

DIRECTOR INTERLOCKS AND CONFLICTS OF INTERESTS

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In my previous article, “Multiple Directorships – How Many is Enough?”, I examined the concern of time fragmentation of a director who is on too many boards. Another concern with multiple directorships which I will now explore is the creation of director interlocks between firms that generate conflicts of interest which may impede directors in the proper discharge of their duties.

Before discussing the two variants of interlocking directorships – horizontal and vertical – it is important to note that interlocks are not restricted to firms that appoint common board members.

The *OECD report*, Antitrust issues involving minority shareholding and interlocking directorates, suggests that the concept of interlocks should be extended to cover situations where, for example, a director

of one firm is a top executive in another firm, or where the director's spouse is a director or top executive in another firm.

HORIZONTAL INTERLOCKS

Interlocks between firms in the same industry are referred to as horizontal interlocks. From a governance perspective, directors are required to discharge their duties and responsibilities as fiduciaries of their firms.

However, an interlock between rival firms can create serious conflicts of interest if it prevents an interlocking director from exercising his objective judgement and discharging his fiduciary duties to both firms.

In certain jurisdictions, horizontal interlocks attract anti-trust scrutiny. For instance, the Clayton Antitrust Act in the US currently prohibits, with certain exceptions, one person from serving as a director of two rival firms.

While Singapore has a similar Competition Act, there are no specific provisions here that prohibit interlocks among rival firms.

This overlapping of business interests led to the resignation of Eric Schmidt, then CEO of Google, from Apple's board in 2009.

The *Wall Street Journal* reported that both firms faced regulatory scrutiny over their interlock due to anti-trust concerns.

Steve Jobs, then CEO of Apple, also commented that "Eric's effectiveness as an Apple board member will be significantly diminished, since he will have to excuse himself from even larger portions of our meetings due to potential conflicts of interest."

Quite apart from anti-competition concerns, conflicts of interest led two directors of SGX-listed Jurong Cement Ltd to resign from its board in 2009 because they were also employees of YTL Corporation, a competitor of Jurong Cement.

According to the company's announcement, the rationale for the resignation was to address potential conflicts of interest when the board discussed "competitive sensitive information in the presence of the directors representing a direct competitor".

VERTICAL INTERLOCKS

Vertical interlocks are formed between firms in a buyer-seller relationship.

A director that represents a buyer owes a duty to secure the lowest possible price from the seller. Conversely, a director that represents a seller owes a duty to secure the highest possible price from the buyer. When the same director represents both firms, it is easy to see how a conflict of interest arises.

The key issue in interlocks, whether vertical or horizontal is, therefore, that conflicts of interest can arise, and regulators and boards tend to have rules and policies focused on such situations.

CONFLICTS OF INTEREST

Transactions between firms connected by vertical or horizontal interlocks can potentially be classified as interested party transactions (IPTs) under the SGX Listing Rules.

IPTs extend to transactions between a listed firm and its directors, CEO, controlling shareholders, or an associate of the aforementioned persons.

In particular, Listing Rules 905 and 906 require material IPTs to be disclosed to, or even approved by, shareholders.

In 2011, the SGX reprimanded KXD Digital Entertainment Ltd for failing to announce and seek approval for sales by it to LG North America Inc.

Both firms were vertically interlocked as the chairman and CEO of KXD and the CEO of LG were spouses. The SGX noted that not only were Listing Rules 905 and 906 breached, the sales also resulted in substantial bad debts that had a material adverse impact on KXD, and which were detrimental to its minority shareholders.

This illustrates a key concern with interlocks. In some cases, the interlock can facilitate the expropriation of shareholder wealth from one company through inter-firm transactions on terms that favour the interested person.

Whether an interlock is horizontal or vertical, Section 156(1) of the Companies Act applies to require every director of a firm who is, in any way, interested in a transaction or proposed transaction with the firm to declare the nature of his interest.

While the disclosure of the conflict is the responsibility of the director concerned, it is the responsibility of the entire board to safeguard the interests of the firm and its shareholders by ensuring that any conflicts that arise are adequately and effectively addressed and that the firm complies with all relevant Listing Rules and regulations. ■