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## It's All About Relationships In Proxies' Fine Print

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Julia Childs accounting and jilted shareholders are two things Enron, Adelphia Communications, WorldCom and other poster children for corporate fraud have in common.

But there's another trait they share, a practice many investors overlook even though the evidence is readily available.

You'll find it in proxy statements companies send to shareholders in advance of annual meetings. Look for a section headlined "certain relationships and related transactions."

The disclosures detail business relationships between the company and its officers and directors. They include directors whose law firm represents the company, a partnership involving officers and/ or directors that leases real estate to the corporation, and relatives of officers and directors who are on the payroll. The disclosures frequently are accompanied by statements that the arrangements are comparable to what the company would have paid if it did business with someone else.

Nearly 40 percent of the companies in the Standard & Poor's 500 disclose these relationships in their proxies, according to RateFinancials, a New York risk research firm that assesses corporate reporting based on their filings with the Securities and Exchange Commission. Victor Germack, founder of the firm, says related-party transactions aren't necessarily illegal but raise doubts about potential conflicts of interest.

"Most of the arrangements were almost always avoidable and therefore appear to raise legitimate questions about whether company insiders are putting their own interests ahead of shareholders," he said.

Here's some of what Rate-Financials found. When The Gap builds stores, its general contractors include a firm owned by the chairman's brother. Tampa, Fla., utility Teco Energy pays more than $1 million annually to the law firm of one of its directors. And Best Buy leases two stores from its chairman at an annual cost of $950,000.

Western Pennsylvania firms aren't strangers to the practice.

American Eagle Outfitters leases its headquarters and distribution center from Linmar Realty, which is owned by Schottenstein Stores Corp. Schottenstein is owned by members of the Schottenstein, Deshe and Diamond families, who own about 25 percent of American Eagle's shares. According to the Marshall retailer's latest proxy, the lease expires at the end of 2020 and Linmar currently is paid about $2.4 million annually.

American Eagle also has paid Schottenstein for using corporate aircraft and for providing legal, real estate, travel and insurance services.

Education Management, the parent of the Art Institute of Pittsburgh, leases buildings in Philadelphia and Fort Lauderdale, Fla., from partnerships whose members include Chairman Robert Knutson and director emeritus Albert Greenstone.

The partnerships receive about $3.9 million in rental income annually, according to the company's proxy.

Moreover, the wife of President and Chief Operating Officer J. William Brooks is an admissions specialist with the company and was paid $142,797 during the most recent fiscal year. “Ms. Brooks does not report to Mr. Brooks and he is not responsible for determining her annual compensation or bonus,” the proxy states.

Dick's Sporting Goods paid $240,000 last year to the estate of founder Richard Stack, the father of Chairman and CEO Edward Stack. The company's most recent proxy also disclosed a $325,000 balance on a loan Richard Stack made to the company in 1986. The loan carries an interest rate of 12 percent, more than the prosperous retailer would be charged if it took out a loan today but “consistent with the terms we would have received from an unaffiliated third party” at the time the loan was made, the proxy states.

Mylan Laboratories paid Coury Investment Advisors, owned by two brothers of CEO Robert J. Coury, $100,000 during its most recent fiscal year for investment advisory services. Two of Coury's brothers are principals in Coury Financial Group, which received nothing for brokering dental insurance for Mylan employees.

The relationships have caught the eye of billionaire investor Carl Icahn, who's waging a proxy fight with the generic drug maker over its plans to acquire King Pharmaceuticals.

Icahn's motives are obvious, but it's often not clear how significant such relationships are until it's too late. They didn't bother shareholders of Enron and other fraudulent companies until their high-flying stocks collapsed.

While corporate scandals of recent years have raised awareness of the transactions, many professional investors continue to discount their importance. To them, investment returns are the ultimate measure and as long as the transactions don't crimp returns investors overlook them.

Although Mylan and Education Management significantly underperformed the S&P 500 and Dow Jones industrial average over the 12 months ended Nov. 30, Dick's and American Eagle outperformed them. All four companies outperformed the two indexes for the three- and five-year periods ended Nov. 30.

The bottom line: Be mindful of the business companies do with officers and directors, but remember it's only one factor to consider when you do your smell test. And as always, be careful out there.