricter standard for approval.[78]

In short, when a related party transaction is proposed to an approving committee, there are two important decisions that the approving committee makes: one on its materiality and the other on its approval. If the committee determines that the transaction is material, then the details of that transaction will be disclosed to the shareholders under SEC regulations when it is approved. If the committee determines that the transaction is not material, however, the details of the transaction will not be disclosed to the shareholders regardless of the approval decision. In other words, the approving committee not only determines whether a certain related party transaction will proceed but also whether and to what extent the transaction's details will be disclosed to the shareholders. Figure 1 presents the basic steps in related party transactions and highlights the importance of the approving committee's determinations on disclosure and approval.

A change in an approving committee's standards could, in turn, affect a related party's behavior in several ways. First, when a related party expects that the approving committee will apply a stricter standard for approval and that only material transactions will be disclosed to shareholders (External Disclosure), there may be a selection effect where the related party engages in more immaterial transactions or fails to disclose material transactions to an approving committee (Internal Disclosure). In the former situation, the underlying distribution of related party transactions changes, while in the latter, the distribution of transactions may remain the same while the distribution of what is disclosed changes.

[78] Under an effective disclosure regime, an approving committee would likely be more risk-averse in approving a related party transaction because the potential cost of harm to the company's and the approving directors' reputations could outweigh the potential benefit. Consequently, the risk aversion of the approving committee would enhance the value of the disclosures that are made under this new regime.

FIGURE 1: FLOW CHART ON HOW TO PROCEED WITH RELATED PARTY TRANSACTIONS



Second, if the related party decides to abandon a transaction because she thinks the transaction might be problematic, the SEC's *ex post* disclosure requirement has effectively deterred a potentially harmful related party transaction. At the same time, however, the requirement might also pose the risk of over-deterrence. If the process for disclosure and approval of a related party transaction is too complicated, burdensome, or futile (in the sense that the approving committee almost always rejects the proposed transaction), a related party who wants to pursue a value-increasing transaction might decide not to proceed with it.[79]

Third, once the related party decides to pursue the transaction, the SEC disclosure requirements can also affect the related person's disclosure behavior. When a related party expects that the approving committee will apply a

[79] For further discussion of the over-deterrence effect, *see infra* Part IV.C.Possible Objections to the Proposal.

stricter standard for approval, the related party may decide not to disclose the transaction at all, believing, either correctly or incorrectly, that the transaction is fair. When a related party does not disclose an interested transaction to the approving committee, it is a violation of SEC Regulation S-K Item 404(a) only if the transaction is "material." Even so, based on the state safe harbor provision, if the related party transaction is deemed fair, it will be valid under corporate law.[80] In such a case, the directors bear the burden of proving the fairness of the transactions in court. Not only is it very difficult for the directors to win the case, but because duty of loyalty violations are usually excluded from directors' indemnification, related parties are likely to end up paying for the litigation out of their own pockets.

Conversely, if a related party transaction is not material, nondisclosure of the transaction violates neither the SEC regulation nor corporate law. When a related person chooses not to disclose a related party transaction, the question of its fairness is determined only when the transaction is challenged. If more problematic transactions are executed but not disclosed under the excuse of either being "non-material," or "fair," much of the deterrence and screening effect can be lost.

Thus, under the current regulatory regime on related party transactions, if each of the courts' implementation of safe harbor provisions in state corporate law, and the SEC's regulation on disclosure work effectively, there can be synergy in policing related party transactions. Incentives would be created for the related party to make the *ex ante* disclosure contemplated by state corporate laws (e.g. DGCL Section 144), by virtue of the fact that the transaction may have to be disclosed *ex post* in a proxy statement or 10-K pursuant to Item 404(a) of Regulation S-K. In turn, it would affect the behavior of the company and its insiders by making them more cautious about related party

[80] *E.g.*, DEL. CODE ANN. tit. 8, §144 (2010). ("The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders.").

transactions, in contrast to a world in which there were only state law safe harbor provisions, or the SEC item 404(a), but not both.

In the following Part III, I present empirical evidence on how companies abide by the SEC disclosure requirements to evaluate the effectiveness of the current regulations.

III. EMPIRICAL ANALYSIS OF DISCLOSURE PRACTICES

Few details on how corporations engage in related party transactions are known; the types, frequencies, and sizes of related party transactions are relatively under-explored. One good source of information for those details is the breach of duty of loyalty cases. Court decisions provide detailed facts of each transaction, and by examining them we can learn a lot about the challenged transaction. The obvious problem, however, is that because the courts are only provided the opportunity to observe those transactions that are accused of being harmful to the corporation, there could be a selection bias problem. Presumably, if a related party transaction is beneficial (or is understood to be beneficial) to the corporation, it is less likely to be challenged in court. Conversely, certain harmful transactions can slip through the cracks and be implemented without being challenged in court.

Another important source of information is the set of disclosures under the federal securities regulations. As discussed in Part II, in 2006, the SEC imposed additional requirements on disclosing related party transactions. Each publicly traded corporation is required to (1) adopt (and disclose) a policy and procedural guidelines for reviewing related party transactions, as well as (2) disclose relevant information about approved related party transactions in its annual report or proxy materials.[81] Disclosures under the SEC regulations, therefore, can offer more comprehensive descriptions of related party transactions in the real world.

---

81 *See supra* Part II.

I focus on the SEC disclosure data. Because a readily available and reliable dataset on related party transaction disclosures does not exist, I manually collected disclosure statements from top fifty publicly traded companies, chosen from the 2012 publication of the Fortune 500 list.[82] My primary methodology is to aggregate and compare the transactions disclosed under SEC Regulation S-K Item 404(a) (on related party transactions) with those under Item 407(a)(3) (on director independence). The advantage of cross-Item comparison will be described in more detail below.

Two principal findings can be briefly summarized. First, the data reveals that directors exercise a large amount of discretion over related party transactions through the *ex ante* screening process. Companies can avoid disclosing potentially important (and potentially material) related party transactions by simply asserting that they are "not material." Second, such exercise of discretion also seems to have blurred the interpretations of what is required from companies under the disclosure regulations, particularly on the question of what constitutes "materiality." This diverges from the SEC's stated intent.

Ambiguity in the federal disclosure regulations is especially visible in two areas. First, because some companies commonly, but wrongfully, exclude related party transactions from disclosure in the ordinary course of business, diverse interpretation and use of "ordinary course

[82] For the purpose of this Article, I limited my sample to publicly traded companies that are the subjects of SEC regulation. All fifty companies disclosed detailed related party transactions, policies, and procedures in their proxy statements (Schedule 14A). Their annual reports (10-K), under the title "ITEM 13: Certain relationships and related party transactions, and director independence," simply refer to the proxy statements for specific information. I used proxy statements filed for annual shareholders' meetings held in 2012, which cover either fiscal year 2011 or 2012, depending on the timing of the company's annual meeting. Thirty-one out of fifty (62%) companies are incorporated in Delaware, and the rest are incorporated in eleven different states, including Ohio (6%), Minnesota (6%), New York (6%), New Jersey (4%), Washington (4%), North Carolina (4%), California (2%), Illinois (2%), Indiana (2%), Pennsylvania (2%), and Virginia (2%).

of business" predictably leads to inconsistent disclosure practices. Second, and perhaps more significantly, there remains uncertainty in determining from whose perspective the transactions should be viewed as material or not. That is, answering the question of "material to whom." I will later elaborate with specific examples on these and other sources of ambiguity.

A. An Overview of the Findings

1. Related Party Transaction Disclosure vs. Director Independence Disclosure

In addition to SEC Regulation S-K Item 404(a) on related party transactions, described in detail in Part II, Item 407(a)(3) on director independence also plays an important role in providing investors with useful information on related party transactions. The two regulations are closely related. Item 407(a)(3), added in 2006, attempts to present a full picture of each director's relationship with a company in determining whether the director is independent from the company. Specifically, Item 407(a)(3) states:

> For each director and nominee for director that is identified as independent, describe, by specific category or type, any transactions, relationships or arrangements not disclosed pursuant to Item 404(a) (§229.404(a)) . . . that were considered by the board of directors under the applicable independence definitions in determining that the director is independent.[83]

Whenever a company deems a director independent, the company must disclose all related party transactions the company has with that director, even when they are not

[83] 17 C.F.R. § 229.407(a)(3) (2014). The definition of independent directors is fulfilled by stock exchange listing rules. *See* NYSE Listed Company Manual 303A.02 (Independence Tests) and Nasdaq Marketplace Rule 4200(a)(15) (Definition of "Independent Director"). They determine who cannot be an independent director but they do not provide what should be disclosed under Item 407(a)(3) when directors are independent.

considered sufficiently material for disclosure under Item 404(a). Therefore, the most notable difference between Item 404(a) and Item 407(a)(3) disclosure requirements is the absence of a "materiality" standard in the latter. By definition, Item 404(a) and Item 407(a)(3) are mutually exclusive and only seven related party transactions from three companies were overlapped and disclosed in both Items.[84] Item 404(a) requires disclosure of "material" related party transactions. In practice, approving committees (consisting of "independent" directors) have discretion over both approving a proposed related party transaction and determining whether the transaction is "material" enough to disclose under Item 404(a). On the contrary, Item 407(a)(3) requires disclosure of all related party transactions, whether material or non-material, that were considered in determining the independence of a director. Disclosures of related party transactions associated with independent directors, therefore, provide a window through which we can examine a broader distribution of related party transactions, which may be helpful in revealing a company's implicit threshold of materiality.

The second difference between the two Items is the breadth of information to be disclosed under each respective section. In brief, Item 404(a) calls for more specific detail regarding the related party transactions than Item 407(a)(3). For instance, Item 404(a) requires disclosure of not only the identity of the related party but also of such matters as the related party's specific relationship to the corporation, the (approximate) dollar values of the transaction, and the related party's (direct or indirect) interest in the

[84] Wal-Mart disclosed two related party transactions in both Items. Dell made one duplicate and Dow Chemical made three duplicate disclosures. In all cases, I counted them only once depending on the substance of disclosures. For Wal-Mart and Dell, the transactions could be characterized as "material" related party transactions of independent directors. Thus, I counted them only under Item 404(a) (related party transactions). Meanwhile, the three related party transactions of Dow Chemical were in a typical format of Item 407(a)(3) disclosures with no specific information regarding the transactions, so I counted them only under Item 407(a)(3) (director independence) disclosure.

transaction.[85] In contrast, Item 407(a)(3) merely requires a description of "detail as is necessary to fully describe the nature" of any related party transaction that was considered to determine a director's independence. It does not sufficiently specify what information is required under Item 407(a)(3).[86]

The third important difference is that the two sections have different categories of directors who are subject to the disclosure requirement. Under Item 407(a)(3), only related party transactions with directors who qualify as being "independent" are required to be disclosed.[87] Thus, the disclosures exclude (1) transactions with officers or employees and (2) transactions with non-employee directors who are not independent. On the other hand, under Item 404(a), all "material" related party transactions by all directors, including officer-directors and other non-independent directors, of the company must be disclosed.

