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Related-Party Deals Raise Red Flags

Loblaw Lease Latest in Succession of Agreements Causing Investor Concern

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By Jacquie McNish and Janet McFarland

When Loblaw Cos. Ltd. struck a deal last August to lease a crumbling art-deco warehouse near Toronto's waterfront for a future grocery store, the contract was unremarkable except for one detail.

Collecting the rent is Wittington Properties Ltd. a private real estate company owned by the family of Loblaw's chairman Galen Weston, who also happens to be Loblaw's controlling shareholder.

Loblaw hasn't told its shareholders that rent money will flow to the Weston family. Nor has it revealed that other Loblaw's stores lease property from the Weston's private company.

Company spokesman Geoff Wilson declined to discuss details of the family's real estate deals because he said the agreements account for only a tiny fraction of Loblaw's business. But he defended the transactions as financially beneficial to shareholders.

These transactions would not have set off alarm bells a few years ago, but in the wake of outrageously lucrative executive side deals at Enron Corp., Adelphia Communications Corp., Hollinger International Inc. and Royal Group Technologies Ltd., investors, directors and auditors are increasingly calling for a halt to these so-called related-party transactions.

"When it comes to Loblaw, there is absolutely no need for there to be a transaction between the family real estate company and the [grocery] company," said Alan Radlo, a portfolio manager with Boston-based fund giant Fidelity Management & Research Co., which holds shares in the grocery store company.

Although side deals between public companies and their officers and directors are legal and, in some cases, financially beneficial, critics warn that the cozy deals leave public companies exposed to potential abuse by executives and officers who may seek to enrich themselves to the detriment of shareholders.

The risks and the growing stigma associated with related-party deals, they say, simply outweigh any potential economic benefit.

"Transactions with directors, officers and their companies are just fraught with so much potential for problems that I believe they should be avoided at all costs.

"Active shareholders and boards are becoming much more skeptical and leery about these transactions," said Charles Elson, a member of three U.S. corporate boards and head of the Weinberg Center for Corporate Governance at the University of Delaware business school.

It is difficult to be precise about how many public companies pay their officers and directors for goods and services, because not all firms publicize related-party deals. The number of companies that do disclose deals with related parties is remarkably high. Earlier this month, New York research firm RateFinancials Inc. offered a stunning insight into the pervasiveness of the controversial practice when it surveyed the public regulatory filings of the United States' biggest public companies.

The study found that 40 per cent of the 500 companies that make up a Standard & Poor's index reported business arrangements with people or companies linked to their officers and directors.

"We were very surprised by the high number," said RateFinancials president Victor Germack. "You would think that these companies would want to avoid the appearance of impropriety that can be associated with related-party deals."

No such studies are available in Canada, but investors, lawyers and directors say they believe the practice is widespread in Canada. "You would be surprised at the volume of related-party transactions," said Edward Waitzer, chairman of Toronto law firm Stikeman Elliott and a former chairman of the Ontario Securities Commission.

A random look at Canadian corporate filings reveals that a variety of companies in all sizes and industries pay their executives, their family members or companies for the lease or purchase of such things as land, office space, cars, airplanes and office equipment.

While such transactions are legal, Mr. Waitzer said he pays much closer attention to those companies that approve them. "If it's going on it heightens my sensitivity to a bunch of issues about the motivations, responsibility and sense of entitlement by executives."

The latest scandal to give related-party deals a bad name emerged last month at Royal Group Technologies, when it revealed that a private company owned by chairman Vic De Zen and others had pocketed a $6.5-million profit after flipping a parcel of land in 1998 to the plastic window and door manufacturer. Mr. De Zen and two other executives were fired and the company's red-faced directors had to explain to investors why they didn't know about the six-year-old sweetheart deal until it was uncovered by a forensic investigator.

Scores of publicly traded Canadian companies have responded to investor pressure for more information about the controversial transactions by disclosing in recent years more information about their deals with people or companies related to directors and officers. In many cases, however, the details are so threadbare that it is difficult to gauge whether shareholders benefited from the deals.

