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INTERLOCKING DIRECTORATES: A SLEEPING BEAR AWAKENS?

For nearly 100 years, the U.S. antitrust laws have prohibited a person from serving as a director or officer of two or more large companies which compete. Section 8 of the Clayton Act states:

> No person shall, at the same time, serve as a director or officer in any two corporations (other than banks, banking associations, and trust companies) that are
>
> (A) engaged in whole or in part in commerce; and
>
> (B) by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the antitrust laws…
>
> if each of the corporations has capital, surplus, and undivided profits aggregating more than [$25,841,000, as adjusted annually based upon the U.S.'s gross national product].

15 U.S.C. §19(a)(1).

The statute does not apply if the competitive sales of either of the competing companies are less than $2,584,100 (as adjusted annually) or 2% of that company's total sales, or if the competitive sales of each of the competing companies are less than 4% of that company's total sales.

Although Section 8 of the Clayton Act is frequently described as prohibiting "interlocking directorates," the statute actually applies to a person serving as either a director or officer in certain competing companies. Because this type of dual service can foster the improper disclosure of confidential information or other anti-competitive practices which are difficult to detect, the statute imposes an absolute and prophylactic prohibition on such dual services regardless whether any anti-competitive conduct in fact occurs.

Other similar prohibitions against interlocking directorates may apply to companies which are not otherwise subject to this federal statute. For example, the Federal Power Act prohibits individuals from being an officer or director of more than one public utility or from holding such a position with a public utility and a company that may underwrite or market public utility securities, absent prior authorization from the Federal Energy Regulatory Commission. Since public utilities do not technically compete, the Clayton Act prohibition for interlocking directorates does not apply to public utilities. However, because the same concerns underlying the Clayton Act provision equally exist with respect to persons serving as directors or officers of multiple public utilities, the Federal Power Act imposes a similar ban on interlocking directorates. Likewise, some states have similar statutory prohibitions, which would apply to

smaller companies that do not meet the minimum monetary thresholds contained in the federal statute. See, e.g., Alaska Statutes 45.50.570.

Unlike the business environment which existed in 1914 when the Clayton Act was first enacted, an interlocking directorate situation which exists today is in all likelihood not the result of an attempt to curb competition or to link two competing companies for economic advantage. Instead, overlapping directors and officers among companies today primarily are a result of a desire to seek the most qualified and experienced outside directors for each company. Not surprisingly, someone with extensive familiarity with a particular industry due to their professional involvement in that industry is frequently viewed as a desirable outside director for a company in that industry. As a result, one could argue that interlocking directors today serve an important and valuable role by creating an informal network among boardrooms for the purpose of sharing governance best practices, experiences and perspectives.

Nonetheless, the statutory prohibitions against interlocking directorates remain firmly entrenched. Regardless of the circumstances, a person may not serve as a director or officer of two companies which compete at a level described in the statute. As a result, all large companies must be constantly vigilant to monitor and control what other outside positions are held by each of its directors and officers. If a company fails to identify interlocking directorates, that oversight will likely be discovered. For example, new disclosure rules recently adopted by the SEC require public companies to disclose all other directorships held by each director of the public company during the past five years, thereby highlighting any interlocking directorate situations. In addition, various watchdog organizations routinely crosscheck public databanks to identify the existence of a proscribed dual service.

One of the more common situations where interlocking directorates exist involves companies supported by a private equity or venture capital firm. Typically, those firms select one or more persons to represent the firm on the Board of Directors of the firm's portfolio companies. Because those firms frequently select the same representatives for various of their portfolio companies, interlocking directorate situations frequently arise in that context.