In sum, when the two sections are compared, Item 404(a) includes a broader category of related persons while narrowing the type of transactions that must be disclosed by applying the "materiality" standard. Hence, for an "independent" director, by invoking "non-materiality," the company can avoid disclosing more specific details of the director's related party transaction by disclosing under Item 407(a)(3) rather than under Item 404(a). Moreover, if an officer-director (or any non-independent director) engages in a related party transaction that is determined to be "non-material" (by the approving committee), it will not be disclosed under either section.

---

85 *See* 17 C.F.R. § 229.404(c)(ii) (2014).

86 Unlike Item 404(a), Instruction to Item 407(a)(3) ("The description of the specific categories or types of transactions, relationships or arrangements required by paragraph (a)(3) of this Item must be provided in such detail as is necessary to fully describe the nature of the transactions, relationships or arrangements.") does not list the specific details of the transaction that must be disclosed. 17 C.F.R. § 229.407(a)(3) (2014).

87 By definition, independent directors are a subset of non-employee directors. 17 C.F.R. § 229.407(a)(3) (2014).

One might be concerned that, given the difference in each Item's purpose in requiring disclosure, Item 407(a)(3) disclosures cannot be useful for understanding Item 404(a) disclosures. Whereas Item 404(a) focuses on whether certain conflicts of interest in related party transactions harm shareholders, and thereby misappropriate corporate assets (or opportunities), Item 407(a)(3) only focuses on whether conflicts of interest in related party transactions impair the independence of directors. Thus, those tasked with preparing a company's proxy statements should apply different standards to each Item, as they are different in nature, like apples and oranges.

Although the two Items are clearly distinguishable in theory, the distinction between the applications of the Items is not always clear in practice. This is partly because they are derived from the same statutory provision, which was in existence before the 2006 amendment. Another reason why in practice the distinction between Item 404(a) and Item 407(a)(3) is diminishing is because directors have and exercise ample discretion in deciding under which Item to disclose a related party transaction. For instance, Wal-Mart and United Technologies Corporation ("UTC") disclosed very similar transactions using different forums; while one disclosed it under Item 404(a), the other used Item 407(a)(3). In 2012, Wal-Mart disclosed the following transaction under Item 404(a) (related party transactions):

> Arne M. Sorenson, a director of Walmart, is the President and CEO and a director of Marriott International, Inc. ("Marriott"). During fiscal 2012, Walmart paid or reimbursed payments made to Marriott and its subsidiaries in the amount of approximately $19 million for hotel, lodging, and related services, and Walmart received payments of approximately $1.07 million from Marriott for purchases of merchandise from Walmart. Walmart anticipates that it will continue to purchase hotel, lodging, and related services from Marriott, and

> Marriott will continue to purchase merchandise from Walmart during fiscal 2013.[88]

On the other hand, UTC disclosed a very similar transaction under Item 407(a)(3). The transaction was between UTC and DuPont: "purchases from UTC, principally elevator and air conditioning services and industrial products; sales to UTC of materials" amount of $7,119,000 and $42,017,000 respectively. These transactions are related party transactions because Ellen J. Kullman, a director of UTC, is also Chair and Chief Executive Officer of DuPont.[89]

Both transactions were sale/purchase transactions between the company for which the related party served as an independent director, and a company for which the related party served as a CEO. Also, the dollar amounts associated with the transactions were similar. More interestingly, if either transaction would have been undertaken by Exxon Mobil's non-independent directors or executives, the transaction would have been categorized as a pre-approved related party transaction and the related party would not have needed to disclose the transaction to Exxon Mobil's approving committee.[90] This example thus

---

88 Wal-Mart Stores, Inc., Definitive Proxy Statement (Schedule 14A) 58 (June 1, 2012), *available at* http://perma.cc/8Q7Y-H6NA.

89 See United Technologies' Item 407(a)(3) (Director Independence) disclosures in its proxy statement filed in 2012. United Technologies Corporation, Definitive Proxy Statement (Schedule 14A) 14 (Apr. 11, 2012), *available at* http://perma.cc/L3Q9-XA3X.

90 See Exxon Mobil's proxy statement:

> In addition, based on a consideration of ExxonMobil's facts and circumstances, the Committee will presume that the following transactions do not involve a material interest for purposes of reporting under SEC rules: Transactions in the ordinary course of business with an entity for which a related person serves as an executive officer, *provided:* (1) the affected director or executive officer did not participate in the decision on the part of ExxonMobil to enter into such transactions; and, (2) the amount involved in any related category of transactions in a 12-month period is less than 1 percent of the entity's gross revenues.

demonstrates how different companies treat related party transactions differently for disclosure purposes and, also, how the line between Items 404(a) and Item 407(a)(3) is quite permeable.

Given the variation in treatment, the purpose of comparing the two Items is to get a glimpse of the related party transactions that are not being disclosed. Since we have too little information on undisclosed related party transaction, despite the differences in the two Items, Item 407(a)(3) disclosures are the closest we can get to better understand the disclosure practices under Item 404(a). If a transaction is determined to be non-material, not only is it not subject to Item 404(a), there also is no need for review and approval by an independent committee. Determining whether a related party transaction is material usually is done as a screening process before deciding whether the transaction should be approved and disclosed. The absence of review and approval by independent committee also contributes to the fact that the disclosures under Item 407(a)(3) tend to be less specific than those under Item 404(a).[91] For this reason, this Article compares Item 404(a) disclosures and Item 407(a)(3) disclosures of each company throughout.

Exxon Mobil Corporation, Definitive Proxy Statement (Schedule 14A) 15-16 (Apr. 12, 2012), *available at* http://perma.cc/X8PY-BTAC.

[91] For instance, General Electric's Item 407(a)(3) disclosure states:

> In addition, with respect to directors Beattie, Cash, Fudge, Hockfield, Jung, Lafley, Lane, Larsen, Lazarus, Mulva, Nunn, Swieringa, Tisch and Warner, and former director Castell, the Board considered the amount of GE's discretionary charitable contributions to charitable organizations where he or she serves as an executive officer, director or trustee, and determined that GE's contributions constituted less than the greater of $200,000 or one percent of the charitable organization's annual consolidated gross revenues during the organization's last completed fiscal year.

The disclosure provided no additional information on each transaction. General Electric Company, Definitive Proxy Statement (Schedule 14A) 10 (Feb. 27, 2012), *available at* http://perma.cc/U9Q4-7JK6.

Table 5 exhibits how companies differ in disclosing under Items 404(a) and 407(a)(3). Twenty-two companies disclosed related party transactions in both Items. Nine companies disclosed related party transactions only in Item 407(a)(3)—that is, only for independent directors' related party transactions. By contrast, sixteen companies disclosed related party transactions only under Item 404(a). The companies may have been hyper-cautious and tended to disclose even non-material related party transactions under Item 404(a). Three companies did not disclose any related party transactions in either Item. Based on the fact that some companies disclosed related party transactions only in Item 404(a) and others only in Item 407(a)(3), we can presume that companies have different preferences in choosing where to disclose related party transactions. The inconsistent disclosure practices would make it more difficult for investors to estimate the signaling value of the disclosed information.

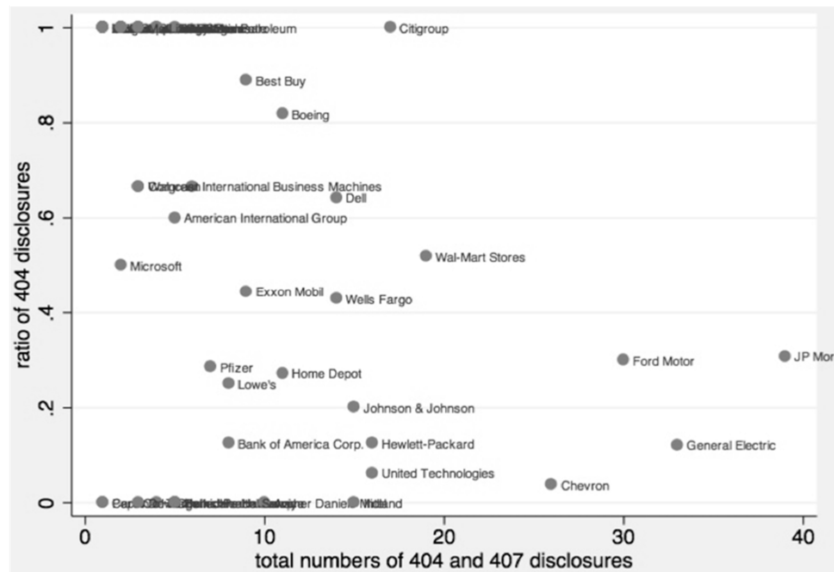
TABLE 5: VARIANCE ACROSS FIRMS IN USING ITEM 404(A) AND 407(A)(3)

	Number of 404(a) Disclosures > 0	Number of 404(a) Disclosures = 0
Number of 407(a)(3) Disclosures > 0	Group A: 22 companies JP Morgan Chase, GE, Ford Motor, Wal-Mart, Chevron, United Technologies, HP, Johnson & Johnson, Wells Fargo, Dell, Home Depot, Boeing, Exxon Mobil, Best Buy, Bank of America, Lowe's, Pfizer, IBM, AIG, Comcast, Walgreen, Microsoft	Group B: 9 companies Intel, Archer Daniels Midland, UPS, UnitedHealth Group, Berkshire Hathaway, Target, Dow Chemical, PepsiCo, Cardinal Health
Number of 407(a)(3) Disclosures = 0	Group C: 16 companies Citigroup, Marathon Petroleum, INTL FCStone, Costco, MetLife, Apple, GM, AmerisourceBergen, P&G, Valero Energy, ConocoPhillips, Kroger, CVS Caremark, Verizon, McKesson, AT&T	Group D: 3 companies Kraft Foods, Caterpillar, WellPoint

Furthermore, Figure 2 shows the relationship between the ratio of Item 404(a) disclosures and the total numbers of disclosures. The Y-axis of the scatter plot represents the ratio of Item 404(a), calculated by the number of Item 404(a) disclosures divided by the total number of disclosures in both Item 404(a) and Item 407(a)(3). The X-axis of the scatter plot indicates each company's total number of disclosures. The scatter plot shows that an increase in the total number of disclosures does not necessarily correlate with an increase in the ratio of Item 404(a) disclosures. Regardless of how many total disclosures a company makes, a company's preferences

in choosing where to disclose seems to determine the ratio of Item 404(a) disclosures. For instance, Wal-Mart has a ratio of 0.52 while UTC shows a relatively lower ratio of 0.06. This partly explains why, when disclosing very similar transactions, Wal-Mart disclosed under Item 404(4), while UTC disclosed under Item 407(a)(4).

