DIRECTORS' CONFLICTS: AN EMPIRICAL STUDY

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I. INTRODUCTION

This chapter has three objectives. First, we consider some theoretical issues associated with the regulation of directors' conflicts of interest. Second, we provide a brief overview of the Australian legal framework for regulating directors' conflicts. Third, we present the results of an empirical study of directors' conflicts in Australia. It is a study of the disclosure by the largest Australian companies of financial benefits between these companies and their directors. The purpose is to provide some insight into the types of matters which potentially involve directors' conflicts. Sixty-four per cent of the companies in our sample disclosed at least one director-related transaction. By dollar amount, the largest category of director-related transactions is goods or property provided to a company by a director or a director-related entity. Another common category of director-related transactions is services provided to a company by a director-related entity. We identify the types of services provided by directors by dollar amount and classify the services according to their type such as management services, legal services and consulting services.

II. THEORETICAL ISSUES ASSOCIATED WITH REGULATING DIRECTORS' CONFLICTS

Is it possible to develop a theoretical framework for dealing with directors' conflicts of interest? The question arises because of the variety of approaches between countries taken to dealing with directors' conflicts. A common underpinning theme in all countries is the

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emphasis given to adequate disclosure by the director of his or her interest. However, approaches differ in relation to a fundamental issue: who reviews and approves of the director's interest? Is the review undertaken by shareholders or by disinterested directors? Is there a role for courts in considering the fairness to the company of the transaction in which the director is interested?

Our objective in this section is to examine a number of the issues associated with different institutional mechanisms which regulate directors' conflicts. We commence by examining the role of market forces in regulating directors' conflicts. We then examine the role of disinterested directors, shareholders and courts.

1. Market forces

A longstanding debate concerns the extent to which various market forces operate to reduce the need for mandatory laws regulating the conduct of directors. These market forces include the market for the company's goods or services, the market for corporate control, the market for corporate capital, and the labour market for directors.[1] To a large extent, the debate is unresolved. The reason is that the effectiveness of these market forces varies from company to company, industry to industry, and country to country. It is therefore not possible to generalise concerning the extent to which these market forces reduce the need for legal rules regulating directors' conflicts. However, it can be said that no major capital market relies solely on market forces to regulate directors' conflicts. Consequently, analysis of additional mechanisms which may have such regulation as their objective is required.

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2. Review by independent directors

It is possible for independent or disinterested directors to operate as a mechanism for regulating directors' conflicts. A director who is in a position of conflict of interest and duty must disclose the conflict to disinterested directors who then review it to decide whether or not the company and/or director should proceed with the transaction in which the director is interested.

Several important points need to be made in relation to the effectiveness of independent directors as a mechanism for regulating directors' conflicts. First, some countries place significant emphasis on independent directors. This is particularly true of the United States where it has been said that the law invests in disinterested directors "a considerable measure of discretion to assess the merits of conflict transactions".[2] To some degree, this may be a reflection of the proportion of independent directors on boards of companies in that country. Professor DeMott reports that in the United States, according to a 1998 study, the average board of a public company had two executive directors and nine non-executive directors.[3] In contrast, in the United Kingdom, it has been reported that in large public companies, boards have roughly equal numbers of executive and non-executive directors.[4] An Australian study of the largest 100 listed companies found that the average board had three executive directors and six non-executive directors.[5]

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[1] For an overview of a number of the key arguments, see F H Easterbrook and D R Fischel, *The Economic Structure of Corporate Law* (1991).

[2] D DeMott, "The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions" (1999) 3 *Company, Financial and Insolvency Law Review* 190.

[3] Ibid at 194, citing Korn/Ferry International, *25th Annual Board of Directors Survey* (1998).

[4] Ibid at 194.

[5] G P Stapledon and J Lawrence, "Board Composition, Structure and Independence in Australia's Largest Listed Companies" (1997) 21 *Melbourne University Law Review* 150.

The second point to note is that a distinction must be drawn between non-executive directors and independent directors. Definitions of who is an independent director differ from country to country. In Australia, the Investment and Financial Services Association, which represents the largest institutional investors, has proposed the following definition. An independent director is a non-executive director who:

- is not a substantial shareholder of the company or an officer of or otherwise associated directly or indirectly with a substantial shareholder of the company;
- has not within the last three years been employed in an executive capacity by the company or another group member or been a director after ceasing to hold any such employment;
- is not a principal of a professional adviser to the company or another group member;
- is not a significant supplier or customer of the company or another group member or an officer of or otherwise associated directly or indirectly with a significant supplier or customer;
- has no significant contractual relationship with the company or another group member other than as a director of the company; and
- is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.[6]

The distinction between non-executive and independent directors is important as it is only independent or disinterested directors in relation to a particular matter in which another

[6] Investment and Financial Services Association, *Corporate Governance: A Guide for Investment Managers and Corporations*, IFSA Guidance Note No 2.00, July 1999.

director has a conflict who are qualified to review the conflict. The Australian study referred to above of the largest 100 listed companies found that only 59 per cent of non-executive directors could be classified as independent directors.[7]

The third point to note is that some commentators have cast doubt on the proposition that independent directors can be truly independent when reviewing actions of their fellow directors because of common cultural bonds.[8]

3. Review by shareholders

As is the case with review of directors' conflicts by independent directors, the emphasis placed on review by shareholders of such conflicts differs between countries. For example, the emphasis on review by independent directors in the United States means there is less emphasis placed on shareholder review in that country.

