RELATED PARTY TRANSACTIONS AND CORPORATE GOVERNANCE

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ABSTRACT

Transactions between a firm and its own managers, directors, principal owners or affiliates are known as related party transactions. Such transactions, which are diverse and often complex, represent a corporate governance challenge. This paper initiates research in finance on related party transactions, which have implications for agency literature. We first explore two alternative perspectives of related party transactions: the view that such transactions are conflicts of interest *which compromise management's agency responsibility to shareholders as well as directors' monitoring functions; and the view that such transactions are* efficient transactions *that fulfill rational economic demands of a firm such as the need for service providers with in-depth firm-specific knowledge. We describe related party transactions for a sample of 112 publicly-traded companies, including the types of transactions and parties involved. This paper provides a starting point in related party transactions research.*

1. INTRODUCTION

Recent corporate scandals have heightened concern about U.S. corporate governance. One of the recurring areas of concern among these corporate scandals is related party transactions. These transactions are diverse, often complex business transactions between a firm and its own managers, directors, principal owners

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or affiliates.[1] As commonly viewed by regulators, market participants, and other corporate stakeholders, related party transactions represent potential conflicts of interest that can compromise management's agency responsibility to shareholders or a board of director's monitoring function. The recent Sarbanes-Oxley Law limits the types of related party transactions in which companies can engage.[2] Regulators, overseers, and standard setters are also considering even more rigorous standards or rules limiting and prohibiting related party transactions:

> . . . it is important to have specific standards or rules (in effect, internal regulation) to prohibit behavior that creates the most serious risk to shareholders, such as *related party transactions* [emphasis added]. Certain basic principles, such as the need to prevent conflicts of interest, need to be embodied in internal rules that then must control the relationship of officers and directors to their company at all times. These fundamental limits should not be waivable. In other cases more general standards or guidelines will need to be used to provide more flexibility and to allow for case by case decisions.
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> "RESTORING TRUST" Report to The Hon. Jed S. Rakoff, The United States District Court for the Southern District of New York, On Corporate Governance for the Future of MCI, Corporate Monitor, August 2003, Richard C. Breeden, From the SEC website (www.sec.gov).

Investors and market observers are concerned that transactions with related parties are harmful to company shareholders:

> These are the kinds of relationships that companies should avoid, in the view of some corporate-governance experts and investors. Such related-party transactions raise questions about whether corporate insiders are fully focused on the interests of shareholders, experts say. The deals, no matter how small, can create the impression that an insider is using company assets for personal benefit, and that the company is getting the short end of the stick.
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> "Even Good Insider Deals Raise Doubts."
> *Wall Street Journal*, May 7, 2003. p. B6.

In addition to investors and market participants, other stakeholders such as employees and labor unions are calling into question the propriety of such transactions:

> A union representing janitors is taking a broom to a corner of the corporate-disclosure world known as related-party transactions. The Service Employees International Union is asking stockholders of Equity Office Properties Trust, a big Chicago-based real estate investment trust, to approve a measure at the coming May 20 annual meeting that would require greater disclosure of such transactions, which involve business dealings between a company and its own officers and directors or their families . . . Union officials, for example, point to Equity Office's report of a transaction last year in which an entity connected to its chairman, Samuel Zell, redeemed certain securities for about $29 million. The union argues that the company's disclosure doesn't provide enough information to determine whether the transaction was in Equity Office's best interest.
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> "Equity Office Faces Move on Related-Party Deals"
> *Wall Street Journal*, May 14, 2003. p. C13.

Despite this interest in related party transactions, there is limited academic research to understand the nature of related party transactions and their economic consequences. In this paper, we offer two main contributions to enhance our understanding of these types of transactions. We first explore the role of related party transactions in the context of the firm's corporate governance environment. Second, we comprehensively describe related party transactions for a large sample of companies. One view, consistent with portrayals in the business press, is that related party transactions are conflicts of interest and encompass agency issues of the type considered by Berle and Means (1932) and Jensen and Meckling (1976). An alternative view is that related party transactions are efficient transactions that rationally fulfill other economic demands of a company such as securing in-depth skills and expertise between participants with private information or providing an alternative form of compensation. These contrasting views offer very different implications of the potential costs and benefits of transacting with related parties.

We also describe in detail related party transactions for a sample of 112 publicly-traded companies in fiscal years 2000 and 2001. We present evidence on the number of, the parties involved with, and the types of transactions for our sample companies. Of the several interesting characteristics we document, we find that companies disclose two related party transactions (at the median) but the number ranges from 0 to 23. We were surprised to find that only 19% of companies report none, while approximately 10% report 10 or more. Approximately 47% of all disclosed transactions are with executives and 47% with non-executive board members, highlighting the need for understanding differing economic implications of transactions with executives versus non-executives board members. Loans to related parties for reasons other than home or stock purchases are reported by the greatest number of companies, with about 25% disclosing at least one. However, real estate transactions are the largest group representing about 14% of all transactions. Loans *from* related parties are the greatest dollar amount of all transactions with a mean (median) of \$38 million (\$6 million).

This paper provides a starting point in comprehensively examining the role of related party transactions in corporate governance. Through describing and discussing the role of related party transactions, we identify issues and raise questions to be further explored. For instance, one question is whether corporate governance mechanisms such CEO compensation, board composition, or large shareholder ownership concentration mitigate the extent of agency problems and/or enhance monitoring in companies with related party transactions (Gordon et al., 2004). Another question is the impact of related party transactions on firm performance. Other avenues for investigation could determine whether the presence of related party transactions is associated with properties of financial reports or introduces incentives for earnings management (Bushman & Smith, 2001; Gordon & Henry, 2003; Sherman & Young, 2001). With our discussion and description of related party transactions, we hope to stimulate interest and research to be useful to company executives, boards of directors, standard setters, legislators, financial statement users and others.

The remainder of the paper proceeds as follows: We describe alternative views of related party transactions and their implications for corporate governance in Section 2. We summarize reporting requirements for related party transactions in Section 3. We describe our sample creation and data collection procedures in Section 4. In Section 5, we present an extensive discussion and descriptive analyses of the related party transactions data. We offer conclusions and extensions in Section 6.

2. TWO ALTERNATIVE VIEWS OF RELATED PARTY TRANSACTIONS AND THEIR IMPLICATIONS FOR CORPORATE GOVERNANCE

Although commonly viewed as conflicts of interest between firm managers/board members and their shareholders, there are two alternative views of related party transactions that are consistent with economic theory. Under the *conflict of interest view*, related party transactions compromise management's agency responsibility to shareholders or a board of director's monitoring function. An alternative perspective, which we refer to as the *efficient transactions view*, is related party transactions fulfill underlying economic needs of the company between parties who have built up trust and shared private information. The conflict of interest view portrays related party transactions as potentially harmful to the interests of the shareholders. On the other hand, the efficient transactions view maintains that related party transactions do not harm, and perhaps even benefit, shareholders.