FIGURE 2: SCATTER PLOT ON THE RELATIONSHIP BETWEEN TOTAL NUMBER OF DISCLOSURES AND THE RATIO OF 404(A) DISCLOSURES



2. Frequency, Types, and Size of Disclosed Related Party Transactions

The fifty sample companies disclosed 413 related party transactions in fiscal year 2012.[92] On average, there were a little over eight related party transaction disclosures per company. Whether a higher number of disclosures is a good thing or a bad thing is not clear. One possible interpretation

[92] See *infra* Figure A for the distribution of related party transaction disclosures for each company.

is that more disclosures mean a company is more transparent. Another interpretation might be that the company is too permissive regarding related party transactions.[93] More extensive empirical evidence is necessary to determine which interpretation is more accurate. Thus, for the purpose of this Article, I will proceed without assuming that either interpretation is correct.

93 To better understand whether more disclosures of related party transactions are correlated with bad corporate governance practices in general, I collected data using ISS Governance Quick Score. ISS Quickscore 2.0 (2014), http://perma.cc/77X5-VUS4. ISS QuickScore ranks corporate governance practices on a scale from 1 to 10. A higher score indicates a higher governance risk, i.e. poorer corporate governance practices. However, even though the results are preliminary, the data support the interpretation that a company with more disclosures of related party transactions is more likely to have worse corporate governance practices. Also, empirical studies by accounting scholars support the same interpretation. *See* Mark Kohlbeck & Brian W. Mayhew, *Valuation of Firms that Disclose Related Party Transactions*, 29 J. ACCT. PUB. POL'Y 115, 134 (2010) (finding that the market views firms that disclose loans and other simple related party transactions with directors, officers, or shareholders negatively. In contrast, the disclosures of complex related party transactions and related party transactions with firm investments are not associated with valuations or returns.); *see also* Michael D. Ryngaert & Shawn E. Thomas, *Not All Related Party Transactions (RPTs) Are the Same: Ex-ante vs. Ex-post RPTs*. 50 J. Acct. Res. 845, 874 (2012) (suggesting that the overall volume of disclosed related party transactions generally is not significantly associated with shareholder wealth as measured by operating profitability or Tobin's Q. Rather, the timing of the transaction matters. Their evidence suggests that related party transactions entered into after a contracting party becomes a related party (*ex post* related party transactions) are negatively associated with shareholder wealth and firm profitability, whereas related party transactions entered into prior to a contracting party becoming a related party (*ex ante* related party transactions) are positively associated with firm value and may well represent efficient contracting outcomes). However, both studies are based on disclosures before 2001 and do not reflect the change caused by the SEC amendment in 2006.

TABLE 6: THE FREQUENCY OF RELATED PARTY TRANSACTIONS DISCLOSURES

	Item 407(a)(3) (Director Independence)	Item 404(a) (Related Party Transactions)	Total
Total	261	152	413
Mean	5.2	3.0	8.3
Median	2	2	5
Max	29	17	39
Min	0	0	0

The types of related party transactions in this sample varied.[94] The three most frequent types were (1) sales and purchases of goods, (2) charitable activities, and (3) family hiring. At the aggregate level, 30.8% of all disclosed related party transactions were sales and purchase transactions, followed by 14.5% for charitable activities and 10.9% for family hiring. The distribution differed, however, depending on the type of disclosure. Under Item 404, for instance, family hiring had the highest frequency (thirty-nine out of 152 disclosures, 25.7%), followed by sales and purchase transactions (twenty-one out of 152, 13.8%), and employee investment opportunities (twenty-one out of 152, 13.8%). Under Item 407(a)(3), on the other hand, sales and purchase transactions disclosures were most frequent (106 out of 261, 40.6%), followed by charitable activities (fifty-seven out of 261, 22.2%) and loans and credit facilities (twenty out of 261, 7.7%). The following table summarizes the types of related party transactions.

[94] For the detailed description, see *infra* Tables A and B.

TABLE 7: TOP THREE MOST FREQUENT TYPES OF RELATED PARTY TRANSACTIONS IN DISCLOSURES

Types of Related Party Transactions	Item 407 (DI)	Item 404 (RPT)	Total
Total Number of Related Party Transactions	261	152	413
Sales and Purchases of Goods	106	21	127
Loans and Credit Facilities	20	3	23
Employee Investment Opportunities	0	21	21
Charitable Activities	57	3	60
Family Hiring	6	39	45
Others	72	65	137

The size or the magnitude of a related party transaction was more difficult to determine. This is partly due to the fact that the companies often did not disclose specific dollar amounts involved in the transactions. As shown in Table 8, only 176 out of 413 (42.6%) disclosures revealed specific dollar amounts. Among the 261 disclosures under Item 407(a)(3) (director independence), only thirty-three (12.6%) disclosures provided the value of the transactions. With respect to Item 404(a) (related party transaction), however, 143 out of 152 (94.1%) disclosures offered the dollar amounts of the transactions. This discrepancy is due to Item 404(a)(2), which requires companies to disclose "the approximate dollar value of the amount involved in the transaction." Item 407(a)(3), conversely, does not specifically require companies to disclose the value of the transaction. Among all 176 disclosures (under either Item 404 or Item 407) with specific dollar amounts, the mean amount disclosed was about $52.1 million while the median is $585,500. The following table

presents the breakdown based on the types of disclosures with specific dollar amounts:

TABLE 8: DISCLOSURES WITH DOLLAR AMOUNTS

	# of Disclosures	% of Total Disclosures	% of Disclosures with $ Amounts
Total Number of Disclosures	413	100%	—
Number of Disclosures with $ Amounts	176	42.6%	—
407 Disclosures with $ Amounts	33	7.9%	12.6%
404 Disclosures with $ Amounts	143	34.6%	94.1%
Mean Dollar Amount	$52,129,098.64		
Median Dollar Amount	$585,500.00		
Minimum Dollar Amount	$16,000.00		
Maximum Dollar Amount	$6,822,000,000.00		

The disclosures with specific dollar amounts under Item 407(a)(3) need more attention. As discussed in Part II.A.1, if a company entered into a related party transaction that the company deemed material, the transaction must be disclosed under Item 404(a) (related party transactions). The SEC suggests that companies apply materiality scrutiny to related party transactions exceeding $120,000. On the other hand, a related party transaction associated with independent directors of a company must be disclosed under Item 407(a)(3) (director independence) even if it is not material. Accordingly, if an independent director engages in a material related party transaction, the transaction still

must be disclosed under Item 404(a) (related party transaction). In that sense, those two Items are divided by materiality with respect to independent directors' related party transactions. Disclosures under Item 407(a)(3) indicate that companies deemed them non-material. Thus, by looking at the dollar values of related party transactions disclosed under Item 407(a)(3) disclosures, we can get a glimpse of the materiality standard that each company used. The disclosures also show the extent to which certain dollar values in related party transactions will not necessarily be deemed material.

The twenty-seven disclosures with dollar amounts under Item 407(a)(3) were all from seven companies: Wal-Mart (one disclosure), Berkshire Hathaway (one disclosure), UnitedHealth Group (five disclosures, ranging from $122,000 to $115,000,000[95]), Archer Daniels Midland (nine disclosures, ranging from $16,000 to $100,100,000[96]), AIG (two

---

[95] With respect to the $115 million transaction, the disclosure states:

> Dr. Shine is the Executive Vice Chancellor for Health Affairs of the UT [University of Texas] System, which includes six health institutions. The health institutions are part of the Company's broad national network of hospitals and physicians and other care providers. In 2011, we paid the UT System approximately $115 million for medical expenses on behalf of consumers who obtain health insurance from us and approximately $560,000 for funded clinical trials, marketing and meeting expenses and tuition payments for employees, which in the aggregate amounts to approximately 1.2% of the 2011 operating revenues of the UT System.

The United Health Group stated that "the Board of Directors evaluated the following relationships and determined that such relationships were in the normal course of business and did not impair the directors' exercise of independent judgment." UnitedHealth Group Incorporated, Definitive Proxy Statement (Schedule 14A) 11-12 (Apr. 25, 2012), *available at* http://perma.cc/CH7L-25WQ.

[96] Archer Daniels Midland's disclosure regarding the biggest related party transaction involving a member of the approving committee states:

> In determining that Mr. Moore is independent, the board considered that, in the ordinary course of business, Ralcorp

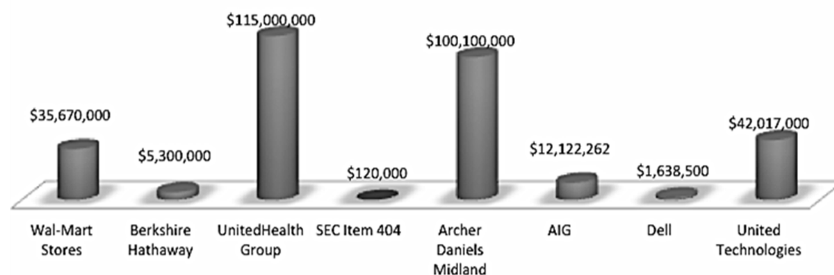
disclosures valued at $2,599,887 and $12,122,262), Dell (one disclosure), and United Technologies (eight disclosures ranging between $62,000 and $42,017,000). When we aggregate the disclosed dollar amounts for each company, there seems to be a large variation in the disclosed dollar amounts, ranging from $1,600,000 for Dell to over $115,000,000 for UnitedHealth Group. The latter is more than seventy-six times larger than the former. The extent to which a company's materiality determination reflects a monetary threshold, such a discrepancy would suggest each company used very different "materiality" standards when examining related party transactions. In other companies, a related party transaction of such magnitude may have triggered a disclosure Item 404(a) (related party transaction) based on its materiality.