Fidelity's Mr. Radlo says it "troubles" him that companies are not more open about arrangements with insiders, and although he often asks questions about the deals, he is not always satisfied with the answers. "You try to ask questions and sometimes you get what turns out to be false answers. We still have further to go in disclosure."

Complicating matters, some investors, directors and analysts complain that assessments of related deals are often based on such subjective valuations that it can be difficult to accurately gauge the worth of land, goods and services sold by executives to their companies.

"Valuations can be a mug's game. Many directors feel uncomfortable with related-party transactions because they involve judgment calls. In many cases it's best not to do it," said Jack Mintz, president of the C.D. Howe Institute and a director of two Canadian companies.

Mr. Mintz should know. He was appointed a director and chairman of the audit committee of CHC Helicopter Corp.'s board this fall, as the company steered away from its long history of side deals with its founder and chairman Craig Dobbin. CHC has paid millions of dollars in recent years to companies controlled by Mr. Dobbin, his brother and a son for office rent, hangar construction and helicopter repairs and loans.

The family deals are being phased out, Mr. Mintz said, because Mr. Dobbin and the company's new slate of independent directors understand that investors are increasingly intolerant of related-party transactions.

"CHC recognized that higher standards had to be adopted," Mr. Mintz said.

The Vancouver-based helicopter firm is only one of many Canadian companies that engage in deals along executive blood lines. Auto parts maker Magna International Inc. has spent more than $15-million since 1997 buying property and even a life insurance policy from chairman Frank Stronach or his companies. Executive search firm Caldwell Partners International Inc. has a long-term contract to pay millions of dollars in rent for an office owned by chief executive officer Douglas Caldwell. Biovail Corp. paid $10.5-million in 2001 to buy a jet from a company owned by its chairman Eugene Melnyk.

At Coolbrands International Inc., three executives earn extra money with a side deal that gives a company they own the right to distribute the frozen desert makers' products in three U.S. states. Toronto financier Rai Sahi presides over a stable of public companies including Morguard Corp. and Tri-White Corp., which frequently buy shares or assets, pay fees, lease real estate and cars and lend money to companies he owns.

Many of the controversial recent related-party transactions have involved CEOs who were founders and controlling shareholders of their companies. These executives tend to be insatiable deal makers with holdings in a variety of investments, such as real estate, apart from their core corporation.

CHC Helicopter Corp. founder Craig Dobbin, for example, is the largest private landowner in Newfoundland. In the past, CHC has had a rental agreement with Mr. Dobbin to use a property he owns for customer events, meetings and social functions. The company paid Mr. Dobbin $561,000 for using the property in fiscal 2004, ended April 30. The rental deal was terminated in June this year.

The company also paid millions of dollars for the services of Vector Aerospace Corp., an aviation repair company run until last year by Mr. Dobbin's son, Mark. CHC has also paid more than $5-million to a company owned by Mr. Dobbin's brother, Derm, as the general contractor for the construction of a new hangar at the Vancouver airport. Most of that money was passed along to other construction companies.

While CHC says it is reducing its reliance on related-party deals, many other companies involved in such deals still argue they benefit significantly from their CEOs' other business interests.

Executive search firm Caldwell Partners, for example, says shareholders get a good deal because the company leases its head office space from Mr. Caldwell. He owns the company's office building in Toronto's tony Yorkville neighbourhood, and also owned the office building the firm previously leased for its headquarters a few blocks away. In 2003, the company paid Mr. Caldwell $418,339 in rent.

Caldwell spokesman Richard Wertheim said the current lease deal was approved by the company's board as a whole, and was supported by an independent real estate valuation that said the rent level was "at or below" market rates.

At Loblaw, the company argues it benefits from access to Mr. Weston's extensive real estate portfolio. His father, Garfield Weston, began shrewdly acquiring land decades ago in anticipation of future development opportunities, and for many years Loblaw locations have been located on Wittington sites. The Toronto head office for Loblaw and parent company George Weston Ltd. is also leased from Wittington, and rent payments totalled about $2-million in 2003.