The potential conflict of interest and impropriety of these related party transactions is demonstrated in highly publicized corporate scandals including Enron, Adelphia, and Tyco as highlighted in excerpts from the business press below:

> Enron told the world that these [dozens of off balance sheet] partnerships allowed it to hedge against fluctuations in the value of its investments. Well, hedge, schmedge. It was the disclosure, in October, that $1.2 billion of its market value had disappeared as result of these "related party" transactions with private partnerships that signaled the beginning of the end. Two weeks later, these partnerships caused Enron to slash its reported earnings since 1997 by almost $600 million. A week later, those pesky side deals caused Enron to reveal that it was out another $700 million. Investor trust understandably collapsed, and, presto, Chapter 11.
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> "What Was Enron?" Editorial,
> *Wall Street Journal*, December 12, 2001. p. A18.

> Warning that corporate crimes will result in “handcuffs and a jail cell,” federal authorities arrested the founder of Adelphia Communications and two sons Wednesday on charges they looted the now-bankrupt cable giant and used it as their “personal piggy bank.”
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> “Government Arrests Founder of Adelphia, Two Sons.” Associated Press Newswires, July 25, 2002.

> From 1997 to 2002, the SEC said Mr. Kozlowski improperly borrowed $242 million from a Tyco program intended to help executives pay taxes on restricted-stock grants. Instead of using the funds for that purpose, Mr. Kozlowski spent the money on yachts, fine art, estate jewelry and luxury apartments. Mr. Swartz similarly used $72 million in loans from the program for personal investments and business ventures, the SEC said.
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> “Former Tyco Executives Are Charged – New York Prosecutors Say Ex-CEO, Finance Officer Ran ‘Criminal Enterprise.’ ”
> *Wall Street Journal*, September 13, 2002.

There are, as well, less widely publicized incidents. For example, a shareholder lawsuit filed in September, 2003, accuses Reckson Associates Realty Corp.’s top executives of self-dealing in agreeing to sell Reckson’s industrial portfolio to the founding Rechler family. The suit, which also names each of the company’s outside board members, alleged that the independent directors who reviewed the plan “are so entangled with the Rechler family that their review is rendered meaningless” (Alan J. Wax, September 30, 2003; Bloomberg News).

While recent scandals perhaps highlight extreme examples of potential abuses of transactions with executives and board members, the view that related party transactions represent a conflict of interest is consistent with agency issues of the type considered by Berle and Means (1932) and Jensen and Meckling (1976). Jensen and Meckling (1976, p. 90) characterize the agency conflict between a manager and outside shareholders as the manager’s tendency to appropriate the firm’s resources for personal consumption, similar to perquisites. As such, they represent the potential for the appropriation of the firm’s resources.

To control potential agency costs, companies can increase scrutiny of these transactions, therefore incurring additional monitoring costs relative to transactions with unrelated third parties. Companies do not consistently disclose whether or how they monitor related party transactions. Some firms have stated policies that related party transactions must be approved by independent members of the board’s audit committee or corporate governance committee. For instance, in its December 31, 2001 10-K, Digital Lightwave discloses that “in accordance with the Company’s policy on related party transactions, the loan was approved by the independent members of the Audit Committee of the Board of Directors.” Executives and non-executive board members can also recuse themselves from decisions pertaining to a transaction in which they are considered a related party. Additional layers of approval or recussal, though clearly justified from a governance perspective, are diversions of managerial resources from other potentially more productive uses and as such are an economic cost to the firm.

The issue of monitoring becomes even more critical when non-executive directors engage in related party transactions. Fama (1980) and Fama and Jensen (1983) assert that the optimal board composition should include both inside (executive) and outside (non-executive) board members. The inside board members bring in-depth knowledge and outside members bring independence and monitoring skills. So related party transactions with non-executive directors not only potentially represent the appropriation of the firm's resources, but they also can conflict with and diminish the outside directors monitoring function. Bushman et al. (2004) also consider the industry-specific expertise of the outside director as beneficial to the firm and its board. However, they do not explore the implications of engaging a non-executive director to perform services contractually separate from the directorship, or to provide goods to the firm.

In contrast to the view of related party transactions as conflicts of interest, an alternative view is that related party transactions are efficient transactions that rationally fulfill economic demands of a company such as securing in-depth skills and expertise or providing an alternative form of compensation. For instance, say a non-executive director possesses an in-depth knowledge of firm-specific activities as well as an expertise that the company demands such as legal expertise. Then it could be more effective and more cost efficient for the company to engage the related party to provide the service than an outsider. Because the non-executive director possesses an in-depth knowledge of the firm, information asymmetries are reduced and contracting enhanced. Not only is the company obtaining needed services, but engaging the director to provide the services can solidify the director's economic bond to the company and escalate the director's commitment. Another example of the efficiency of related party transactions is offering a home loan to a new employee as part of a relocation or employment package. Instead of spending time and efforts to apply for a loan, a new executive can begin to lead the company. Finally, there may also be situations when working with parties whom an executive knows and trusts (such as family members or family-owned enterprises) enables that executive to perform more effectively and enthusiastically, perhaps also enhancing shareholder value.

Even though the presumption by regulators and standard setters is that related party transactions are not carried out on an arm's length basis and some may not have occurred or may have occurred on different terms with an unrelated party (Statement of Financial Accounting Standards No. 57, paragraph 13), many companies disclose that their contracts with related parties have been made on terms at least as favorable as with unrelated parties. Therefore, under the efficient transactions view, a firm engaging in related party transactions would incur no conflicts of interest and no increased agency or monitoring costs. Indeed, monitoring *benefits* could arise from greater trust in dealing with family members or longer-term relationships. If a firm undertakes related party transactions which enhance – or at least do not harm – the economic interests of the shareholders, there should be no negative impact on the firm other than the increased costs of reporting complexity.

Consistent with the view that related party transactions do not harm the interests of shareholders, arguments also have been made that the amount of the transactions is small to the related parties and not material to companies. Therefore, even if some agency conflict potentially exists, it is of little concern. Despite these arguments, related party transactions are being questioned even at companies that have not been the subject of intense investigation, as noted in a recent Wall Street Journal article:

> The dollar amounts of related-party transactions may be small, but "each of these little things is a piece of mosaic and pretty soon they form a picture," said Julie Fox Gorte, director of social research at Calvert. At Oracle, that picture is a company where the values of shareholders and executives aren't aligned, she said.
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> Other investors aren't alarmed by the transactions because they are publicly disclosed, and the amount of money involved is relatively small, said Bhasin, the hedge fund analyst. But most would prefer to see the practice end because of the risk that bad publicity over the deals could hurt a company's stock price.
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> "Even Good Insider Deals Raise Doubts."
> *Wall Street Journal*, May 7, 2003. p. B6.