The following histogram in Figure 3 graphically presents this data. Also, the variance in the dollar amounts that the companies used to classify certain transactions as being "non-material" seems much higher than $120,000, the dollar amount threshold set by the SEC in Item 404(a). To explain this variance, in the next sub-Part, I examine the use and potential abuse of the "materiality" criterion more closely.

> Holdings, Inc., of which Mr. Moore is a director, purchased approximately $100.1 million worth of certain commodity products from our company, on an arms-length [*sic*] basis during such fiscal year. The board determined that Mr. Moore does not have a direct or indirect material interest in such transactions, and that such transactions do not otherwise impair Mr. Moore's independence.

Archer-Daniels-Midland Company, Definitive Proxy Statement (Schedule 14A) 12 (Sept. 21, 2012), *available at* http://perma.cc/V5U6-8KJ6.

FIGURE 3: THE LARGEST RELATED PARTY TRANSACTIONS DISCLOSED UNDER ITEM 407 (DIRECTOR INDEPENDENCE)



B. Variation in Item 404(a) Disclosure

Some companies disclose more than required. Among the 154 disclosures under Item 404(a), sixteen disclosures by ten companies explicitly identified that disclosed transactions with related persons were not material.[97] In those cases, disclosures were much simpler and contained much less information. For instance, Apple disclosed three transactions under the combined section of Item 404(a) and Item 407(a)(3)

97 Exxon Mobil (4), ConocoPhillips (2), General Electric (1), Hewlett-Packard (1), Apple (3), Citigroup (2), Kroger (1), Proctor&Gamble (1), and Lowe's (1). Exxon Mobil Corporation, Definitive Proxy Statement (Schedule 14A) 8-9 (Apr. 12, 2012), *available at* http://perma.cc/X8PY-BTAC; ConocoPhillips, Definitive Proxy Statement (Schedule 14A) 7 (Mar. 28, 2012), *available at* http://perma.cc/QA3P-AXPC; General Electric Company, Definitive Proxy Statement (Schedule 14A) 38 (Apr. 25, 2012), *available at* http://perma.cc/U9Q4-7JK6; Hewlett-Packard Company, Definitive Proxy Statement (Schedule 14A) 51 (Mar. 21, 2012), *available at* http://perma.cc/U78P-VU3H; Apple Inc., Definitive Proxy Statement (Schedule 14A) 19 (Feb. 23, 2012), *available at* http://perma.cc/GGU7-SHS3; Citigroup Inc., Definitive Proxy Statement (Schedule 14A) 13-14 (Mar. 8, 2012), *available at* http://perma.cc/7ZJV-J4R8; The Kroger Co., Definitive Proxy Statement (Schedule 14A) 42 (May 14, 2012), *available at* http://perma.cc/375S-MS5Q; The Procter & Gamble Company, Definitive Proxy Statement (Schedule 14A) 19 (Aug. 24, 2012), *available at* http://perma.cc/G4X6-VMQG; Lowe's Companies, Inc., Definitive Proxy Statement (Schedule 14A) 40 (June 1, 2012), *available at* http://perma.cc/HPB5-VRUM.

with the title of "Transactions with Related Persons" and claimed all of them to be non-material.

> The Company enters into these commercial dealings in the ordinary course of its business. Mr. Jobs was a director of Disney during the fiscal year, and Mr. Iger, a director of the Company since November 15, 2011, is President and Chief Executive Officer and a director of Disney. Mr. Drexler is Chairman and Chief Executive Officer of J.Crew. Ms. Jung is Chairman and Chief Executive Officer of Avon. The Company does not believe that Mr. Jobs had and any of Mr. Drexler, Mr. Iger, or Ms. Jung has a material direct or indirect interest in any of such commercial dealings.[98]

On the other hand, other companies disclose less than what is required. Even for related party transactions that were determined to be material (except for transactions involving family hiring, where companies disclosed the exact dollar amount of compensation), the disclosures often did not satisfy the requirements under Item 404(a).[99] Specifically, "[t]he related person's interest with the registrant, including the related person's position or relationship with, or ownership" required by Item 404(a)(2) was missing in most disclosures, necessitating a search for each person's position to identify his relationship with the company.[100] Another frequently missing element was Item 404(a)(4), which requires disclosure of "[t]he approximate dollar value of the

98 Apple Inc., Definitive Proxy Statement (Schedule 14A) 19 (Feb. 23, 2012), *available at* http://perma.cc/GGU7-SHS3.

99 17 C.F.R. Section 229.404(a) requires companies to disclose information regarding the transactions, such as: the name of the related person, the basis on which the person is a related person, the related person's interest in the transaction, the approximate dollar value of the amount involved in the transaction, the approximate dollar value of the amount of the related person's interest in the transaction, and any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction. SEC Standard Instructions for Filing Forms, 17 C.F.R. § 229.404(a) (2014).

100 17 C.F.R. § 229.404(a)(2) (2014).

amount of the related person's interest in the transaction."[101] This may be partly due to the fact that it is difficult to estimate the related person's "indirect" interest in the transaction.[102]

Both practices contributed to a large variation in disclosures. This is problematic because the variance in disclosure practices itself can lower the reliability of disclosures. From the investor's perspective, if disclosure practice varies too much from company to company, disclosures become less reliable and useful. "[T]his lack of uniformity makes comparison among companies costly for investors."[103] At least some degree of consistency across companies is, therefore, desirable. It is very difficult, if not impossible, to identify the optimal level of disclosure, and some amount of variation and discretion is even inevitable. Still, a more effective and reliable disclosure system would

---

101 17 C.F.R. § 229.404(a)(4) (2014).

102 For instance, in General Motors' 2012 proxy statement, the company disclosed that:

> David Bonderman is a founding partner of TPG, a private investment firm, whose affiliate invests in automobile dealerships in Asia representing various vehicle manufacturers. These investments include dealerships in China that sell Chevrolet and Buick brand vehicles under a distribution agreement with Shanghai General Motors Co., Ltd ('SGM'), a joint venture in which GM has a significant interest. Under the terms of SGM's joint venture agreement, we do not control SGM's distribution activities.

General Motors Co., Definitive Proxy Statement (Schedule 14A) 29 (Apr. 25, 2014). This disclosure omitted three types of information required by Items 404(a)(1), (3), and (4), respectively: the basis on which the person is a related person (the disclosure did not specify whether Mr. Bonderman is a director or an officer), the approximate dollar value of the amount involved in the transaction, and the approximate dollar value of the amount of the related person's interest in the transaction.

103 *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 GEO. L.J. 923, 947–48 (2013). The authors addressed this issue on the context of voluntary disclosure of corporate political spending. Although disclosure of related party transactions is mandatory, these disclosures suffer from the typical discretionary disclosure issues relating to the "materiality" standard.

be desirable to restore market confidence in the related party transaction disclosure regime.

C. Analysis of "Materiality"

One of the necessary requirements to be a "reportable" related party transaction under Item 404(a) is that the related person have a direct or indirect "material" interest in the transaction.[104] While the SEC's rationale underlying the use of a "materiality" standard may be evident, the ambiguity of the regulation and the SEC's potentially confusing or conflicting instructions in the 2006 final release have allowed companies to apply the materiality standard strategically for their own benefit. Three problematic areas, in terms of both definitional uncertainty and potential abuse of discretion, are: (1) from whose perspective the transaction must be judged material; (2) the identification and valuation (estimation) of indirect interest; and (3) the definitional ambiguity and frequent use of the "ordinary course of business" exception.

1. Material to Whom?

Item 404(a) requires companies to disclose any related party transaction "in which a related person has or will have material interest."[105] Based on this language, a natural, plain meaning interpretation might be that materiality must be judged from the related person's perspective. The SEC's position, however, is that materiality must be judged from both the investors' and the related person's perspectives.[106]

---

104 17 C.F.R. § 229.404(a) (2014).

105 *Id.*

106 The SEC's definition of materiality is consistent with definitions from other provisions. Both Regulation C (Registration) Rule 405 under the 1933 Act and Rule 12b-2 (Registration and Reporting) under the 1934 Act have exactly the same definition of materiality: "The term ***material***, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered." SEC General Rules and Regulations, Securities Act of 1933, 17 C.F.R. §

Prior to the 2006 amendment, the SEC's interpretation of the materiality standard was made clear through instruction 1 to Item 404(a):

> The materiality of any interest is to be determined on the basis of the significance of the information *to investors* in light of all the circumstances of the particular case. The importance of the interest *to the person having the interest*, the relationship of the parties to the transaction with each other and the amount involved in the transactions are among the factors to be considered in determining the significance of the information to investors.[107]

The SEC removed this instruction with the 2006 amendment but expressly stated that, "[t]he materiality standard for disclosure embodied in the Item 404(a) prior to these amendments is retained."[108] According to the Supreme Court case the SEC cites, this means that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[109] While confirming that materiality must ultimately be judged from the investors' perspective, the SEC explicitly distinguished between "significance to investors" and "importance to related party." The SEC further identified the materiality to the related person as one of the elements that can be considered in determining the related party transaction's materiality to the reasonable investors.

230.405 (2014); SEC General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.12b-2 (2014).

107 SEC Standard Instructions for Filing Forms, 17 C.F.R. § 229.404(a) (2005) (emphasis added).

108 Related Person Disclosure, SEC Exchange Act Release No. 33-8732a, 149, (Nov. 7, 2006). According to the SEC, "[t]he materiality of any interest will continue to be determined on the basis of significance of the information to investors in light of all the circumstances." (citing Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) and TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). In *TSC Industries*, the Court was also concerned that too much information induced by overly broad materiality criteria would hamper investors from making informed decisions. *Id.* at 448–49.

109 TSC Industries, 426 U.S. at 449.

Despite the SEC's instruction, in practice, some companies apply the materiality standard from the perspective of a related party. For instance, Microsoft briefly explained that a particular related party transaction did not go through the approving committee's review and approval process because, "the business [was] not material to Microsoft or Mr. Gates."[110] To a certain extent, it is possible that transactions that are not material to the related party or the company are also not material to reasonable investors. However, using the related person perspective rather than the investor perspective to determine the materiality of transactions gives directors more flexibility in applying the materiality standard.