There are problems with shareholder review of directors' conflicts. First, in the case of companies with many shareholders, it can be costly to have decisions made by shareholders. Second, shareholders with only a small investment have little incentive to become informed and vote on a matter regarding a director's conflict. Shareholders with a small investment suffer a collective action problem when voting which undermines their effectiveness as a decision-making body. A rational small shareholder in a public company will not expend the time and effort to evaluate a particular director's conflict because the shareholder's costs of becoming informed and voting typically outweigh any expected benefits. This is because the

7 Stapledon and Lawrence, supra n 5.
8 See, for example, J D Cox and H Munsinger, "Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion" (1985) 48 *Law and Contemporary Problems* 83.

shareholder’s vote would have only a small effect on the outcome and the shareholder would have difficulty identifying any significant benefit in voting.

Of course whether shareholders suffer a collective action problem depends on the proportion of shares held by shareholders. Shareholders with a substantial investment in a company, including some institutional shareholders, have much more of an economic incentive to become informed and vote on particular matters. The extent of institutional investors’ holdings varies from country to country. In Australia and the United States it is estimated that the shareholdings of institutional investors are approximately 50 per cent of total sharemarket capitalisation, while in the United Kingdom institutional shareholdings account for about 60 per cent.[9] Consequently, the extent to which shareholders can be considered an effective review mechanism for directors’ conflicts will depend to a large extent on the ownership structure of companies. In small private companies with few shareholders, these shareholders may be an effective review mechanism. In the case of large publicly listed companies, shareholders can be expected to be a less effective review mechanism.

This may not be true of publicly listed companies with a high degree of institutional shareholdings. However, even in relation to these companies, there are two significant qualifications. First, to the extent to which the review by shareholders of a director’s conflict has to be decided in a general meeting, there is a significant cost to holding such a meeting for a publicly listed company when compared to the cost of holding a meeting of directors. Second, even institutional shareholders do not always have an incentive to become informed and vote on a particular matter. There can be a number of disincentives to institutional

[9] I Ramsay and G Stapledon, “Institutional Investors, Corporate Governance and the New International Financial Architecture” forthcoming in J Norton and S Goo (eds), *Challenges for the New International Financial Architecture: Lessons for East Asia*.

shareholders playing an active role in the governance of companies. These disincentives include legal barriers, economic barriers, and practical and political barriers.[10]

4. Review by courts

It is possible to envisage a role for courts in reviewing directors' conflicts. There may be a narrow or broad role. A narrow role is where the court determines whether a director has made appropriate disclosure to either shareholders or disinterested directors. A broader role is where the court reviews the fairness of a particular transaction in which a director is interested. Such a role is given to the court under the Delaware companies law. Section 144 of the Delaware General Corporation Law provides that a contract in which a director is interested is valid if the contract "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 shareholders".

Some commentators have expressed reservations about a significant role for the courts in corporate regulation. For example, it is sometimes said that courts lack the flexibility, expertise, initiative and powers of coordination which are necessary to deal with complex regulatory problems.[11] However, this would not apply to courts determining the adequacy of disclosure by a director who has a conflict.

In terms of an alternative review body, it may be that a specialist corporate regulator which has a greater fact finding capacity and accountability may be preferable to a court if it is decided that either independent directors or shareholders are inadequate review mechanisms.

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[10] See G P Stapledon, "Disincentives to Activism by Institutional Investors in Listed Australian Companies" (1996) 18 *Sydney Law Review* 152.

However, as was the case with shareholder review, there is the important issue of cost. It may be costly to have a review undertaken by the regulator. In addition, the regulator may have other priorities and may be subject to constraints – whether those constraints are imposed by funding restrictions or by government direction.

5. Summary

There are both costs and benefits to each of the review mechanisms for directors' conflicts identified above. It can be efficient to have the review undertaken by disinterested or independent directors. Alternatively, the review could be undertaken by shareholders in a small private company with few shareholders. As we have seen, the choice between independent directors and shareholders turns, to a substantial degree, upon the ownership structure of the particular company concerned. It is also possible for review of directors' conflicts to be undertaken by courts or regulators although once again there are costs associated with such review.

We provide an overview of the Australian legal framework for regulating directors' conflicts in the next section. We see that, depending on the type of conflict, Australian law utilises as review mechanisms disinterested directors and shareholders, and there is also a role for courts.

III. THE LEGAL FRAMEWORK FOR REGULATING DIRECTORS' CONFLICTS

The legal framework for the regulation of directors' conflicts under Australian law includes three levels of regulation. These are:

[11] I M Ramsay, "Models of Corporate Regulation: The Mandatory/Enabling Debate" in R Grantham and

- common law principles;
- the company's constitution (if it has one)[12] which can modify the common law principles; and
- statutory provisions such as:
  - sections 191-196 of the Corporations Law which apply to directors of both proprietary (private) and public companies;
  - sections 182 and 183 of the Corporations Law which prohibit officers and employees making improper use of their position and improper use of information;
  - chapter 2E of the Corporations Law which regulates financial benefits given by public companies to their related parties – where related parties include directors; and
  - sections 296 and 304 of the Corporations Law which require companies' financial statements to comply with Australian Accounting Standards – including Accounting Standard AASB 1017, which requires disclosure of transactions between companies and their related parties (including directors).