The two alternative views have significantly different implications for corporate governance. Under the conflict of interest view, corporate governance mechanisms such as those explored by the agency literature will be less effective in reducing the extent of related party transactions. As a consequence, we would expect to find little relationship between the extent of a firm's related party transactions and governance mechanisms such as CEO compensation, large shareholder ownership, board size and composition, and firm leverage. Under the efficient transactions view, corporate governance mechanisms as mentioned above either would be positively related to these transactions (if such mechanisms contribute to efficiency), or would be unnecessary (and thus unassociated with related party transactions).

We know of no research that comprehensively describes or examines a firm's related party transactions. Research on board composition uses the presence of related party transactions to classify non-executive board members as "affiliated" or "grey" directors (Denis & Sarin, 1999; Klein 2002a, b; Vicknair et al., 1993; Weisbach, 1988). Affiliated directors typically are viewed as non-independent, outside directors. Under this definition, the existence of one related party transaction classifies a non-executive director as non-independent. This classification does not consider the magnitude or type(s) of involvement, which could understate any potential conflicts of interest.

Additionally, limited research investigates related party transactions with executives. Shastri and Kahle (2003) focus on executive loans and find the ceteris paribus result that executive stock ownership increases following stock purchases and option exercise loans. This research, too, does not investigate other transactions with executives that could offer insights into the extent of the agency conflict between managers and owners. To summarize, current research does not address the complexity or diversity of related party transactions, important in understanding the economic implications of these transactions.

3. REPORTING REQUIREMENTS FOR RELATED PARTY TRANSACTIONS

Regulators and standard setters have primarily exercised oversight of related party transaction by requiring that they be disclosed, assuming that:

> information about transactions with related parties is useful to users of financial statements in attempting to compare an enterprise's results of operations and financial position with those of prior periods and with those of other enterprises. It helps them to detect and explain possible differences. Therefore, information about transactions with related parties that would make a difference in decision making should be disclosed so that users of the financial statements can evaluate their significance.
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> Statement of Financial Accounting Standards No. 57, paragraph 18.

By requiring disclosure rather than limiting certain transactions, regulators and standard setters have not taken a position on whether related party transactions are harmful or beneficial to the firm and its shareholders. In essence, such regulations leave open the possibility that the efficient transaction view of related party transactions holds. Yet, regulators and standard setters require that the information be made available to allow financial statement users to make their own judgments regarding whether the transactions are efficient or potential conflicts of interest.

Managers, then, make the choice to engage in related party transactions knowing that these transactions will have to be disclosed. Because of the required disclosure, they may avoid engaging in certain transactions that they believe would raise questions of a conflict or impropriety, even when the firm would benefit or at least not be harmed.[3]

There are several limitations of disclosure and disclosure requirements that impact what investors observe in corporate reports. One limitation of disclosure rules is that only transactions with named executives and board members must be disclosed. While these transactions perhaps present the greater potential for conflict of interest, related party transactions with upper management (but which are below the disclosure threshold) can also result in the potential appropriation of company resources. Another limitation is the $60,000 materiality threshold for disclosure. While we find cases of disclosures below the $60,000 threshold, there are perhaps other relations or transactions in lower amounts (either individually or cumulatively) that would be informative to financial statement users. Another shortcoming is that related parties are, perhaps by necessity, fairly narrowly defined. There are no doubt instances of other relationships, for example among board members, which do not fall strictly in the definition of related parties but are nonetheless obstacles to true board independence.[4] Family relationships are clearly definable as are interlocking board relationships which must be disclosed with respect to compensation committees; but while nepotism is unambiguous, cronyism is not. Beyond these limitations of disclosure requirements, problems can of course also arise when companies do not comply with standards to disclose related party transactions as with certain of Tyco's transactions or when they provide too limited disclosure as with certain transactions at Enron.

Recently, with the passage of the Sarbanes-Oxley Law, lawmakers have specifically prohibited certain related party transactions due to the perceived conflict of interest. Section 402 of Sarbanes-Oxley generally provides that it will be unlawful for an issuer to extend credit to any director or executive officer.[5] As we discuss further below, our sample shows that over 23% of all RPTs we identified are loans to related parties, with over 25% of companies reporting at least one. Given that loans possibly represent a form of compensation, this prohibition on executive loans may result in companies providing some alternative remuneration.

Below we discuss in more detail the definition of related parties and disclosure required by the two main sources of reporting regulations on related party transactions: FASB disclosure guidelines and SEC requirements.[6] FASB Statement No. 57, Related Party Disclosures, provides guidance for disclosure of transactions with related parties. The relevant SEC financial statement regulations are included in Regulation S-X, rules 4-08(k)(1) and (2), and the SEC non-financial statement disclosure requirements are presented in Regulation S-K (Reg. §229.404. Item 404). Each of these sources is summarized below.[7]

3.1. FASB Statement of Financial Accounting Standards No. 57, Related Party Disclosures

Related parties are defined to include three basic categories of individuals: board members, executives, and principal owners (owners of more than 10% of voting interests of the enterprise). In addition, the immediate family members of any of these categories of individuals, as well as any entities controlled by any of these categories of individuals, are also considered to be related parties. Related parties also include affiliates of the enterprise, where an affiliate is described as "a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise"; (para. 24) and, specifically, entities for which the enterprise uses the equity method to account for its investment. Examples include subsidiaries of the enterprise or of the enterprise's parent company, and trusts such as pension trusts managed by or under the trusteeship of the enterprise's management. Related parties are also defined by SFAS 57 to include "other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests" (para. 24).

Other than compensation and similar arrangements in the ordinary course of business, transactions with related parties must be disclosed in the financial statements. The disclosure must include the nature of the relationship, as well as the nature and value of the transaction.

3.2. SEC Regulation S-X. 4-08(k) Related Party Transactions, which Affect the Financial Statements

Rule (1) requires related party transactions and amounts to be identified on the financial statements. Rule (2) requires "in cases where separate financial statements are presented for the registrant, certain investees, or subsidiaries, separate disclosure shall be made in such statements of the amounts in the related consolidated financial statements which are: (a) eliminated; and (b) not eliminated. Also any intercompany profits or losses resulting from transactions with related parties and not eliminated and the effects thereof shall be disclosed."