2. Identification of Related Person's Indirect Interest

When a related person has a direct interest, computing the dollar value of the amount of his or her interest in the transaction is straightforward. For instance, when a director sells her personally and wholly owned factory to the company she is serving, the sale price would be the approximate direct interest of the director. Estimating a related person's interest becomes more difficult when she only has an indirect interest in the transaction. Suppose a

[110] Microsoft's Item 404(a) disclosure in its 2012 proxy statement reads:

> In addition [to the arrangement that was reviewed and approved by the audit committee], Mr. Gates has extensive personal holdings in private and public companies where he is not involved in management or daily operations. Microsoft may do business with these companies in the ordinary course. Mr. Gates also owns several business entities that purchase technology consulting services from Microsoft. The business described in this paragraph is conducted at arm's length on terms that are available to unrelated parties. The business is not material to Microsoft or Mr. Gates.

Microsoft Corp., Definitive Proxy Statement (Schedule 14A) 9 (Oct. 29, 2012).

director of company A is simultaneously a CEO or an officer of company B. Company A and B enter into a sales contract for six million dollars. How much direct or indirect interest does the director have in the transaction? Six million dollars is merely the gross value of the amount involved in the transaction, and presumably the director's interest is only a small part. Without more details about the transaction, such as how much the director is being paid as part of her compensation through the sale, it may be quite difficult to estimate the director's interest in the transaction.

In fact, the data shows that in most disclosed related party transactions, a related person is affiliated as an officer or part owner of a counterparty company rather than as an individual sole-proprietor. However, this is not the case when a related person enters directly into a contract providing professional services.[111] Prior to the 2006 amendment, Item 404(b) provided a bright-line instruction to these indirect interest cases: if the dollar amount involved in a related party transaction was less than five percent of either the registrant's or the other entity's consolidated gross revenue for its last full fiscal year, the transaction was not subject to disclosure.[112] More importantly, if a related party transaction exceeded the five percent threshold, the

[111] Professional services include legal, marketing, or advising services. For instance, in its 2012 proxy statement, Ford Motor Company disclosed:

> Since January 1993, Ford has had a consulting agreement with William Clay Ford. Under this agreement, Mr. Ford is available for consultation, representation, and other duties. For these services, Ford pays him $100,000 per year and provides facilities (including office space), an administrative assistant, and security arrangements. This agreement will continue until either party ends it with 30 days' notice.

William Clay Ford is a five percent beneficial owner of Class B Stock, (non-paid) Director Emeritus, and immediate family member of the CEO. Ford Motor Co., Definitive Proxy Statement (Schedule 14A) 32 (Mar. 30, 2012).

[112] SEC Standard Instructions for Filing Forms, 17 C.F.R. 229.404(b) (2005).

transaction was subject to disclosure even when the director's interest was indirect. Since it is difficult to calculate the dollar amount of the indirect interest that a related party receives from a transaction, eliminating the five percent threshold effectively provides the approving committee unlimited discretion in determining when a transaction is not material, especially when the related party's interest is indirect.

3. Use of the "Ordinary Course of Business" Exception

The most frequently invoked justification for non-materiality is the "ordinary course of business" exception. Almost always accompanied with an "arm's length" defense, "ordinary course of business" was used in 31.5% of total combined disclosures under Items 404(a) and 407(a)(3). It is more frequently used for Item 407(a)(3) than for Item 404(a): 43.8% as opposed to 9.5%. Table 9 summarizes the findings.

Each Item uses the "ordinary course of business" exception in a different way. Item 404(a) uses the term "ordinary course of business" to support the committee's approval of the related party transactions.[113] In contrast,

---

113 For instance, one of Ford Motor Company's disclosures under Item 404(a) is:

> Paul Alandt, Lynn F. Alandt's husband, owns two Ford-franchised dealerships and a Lincoln-franchised dealership. In 2011, the dealerships paid Ford about $124.9 million for products and services *in the ordinary course of business*. In turn, Ford paid the dealerships about $23.6 million for services *in the ordinary course of business*. Also in 2011, Ford Motor Credit Company LLC, a wholly-owned entity of Ford, provided about $195.4 million of financing to the dealerships and paid $851,246 to them *in the ordinary course of business*. The dealerships paid Ford Credit about $188.6 million *in the ordinary course of business*. Additionally, in 2011 Ford Credit purchased retail installment sales contracts and Red Carpet Leases from the dealerships in amounts of about $16.1 million and $64.6 million, respectively.

Item 407(a)(3) uses the term to justify why the committee deemed the transaction non-material and thus did not disclose.

TABLE 9: FREQUENCY OF "ORDINARY COURSE OF BUSINESS" USED IN DISCLOSURES OF RELATED PARTY TRANSACTIONS

	# of Disclosures Using "ordinary course of business"	# of Total Disclosures of Related Party Transactions	% of Disclosures Using "ordinary course of business"
Item 407 (Director Independence)	118	261	45.2%
Item 404 (Related Party Transactions)	12	152	7.9%
Total Disclosures	130	413	31.5%

Although use of the "ordinary course of business" exception is quite prevalent,[114] at least according to the SEC's Instruction 4, Item 404(a) allows the ordinary course of business exception only in the context of indebtedness.[115]

Ford Motor Co., Definitive Proxy Statement (Schedule 14A) 32 (Mar. 30, 2012) (emphasis added).

114 One reason for the frequent use of "ordinary course of business" for related party transactions could be found in the principal accounting rule that allows "ordinary course of business" exceptions. *See* Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No.57 (1982), *available at* http://perma.cc/L7XA-JSHY. Even in the context of accounting disclosures, the "ordinary course of business" exception is criticized for making the disclosure of material related party transactions "often weak or absent." *See* Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 14 (2011).

115 17 C.F.R. 229.404(a) (2012).

Furthermore, the SEC rejected commenters' requests to create an express ordinary course of business disclosure exception.[116] While this may make it seem as if the use of the "ordinary course of business" exception in Items 404(a) and 407(a)(3) is unjustified, the SEC seems to have taken a somewhat inconsistent position, despite its express rejection of the commenters' requests. According to the SEC:

> We note that whether a transaction which was not material to the company or the other entity involved and which was undertaken in the ordinary course of business of the company and on the same terms that the company offers generally in transactions with persons who are not related persons, are factors that could be taken into consideration when performing the materiality analysis for determining whether disclosure is required under the principle for disclosure.[117]

One possible interpretation of the SEC's instructions is that although the SEC has rejected an ordinary course of business exception, a company could consider (1) whether a

[116] Related Person Disclosure, SEC Exchange Act Release No. 33-8732a, 165–66 (Nov. 7, 2006). This Release states:

> Some commenters requested that we create a new exception for transactions undertaken in the ordinary course of business of the company and conducted on the same terms that the company offers generally in transactions with persons who are not related persons. Former Item 404(a) did not include such an "ordinary course of business" disclosure exception, and we are not persuaded that it should be expanded to include one. In this regard, we note that transactions which should properly be disclosed under Item 404(a) might be excluded under an ordinary course of business exception, such as employment of immediate family members of officers and directors.

Id.

[117] *Id.*

transaction was material[118] and (2) whether a transaction was in the ordinary course of business and at arm's length, to determine the materiality of the transaction.

At least in theory, the fact that a related party transaction is in the "ordinary course of business" of the company should not entitle the company to completely avoid disclosure obligations. That a transaction is in the ordinary course of business of the company, for instance a typical sale and purchase transaction, does not necessarily imply that it is insignificant to the transacting parties or to the shareholders. Presumably, the shareholders would still want to know about any related party transaction involving a significant dollar amount between a company and its directors or officers.[119] Accordingly, whether or not a certain transaction is "material" should be affected not only by whether the transaction is in the "ordinary course of business" but also whether it may have a significant effect on the company, e.g., the size of the transaction. In that sense, the SEC's refusal to create an express "ordinary course of business" exception seems to make sense. At the same time, the fact that the "ordinary course of business" exception is being used with such frequency raises some concern about whether the exception is being abused.

---

118 *Id.* It is possible that what the SEC means by "material" in this first prong is not "material interest" but "size/magnitude" of the transaction.

119 For instance, Hewlett-Packard's Item 407(a)(3) (Director Independence) disclosures read:

> Each of Mr. Andreessen, Mr. Babbio, Ms. Baldauf, Mr. Banerji, Mr. Gupta, Mr. Reiner, Ms. Russo, Mr. Thompson and Mr. Whitworth, or one of their immediate family members, is a non-employee director, trustee or advisory board member of another company that did business with HP at some time during the past three fiscal years. These business relationships were as a supplier or purchaser of goods or services in the ordinary course of business.

This disclosure does not provide any information on the frequency or size of the transactions that were deemed immaterial. *See* Hewlett-Packard Co., Definitive Proxy Statement (Schedule 14A) 22 (Feb. 3, 2012).

D. Related Party Transactions Pre-Approved by Internal Policies and Procedures

Forty-nine out of fifty sample companies disclosed policies and procedures on related party transactions pursuant to SEC regulation S-K Item 404(b).[120] One notable practice here is that some companies have a separate category for pre-approved related party transactions in their Policies and Procedures.[121] If a related party transaction falls into this category, it is automatically pre-approved and the related person may undertake the transaction without disclosing it to the approving committee. Even where some companies require approving committees to periodically review the summary of pre-approved transactions, it is not clear how substantial such *ex post* reviews are.[122] More importantly, companies need not disclose these transactions in their SEC filings.

---

120 The lone exception is INTL FCStone.

121 For instance, in its 2012 proxy statement Apple Inc. listed five pre-approved categories of transactions: (1) Employment as an executive officer, subject to conditions; (2) Any compensation paid to a director if the compensation is required to be reported in the Company's proxy statement under Item 402 of SEC Regulation S-K; (3) Any transaction with another company at which a related person's only relationship is as an employee (other than an executive officer or director) or beneficial owner of less than ten percent of that company's equity, if the aggregate amount involved does not exceed the greater of $1,000,000, or two percent of that company's total annual revenue; (4) Any charitable contribution, grant or endowment by the Company to a charitable organization, foundation or university at which a related person's only relationship is as an employee (other than an executive officer or director), if the aggregate amount involved does not exceed the lesser of $1,000,000, or two percent of the charitable organization's total annual receipts; and (5) Any transaction where the related person's interest arises solely from the ownership of the Company's common stock and all holders of the Company's common stock received the same benefit on a pro rata basis, such as dividends. *See* Apple Inc., Definitive Proxy Statement (Schedule 14A) 31 (Feb. 23, 2012).