Historically, the Federal Trade Commission ("FTC") and private plaintiffs brought relatively few proceedings to enforce the interlocking directorate prohibition provisions in the Clayton Act. Consistent with its laissez-faire antitrust regulatory philosophy in recent years, the FTC rarely investigated or alleged violations of this provision. Likewise, the plaintiffs' bar generally has not filed lawsuits alleging a violation of the interlocking directorate statute because that litigation is not particularly lucrative for plaintiff lawyers. The requested remedy in such a lawsuit typically is the removal of the overlapping director or officer. Absent a significant monetary recovery, the plaintiff attorney fee in such a lawsuit is usually rather modest. Other types of plaintiffs which have occasionally filed lawsuits alleging a violation of these interlocking directorate statutes include competitors who believe the interlocking directorate is impeding full and fair competition or shareholders who seek to keep an insurgent director off the board by reason of his relationship with a competitor.

Recent developments, though, suggest that the attention being given to interlocking directorate issues is increasing and the scope of the interlocking directorate prohibition is expanding. Those recent developments are summarized below.

A. INCREASED FOCUS

In 2009, the FTC commenced an investigation into a potential interlocking directorate violation involving Google and Apple. That investigation resulted in the October 12, 2009 announcement by Google that Arthur D. Levinson, who was a director of both Google and Apple, was resigning from the Google board. That resignation followed a similar announcement by Apple that Eric E. Schmidt, who was the CEO of Google and served as a director of both Google and Apple, was resigning from the Apple board. The FTC publicly commended Google and Apple "for recognizing that overlapping board members between competing companies raise serious antitrust issues." The FTC further stated that "we will continue to monitor companies that share board members and take enforcement actions where appropriate."

More recently, the FTC investigated an interlocking directorate situation between Amazon and Google, resulting in John Doerr, who was a director of both companies, resigning from the Amazon board. Media reports indicate that the FTC is also investigating several other interlocking directorate situations; however, those investigations have not to date resulted in further formal FTC action. This heightened focus by the FTC is a noticeable change in enforcement philosophy by the FTC and the Obama administration and suggests that companies should be extra vigilant in self-policing compliance with Section 8 of the Clayton Act.

B. EXPANDING SCOPE

Determining whether a particular interlocking directorate violates the Clayton Act is not as easy as it may appear. The statute applies only to companies that are competitors by virtue of their business and location of operation. Which companies "compete" with each other in today's business world is quite murky at best as companies diversify more, sell a wider array of products and operate in rapidly changing and ill-defined industries. For example, does the sale of a DVD video game compete with the sale of a movie or music DVD or a book? Obviously, this analysis becomes highly subjective and therefore invites conflicting interpretations of what constitutes "competition."

Traditionally, courts have interpreted "competitors" for this purpose rather narrowly. For example, the Seventh Circuit Court of Appeals in 1973 held that two corporations with common directors are in direct competition for purposes of the interlocking directorate prohibition in the Clayton Act if those two corporations produce the same line of products in the same region and compete for the same business. *Protectoseal Co. v. Barancik*, 484 F.2d 585 (7th Cir. 1973). A few courts adopted a more expansive definition, defining "competitors" for this purpose to mean companies that vie for business from the same prospective purchasers even if the products they offer are sufficiently dissimilar to preclude a single purchaser from having to choose between each of the products. *TRW, Inc. v. FTC*, 647 F.2d 942 (9th Cir. 1981).

Following these more active enforcement efforts by the FTC, the plaintiffs' bar has likewise increased the frequency of private lawsuits alleging violation of the interlocking directorate prohibition in the Clayton Act. For example, three shareholder derivative lawsuits alleging illegal interlocking directorates among the following companies were filed in the first half of 2010:

1. Sears Holding Corporation; Jones Apparel Group (a clothing and accessories retailer); Auto-Zone, Inc. (an auto parts retailer); and AutoNation, Inc. (provider of auto repairs and services). *Robert F. Booth Trust v. Crowley*, Case No. 09-C-5314, Northern District of Illinois.

2. Cable Vision (cable, telecommunications, entertainment and newspaper publishing business); Citadel Broadcasting Corp. (radio broadcasting); Lamar Advertising Co. (outdoor/billboard advertising); and Mediacom Communications Corp. (cable company). *Gross v. Reifenheiser*, Case No. 2:10-CV-00399, Eastern District of New York.