1. Common law principles

The common law principles which underpin the regulation of directors' conflicts of interest derive from classifying company directors as fiduciaries. Fiduciaries must avoid placing themselves in a position in which they prefer their own interests or the interests of someone other than their principal.

C Rickett (eds), *Corporate Personality in the 20th Century* (1998), 234-238.

[12] As a result of amendments to the Corporations Law effective 1 July 1998, Australian companies are no longer required to have a constitution. Rather than having a constitution, a company may elect to be governed by the "replaceable rules" contained in the Corporations Law. These rules deal with matters of internal governance.

Under Australian law, it is not an abstract conflict which brings the common law principles into play. Rather, the director must have a real or substantial possibility of conflict.[13] Where a director has a real or substantial possibility of conflict, the director is only free to proceed if the director discloses the nature and extent of the interest to either the shareholders or the other directors, depending on whether the company's constitution (if it has one) or relevant statutory provisions require disclosure to either shareholders or other directors.

Even if the director makes adequate disclosure of the interest, in some circumstances, mere disclosure is not sufficient to satisfy the director's fiduciary obligations. There may be a positive duty on the director to protect the company's interests by taking steps to prevent the transaction in which the director is interested from going ahead. In *Permanent Building Society (in liq) v McGee*,[14] the defendant Wheeler was chairman of Permanent Building Society. He was also chairman of Capital Hall Ltd and had a controlling interest in this company. The directors of Permanent Building Society voted to have the Society loan $1.5 million to Capital Hall. Wheeler disclosed his interest and did not vote. However, Capital Hall did not have the resources to repay the loan and this was known to Wheeler. In these circumstances, the court held that Wheeler had breached his fiduciary obligations to Permanent Building Society. It was not enough for him to merely disclose his interest and abstain from voting. He had a duty to take positive steps to protect the interests of Permanent Building Society and this involved Wheeler making appropriate disclosure of the extent of Capital Hall's financial incapacity at the time of the loan.

2. The company's constitution

[13] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 103, per Mason J.

Under common law principles, where a director has a real or substantial possibility of a conflict of interest and duty, disclosure of that interest must be made to the shareholders. Because it is typically not feasible to refer all conflicts to shareholders for their approval, companies usually adopt a provision in their constitutions that allows disclosure to disinterested directors. A typical provision of a constitution will provide that so long as a director discloses at the first meeting of the board when it becomes relevant to do so that the director has an interest in a matter relevant to the company, and the director discloses the nature and extent of that interest, then:

- the company cannot avoid the contract because of the director's interest; and
- the director is not liable to account to the company for any profit the director obtains in relation to the contract by reason only of being a director; and
- the director may vote in respect of the contract in which the director is interested.

For companies that do not have a constitution and which elect to be governed by the replaceable rules contained in the Corporations Law, section 194 is a replaceable rule which provides that if a director of a proprietary company has a material personal interest in a matter that relates to the affairs of the company and the director discloses the nature and extent of the interest (or the interest is one that is specifically excluded under the statutory provisions), then:

- the director may vote on matters that relate to the interest; and
- any transactions that relate to the interest may proceed; and

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[14] (1993) 11 ACSR 260; 11 ACLC 761.

- if the disclosure is made before the transaction is entered into:
  - the director may retain benefits under the transaction even though the director has the interest; and
  - the company cannot avoid the transaction merely because of the existence of the interest.

3. Statutory provisions regulating conflicts of interest

Under Australian law, the main statutory provisions which regulate directors' conflicts of interest are ss 191-196, 182-183, and Chapter 2E of the Corporations Law.

(i) Section 191: Duty to disclose interests

Section 191 imposes a duty upon directors of both public and proprietary companies to disclose particular interests. It states that a director of a company who has a material personal interest in a matter that relates to the affairs of the company must give the other directors notice of the interest unless the section provides an exemption.

The notice to be given by a director to the other directors must:

- give details of the nature and extent of the interest and the relation of the interest to the affairs of the company; and

- be given at a directors' meeting as soon as practicable after the director becomes aware of his or her interest in the matter.

Section 191 provides a list of exemptions from the disclosure requirement. The exemptions include an interest that arises merely because the director is a member of the company and the interest is held in common with the other members of the company.

Only material personal interests must be disclosed. The Corporations Law does not provide a definition of "material personal interest". Several points can be made. First, the material personal interest must relate to the affairs of the company. The Corporations Law defines affairs of a company very broadly in s 9.

Second, the word "material" requires an assessment of the relationship between the advantage which the director personally expects and the matter being considered. It has been said that a material interest is one that influences the vote of a director upon the decision being made, bearing in mind that the conflict of interest must be of a real or substantial kind.[15] Third, the material interest must also be a "personal" interest. This would seem to require that the director be affected or benefit in some way.