122 *Id.* ("A summary of new transactions covered by the pre-approvals is provided to the audit committee for its review at each regularly scheduled meeting."). In most cases, companies are silent on how substantial the audit committee's review and approval on pre-approved transactions.

In the data, seventeen companies adopted pre-approved categories of related party transactions in their policies and procedures.[123] The criteria (e.g. type or size of transaction) for selecting the pre-approved categories varied, and the boards' discretion in this respect amplifies their discretion in applying the materiality standard to a related party transaction. It is problematic that such discretion allows a great deal of related party transactions to be hidden from investors' views. The SEC needs to provide better guidance on what companies should or should not include in selecting categories of pre-approved transactions.

IV. IMPLICATIONS

The previous two Parts of this article presented a picture of the current regulatory regime, focusing on corporate law and securities regulations and how companies are responding to the SEC's disclosure requirements. Building upon the findings, in this Part, I first examine whether the existing legal regime is effective and then present a proposal

---

[123] Specifically, Exxon Mobil, Wal-Mart, Chevron, Hewlett-Packard, JP Morgan Chase, Apple, CVS Caremark, Citigroup, Cardinal Health, Kroger, Wells Fargo, Medco Health Solutions, Pepsi Co., Johnson & Johnson, Well Point, Dow Chemical, and Lowe's all adopted pre-approved categories of related party transactions. *See* Exxon Mobil Corp., Definitive Proxy Statement (Schedule 14A) (Apr. 12, 2012); Wal-Mart Stores, Inc., Definitive Proxy Statement (Schedule 14A) (Apr.16,2012); Chevron Corp., Definitive Proxy Statement (Schedule 14A) (Apr. 4, 2012); Hewlett-Packard Co., Definitive Proxy Statement (Schedule 14A) 50-51 (Feb. 3, 2012); JPMorgan Chase & Co., Definitive Proxy Statement (Schedule 14A) 33 (Apr. 4, 2012); Apple Inc., Definitive Proxy Statement (Schedule 14A) 19 (Feb. 23, 2012); CVS Caremark Corp., Definitive Proxy Statement (Schedule 14A) (Mar. 26, 2012); Citigroup Inc., Definitive Proxy Statement (Schedule 14A) 13 (Mar. 8, 2012); Cardinal Health, Inc., Definitive Proxy Statement (Schedule 14A) (Sept. 14, 2012); The Kroger Co., Definitive Proxy Statement (Schedule 14A) 44 (May 11, 2012); PepsiCo, Inc., Definitive Proxy Statement (Schedule 14A); Johnson & Johnson, Definitive Proxy Statement (Schedule 14A) (Mar. 14, 2012); WellPoint Inc., Definitive Proxy Statement (Schedule 14A); The Dow Chemical Company, Definitive Proxy Statement (Schedule 14A) (Mar. 30, 2012); Lowe's Companies, Inc. Definitive Proxy Statement (Schedule 14A) 40 (Apr. 16, 2012).

for change. The proposal aims to coordinate the disclosure regulation with fiduciary duty litigation. The goal is to reduce the current doctrinal uncertainty while inducing more consistent disclosure practices across companies to allow the market and investors to more effectively address the agency problem.

A. Questioning the Efficacy of the Current Regulatory Regime

The ideal regulation of related party transactions involves a legal regime that is clear but at the same time discriminating, and one that minimizes the cost of litigation.[124] Given that a related party transaction can be beneficial or harmful to a corporation, it may not be in the best interest of shareholders to set a simple but inflexible rule in advance. Litigation will inevitably be fact-specific and may produce seemingly inconsistent results, but the court may be in the best position to determine whether a disputed related party transaction is indeed beneficial to the corporation.

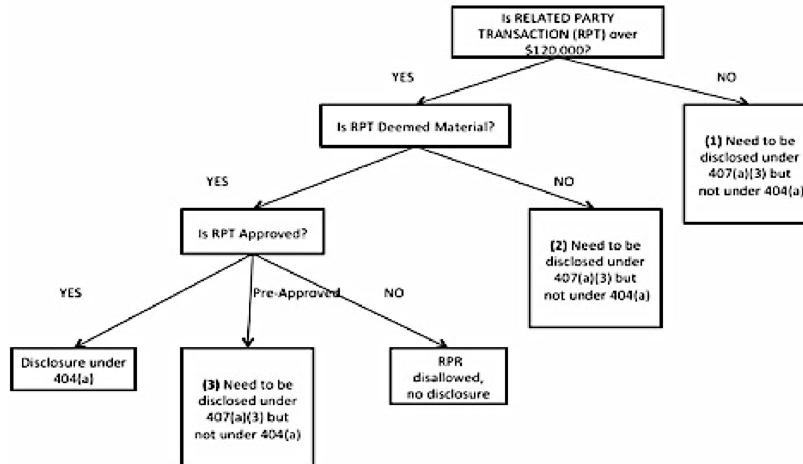
While *ex post* litigation may be the best tool for regulating related party transactions,[125] the courts have not adopted a consistent rule to determine whether a related party transaction does or does not breach the fiduciary duty of loyalty. In fact, there has been significant normative uncertainty. For decades, corporate law scholars and practitioners have debated when courts may apply the business judgment rule rather than fairness review to a related party transaction. This is partly due to the fact that corporate safe harbor provisions, such as DGCL Section 144,

124 WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 276 (4th ed. 2012).

125 Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review,* 169 J. INSTITUTIONAL & THEORETICAL ECON. 160 (2013).

address the *per se* voidability issue without giving any guidance to the court about which standard to apply.[126]

FIGURE 4: COMPANIES' APPROVAL AND DISCLOSURE PRACTICE ON RELATED PARTY TRANSACTIONS



While the corporate law regime exhibits uncertainty over the *ex post* standard of review, securities regulations on disclosure of related party transactions, on the other hand, seem to suffer from granting potentially excessive discretion to the approving directors on what to disclose. Based on the disclosure data, I observed three groups of related party transactions that do not have to be disclosed under the SEC regulations. The first group consists of transactions involving $120,000 or less. The second group consists of related party transactions involving more than $120,000 but determined (by the approving committee) to be "non-material." The third group is a category of transactions deemed pre-approved in each company's policies and procedures on related party

[126] *See* Blake Rohrbacher, et al., *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719 (2008); Ann M. Scarlett, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals*, 60 FLA. L. REV. 589, 593 (2008).

transactions.[127] Especially if a related party transaction falls into one of the last two categories, a company does not have to disclose the details of the transaction regardless of the dollar amount involved or its actual materiality. The approving committee exercises considerable discretion in determining the "materiality" of a transaction and selecting the categories of pre-approved transactions. This raises a potentially troubling concern over whether shareholders are receiving sufficient information regarding related party transactions.

When we examine corporate law and the securities regulations as a whole, the current regulatory regime seems to exhibit both insufficient *ex ante* disclosure and uncertain *ex post* judicial review. Insufficient *ex ante* disclosure implies that the current regime could be non-discriminating. When neither beneficial nor harmful transactions are being disclosed, *ex post* litigation will not ensue and therefore will not have much effect in discriminating between beneficial transactions and harmful ones. At the same time, the uncertain judicial standard can produce a lack of clarity and also increase the cost of litigation or possibly discourage *ex ante* disclosure altogether.

B. Legal Policy Proposal

1. Proposal to the SEC: Sticks

The SEC can better deter explicit violations, such as omitting required information from disclosure or misinterpreting the rules, with enhanced enforcement of the regulations. The SEC can also announce and post instructions about such mistakes on its website. The more thorny problem is the application of the materiality standard. As previously discussed, the materiality standard is an important factor that determines the number of disclosures, but its application is quite subjective and contextual. Once a related party transaction is not disclosed because it is deemed non-material, it is quite difficult for

[127] *Infra* Part III.D.

anyone other than the related party and the approving committee to learn about the transaction except in exceptional circumstances (e.g., when the transaction happens to be revealed in a media report).

Given such considerations, should the SEC bring back the bright-line rules that Item 404(a) contained before the 2006 amendment? That would be helpful to a certain degree but it might be incapable of fundamentally altering corporate disclosure practices. Given that the SEC eliminated the bright-line instructions to prohibit companies from circumventing the rule, rehabilitating such a bright-line rule will likely bring back the same concerns. The materiality standard, hence, is a double-edged sword with inherent limitations. Without providing directors with increased incentive to disclose related party transactions, disclosures may remain nominal and the market's confidence on the disclosures may remain weak. Thus, we need to turn our focus to incentivizing directors to make less strategic and more consistent disclosure of related party transactions.

2. Proposal to the Courts: Carrots

As the least intrusive alternative, one potential proposal that mitigates both problems of strategic disclosure and uncertain judicial review is to link the level of *ex ante* disclosure to the standard of review in fiduciary duty of loyalty litigation. Specifically, this Article proposes that the courts consider using lack of disclosure under the SEC regulations as one justification for sticking with the fairness test rather than moving to the business judgment rule. Conversely, in the presence of full disclosure combined with satisfaction of the requirements under DGCL Section 144, the courts should be more willing to apply the business judgment rule.

Under DGCL Section 144, if a related party transaction satisfies one of three disjunctive conditions, it is not *per se* voidable. The Section, however, states little more than that, creating much uncertainty as to whether the court should apply the fairness test or the business judgment rule when reviewing a related party transaction. Some argue that

regardless of whether a challenged transaction satisfies any of the conditions, the courts should still apply the fairness test to bless the transaction, while others argue that satisfying any of the conditions should qualify the transaction for the application of the business judgment rule.[128]

This problem can be conceptualized as one of drawing the line. Hypothetically, if a related party transaction satisfies all three of the conditions—approval by disinterested directors, approval by disinterested shareholders, and intrinsic fairness—applying of the fairness test would presumably be unnecessary, and overkill. At the other extreme, if a transaction satisfies none of the provisions, setting aside the issue of whether or not it should be *per se* voidable, applying the fairness test to examine the transaction seems to be a reasonable rule. Hence, the question becomes to what extent must a transaction satisfy the safe harbor provisions to cross over into business judgment rule territory?

Based on the actual data, this Article has shown that, in practice, most related party transactions get approval from an approving committee consisting of "disinterested" directors, thereby satisfying the first of the three conditions under DGCL Section 144. This Article has also shown that because the shareholders are often kept in the dark, it is difficult to figure out whether or not the committee's approval was granted on an informed basis and in good faith. Such empirical findings can challenge the argument that satisfying the first condition of DGCL Section 144 (approval by disinterested directors) should entitle the corporation to protection under the business judgment rule.