3.3. SEC Regulation S-K (Reg. §229.404. Item 404) Non-Financial Statement Disclosure Requirements

SEC Regulation S-K requires disclosure of the following relationships and related transactions:

- Nature and Amount of transactions exceeding $60,000 with directors (existing and nominees), executives, owners of more than 5% voting interest, and immediate family members of any of the foregoing persons.

- Nature and Amount of certain business relationships with an entity owned or managed by a director (or nominee), including: sales to, purchases from, borrowings from, legal or investment banking services from the related entity.
- Indebtedness of a related party to the enterprise, including amounts owed by: any director or executive officer of the registrant, or their immediate families; any corporation or organization (other than the enterprise or a majority-owned subsidiary of the enterprise) which a director or executive owns more than 10% or serves as an executive officer or partner.
- Nature and amounts involved in transactions with Promoters.

4. SAMPLE CREATION AND DATA COLLECTION PROCEDURES

4.1. Sample Creation

Because we aim to assess related party transactions for a broad group of publicly-traded firms, we select our sample from the population of companies on COMPUSTAT. We stratify our sample by size (quintiles of market value) and industry to ensure comprehensive coverage. We define industries following Fama and French (1997). We restrict our sample to those companies with sales, income, market value and other key data in COMPUSTAT available for the 2000 fiscal year.[8] We examine two years of RPT disclosures, 2000 and 2001, selected because of increased scrutiny of company's financial reports and transactions in 2001 following the Enron debacle unfolding in 2000. We initially select 448 firms in 20 different industries, representing about 10% of the population of eligible firms. We limit this initial sample to 112 firms which have compensation data on EXECUCOMP.

4.2. Identification and Characterization of Related Party Transactions

We search (using a key word search supplemented by direct reading) a company's proxy statements and 10-Ks for related party disclosures. Related party transactions (RPTs) are most commonly found in proxy statements, often being incorporated by reference in the 10-K. RPTs are described in the 10-K under Item 13, "Certain Relationships and Related Transactions" as well as in the footnote(s) to the financial statement, which are often titled "Related Party Transactions." In the proxy, RPTs are usually described under "Certain Relationships and Related Transactions" or "Certain Company Transactions with Management" or "Certain Transactions."

Family relationships are noted in the biographical descriptions of board members and named executives, which are included in the proxy.

We characterize related party transactions along four main dimensions: the primary party involved, the secondary party involved (if any), the type of transaction, and the amount of the transaction, if disclosed. Parties involved are identified first by their relationship with the firm such as executives, non-executive board members, principal owners, subsidiaries or other. Because we are interested in potential conflicts of interest on the management side and impairment of the monitoring function on the board side, we track executives and non-executives separately and further categorize these groups. Within the executive group, we separate transactions with an executive chairman, executive board members and non-board executives. We track executive chairman as a separate group, motivated by Jensen's (1993) assertion that boards are less effective when the chief executive officer is also the chairman. Similarly, having a larger percentage of inside executives on board could impair monitoring. Within the non-executive group we separately identify non-executive board members and a non-executive chairman.

If transactions involve a family member of, or a company owned by or affiliated with, any of these related individuals, we identify both parties. The party having the most direct or most senior relationship with the firm is identified as the "primary related party."[9] The family member, or company owned by or affiliated with the primary related party, is the secondary related party. We group secondary related parties by executives, executive's business, non-executives, non-executive's business, principal owners, subsidiaries and other. When a transaction is directly between the company and the primary related party (e.g. loans), the secondary related party category is not applicable. The third dimension we identify is the type of transaction. We identify seven main types of transactions: direct service between related parties or the related party and the company, purchases of goods or contract services acquired from the related party, sales to the related party, loans to related parties, loans from related parties, investment and other. Within type, we report the different kinds of transactions disclosed by companies. Examples of direct service transactions are an executive chairman of the board hiring a relative in a non-executive position, a non-executive director being directly employed by a principal owner, or a relative of an executive serving on the board. Contracted services acquired from the related party include management services, legal services, marketing, real estate, accounting, investment banking, and other. We also include with contracted services the purchases of any goods from the related party. We classify loans into those to the related party for houses and stock purchases, where specified, or other, where another purpose is given or none is identified.[10] As previously mentioned, such loans to related parties are now prohibited under the Sarbannes-Oxley Law. Another class of loans we separately identify is loans from the related party such as arise, for example, from debt-financed purchases from the related party. The "other" category includes other types of transactions such as shareholder agreements and shared R&D. We do not include the existence of employment agreements or indemnification agreements, which some companies disclose as related party transactions, since these items are unambiguously compensation.

The final dimension we identify is the amount of related party transactions. For loans, investments and single transactions, we collect principal amounts; we code annual amounts where the transaction is ongoing or a multiple year involvement as a contracting service. We give examples of reported related party transactions disclosures and our classification in the Appendix.

4.3. Variable Definition – Related Party Transactions

Because related party transactions are diverse and often complex business transactions, we investigate different measures of a firm's related party transactions and their complexity. Unlike audit committee (or board) independence, where a logical measure is the number of independent directors scaled by the size of the committee (or board), a firm-specific scalar for related party transactions is less obvious because there is no limit on the number, types or people in which a firm can engage in a related party transaction. In an examination of determinants of related party transactions, Gordon et al. (2004) scale the number of RPTs by the total number of named executives. However, for the purposes of the current paper, our objective is to offer a thorough description of the transactions including their complexity; in gauging complexity, our objective is to capture the notion of the firm's "web" of related party transactions. Therefore, we first examine simple measures of a firm's related party transactions including the total number of different related party transactions and whether or not a firm has a related party transaction with a specific group of primary related parties, a specific group of secondary related parties, or a specific type of related party transaction and the amount, if available.

We next attempt to measure the overall complexity of a firm's related party transactions. We believe that more parties and more types of transactions indicate extensive and pervasive potential conflicts of interest and monitoring problems. To do this, we count the number of unique related parties and types of transactions. For example, say a firm has three different transactions, all with a single executive: (1) a relative is also employed by the firm; (2) the executive received a loan from the firm; and (3) the firm leases real estate from a trust owned by the executive. The number of primary related parties is one. The number of secondary related parties is two (the relative and the trust); since the loan is a direct transaction between the firm and the executive, there is no secondary related party. The number of different types of transactions is three. Each of these is a gauge of the complexity of transactions.[11]

5. DESCRIPTIVE ANALYSES OF RELATED PARTY TRANSACTIONS

Table 1 describes the industry composition of our sample by one-digit SIC codes, indicating substantial coverage of the various industries. Because we limit our sample to companies covered by EXECUCOMP, the mean (median) market value of sample firms is high at $11.1 billion ($1.5 billion). Table 1 also presents descriptive statistics on the number of related party transactions by industry. The variation in the median as well the maximum reported suggests industry effects in the number of related party transactions.

