

# Transactions with related parties: shareholder consent (2/37/20)

This explores conditions under which a company's transactions with related parties require shareholder consent under the Commerce Act ("CA").

CA section 184.2(2) provides that a company's transactions with related parties are subject to the consent of its council, or of the general meeting of shareholders if the company does not have a council. Shareholder consent is required under CA section 184.2(1) if a related-party transaction meets one or both of the following conditions:

- The transaction is not made in the company's normal course of business;
- The transaction is not arm's length.

The related-party transaction will be void if the parties have failed to observe the procedure for entering into transactions specified by CA section 184.2 and the related party knew or was supposed to know that council or shareholder consent is required and has not been given.

## The form of a transaction

An agreement between related parties can exist not only in the form of a written contract but also in their mutual communication (correspondence). In the absence of a written contract, terms and conditions should be inferred from the economic principles usually agreed between independent entities.

In a single-member company, any transaction between the company and its owner must always be in writing under CA section 184.2(8).

## The content and conditions of a transaction

In their guidelines, the State Revenue Service ("SRS") explains what kind of transaction is not arm's length: if goods or services are bought for a price above the market price or sold for a price below the market price, or if any other deal is done for a price (value) that is not arm's length.

Unfortunately, Latvian legislation fails to define the "normal course of business" and criteria the company can use to assess whether a transaction qualifies as conducted in the normal course of business. The same phrase is used in CA sections 84(1-2) and 121(2), with no definition found in Latvian statute law or case law. However, the following criteria need to be highlighted.

### *The transaction creates income*

As defined in CA section 1, commercial activity means "an open business that a company carries on in its own name for profit." This definition essentially includes the concept of normal course of business. Accordingly, a key condition for recognising the normal course of business is transactions that represent a source of income for the company.

In related-party transactions, however, we need to understand that for a company that provides, say,

accounting services, the transaction will create income, while for the other company that acquires and pays for those services, this will be a cost. Is shareholder consent required before the company can enter into this sort of transaction?

Unfortunately, there is no clear answer to this question. Yet this income/expense condition should also be considered in terms of the transaction being systematic. In other words, transactions that create income or expenses but are systematic should be considered to occur in the normal course of business and would not require prior shareholder consent.

#### *Systematic transactions in a particular commercial activity*

A company's transactions in the normal course of business definitely include transactions entered on the SRS's Register of Taxpayers as the company's core business activity and additional activities. Yet companies will not always have registered or defined in their articles of association all types of their core business activities and additional activities.

Accordingly, transactions in the normal course of business also include day-to-day transactions that are conducted according to the company's standard practice if they are predictable and uniform and have certain regularity.

#### *An example*

A company manufactures furniture only for related companies, with an appropriate NACE code registered on the SRS's tax system. The company also provides regular accounting and IT services to related companies. On the one hand, assuming the services are systematic, these transactions could be considered to occur in the normal course of business, without requiring shareholder consent. On the other hand, neither accounting nor IT services are the company's core business activity, so the company for which this is an expense should obtain shareholder consent. An even better example would be a furniture maker that sells off its excess inventories or fixed assets, a transaction that has never happened before or has been done very rarely. In that case, the company must obtain shareholder consent before entering into the transaction.

As none of the Latvian laws defines conditions under which a company's transactions could be considered to occur in the normal course of business, and given the scarce case law on this issue, CA section 184.2 should be interpreted as narrowly as possible.

Without obtaining shareholder consent, it is possible that someone whose rights are infringed by the transaction could ask the courts to recognise it as void.

We believe that obtaining shareholder consent is the safest bet to avoid potential disputes and lawsuits in the future. Accordingly, if there is any doubt before entering into a related-party transaction that does not create income for the company, or is not registered as the company's core business activity or additional activity, or is not arm's length, the company is advised to obtain shareholder consent.