(ii) Section 195: Restriction on voting by directors of public companies

Section 195 imposes a restriction upon directors of public companies being present and voting at meetings which consider a matter in which they are interested unless the other

[15] *McGellin v Mount King Mining NL*, unreported, 7 April 1998, Supreme Court of Western Australia, Murray J.

directors approve. The section states that a director of a public company who has a material personal interest in a matter that is being considered at a directors’ meeting must not:

- be present while the matter is being considered at the meeting; or
- vote on the matter;

unless:

- the other directors vote to allow the director to be present or the Australian Securities and Investments Commission makes an order allowing the director to be present; or
- the interest is one that is exempt under s 191.

(iii) Sections 182 and 183: Improper use of position and information

Section 182 provides that a director, secretary, other officer or employee of a company must not improperly use their position to:

- gain an advantage for themselves or someone else; or
- cause detriment to the corporation.

Section 183 provides that a person who obtains information because they are, or have been, a director or other officer or employee of a company must not improperly use their position to:

- gain an advantage for themselves or someone else; or
- cause detriment to the company.

The High Court of Australia has held that the test of impropriety is objective in that it does not depend on the alleged offender's consciousness of impropriety.[16]

A breach of ss 182 or 183 gives rise to a civil penalty. A civil penalty is an order to pay a pecuniary penalty (of up to $200,000) and/or an order prohibiting the person from managing a corporation for a specified period of time. The civil penalty provisions of the Corporations Law are enforced by the Australian Securities and Investments Commission. It is possible for the court in a civil penalty proceeding to order a person to pay compensation to the company. A person who has breached a civil penalty provision with dishonest intent may be subject to criminal proceedings which can result in the imposition of a fine and/or imprisonment.

(iv) Chapter 2E[17]

Chapter 2E of the Corporations Law regulates financial benefits given by public companies to their related parties (including directors). We describe Chapter 2E in some detail because the empirical study in the next section is based upon disclosure of related-party dealings.

Chapter 2E was enacted following a report of the Companies and Securities Advisory Committee.[18] The Report referred to evidence arising out of the corporate collapses of the 1980s that some corporate controllers had abused their positions of trust by arranging for the

16 *R v Byrnes* (1995) 130 ALR 529.
17 This section is drawn from H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law*, 9th ed, Butterworths, Sydney, 1999, para [9.470] ff.
18 Company and Securities Advisory Committee, *Report on the Reform of the Law Governing Corporate Financial Transactions* (July 1991).

shifting of assets around and away from companies and corporate groups, and into their own hands. It was said that this was achieved by various means, including remuneration payments, asset transfers and loan arrangements. In the Committee's view, the lack of specific provisions of the Corporations Law on these matters could be interpreted as a “statutory licence” to engage in such conduct.

The object of Chapter 2E is expressed in s 207 which provides that:

> “The rules in this Chapter are designed to protect the interests of a public company’s members as a whole, by requiring member approval for giving financial benefits to related parties that could endanger those interests.”

Scope of Chapter 2E

Subject to important exceptions:

- a public company must not give a financial benefit to a related party; and
- an entity that the public company controls must not give a financial benefit to a related party of the public company: s 208.

A short list of some potential practical applications of Ch 2E will indicate its breadth:

- intra-group loans and loans to directors;
- intra-group guarantees and indemnities;
- management and consulting agreements with director-controlled entities;
- supply or trading contracts with director-controlled entities;
- housing loan schemes and staff discount schemes, if directors may participate;

- employee share and option schemes, if directors may participate;
- professional fees to a firm, if a partner is on the board; and
- benefits to spouses of directors.

The key concepts in s 208 are “give a financial benefit”, “related party” and “entity that the public company controls” each of which is considered in turn below.

“Give a financial benefit”

Section 229 provides guidelines on what will be a financial benefit, although there is no exhaustive definition of this concept in the section. In determining whether a financial benefit is given for the purposes of Chapter 2E:

- a broad interpretation should be adopted, even if criminal or civil penalties may be involved;
- the economic and commercial substance of conduct is to prevail over its legal form; and
- any consideration that is or may be given for the benefit, even if the consideration is adequate, should be disregarded: s 229(1).

For additional guidance, six examples of the giving of a financial benefit are provided in s 229(3):

- giving or providing the related party finance or property;

- buying an asset from or selling an asset to the related party;
- leasing an asset from or to the related party;
- supplying services to or receiving services from the related party;
- issuing securities or granting an option to the related party; and
- taking up or releasing an obligation of the related party.

Related parties

Related parties of a public company (that is, those for whom benefits are prohibited, subject to the exceptions) include:

- an entity that controls the public company;
- directors of the public company or directors of an entity that controls the public company;
- a spouse or de facto spouse of those directors;
- a parent, son or daughter of such directors or their spouses or de facto spouses; and
- entities controlled by any of those persons: s 228.

The definition of control

The definition of "control" is important for the purposes of Chapter 2E because, as we have seen, the prohibition in s 208 on giving a financial benefit to a related party of a public company extends to an entity that the public company controls. In addition, the definition of related party in s 228 states that a related party of a public company includes an entity that controls the public company and any directors of that entity.

The definition of "control" for the purposes of Chapter 2E is found in s 50AA. Section 50AA(1) provides that an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity's financial and operating policies. In determining whether the first entity has this capacity, s 50AA(2) provides that:

- the practical influence the first entity can exert (rather than the rights it can enforce) is the issue to be considered; and
- any practice or pattern of behaviour affecting the second entity's financial or operating policies is to be taken into account (even if it involves a breach of an agreement or a breach of trust).