Table 2 presents descriptive statistics on summary related party transaction variables. The mean (median) number of related party transactions per company is 3.92 (2). To examine the complexity of transactions, we calculate the number of transactions per individual primary related party by company. The mean (median) number of transactions per individual primary related party is 3.29 (3). Another gauge of complexity is the number of different primary related party groups (i.e. executives, board members) engaged in transactions. On average (at the median),

Table 1. Sample Industry Composition and Summary of Related Party Transactions by Industry[a]

Industry	Number of Companies	Market Value (in $ Millions)		Related Party Transactions			
		Mean	Median	Mean	Median	Min	Max
1. Mining and construction	10	2,169	912	3.5	3	0	7
2–3. Manufacturing	51	10,547	1,833	2.7	2	0	19
4. Transportation & communication[b]	7	16,120	5,269	7.4	7	2	20
5. Wholesale and retail	25	5,374	846	5.6	4	0	20
7–8. Hotels and services	19	15,338	1,337	4.1	3	0	16
Total[c]	112	11,092	1,496				

[a] We define industries using one-digit SIC codes.
[b] We exclude public utilities from our sample.
[c] We collect data on related party transactions from 112 companies for fiscal years 2000 and 2001.

Table 2. Descriptive Statistics of Related Party Transaction Summary Variables.

Related Party Transaction (RPT) Summary Variables ($N = 224$)	Mean	Std. Dev.	Median
Overall			
Number of RPTs per company	3.920	4.310	2
Primary related parties			
Number of RPTs per individual primary related party	3.288	2.518	3
Number of different types of primary related parties per company	2.055	1.068	2
Secondary related parties			
Number of RPTs per individual secondary related party	2.686	2.745	2
Number of different types of secondary related parties per company	2.121	1.280	2
Types of transactions			
Number of different types of transactions per company	2.607	1.544	2

companies have related party transactions with 2.06 (2) different types of primary related parties.

We examine the complexity of dealings with secondary related parties in a similar way. The mean (median) number of transactions per unique secondary related party is 2.69 (2). On average (at the median), companies have related party transactions with 2.125 (2) different types of secondary related parties. Finally, we evaluate the complexity by type of transaction, finding that companies have a mean (median) of 2.61 (2) number of different types of transactions out of the 18 different types we identify.

Table 3 presents more detail on the number of RPTs per company and primary related party. Table 4 presents more detail on the secondary related party in transactions. Table 5 presents more detail on the types of related party transactions.

Table 3 presents the number of related party transactions per company and by primary related party. The 112 companies (224 observations over two years) in our sample report a total of 878 different related party transactions (445 in 2000 and 433 in 2001). Approximately 80% of observations report at least one RPT, with number per company ranging from 0 to 20. Of the RPTs, approximately 47% are with executives (approximately 18, 16 and 12% with executive chairmen, executives on the board and non-board executives, respectively), indicating potential situations of traditional agency conflict between owners and managers. Of note also is that approximately 47% of the RPTs are with non-executive board members (approximately 6 and 41% with non-executive chairmen and non-executive directors, respectively), potentially indicating that the board's role as independent monitor may be impaired. The remaining transactions are with principal owners, subsidiaries or other affiliates.

Table 3. Summary of Related Party Transactions by Company and Primary Related Party.

Number of Related Party Transactions per Company	Number of Obs.[a]	Percent of Obs.	Number of Related Party Transactions[a]	Percent of RPTs	Percent of Transactions With:[b]							
					Executives[c]			Non-Executives[c]		Principal Owner	Subsidiary[d]	Other
					Chairman	Board Member	Non-Board	Director	Chairman			
0	43	19.2	0	0.0	0	0	0	0	0	0	0	0
1	29	12.9	29	3.3	0.5	0.8	0	1.5	0	0.1	0.2	0.2
2	42	18.8	84	9.6	0.9	1.9	0.7	4.7	0.6	0.7	0.1	0
3	22	9.8	66	7.5	1.1	1.6	0.8	2.5	0.7	0.5	0.2	0.1
4	13	5.8	52	5.9	1.0	1.4	0.9	2.1	0.6	0	0	0
5	15	6.7	75	8.5	1.5	1.7	1.3	2.4	0.6	0	0.9	0.2
6	11	4.9	66	7.5	0.1	1.3	0.5	4.0	0.2	0.8	0	0.7
7	9	8.5	63	7.2	2.5	3.2	2.6	3.7	2.2	0.3	0.3	0.1
8	6	2.7	48	5.5	1.5	0.3	0.6	2.6	0.3	0.1	0	0
9	1	0.5	9	1.0	0	0.7	0.2	0.1	0	0	0	0
10	9	4.0	90	10.3	3.5	0.3	1.4	4.0	0.6	0	0.5	0.3
11	2	0.9	22	2.5	1.1	2.6	0	0.7	0.5	0	0	0
12–20	12	5.4	274	31.2	4.5	0.4	3.2	12.2	0	0	0.4	0
	224	100.0	878	100.0	18.2	16.2	12.2	40.5	6.2	2.5	2.6	1.4
Percent of Companies with Transaction					28.1	29.9	21.8	57.1	12.9	6.7	5.8	3.6

[a] Related party transactions data is presented for 112 companies for two years (fiscal years 2000 and 2001). Of the number of related party transactions, 444 are reported in 2000 and 433 in 2001.

[b] The "Percent of Transactions with": columns report the percent out of 100% by primary party and number of transactions.

[c] Includes both current and former executives and non-executives. Approximately 2% (1%) of transactions with executives are with former executives (non-executives).

[d] Also includes transactions with joint venture partners.

Table 4. Summary of Related Party Transactions by Secondary and Primary Party.