3. Burger King Holdings, Inc. (fast food); and Dominoes, Inc. (pizza). *Cohen v. Brandon*, Case No. 1:10-CV-20573, Southern District of Florida.

Each of these lawsuits alleged the full board of the respective company breached their fiduciary duties by allowing the interlocking directorate in violation of the Clayton Act and sought a court order to remove the interlocking directors from the respective boards. An obvious issue in dispute in many of these cases is whether the respective companies are in fact competitors. For example, does a cable or newspaper company which generates significant advertising revenue compete with an outdoor advertising/billboard company? Or, does a fast food hamburger restaurant compete with a pizza outlet? These questions were largely ignored in the past, but appear to now be much more important as the FTC and the plaintiffs' bar begin to reinvigorate Section 8 of the Clayton Act.

Additionally, Section 8's prohibition on interlocking directorates was recently used by a company as a partial defense to a takeover attempt. In late spring 2010, Genzyme Corp. invoked Section 8 to defeat minority shareholder Carl Icahn's proxy contest effort to gain seats on the Genzyme board of directors. Icahn nominated himself and three of his associates to Genzyme's board, although Genzyme and one of Icahn's affiliated companies (Biogen Idec Inc.) were competitors. Genzyme argued that the election of Icahn representatives to Genzyme's board would be a per se violation of Section 8, while Icahn responded that any competition between Genzyme and Biogen was "de minimus." The two sides eventually reached a compromise whereby Genzyme added to its board two of the four directors Icahn had originally nominated. This development may signal yet another arena in which Section 8 issues can arise.

C. RELATED LIABILITY ISSUES

Even if an interlocking directorate is not prohibited by statute, either because the companies are not competitors or because the monetary thresholds are not satisfied, persons serving as a director or officer of multiple companies nonetheless face unique legal challenges arising out of their duty of loyalty to each company. Some of the areas of concern for interlocking directors in this regard include the following:

1. Intercorporate Transactions. When a director or officer is on both sides of a transaction, he or she is required to demonstrate his or her utmost good faith and the "entire fairness" of the transaction. Courts will apply careful scrutiny to

determine whether that person's actions were fair to both companies. The business judgment rule is not available to that person as a defense, and instead that person may have the burden to overcome a presumption that the transaction is invalid due to the conflict of interest.

In order to reduce this increased liability exposure, persons serving multiple corporations should be especially vigilant to recuse themselves from the deliberations and approval of any transaction between the two companies, or any other matter in which the interests of the two companies are perceived to be in conflict. When in doubt, the person should be recused since perception is as important as reality in this context.

2. Maintaining Confidences. A D&O has a duty to use reasonable diligence to protect and safeguard the property of the corporation, including confidential information. If the D&O either knowingly or inadvertently discloses confidential information to a third party, the D&O can be liable for any resulting loss. This liability can be based on a person who serves multiple companies disclosing confidential information about one company to the other company. While acting as a D&O of either company, the person must act solely in the best interest of that company regardless of any duties owed to the other company.

   Because it is frequently not entirely clear what constitutes confidential information for this purpose, a person serving multiple companies with similar interests runs the risk of unintentionally breaching this duty of loyalty to one or both companies by disclosing certain information to the other company. In order to reduce this liability exposure, persons serving multiple companies need to be constantly sensitive to what information may and may not be properly disclosed to each company. When in doubt, the person should inquire whether the information is confidential and should not disclose any potentially confidential information.

3. Corporate Opportunity. A D&O may not usurp or misappropriate business opportunities belonging to the company he or she serves. A D&O generally must refrain from directly or indirectly seizing a business opportunity for which the company has a reasonable expectancy and capability to perform. For example, a D&O may not personally or on behalf of another entity purchase property or a business which is offered or available to the company unless the company rejects or cannot accept the opportunity. This can be a highly subjective analysis, and therefore a person serving multiple companies runs the risk of either company complaining that he or she usurped for the benefit of the other company a business opportunity available to the first company.