Exemptions to s 208

Chapter 2E contains the following exemptions from the central prohibition in s 208:

- a financial benefit given on arm's length terms (s 210);
- reasonable remuneration for company officers or employees (s 211);
- financial benefits that are payment of expenses reasonably incurred by an officer or employee (s 211);
- financial benefits that are certain indemnities, insurance premiums or payment for legal costs for officers that are reasonable in the circumstances (s 212);
- a financial benefit that is an amount of money that does not exceed $2,000 paid to a director or the director's spouse or de facto spouse (s 213);
- financial benefits given to or by a closely held subsidiary, defined effectively as a wholly-owned subsidiary (s 214);
- financial benefits given to members in their capacity as members provided that the benefit does not discriminate unfairly against other members of the public company (s 215); and
- a financial benefit given under an order of a court (s 216).

These exemptions do not relieve directors of their fiduciary duties: s 230. This will be of particular importance in relation to intra-group transactions.

An important exemption in practice relates to benefits on arm’s length terms.

Benefits on arm’s length terms

Section 210 provides that a public company, or an entity that the public company controls, may give a financial benefit to a related party of the public company if the financial benefit is given on terms that:

- would be reasonable in the circumstances if the public company or entity and the related party were dealing at arm’s length; or
- are less favourable to the related party than the terms referred to immediately above.

This is an integral part of the scheme of Chapter 2E, because it allows a transaction justifiable on arm's length terms to go ahead without a shareholders' meeting. Directors wishing to protect themselves may seek independent advice that a particular transaction is on arm's length terms. Alternatively, they may opt for the safety of a shareholders' meeting.

Former s 243N(2) provided a non-exhaustive list of matters to be considered before deciding whether a financial benefit which is a loan or other financial accommodation, is on arm's length terms. These included:

- the amount of the loan or the extent of the accommodation;

- what interest or charges are payable;
- the credit risks;
- the securities given; and
- the timetable for repayments of amounts owing and payments of interest or charges.

Although former s 243N(2) was repealed as part of the simplifying amendments to Chapter 2E made by the Corporate Law Economic Reform Program Act 1999, these matters would still be relevant to deciding whether a financial benefit which is a loan or other financial accommodation is on arm's length terms.

Certain transactions will inevitably be outside this exception. For example, most intra-group loans and guarantees cannot be regarded as on arm's length terms. Nor is it likely that remuneration benefits to directors could fall within the "arm's length terms" category, though they may be exempted as "reasonable remuneration" within s 211.

Shareholder approval for financial benefits

If a financial benefit is not exempt, then the approval of the public company's shareholders is required and the benefit must be given within 15 months after the approval: s 208(1). Sections 217-227 set out in considerable detail the requirements for valid shareholder approval. The procedure involves notifying the Australian Securities and Investments Commission (ASIC) so that ASIC may supply written comments on the proposal for transmission to the shareholders.

Voting restrictions are imposed by s 224(1). A vote on a proposed resolution to approve the giving of a financial benefit to a related party must not be cast by or on behalf of a related party to whom the benefit may or will be given or an associate of such a related party.

Exceptions may be made by regulation, or in specific cases by ASIC declaration. ASIC can act only if satisfied that the declaration will not cause unfair prejudice to the interests of any member of the public company: s 224(4).

IV. EMPIRICAL STUDY

In this section we describe our empirical study of directors' conflicts. We commence by outlining the disclosure rules which apply to related-party transactions and then identify the methodology employed in the study and our results.

1. Disclosure rules governing related party transactions

The rules regarding disclosure of related party transactions by Australian companies listed on the Australian Stock Exchange (ASX), and certain other companies and entities, are set out in Accounting Standard AASB 1017: Related Party Disclosures.[19]

The commentary to AASB 1017 explains the purpose of the disclosure required by the

[19] The Accounting Standards are issued by the Australian Accounting Standards Board – a body established under the Australian Securities and Investments Commission Act 1989 (Cth), Part 12. The Board's power to make accounting standards is located in s 32 of the Corporations Act 1989 (Cth). Most Australian companies and entities that are required to prepare financial statements must comply with the Accounting Standards when preparing those statements: Corporations Law, ss 296, 304.

Standard by reference to the potential for conflict of interest when companies transact with related parties:

> "The existence of a related party relationship may expose a [company] to risks, or provide opportunities, which would not have existed in the absence of the relationship. Related party relationships may, therefore, have a material effect on the performance, financial position, and financing and investing of a [company]. Consistent with [the principle] that general purpose financial reports shall provide information useful to users for making and evaluating decisions about the allocation of scarce resources, users of the accounts or consolidated accounts need to be informed of related party relationships and transactions. Transactions involving related parties cannot be *presumed* to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist."[20]

Under AASB 1017, the related parties of a listed company are:

(i) any entity that controls the listed company (that is, a "parent entity"), or significantly influences[21] the listed company;

(ii) any entity that is controlled or significantly influenced by the listed company, or by the listed company's parent entity (assuming it has one);

(iii) any entity that is controlled by the same entity that significantly influences the listed company (assuming there is an entity that significantly influences the listed company);

(iv) each director of the listed company, and their director-related entities;[22] and

(v) each director of the related parties listed in items (i) to (iii), and their director-related entities.[23]

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[20] AASB 1017, Commentary, para (iv). Emphasis added.