With the corporations' actual practices in mind, one proposal to consider is shifting the court's standard from the fairness test to the business judgment rule when two factors are satisfied: (1) a related party transaction has received approval from informed, independent, and disinterested directors acting in good faith; and (2) the nature and the

[128] *See supra* note 72.

details of the transaction have been disclosed to the shareholders. Such a proposal does not go so far as to require a corporation to receive approval from both independent and disinterested directors and shareholders but rather provides an incentive for corporations to at least disclose the nature of the transaction to shareholders, even if on an *ex post* basis. The recurrent nature of related party transactions will mitigate the timing-of-disclosure problem. In some sense, under the proposal a related party transaction will be blessed with business judgment rule protection when it receives active approval from disinterested directors and passive ratification, in the name of proper disclosure, from the shareholders.

The proposal thus attempts to limit corporations' frequent reliance on receiving only "disinterested" directors' approval while not disclosing any information about the transactions to the shareholders under the excuse of "non-materiality" or "pre-approval." At the same time, the proposal attempts to provide a meaningful opportunity for the directors to receive the protection of the business judgment rule with respect to related party transactions whose details are disclosed to the shareholders. Accordingly, not all related party transactions would be burdened with fact-intensive, *ex post* fairness review when challenged.

There are several benefits to this approach. First and foremost, the proposal can help litigants predict which standard of review courts will apply and reduce litigation uncertainty. This can, in turn, reduce litigation costs of litigation borne by litigants as well as the burden on the court. When the standard of review is predictable, it can also encourage the parties to settle more easily, further reducing the cost of litigation.

Second, such a regime can give directors more incentive to disclose related party transactions and less incentive to use "non-materiality" or "pre-approval" excuses in order to avoid the potential risk of facing a consequent fairness review. This can, in turn, create a better filtering policy, allowing beneficial transactions to proceed while deterring harmful transactions. Under the current regime, when an

approving committee faces a potentially beneficial related party transaction, the *ex post* litigation uncertainty creates an incentive for the committee to hide its details from the shareholders by claiming that the transaction is "not material." Under the proposal, when the committee is assured that it will receive the protection of the business judgment rule when the details of the transaction are disclosed to the shareholders, the committee will be much less concerned with *ex post* litigation uncertainty and will be more inclined to disclose the details of the transaction.

Even when the approving committee is uncertain as to whether the transaction is beneficial, by disclosing its details the committee can again receive the protection of the business judgment rule *ex post*. This could reduce the over-deterrence problem and lead to more disclosures over time, allowing shareholders and the court to become more discriminating. Finally, when the proposed transaction is clearly harmful to the corporation, the court, with the details of the transaction in hand, will easily find a breach of fiduciary duty, even under the business judgment rule.

On the other side, imposition of fairness review to non-disclosed transactions can function not only as a punishment against non-disclosure but also against the pursuit of a potentially harmful transaction. When a potentially harmful related party transaction is before an approving committee, the committee would be more hesitant to approve the transaction (and not disclose its details) when it knows that the court will likely invalidate the transaction *ex post* using fairness review. While identifying a non-disclosed, detrimental transaction may be difficult, this is also true under the current regime. At the same time, when it is certain that the court will apply fairness review and likely invalidate the transaction, the clearer rule will be a more effective deterrent. When the *ex post* review standard is easy to predict, the committee can no longer hide behind the uncertainty: approving a detrimental transaction and not disclosing its details will invite the fairness test.

Third, in the long run, through the accumulation of disclosure data on related party transactions, the regime

would provide better guidance for distinguishing between beneficial and detrimental related party transactions to all relevant parties, including corporate directors, investors, regulators, and the courts. Currently, because too few transactions are disclosed with any detail, it is quite difficult for the relevant parties to discern whether a proposed transaction is beneficial or harmful to the corporation and also to predict whether the transaction will be upheld if challenged in court. When more transaction details are disclosed to the market, over time, the accumulation of that data can give clearer guidance to corporations and also to investors in determining which types of transactions are beneficial to the corporation. Corporate directors will, for instance, have a better idea of which types of transactions have been problematic in the past and how the market reacted to the implementation of such transactions. The courts and enforcement agencies, including the SEC, will also be more effective in identifying which transactions should be challenged or invalidated for breach of fiduciary duty. Furthermore, the accumulation and aggregation of more accurate information can lower the transactions costs (both *ex ante* screening and *ex post* litigation) in undertaking related party transactions and effectively address the agency problem.

C. Possible Objections to the Proposal

There are several concerns and potential objections to this proposal. Since it is based on a finding of the ineffectiveness of the current disclosure regime, some might question whether the mandatory disclosure regime should be abandoned entirely. It poses a more fundamental question, the answer to which requires a deeper examination of the current system. In this Article, rather than focusing on such an overarching objection, I focus on how we could make the best out of the current disclosure system.

1. Solicitation of More Related Party Transactions

Some might be concerned that if disclosure under federal securities law guarantees review under the business judgment rule for a company's related party transaction, the company might more willingly enter into related party transactions by simply disclosing them to get business judgment protection. Furthermore, if many companies adopt the same strategy and disclose large numbers of transactions, the disclosures may lose their discerning function. Finally, as with the disclosure of executive compensation, if a company finds its number of related party transactions to be lower than that of its peers, it may be inclined to increase the number of related party transactions.

Such a solicitation is a legitimate concern but may not be very persuasive for the following reasons. First, an increase in the number of disclosures compared to the status quo in some companies may be necessary when transitioning to a new regime. In theory, when interpreting vague regulations, companies can react in two ways: being hyper-cautious, or taking advantage of the loopholes. While a small number of my sample companies were hyper-cautious and disclosed their related party transactions more than required, many more companies took the opposite approach. The maximum number of disclosures in my sample is thirty-nine, which seems far from being excessive.[129] Furthermore, to have a more effective and informative disclosure system, an accumulation of disclosure data is necessary. After going through the transition phase, related party transactions that do not need to be disclosed would be eliminated, and eventually only transactions needing to be disclosed would remain.

Second, even during the phase in which the number of disclosures temporarily increases, there is a constraint that discourages excessive disclosure. Whenever a company discloses a related party transaction in its SEC filing, it runs

---

[129] *See* Appendix 1.

the risk of being sued by its shareholders. Because the cost of this risk is substantial, in many cases the cost may outweigh the benefit of getting business judgment review in a shareholder derivative suit. Some of the costs of conflict-of-interest transactions might lie beyond potential litigation, because media coverage of shareholder litigation against a company's fiduciary responsibility often causes irreparable damage to the company's reputation regardless of the outcome of the litigation. Also, various corporate governance monitors such as Institutional Shareholder Services ("ISS") or investment analysts professionally evaluate the disclosures. Thus, even under the new regime, companies still have incentives to disclose fair and/or beneficial transactions only. Hence, there is a reason to believe that companies are more forthcoming with disclosing related party transactions.

Third, my proposal does not ask the courts to indiscriminately apply business judgment review to all challenged related party transactions, but only to those that have been disclosed. Thus, my proposal adds another useful factor for the courts to consider in deciding the applicable standard of review. If a court finds any procedural problem in getting directors' approval, the court would apply the fairness test regardless of the disclosure. What I emphasize is that when a corporation discloses a related party transaction in its SEC filings, this is a credible signal that the transaction is fair and that the corporation is confident enough to persuade the court of that. Consequently, not only can we benefit from this valuable information, but we can also encourage greater disclosure by rewarding corporations.

2. Over-Deterrence of Beneficial Related Party Transactions

One may be concerned that, under my proposal, if a corporation has to disclose a related party transaction for business judgment protection, it might discourage not only potentially harmful related party transactions but also possibly beneficial transactions. Even if a related person knows that her transaction with the company she's serving is

beneficial to the company, she might not feel comfortable disclosing her conflict of interest and seeking approval from the directors. To avoid such a circumstance, she might choose not to pursue the transaction.

That is a foreseeable downside of inducing more disclosure, but it is likely to be only temporary. As disclosures accumulate, the legal cases on related party transactions would accumulate accordingly. If the courts, over time, determine that certain related party transactions are beneficial to companies depending on their type, size, or interests to related persons, eventually the accumulated data would provide better guidance on the transactions and their disclosure. Furthermore, if the courts continuously decide that certain kinds of related party transactions constitute a breach of the duty of loyalty, those transactions will signal red flags to shareholders and subsequently deter directors from entering into those types of transactions. Through this process, the over-deterrence effect on beneficial transactions will diminish as data accumulate.

D. Implications for Privately Held Corporations

Since my proposal is applicable mainly to publicly traded companies subject to SEC disclosure obligations, there might be concern over why state courts apply one set of standards to publicly traded companies and a different set to privately held companies. State corporate laws traditionally have applied fiduciary duty standards equally to directors of publicly traded and privately held companies, and the proposal raises a question of why directors of companies that must disclose under Rule 404(a) should receive any more or less protection than other directors.

Although most privately held companies are not subject to SEC regulation and thus lie outside the scope of this Article, my proposal underlines the importance of disclosures to shareholders (External Disclosures) even for privately held companies. The key implication of this proposal is not disclosure to the SEC, but extended disclosure to shareholders of privately held companies. While most states' safe harbor provisions have a prong of shareholder approval,

it is not used very often. In most cases, companies get directors' approval to satisfy the safe harbor provisions. Thus, the implication of my proposal to privately-held companies is to encourage disclosures to shareholders as follows: when a related party transaction is disclosed to shareholders in addition to approving directors, the court should take it as a strong signal of the fairness of transaction when applying a business judgment rule. This would encourage External Disclosures in privately held companies where stealthy conflict of interest transactions have been troublesome for a long time.

V. CONCLUSION

Related party transactions between a corporation and its officers or directors raise some important corporate governance questions. Traditionally such transactions were deemed *per se* voidable, but the current regulatory regime, consisting of corporate laws and securities regulations, attempts to allow beneficial transactions while preventing harmful ones. This Article identifies two main problems with the current regime. On the one hand, state corporate law litigation suffers from uncertainty surrounding the applicable standard of review. On the other hand, the reliability of disclosures under the federal securities regulations is questionable due to companies' strategic and inconsistent disclosure behavior. Particularly with respect to the latter, this Article has presented an analysis of manually collected and coded data on actual disclosures by large, publicly traded U.S. corporations. The Article has proposed that one possible way of improving the current regime is to link disclosure with the standard of review problem: granting business judgment rule protection for related party transactions that satisfy both disinterested directors' approval and disclosure to shareholders. Implementing the proposal can lead to (1) reduction of litigation uncertainty; (2) better incentives for disclosure; and (3) better aggregation of data over time and better guidance for related party transactions.