Secondary Party	Percent of Companies with Transaction ($N = 224$ Obs.)[a]	Percent of Related Party Transactions ($N = 878$ Trans.)[a]	Primary Party Percent of Transactions With:[b]							
			Executives[c]			Non-Executives[c]		Principal Owner	Subsidiary[d]	Other
			Chairman	Board Member	Non-Board	Director	Chairman (Not CEO)			
Executives										
Chairman	8.0	3.2	3.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Board member	3.6	1.0	0.0	1.0	0.1	0.1	0.0	0.0	0.0	0.0
Non-board	8.9	3.7	0.0	0.0	1.4	1.4	0.9	0.0	0.0	0.0
Executive's business										
Chairman	12.5	7.7	7.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Board member	6.3	2.4	0.0	2.4	0.0	0.0	0.0	0.0	0.0	0.0
Non-board	7.1	3.2	0.0	0.1	2.3	0.9	0.0	0.0	0.0	0.0
Non-executives										
Director	12.9	4.8	3.4	0.0	0.0	0.5	0.9	0.0	0.0	0.0
Chairman	6.3	3.3	0.2	0.0	0.0	0.0	3.1	0.0	0.0	0.0
Non-executive's business	34.8	24.8	0.0	0.0	0.2	24.6	0.0	0.0	0.0	0.0
Principal owner	4.0	2.1	0.0	0.0	0.0	1.8	0.0	0.0	0.2	0.0
Subsidiary	1.8	1.1	0.2	0.2	0.1	0.6	0.0	0.0	0.0	0.0
Other	1.8	1.8	0.0	0.0	0.8	0.8	0.2	0.0	0.0	0.0
Not applicable (transaction directly with company)	63.4	40.9	3.4	12.6	7.4	9.9	1.0	2.5	2.6	1.4
Total		100.0	18.2	16.2	12.2	40.5	6.2	2.5	2.6	1.4

[a] Related party transactions data is presented for 112 companies for two years (fiscal years 2000 and 2001). Of the number of related party transactions, 445 are reported in 2000 and 433 in 2001.

[b] The "Percent of Transactions with": columns report the percent out of 100% by primary party and number of transactions.

[c] Includes both current and former executives and non-executives. Approximately 2% (1%) of transactions with executives are with former executives (non-executives).

[d] Also includes transactions with joint venture partners.

Table 5. Summary of Related Party Transactions by Type and Primary Related Party.

Type of Relation	Percent of Companies With Transaction ($N = 224$ Obs.)[a]	Percent of Related Party Transactions ($N = 878$ Trans.)[a]	Primary Party Percent of Transactions With:[b]							
			Executives[c]			Non-Executives[c]		Principal Owner	Subsidiary[d]	Other
			Chairman	Board Member	Non-Board	Director	Chairman			
Employment/Direct services										
Direct service	4.0	2.3	0	0.5	0.9	0.2	0	0	0	0
Direct service-exec	20.5	9.6	3.9	0.2	0	4.4	1.0	0	0	0
Direct service-non-exec	11.2	4.7	3.7	0	0	0.4	0.7	0	0	0
Goods or services provided										
Management services	10.3	4.0	0.5	1.3	0	1.6	0.5	0.2	0	0
Legal services	20.5	6.6	0	0	1.0	5.5	0	0	0	0
Marketing	0.4	0.1	0	0	0	0.1	0	0	0	0
Real estate	21.0	14.4	2.9	2.0	2.0	6.8	0.8	0	0	0.1
Accounting	0.4	0.1	0	0	0	0.0	0	0	0	0.1
Investment banking	5.8	1.7	0	0	0	1.3	0	0.5	0	0
Other	7.6	2.8	0.4	0	0.1	2.1	0.2	0	0	0
Purchases from	21.0	7.0	1.3	0.4	0.5	2.9	0.6	0.5	0.7	0.4
Sales to related party	17.0	8.9	1.4	0.8	0.4	4.2	0.6	0.6	1.0	0
Loans										
Loans to – home	15.2	11.3	1.0	5.9	3.6	0.7	0.1	0	0	0
Loans to – stock	2.7	1.0	0.2	0.5	0.4	0	0	0	0	0
Loans to – other	20.1	10.5	1.6	3.5	1.7	2.9	0.4	0	0.5	0
Loans from	8.5	2.7	0.7	0.3	0.3	0.7	0.4	0.4	0.2	0
Investment	7.6	5.9	0.2	0.9	0.6	3.6	0.4	0	0.2	0
Other	17.0	6.3	0.4	0.4	0.8	3.0	0.2	0.5	0.2	0.9
Total		100.0	18.2	16.2	12.2	40.5	6.2	2.5	2.6	1.4

[a] Related party transactions data is presented for 112 companies for two years (fiscal years 2000 and 2001). Of the number of related party transactions, 445 are reported in 2000 and 433 in 2001.

[b] The "Percent of Transactions with:" columns report the % out of 100% by primary party and number of transactions.

[c] Includes both current and former executives and non-executives. Approximately 2% (1%) of transactions with executives are with former executives (non-executives).

[d] Also includes transactions with joint venture partners.

Table 4 describes the number of transactions by primary and secondary party. The first column gives the percent of companies reporting a transaction with the given secondary related party. About 63% of companies have at least one transaction where the transaction is directly between the company and a single related party such that there is no secondary related party. Examples of these transactions would include an executive loan or engaging a director to provide management services. Overall, transactions directly between the company and a single related party represent approximately 41% of all transactions. Transactions involving a director's business are the next highest group by secondary related party, representing nearly 25% of all transactions, with 35% of companies reporting at least one. Transactions with executive chairmen's businesses make up nearly 8% of all transactions. The large proportion of transactions with related party's businesses contribute to the ambiguity in the role of RPTs. For example, disclosures that a director owns or is affiliated with a company providing goods or services to the firm does not necessarily clearly signal either an efficient transaction or a conflict of interest. Without details on the price and terms of the transaction compared to the company's alternative suppliers – which in many cases would be impractical to identify much less to disclose – an unambiguous determination between conflict and efficiency cannot be made.

Table 5 shows the types of transactions by primary related party. The table indicates a broad range of types of related party transactions. It also shows that several types of transactions are prevalent, reported by about 20% of sample companies: direct service where the executive is one party involved, legal services purchased from a related party, real estate transactions – either renting or sales, sales to a related party, and loans for purposes other than home or stock purchases. The most common type of transaction disclosed is real estate transactions, representing 14.4% of all RPTs. Loans to related parties for homes and other reasons are also common, each representing about 11% of all transactions.

6. CONCLUSIONS AND EXTENSIONS

Our discussion of related party transactions emphasizes that the underlying nature of these transactions is unclear. While one view is that they are conflicts of interest, a contrasting view is they are efficient transactions. These two views have dramatically different implications for shareholders. What is clearer from our comprehensive description of related party transaction in our sample companies is that related party transactions are common, varied and can be large. We find about 80% of companies disclose at least one, with a mean of 3.9. Transactions with executives and non-executives board members are equally as common, each resenting about 47% of all transactions, which highlights the importance of understanding the differing economic implications of transactions with executives versus non-executives board members. The types of transactions that companies engage in are varied, but about 20% of companies report at least one of the following types: direct service where the executive is one party involved, legal services purchased from a related party, real estate transactions – either rental or purchase, purchases of goods from a related party, and loans for purposes other than home or stock purchases.