[21] Significant influence is defined as the capacity of an entity to affect substantially (but not control) either, or both, of the financial and operating policies of another entity: AASB 1017, para 9 (definition of "significant influence").

[22] Director-related entities are directors' spouses and relatives (and their spouses), and any other entity under the joint or several control or significant influence of such directors, spouses or relatives: AASB 1017, para 9 (definition of "director-related entities").

[23] AASB 1017, para 9 (definition of "related party").

At a general level, AASB 1017 requires disclosure (in varying degrees of detail) whenever information concerning a related party dealing is "material".[24] Information about any dealing with directors (of the listed company, its subsidiaries[25] or certain other related entities[26]), or with director-related entities,[27] is deemed material regardless of the quantum of the amounts involved.[28] Information concerning dealings with related parties other than directors and director-related entities is material if its omission or misstatement has the potential to affect, adversely:

- decisions about the allocation of scarce resources made by users of the accounts; or
- the discharge of accountability by the directors.[29]

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[24] AASB 1017, para 8.

[25] The term "subsidiary" is used in this chapter for convenience. AASB 1017 uses the expression "controlled entity" rather than "subsidiary". The terms "control" and "entity" (and thus "controlled entity") are defined in AASB 1017 in such a way that a broader range of entities may constitute a corporate group than if the traditional legal concept of "subsidiary" were used. To illustrate the point, under s 46 of the Corporations Law, a company (A) is a subsidiary of another company (B) if B:

- controls the composition of A's board of directors; or
- is in a position to cast, or control the casting of, more than one-half of the maximum number of votes that might be cast at a general meeting of A; or
- holds more than one-half of the issued share capital of A (excluding any part of that issued share capital that carries no right to participate beyond a specified amount in a distribution of either profits or capital).

In the early 1990s the Accounting Standards were amended to move away from the legal definition of subsidiary contained in s 46, because the legal test had proven too inflexible for indicating when financial statements of entities should be consolidated. One of the shortcomings of the legal definition of subsidiary for the purposes of providing financial information to shareholders of a holding company was that it did not include enterprises which – although controlled by the holding company – were not corporations (such as trusts, partnerships and unincorporated joint ventures): H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law*, 9th ed, Butterworths, Sydney, 1999, para [4.340]. Another shortcoming was that, where a company holds under 50 per cent of the shares in another company, but exercises practical control over its affairs, there is unlikely to be a holding company/subsidiary relationship due to the courts' narrow construction of the concept of "control[ling] the composition of the board of directors" used in s 46: see *Mount Edon Gold Mines (Aust) Ltd v Burmine Ltd* (1994) 12 ACSR 727; *Bluebird Investments Pty Ltd v Graf* (1994) 13 ACSR 271. The term "control", as defined in AASB 1017, is broad enough to catch situations of practical control: "'control' means the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity": AASB 1017, para 9. See also I M Ramsay, "Allocating Liability in Corporate Groups: An Australian Perspective" (1999) 13 *Connecticut Journal of International Law* 329.

[26] Namely, those listed in items (i) to (iii) in the text at n 23, above.

[27] For the definition of director-related entities, see n 22, above.

[28] AASB 1017, para 8.

For each category of related party, varying degrees of disclosure are required depending on the type of related party transaction in question and its magnitude and degree of materiality. For example, in the case of directors, different requirements are prescribed for the following different types of transaction (and in some cases varying degrees of disclosure are required within each type depending on the characteristics of the transaction):

- remuneration;
- retirement benefits;
- loans;
- transactions concerning shares and share options; and
- all other transactions.

As discussed in the next section, the focus of our empirical study was the "directors: all other transactions" category. The disclosure rules governing this category of transactions apply in relation to dealings between, on the one hand, any of the entities in a group;[30] and, on the other hand, any of the directors of a group entity or their director-related entities. The general rule – contained in paragraph 25 of AASB 1017 – is that the accounts must disclose the nature and terms of each different type of transaction, the names of the directors concerned and the amount concerned. However, a "general description" is sufficient where a particular transaction:

(i) occurs within a normal employee, customer or supplier relationship on terms no more favourable than those which it is reasonable to expect the entity would have adopted if

[29] AASB 1017, para 8.

dealing with the director (or director-related entity) at arm's length in the same circumstances;

(ii) does not have the potential adversely to affect decisions about the allocation of scarce resources made by users of the accounts, or the discharge of accountability by the directors, if disclosed only by general description; and

(iii) is trivial or domestic in nature.[31]

2. Sample and methodology for the study

The study described in this chapter is the first stage of a broader study involving a larger sample, a longer timeframe and a wider range of related party transactions.

The sample frame for the present study was the top 100 companies listed on the ASX, ranked by market capitalisation, as at 30 June 1997. After excluding eight overseas-based (New Zealand and Papua New Guinea) companies,[32] the sample became 92 companies and listed property trusts. The total market capitalisation of the sample companies was A$346,568 million, ranging from A$680 million to A$38,957 million.[33] The average market capitalisation was A$3,767 million; the median was A$1,690 million.