Mr. Wilson said his company's planned new store in the empty heritage building at the corner of Lake Shore Blvd. and Bathurst Street in central Toronto is an excellent example of the benefits Loblaw derives from its affiliation with Wittington.

"Loblaw believed it was a good site for a future location, and Wittington controlled the property," he said. "Isn't it a win-win? Wittington gets a market valuation and lease, and Loblaw gets a site that's going to be a wonderful food store."

Jim Fisher, a professor at University of Toronto's Rotman School of Business and a director on two boards, says a related-party transaction must be a uniquely beneficial deal to win directors' approval, otherwise it isn't worth the criticism.

"I've got to do what's right for the company. I think that is, in the end, what your bottom line is going to be."

This can be a difficult judgment call, however, when CEOs have an unobstructed opportunity to carry out their private deals and directors lack adequate information. Many related-party deals involve a CEO who is also a company's controlling shareholder, making it easier to appoint a compliant board of directors to rubberstamp deals with little or no review.

The controversial land swap that enriched executives at Royal Group Technologies was not presented to the company's board because company policy requires that directors only approve deals worth more than $60-million. Such policies are no longer acceptable, critics say, if companies want to protect the interests of all shareholders.

"Any transaction at all where there is a conflict of interest should be divulged by management to an independent committee of the board," says David Beatty, who is a director on the boards of Bank of Montreal, GoldCorp Inc., Inmet Mining Corp., FirstService Corp. and Husky Injection Molding Systems Ltd.

Moreover, he said companies should describe the processes they use to review such deals, to give shareholders confidence that conflicts are being carefully managed by independent directors.

Securities lawyer and governance expert Carol Hansell says trouble arises when a deal is small by the standards of a huge public company, but is meaningful for the executive involved.

"The problem you run into from a disclosure perspective is that it may be very important to a person who is making decisions in management, but it doesn't hit the corporation's materiality threshold, so there's no disclosure requirement," she said.

Many corporate advisers are now counselling going well beyond mandatory rules, saying expectations have shifted. Canada's accounting overseer, the Canadian Institute of Chartered Accountants (CICA), recently issued a risk alert to auditors, stressing that investors today want more than the required minimum disclosure about related-party deals.

Greg Shields, Canada's director of auditing and assurance standards at the CICA, said the alert was intended to remind auditors that related-party transactions have often been a source of major frauds. Investors, he added, need a "very accurate and complete picture" of the deals so they can assess their appropriateness.

"I think it's fair to say that lots of companies really don't have the controls and governance structures in place to really get a good handle on related-party transactions," he said in an interview.

Crony Capitalism

Magna: A unit of auto parts maker Magna International spent more than $11-million (U.S.) to buy 200 acres of land in Aurora, Ont., in 2000 from the family of Frank Stronach, the company's chairman and founder. The Magna unit is currently building a gated community called Adena Meadows, pictured in the top photo of the two above, which features mansion-sized homes surrounding a golf course.

CHC Helicopter: CHC paid a construction company owned by Derm Dobbin, the brother of CHC's chairman and founder, more than $5-million (Canadian) to oversee the construction of a new hangar and head office at Vancouver airport this summer. Most of the money was passed on to other construction companies and CHC paid Derm Dobbin's company a $500,000 fee for managing the building's construction.

Caldwell Partners: The executive search company paid company chairman and chief executive officer Douglas Caldwell $418,339 to rent office space in a Toronto building. The leasing contract calls for Caldwell to increase its rental payment every year, reaching an annual rent payment of more than $1-million in 2008.

Loblaw: The company signed a ground lease on Aug. 10, 2004, to open a new grocery store in a 77-year-old warehouse at the corner of Toronto's Bathurst Street and Lake Shore Boulevard, pictured at bottom. The owner of the property is Wittington Properties, a private real estate company owned by the family of Loblaw's chairman Galen Weston. Loblaw declined to discuss the financial terms of the lease or those of other Wittington properties leased to the grocery store chain