APPENDIX

FIGURE A: TOTAL NUMBER OF DISCLOSURES OF RELATED PARTY TRANSACTIONS

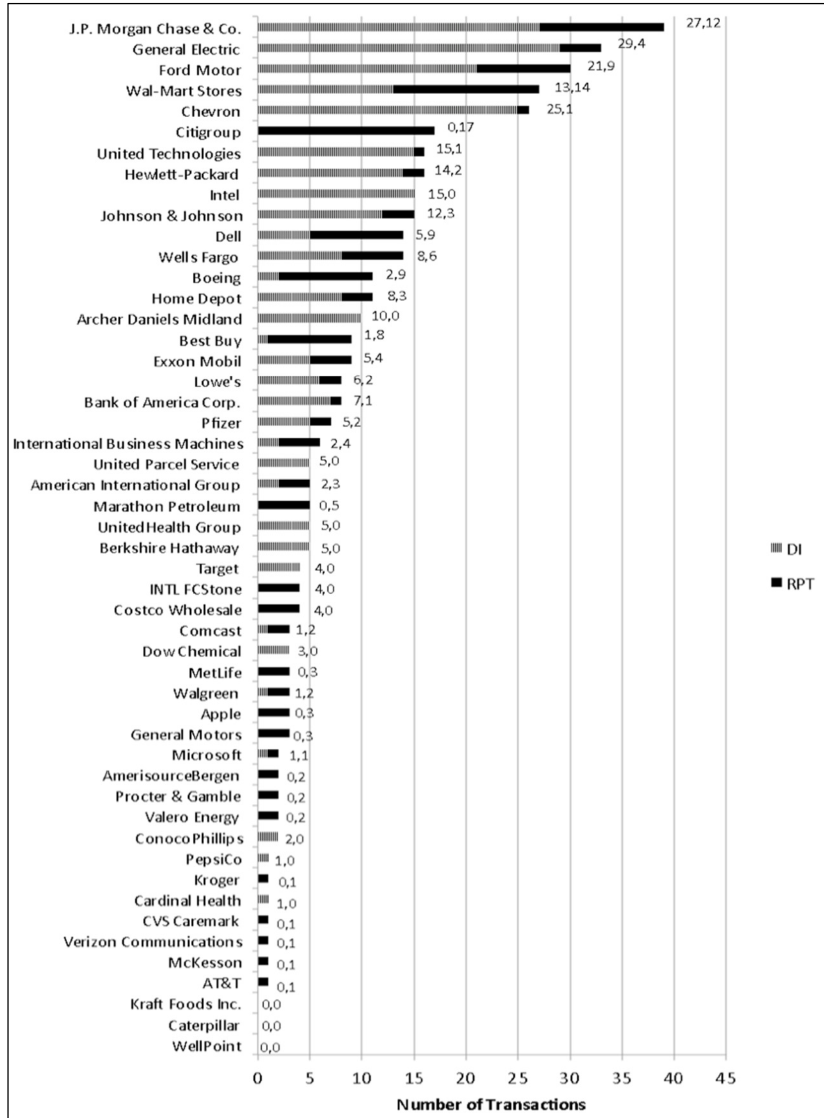


TABLE A: TYPES OF RELATED PARTY TRANSACTION DISCLOSURES

Category of Transaction	Item 407(a)(3) (DI)	Item 404(a) (RPT)	Total Trans-actions	% of Total Trans-actions
Transactions with Directors and Executives or Their Immediate Family				
Sales & Purchases of Goods	106	21	127	30.8%
Charitable Activities	57	3	60	14.5%
Family Hiring	6	39	45	10.9%
Loans/Credit Facility	20	3	23	5.6%
Employee Investment Opportunities	0	21	21	5.1%
Unidentified Transactions	13	4	17	4.1%
Educational Grants/Fellowships/ Tuition	14	1	15	3.6%
Credit Cards	9	0	9	2.2%
Law Firm Affiliations	5	3	8	1.9%
Consulting/Advisory Services	2	6	8	1.9%
Mergers & Acquisitions	1	6	7	1.7%
Real Estate Leases	1	4	5	1.2%
Planes	0	5	5	1.2%
Joint Ventures	2	2	4	1.0%
Employee Benefit Plans	4	0	4	1.0%
Security Costs	1	2	3	0.7%
Conference Exhibit Fees	2	1	3	0.7%

TABLE A: TYPES OF RELATED PARTY TRANSACTION DISCLOSURES (CONT.)

Category of Transaction	**Item 407(a)(3) (DI)**	**Item 404(a) (RPT)**	**Total Trans-actions**	**% of Total Trans-actions**
Purchase of Company Investment Notes	2	0	2	0.5%
Naming & Licensing Fees	0	2	2	0.5%
Fund Investments	2	0	2	0.5%
Prior Employment of Directors	2	0	2	0.5%
Research Payments	2	0	2	0.5%
Advertising	2	0	2	0.5%
Sponsorships	1	1	2	0.5%
Commercial Banking	2	0	2	0.5%
Marketing Services	0	2	2	0.5%
Recruiting Fees	1	0	1	0.2%
Expatriate Reimbursements	0	1	1	0.2%
Medical Expenses	1	0	1	0.2%
Royalty Payments	1	0	1	0.2%
Banking Services	1	0	1	0.2%
Telecommunication Services	1	0	1	0.2%
Transactions with Beneficial Owners or Their Immediate Family	0	25	25	6%
Total Transactions	**261**	**152**	**413**	**100%**

TABLE B: DESCRIPTION OF TYPES OF RELATED PARTY TRANSACTION DISCLOSURES

Category of Transaction	Description of Transactions
Transactions with Directors and Executives	
Sales & Purchases of Goods	Includes sales and purchases of goods between companies, etc.
Charitable Activities	Includes corporate donations to related charitable entities, one bulk purchase of a CEO's book for Foundation's initiative, a payment of fees related to promoting medical access to underserved communities, etc.
Family Hiring	Includes all corporate family relationships, such as executives or directors whose spouses, parents, siblings, or children also work for the company, etc.
Loans/Credit Facility	Includes loans made to related companies, extensions of credit to directors or executives, interest-free mortgages made to employees who relocated, etc.
Employee Investment Opportunities	Includes corporate investment funds maintained on behalf of employees, usually at beneficial rates or terms more favorable than those offered to general clients, co-investment opportunities offered to corporate employees, etc.
Unidentified Transactions	Includes transactions identified by companies but the subjects (detailed information) of which were left undisclosed
Educational Grants/Fellowships/ Tuition	Includes transactions with related colleges and universities, fellowship payments, educational grants, tuition payments, etc.

TABLE B: DESCRIPTION OF TYPES OF RELATED PARTY TRANSACTION DISCLOSURES (CONT.)

Category of Transaction	**Description of Transactions**
Transactions with Directors and Executives	
Credit Cards	Includes credit cards issued by a company to its directors and members of their family
Law Firm Affiliations	Includes transactions with law firms that employ a company's directors, executives, etc.
Mergers & Acquisitions	Includes a company's acquisition of related party companies, payouts to related parties in conjunction with mergers or acquisitions, etc.
Consulting/Advisory Services	Includes payments to prior employees or directors for contracted consulting services, payments to related companies providing consulting or advisory services, etc.
Real Estate Leases	Includes corporate leasing from related parties, etc.
Planes	Includes aircraft time sharing agreements, corporate reimbursements for business use of an executive's or director's personal aircraft, payments to a charter company for leasing of a related entity's private plane, etc.
Joint Ventures	Includes corporate investments in companies with related party affiliations, a contract with a director for a right of first refusal on his shares in a mutual investment, etc.
Security Costs	Includes costs of personal security allocated to executives or directors, payments made to related companies for the costs of security systems installed on company premises, etc.

TABLE B: DESCRIPTION OF TYPES OF RELATED PARTY TRANSACTION DISCLOSURES (CONT.)

Category of Transaction	Description of Transactions
Transactions with Directors and Executives	
Employee Benefit Plans	Includes costs of medical services, health insurance, and disability insurance purchased for employees from related companies, etc.
Prior Employment of Directors	Includes prior working relationships with current directors
Purchase of Company Investment Notes	Includes purchases of related company commercial paper, etc.
Naming & Licensing Fees	Includes payments to related companies for licensing fees, naming rights to sports stadiums, etc.
Fund Investments	Includes related investment affiliations among directors, capital contributions by companies to corporate funds run by related parties, etc.
Conference Exhibit Fees	Includes conference exhibit fees paid to related parties, etc.
Research Payments	Includes funded clinical trials, payments to related organizations for research services, etc.
Advertising	Includes payments to related companies for advertising services, etc.
Marketing Services	Includes payments to related companies for marketing services, etc.
Expatriate Reimbursements	Includes payments to relocated employees to offset high living costs, etc.
Royalty Payments	Includes royalty payments to related companies, etc.
Recruiting Fees	Includes recruiting fees paid to related companies, etc.

TABLE B: DESCRIPTION OF TYPES OF RELATED PARTY TRANSACTION DISCLOSURES (CONT.)

Category of Transaction	**Description of Transactions**
Transactions with Directors and Executives	
Sponsorships	Includes a sponsorship agreement with an NBA team once owned by an organization for which a company director served as an executive officer
Medical Expenses	Includes medical expenses for consumer health insurance, etc.
Commercial Banking	Includes commercial banking, brokerage, trust, equipment financing, and credit facility fees paid to related companies, etc.
Banking Services	Includes corporate use of a depository bank with related party affiliations, etc.
Telecommunication Services	Includes payments to related companies for telecommunication services, etc.
Transactions with Beneficial Owners or Their Family Members	Includes transactions with shareholders (or their families), companies, or organizations claiming beneficial ownership of corporate stock, etc.

TABLE C: FREQUENCY CHART OF DISCLOSURES WITH DOLLAR AMOUNTS

Bins ($)	Number of Disclosures Within Bin
10,000	4
60,000	12
120,000	10
180,000	18
240,000	12
300,000	11
500,000	16
1,000,000	20
1,500,000	6
2,000,000	6
10,000,000	29
50,000,000	17
500,000,000	14
1,000,000,000	0
5,000,000,000	0
10,000,000,000	1
Total # of Disclosure with Dollar Amounts	**176**