The sample companies' 1997 annual reports were examined for related party disclosures involving directors or director-related entities. Disclosures concerning directors'

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30 The Accounting Standard uses the term "economic entity" rather than group, defined as "a group of entities comprising the parent entity and each of the entities it controls": AASB 1017, para 9 (definition of "economic entity").

31 AASB 1017, para 27. The commentary to AASB 1017 says that transactions are "trivial" when they are of little or no interest to the users of the accounts; and "domestic" when they are related to the director's personal household activities: AASB 1017, Commentary, para (xxx).

32 The overseas-based companies were excluded because – although listed on the ASX – they are not subject to the same related party disclosure rules as Australian companies.

remuneration, retirement benefits, loans and dealings in shares and share options were excluded from the study, on the basis that these transactions raise discrete issues that have been addressed in other studies.[34] Therefore, the study was essentially concerned with disclosures of the "other transactions" covered by paragraph 25 of AASB 1017 (to which the "general description" exception[35] did not apply).

The disclosures were categorised as involving goods, services, leasing of property, loans (other than loans to directors) or miscellaneous transactions. Each category was sub-divided into transactions where a group company paid for goods or services, etc, provided by a director or a director-related entity; and transactions where a group company was paid for providing goods or services, etc, to a director or a director-related entity.[36]

3. Results

33 In recent years the Australian dollar has traded mainly in the range A$1.00 = US$0.60 - 0.70.

34 In relation to directors' remuneration, see A Defina, T Harris and I M Ramsay, "What is Reasonable Remuneration for Corporate Officers? An Empirical Investigation into the Relationship Between Pay and Performance in the Largest Australian Companies" (1994) 12 *Company and Securities Law Journal* 341. In relation to loans to directors, see I M Ramsay, "Corporate Disclosure of Loans to Directors: Report of an Empirical Study" (1991) 9 *Company and Securities Law Journal* 80. In relation to director share ownership, see J Farrer and I M Ramsay, "Director Share Ownership and Corporate Performance: Evidence from Australia" (1998) 6 *Corporate Governance: An International Review* 223.

35 See n 31, above, and accompanying text.

36 It was necessary to make two assumptions given the varying degrees of specificity in different companies' disclosures. First, where a company included one figure for goods *and* services provided to the company, this sum was allocated 50 per cent to goods and 50 per cent to services. Second, where a disclosure grouped two services together, the sum involved was allocated 50 per cent to one service and 50 per cent to the other.

Fifty-nine (64 per cent) of the sample companies disclosed at least one director-related transaction. The total number of disclosed transactions, 262, represents an average of 2.85 disclosures per sample company. The 262 total disclosures comprised:

- 145 transactions involving a director (or directors or director-related entities) of the ASX-listed company;
- 115 transactions involving a director (or directors or director-related entities) of a subsidiary of the ASX-listed company; and
- two transactions involving a director (or directors or director-related entities) of a related entity of the ASX-listed company.

[INSERT TABLE 1]

The most common category of transactions was services provided to a group company by a director or director-related entity. These transactions accounted for 137 (52 per cent) of the 262 total disclosed transactions. The next-most-common category of transactions was goods/property provided by a group company to a director or director-related entity – comprising 26 (10 per cent) of the 262 total disclosed transactions. However, as Table 1 shows, in terms of the total value involved, services provided to a group company by a director or director-related entity ranked only 5th out of the 12 categories: A$158.9 million (16 per cent) of the total value of all related party transactions covered by the study (A$1,007 million). Using this criterion, the top category was goods/property provided to a group company by a director or director-related entity – accounting for A$199.8 million (20 per cent) of the total; followed by goods/property provided by a group company to a director or director-related entity – accounting for A$190.5 million (19 per cent) of the total.[37]

[INSERT TABLE 2]

In Table 2, the information gathered in the study is grouped according to the industry classification of the sample companies. In all industries other than Miscellaneous Industrials, there were some disclosed related party transactions involving a group company paying for goods or services, etc, provided by a director or director-related entity. The industries having the largest average transactions of this nature were Infrastructure & Utilities (A$23.3 million), Media (A$12.3 million) and Retail (A$6.8 million). Six of the 23 industries had no disclosures involving a director or director-related entity paying for goods or services, etc, provided by a group company. The industries with the largest average transactions of this kind were Diversified Resources (A$23.5 million), Energy (A$23.2 million) and Paper and Packaging (A$18.5 million).

[INSERT TABLE 3]

Given that over half of all disclosed transactions involved services being provided to a group company by a director or director-related entity, it was considered useful to further classify these transactions. Table 3 shows that legal services were the most commonly disclosed service provided by director-related parties – accounting for 50 (36 per cent) of the 137

37 The categories ranked 3rd and 4th ("Unallocated payments" and "Unallocated receipts") reflect the inadequate disclosure provided by one sample company. The company disclosed that it had "conducted business in the nature of goods and services provided, rental of properties, and computer services with the following related entities". It then included a table showing the related parties' names and the total sum for each related party – but without any description of the transaction(s) each particular related party had

disclosed transactions of this type. Legal services was followed by management services (20 disclosures; 15 per cent of the total) and consulting services (17 disclosures; 12 per cent of the total). However, in terms of the average sum involved per transaction, legal services (A$0.41 million), management services (A$0.66 million) and consulting services (A$0.30 million) trailed – among others – mining-related services (A$1.65 million) and advertising (A$1.54 million).

