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Related party transactions and shareholder approval

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Concept of related party transactions

Related party transactions between public companies are common business deals. However, by entering into related party transactions, an entity could affect the balance sheet of another, making it incur losses or profits in such a manner that would be impossible in a transaction with independent third parties. The usual concern is that a controlling entity extracts benefits from the public company through such deals, which could be detrimental to the other shareholders. Therefore, related party transactions are at the crossroads between rules providing for directors' fiduciary duties and rules preventing conflicts of interest.

According to Article 66A of the Companies Code, the concept of a related party is drawn from the International Accounting Standards. International Accounting Standard 24 provides examples and key criteria to define the circle of related parties. A person or entity may be considered a related party of another entity if the former exerts a certain degree of influence or control over the latter. As an example, two companies belonging to a same group are related parties, but two entities that control a joint venture are not related parties simply because of that venture.

A 'related party transaction' is defined by International Accounting Standard 24 as a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Disclosure

The first layer of rules on related party transactions regards their disclosure to the public in an annex to companies' financial statements (Article 66A of the Companies Code). Disclosure is the most common approach across Europe, according to European legislation.

By disclosing related party transactions, companies provide shareholders with an important tool to assess how boards should discharge their fiduciary duties. For this purpose, International Accounting Standard 24 requires companies to disclose not only the existence of the transactions themselves, but also amounts, guaranties, conditions and outstanding balances.

Arm's-length transactions

A second layer of rules imposes material requirements on some related party transactions. For instance, according to the Companies Code, transactions between a company and its board members or entities controlled by them should be carried out at arm's length – that is, at current market prices and in the normal pursuit of business. Otherwise, these deals could be deemed void, unless they are approved by the supervisory body of the company.

These mandatory rules do not directly cover transactions, for instance, between a company and its significant shareholders or a parent company and a subsidiary. However, as board members should act for the benefit of all shareholders and of the company, they may be held liable if entering into a transaction below market prices with such related parties, as this could negatively affect the balance sheet of the company.

Soft law (eg, recommendations adopted by the Portuguese Securities Commission on corporate governance) typically broadens the scope of the arm's-length principle, recommending that deals also involving company shareholders always be concluded at normal market prices.

One step forward: shareholder approval of significant transactions

The 2011 European Commission green paper on corporate governance cast some doubts on the efficiency and sufficiency of the abovementioned framework. According to some European voices, it would be better if significant related party transactions were approved by minority shareholders. Controlling shareholders should also be prevented from voting, as they normally have conflicting interests in these matters. Consequently, a minority would have the power to block such transactions.

The 2011 Statement of the European Corporate Governance Forum has paved the way forward with a precise proposal:

> "*[T]ransactions representing more than 5% of assets or which have a significant impact on profits or turnover should have the additional requirement of being submitted to a vote by the shareholders in General Meeting but with the related party being precluded from voting.*"

The tendency is to consider an option for such a proposal to be an important mistake. There is no evidence that a set of disclosure duties combined with a mitigated arm's-length principle, against the background of directors' fiduciary duties, is insufficient to protect minority shareholders and the company itself from impaired related party transactions.

Submitting relevant related party transactions to the general shareholders' meeting and allowing minority shareholders to block them, regardless of whether the arm's-length principle is complied with, would transform an issue that to some extent relates to managerial discretion into a potential cause of conflict between minority and majority shareholders. This would definitely leverage minority shareholders' position in the usual skirmishes at annual general meetings, but would not contribute to sound and efficient management of public companies.

For further information on this topic please contact José Pedro Fazenda Martins at Vieira de Almeida & Associados by telephone (+351 21 311 3400), fax (+351 21 311 3407) or email (jpfm@vda.pt).

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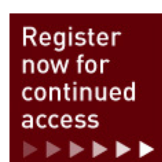

José Pedro Fazenda Martins

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