This paper presents initial evidence on the nature of related party transactions in which companies engage. We also identify issues and raise questions to be further explored. For instance, do corporate governance mechanisms such as CEO compensation, board composition, or large shareholder ownership concentration mitigate the extent of agency problems and/or enhance monitoring in companies with related party transactions? Do shareholders benefit from or are they harmed by these transactions? Is the presence of related party transactions associated with properties of financial reports such as earnings management? Further exploration of related party transactions and questions such as these should be useful to company executives, boards of directors, standard setters, legislators, and others.

NOTES

1. A related party can be an executive, a non-executive director, a principal owner or investor, a subsidiary, or a joint venture partner. Alternatively, the party may be a family member of, or a company owned by or affiliated with, any of these related individuals. Types of related party transactions include: the firm's purchases of goods or services from the related party, the firm's sale of goods or services to the related party; the firm's loans to or investments in the related party; the related party's loans to and investments in the firm; shareholder agreements on board representation; shared R&D. FASB Statement No. 57, Related Party Disclosures, as well as SEC reporting requirements are summarized in Section 3.

2. Specifically, Section 402 Enhanced Conflict of Interest Provisions (a) Prohibition on Personal Loans to Executives amends the Securities Exchange Act of 1934 to add prohibition on personal loans to executives.

3. The decision by Carly Fiorina, chief executive of Hewlett-Packard, to resign from the board of Cisco Systems, was interpreted as possibly motivated by a "desire to avoid potential conflicts of interest should the two companies develop co-operative projects" *Sunday Times* (London) September 19, 2003.

4. For example, a shareholder suit filed against Reckson Associates Realty by a Michigan police and fire pension fund alleges both that: (a) a sale of assets to the founding family is a "'self-dealing . . . giveaway' after years of double-dipping by co-presidents and co-CEOs who were Rechler family members"; and (b) certain independent directors are tied to the founding family members "through New York and Long Island social, business and charitable circles – and dogs. The suit alleges, for instance, that three of the [founding family members] breed champion Afghan hounds and are tied to . . . [an independent director] through their involvement in the American Kennel Club, which [the director] heads" *Wall Street Journal*. October 15, 2003. Page C1, C4.

5. Financial institutions may extend credit for home improvement, charge cards or securities trading so long as these extensions of credit are made in the ordinary course of business, of a type generally made available by the institution to the public, and on the same general terms and conditions available to the general public. The Act also requires directors, executives and principal owners (of 10%) to report ownership within 10 days of becoming a director, executive or principal owner; and to report changes of ownership within two business days of the transaction.

6. In addition, auditing for Related Party Transactions is covered in various Statements on Auditing Standards (SAS) and related interpretations. In audit planning, for example, the existence of related parties and related party transactions is highlighted as a "condition that may require extension or modification of audit tests." SAS No. 22, Planning and Supervision, (AICPA, Professional Standards, vol. 1 AU sec 311.03) as referenced in AICPA (2001). Since the focus of this paper is on disclosure for Related Party Transactions, auditing guidelines are not included.

7. In addition to the accounting requirements for Related Parties described in the body of the paper, the FASB, SEC and Sarbannes-Oxley Act of 2002 each include aspects of accounting for investments in other entities.

8. We limit our sample to companies with fiscal year-ends in December or January, to non- financial companies due to the nature of regulation, and to industries with more than 50 observations.

9. We also collect additional detail on the parties such as their titles and names. Family relationship to or ownership interest in the secondary related party are specified.

10. Specific characteristics of the loans are coded as disclosed including: whether the loans have a conversion feature or associated warrants, whether loans were made to the related party for purposes of stock purchase, and whether the loan was made at a 0% interest.

11. As mentioned, in gauging complexity, our objective is to capture the notion of the firm's "web" of related party transactions. As another measure of complexity, we multiply the number of primary related parties time the number of secondary related parties times the number of different types of transactions. However, we find this measure is highly and significantly correlated with the number of related party transactions so do not present tests using it.

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APPENDIX

Examples of Related Party Transaction Disclosures

EXAMPLE I OF DISCLOSURE AND DATA CODING

The sections below are from the Proxy, form 14A, of Looksmart Ltd. filed as of April 26, 2002 and obtained from the SEC website (www.sec.gov). All items, other than the numbered and italicized remarks, have been cut and pasted from the SEC website and so are direct quotes. The numbered, italicized remarks are comments added to indicate how the relevant related party transaction information was coded for this study. There are three related party transactions in this example.

DEF 14A

PUBLIC DOCUMENT COUNT:	3
CONFORMED PERIOD OF REPORT:	20020605
FILED AS OF DATE:	20020426

FILER:

COMPANY DATA:

COMPANY CONFORMED NAME:

LOOKSMART LTD

PROPOSAL ONE – ELECTION OF DIRECTORS

Our board of directors consists of seven directors, three of whom are standing for election: Evan Thornley, Tracey Ellery and Edward West. In addition to the three directors standing for election, we have two incumbent directors with terms expiring in 2003 and two incumbent directors with terms expiring in 2004. Our bylaws provide that the board of directors be divided into three classes, with each class to be as nearly equal in number as possible. There is no difference in the voting rights of the members of each class of directors. Each class of directors serves a term of office of three years, with the term of one class expiring at the annual meeting of stockholders in each successive year. There are no family relationships among any directors or executive officers of the Company, except that Evan Thornley, Chairman and Chief Executive Officer, is married to Tracey Ellery, a member of the board of directors.

Nominees for Election to the Board of Directors

The nominees for election to the board of directors are Evan Thornley, Tracey Ellery and Edward West. The board of directors unanimously recommends that you vote FOR election of all nominees as directors.

Evan Thornley co-founded LookSmart and has served as its Chairman and Chief Executive Officer since July 1996. From July 1996 to June 1999, Mr. Thornley also served as President. From 1991 to 1996, Mr. Thornley was a consultant at McKinsey & Company, a global consulting company, in their New York, Kuala Lumpur and Melbourne offices. Mr. Thornley holds a Bachelor of Commerce and a Bachelor of Laws from the University of Melbourne, Australia. Mr. Thornley is married to Ms. Ellery.

Tracey Ellery co-founded LookSmart and has served as a director since September 1997. Ms. Ellery served as President of LookSmart from June 1999 through

March 2001 and Senior Vice President of Product from July 1996 to June 1999. From 1991 to 1994, Ms. Ellery was Chief Executive Officer of Student Services Australia, an Australian college publishing and retail company. Ms. Ellery studied drama and legal studies at Deakin University, Australia. Ms. Ellery is married to Mr. Thornley.