V. CONCLUSION

Different countries deal with the issue of directors' conflicts in different ways. However, a recurring theme is the desirability of adequate disclosure. In Australia's case, disclosure requirements underpin each of the three levels of the legal framework for regulating directors' conflicts (summarised in Section III of this chapter). In relation to listed Australian companies, there are detailed disclosure rules contained in Accounting Standard AASB 1017. Section IV of the chapter provided a one-year snapshot of disclosures under AASB 1017, for the purpose of giving an insight into the types of matters which potentially involve directors' conflicts.

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entered with the company. The total sum involved was notionally allocated 50 per cent to transactions involving payment *by* the company and 50 per cent to transactions involving payment *to* the company.

Table 1 Related party transactions by type

Type of transaction (and number)	$ paid by company to related party			$ received by company from related party		
	Total ($A)	Average ($A)	Median ($A)	Total ($A)	Average ($A)	Median ($A)
Services provided to company (137)	158,862,894	1,159,583	163,395			
Services provided by company (9)				28,308,636	3,145,404	501,000
Goods/property provided to company (24)	199,841,036	8,326,710	873,965			
Goods/property provided by company (26)				190,525,490	7,327,903	1,030,364
Property leased to company (18)	69,345,749	3,852,542	484,341			
Property leased by company (6)				3,743,091	623,849	335,457
Interest paid: loan from RP (5)	14,961,655	2,992,331	140,000			
Interest received: loan to RP (7)				3,767,070	538,153	339,000
Miscellaneous payments (6)	3,601,437	600,240	318,000			
Miscellaneous receipts (2)				13,550,000	6,775,000	6,775,000
Unallocated payments (11)	160,274,000	14,570,364	1,373,000			
Unallocated receipts (11)				160,274,000	14,570,364	1,373,000
Total payments (201)	606,886,771	3,019,337	252,000			
Total receipts (61)				400,168,287	6,560,136	669,112

Table 2 Related party transactions by industry

INDUSTRY	$ PAID BY COMPANY TO RELATED PARTY			$ RECEIVED BY COMPANY FROM RELATED PARTY		
	TOTAL	AVERAGE	MEDIAN	TOTAL	AVERAGE	MEDIAN
Alcohol & Tobacco	19,325,000	2,760,714	3,194,000	795,000	397,500	397,500
Banking & Finance	24,418,497	1,744,178	290,084	7,594,299	3,797,150	3,797,150
Building Materials	18,357,899	1,079,876	152,508	1,486,796	371,699	148,288
Chemicals	532,000	66,500	61,500	176,000	88,000	88,000
Developers & Contractors	726,549	181,637	208,619	2,303,745	1,151,873	1,151,873
Diversified Industrials	19,828,500	1,982,850	872,000	6,501,000	1,625,250	1,551,500
Diversified Resources	13,355,106	1,214,101	119,775	70,432,000	23,477,333	17,968,000
Energy	867,086	173,417	106,000	46,423,000	23,211,500	23,211,500
Engineering	2,635,529	658,882	129,765	-		
Food & Household	4,321,911	360,159	174,548	2,863,457	1,431,729	1,431,729
Gold	1,715,514	171,551	32,926	-		
Healthcare & Biotechnology	1,224,697	174,957	136,000	5,744,612	2,872,306	2,872,306
Infrastructure & Utilities	163,168,000	23,309,714	414,000	-		
Insurance	3,838,061	639,677	309,980	680,871	340,436	340,436
Investment & Financial Services	10,165,000	1,694,167	225,500	1,476,383	246,064	237,192
Media	160,349,858	12,334,604	1,147,000	161,592,666	10,772,844	1,147,000
Miscellaneous Industrials	-			-		
Other Metals	8,654,618	480,812	130,182	5,635,577	2,817,789	2,817,789
Paper & Packaging	13,504,000	3,376,000	2,327,500	37,074,000	18,537,000	18,537,000
Property Trust	2,736,385	1,368,193	1,368,193	2,108,638	2,108,638	2,108,638
Retail	128,854,505	6,781,816	643,071	47,280,243	5,910,030	1,243,417
Tourism & Leisure	5,994,056	666,006	585,455	-		
Transport	2,314,000	289,250	310,500	-		

Table 3 Commonly provided services

Type of service	Number of transactions	Total amount spent ($A)	Average (mean) amount spent per transaction ($A)	Median amount spent per transaction ($A)
Legal	50	20,347,891	406,958	101,925
Management	20	13,197,349	659,867	211,750
Consulting	17	5,132,894	301,935	150,000
Finance*	13	6,771,501	520,885	252,000
Accounting	7	3,225,576	460,797	75,000
Mining-related	4	6,611,475	1,652,869	1,937,238
Advertising**	3	4,614,919	1,538,306	252,000
Insurance***	3	2,211,159	737,053	130,159
Other****	20	96,750,130	4,837,507	392,486
Total	137	158,862,894	1,159,583	163,395

* “Finance” includes investment banking, corporate advisory and stockbroking.
** “Advertising” includes advertising, marketing and market research.
*** “Insurance” includes insurance and insurance-broking services.
**** The bulk (A$80,850,000) of the “Other” figure is one transaction, involving construction services.

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