1. This relationship between Thornley and Ellery was coded as a single transaction. The primary related party is Thornley, Chairman and CEO. The relationship is "husband." The secondary related party is Ellery. The transaction type 12 means that the transaction type is a "direct service" relationship, in this case the related party serving as a non-executive director.

Certain Relationships and Related Transactions

In October 2001, the Company entered into a license agreement with Viator Ventures, Inc., a technology company wholly owned by Peter Adams, the Company's Senior Vice President, Product and Chief Technical Officer. The license agreement provides for an exclusive license to Viator Ventures' technology in exchange for payment to Viator Ventures of $400,000 and 300,000 shares of Company common stock.

2. The primary related party is an executive [10] Adams whose title is VP but not on the board [111]. The secondary related party is a company owned by an executive [11] with the ownership percentage 1, i.e. 100%. The transaction type is a purchase from the RP [35], with an amount shown in the principal amount of $*400,000 and a code '1' to indicate the payment had an equity component.*

In April 2002, the Company loaned $250,000 to Dianne Dubois, its Chief Financial Officer, in connection with the purchase of a personal residence. The loan bears no interest and is due and payable upon the earliest to occur of: (a) 120 days after Ms. Dubois's resignation from the Company; (b) 180 days after termination of Ms. Dubois's employment, provided that if at that time, the realizable post-tax gain from the stock options held by Ms. Dubois is less than the amount required to repay the loan in full, then the amount of loan due and payable at that time shall equal the amount of the realizable post-tax gain, and the remainder of the loan shall remain outstanding and shall mature upon the next anniversary of the date the loan was made; or (c) 30 days after the sale of the residence. The loan may be forgiven by the Company over a four-year period if Ms. Dubois reaches certain performance milestones or if Ms. Dubois is terminated without cause following a change of control of the Company.

3. The primary related party is an executive [10] Dubois whose title [19] indicates an executive but not a director. There is no secondary related party since the *transaction is directly between the company and the primary related party. The transaction type [427] indicates that the loan is for purchase of a residence and that it is below market (since it is intended to be forgiven).*

EXAMPLE II OF DISCLOSURE AND DATA CODING

The sections below are from the Proxy, form 14A, of Applied Molecular Evolution Inc. filed as of April 29, 2002 and obtained from the SEC website (www.sec.gov). All items, other than the numbered and italicized remarks, have been cut and pasted from the SEC website and so are direct quotes. The numbered, italicized remarks are comments added to indicate how the relevant related party transaction information was coded for this study. There are six related party transactions in this example.

DEF 14A

PUBLIC DOCUMENT COUNT:	7
CONFORMED PERIOD OF REPORT:	20020529
FILED AS OF DATE:	20020429
FILER:	
COMPANY DATA:	
COMPANY CONFORMED NAME:	APPLIED
MOLECULAR EVOLUTION INC	
CENTRAL INDEX KEY:	0001111312
STANDARD INDUSTRIAL CLASSIFICATION:	SERVICES-COMMERCIA

CERTAIN TRANSACTIONS

On June 15, 2000 and June 16, 2000, certain options were exercised in exchange for cash and promissory notes, including: 280,000 shares purchased by William D. Huse, one of our directors and our Chief Executive Officer and President, for $280 cash and a promissory note for $209,720; 240,000 shares purchased by Jeffry D. Watkins, our Chief Scientific Officer, for $240 cash and a promissory note for $179,760; 200,000 shares purchased by Lawrence E. Bloch, our Chief Financial Officer and Secretary, for $200 cash and a promissory note for $149,800 and 140,000 shares purchased by Keith S. Manchester, our Vice President of Business

Development, for $140 in cash and promissory notes for $154,860. As of April 22, 2002, $235,167, $201,637, $168,031 and $173,684 were still outstanding for the promissory notes of Dr. Huse, Dr. Watkins, Dr. Bloch and Dr. Manchester, respectively. Interest, at the rate of 6.62%, cumulates and is payable with principal at maturity. The maturity date for all of these promissory notes is June 2005. All of these promissory notes are full recourse.

1. In each of the above 4 related party transactions, the primary related party is an executive [10.] In the case of Huse, the title is President and CEO [10], and for the other three, the title is a non-director VP. The amounts of the notes are shown as principal.

In March 2002, we provided James B. Breitmeyer, our Chief Medical Officer, with a $400,000 loan to purchase a home. This loan is secured by a second deed of trust on the home that Dr. Breitmeyer purchased and carries an annual interest rate of 6%. Interest on the loan will cumulate and is payable four years from the date of the loan. We agreed to fully forgive the loan in the event that Dr. Breitmeyer is fully employed by us four years from the date of the loan.

2. The primary related party is an executive [10] whose title is non-director executive [19.] The type of transaction is a 427 because its purpose is to purchase a house, and its terms are below market, i.e. it will be forgiven.

In connection with Dr. Breitmeyer's relocation to the San Diego area, we paid to move his household goods and automobiles and gave him $20,000 in gross pretax dollars for miscellaneous moving expenses.

Moving expenses not coded.

The Company believes that the foregoing transactions were in its best interests. It is the Company's current policy that all transactions by the Company with officers, directors, 5% stockholders or their affiliates will be entered into only if such transactions are approved by a majority of the disinterested directors, and are on terms no less favorable to the Company than could be obtained from unaffiliated parties.

See also "Report of the Compensation Committee of the Board of Directors on Executive Compensation" and "Compensation Committee Interlocks and Insider Participation."

The following cross-referenced sections are found on other pages of the proxy.

Compensation Committee Interlocks and Insider Participation

None of our executive officers serves as a member of the Board of Directors or Compensation Committee of any other entity that has one or more executive officers serving as a member of our Board of Directors or Compensation Committee.

Biosynexus, Inc. (“Biosynexus”), paid the Company $250,000 in March 2001 and $250,000 in October 2001 for services provided pursuant to a collaboration with the Company. Dr. Hilal is a director of Biosynexus.

3. The primary related party Hilal is a non-executive director [20.] The secondary related party Biosynexus is a company with which the non-executive director is affiliated [211] and his ownership position, if any is undisclosed [–0.0001] The type of transaction is [30] indicating the firm sells to the RP.

Miscellaneous

Section 162(m) of the Internal Revenue Code disallows the deductibility by the Company of any compensation over $1 million per year paid to each of the chief executive officer and the four other most highly compensated executive officers, unless certain criteria for an exemption under Section 162(m) are satisfied. The 2000 Stock Incentive Plan and 2001 Stock Incentive Plan have been drafted to qualify for an exemption from the $1 million limit on deductions under Section 162(m) with respect to nonstatutory stock option grants under the plans.