   In order to reduce this increased risk, persons serving multiple companies should refrain from involving one company in a business opportunity until the other company which first identified the business opportunity fully abandons the opportunity and written confirmation of that abandonment exists.

D. D&O INSURANCE ISSUES

Unique D&O insurance issues arise if the interlocking directorate situation is due to the person serving in one or both of the interlocking positions at the request of an organization, including a private equity or venture capital firm. In that situation, the person serving in the interlocking positions may have insurance coverage both through the company for whom the person serves as a director or officer as well as through the company which requests such service. Many D&O insurance policies include coverage for persons serving at the request of the insured company as a director or officer of another company. In order to maximize the financial protection available to that person, this so-called Outside Position coverage in the requesting company's D&O policy should be carefully reviewed and structured. The following summarizes many of the issues which should be considered when evaluating this Outside Position coverage.

1. Company Request. Policies differ as to what type of Outside Position request by the company will trigger the Outside Position coverage. At one extreme, some policies require a written request that the insured person serve in the Outside Position. Other more liberal policies recognize coverage if the Outside Position service is "with the knowledge and consent of, at the direction or request of, or part of the duties regularly assigned to the Insured Person by, the Company." At a minimum, the insurance policy language describing this request should include the type of request required by the requesting company's Outside Position indemnification provision so that the requesting company will have coverage if it indemnifies someone serving in an Outside Position.

2. Insured Persons. Policies differ with respect to the type of persons who are covered while serving in an Outside Position. Many policies cover any director or officer of the company who serves in an Outside Position. Other policies are more liberal and afford this coverage to any person (not just a director or officer) who serves in the Outside Position at the request of the company. A much more restrictive approach affords this coverage only for individuals specifically listed by endorsement or only to certain types of senior executives. This more restrictive approach most often applies to Outside Positions in a for-profit company.

3. Type of Outside Position. Policies differ with respect to what types of positions in an Outside Entity are covered. Many policies cover service as a director, officer, governor, trustee, manager or other equivalent executive position with the Outside Entity. Other more liberal provisions also cover service as an employee or agent of the Outside Entity.

4. Type of Outside Entity. Policies differ as to the type of Outside Entity in which the outside service is performed. Most policies at least include Outside Positions in non-profit entities which are exempt from federal income tax pursuant to Section 501(c)(3) of the Internal Revenue Code (i.e. charitable outside entities). Other more liberal policies extend this coverage to Outside Positions in any tax exempt Section 501(c) entity or, perhaps, any entity chartered as a non-profit organization. Typically, coverage for Outside Positions in for-profit organizations

applies only if the for-profit organization is specifically listed in an endorsement, thereby allowing the insurer to underwrite the risks associated with that outside for-profit entity.

5. Blanket versus Specific Coverage. Policies differ as to whether the Outside Position coverage applies to all Outside Positions or only to Outside Positions which are specifically listed by endorsement to the policy. Typically, blanket coverage is afforded for all Outside Positions with non-profit entities, although certain types of higher-risk non-profit entities such as hospitals and financial institutions may need to be specifically listed to be covered. In contrast, policies typically do not afford blanket coverage for Outside Positions with for-profit entities, but require the specific for-profit Outside Entity (and perhaps the specific person serving in the specific Outside Position with the specific for-profit Outside Entity) to be listed by endorsement to the policy.

6. Double versus Triple Excess Coverage. All policies state that any Outside Position coverage is expressly excess of any indemnification available from and any insurance maintained by the Outside Entity. This is frequently described as double excess Outside Position coverage. A more limited type of Outside Position coverage insures only Outside Position losses which are also not indemnified by the requesting company. This type of more limited coverage is frequently described as triple excess (i.e., excess of both insurance and indemnification from the Outside Entity and excess of the requesting company's indemnification).

7. Insured versus Insured Exclusion. Some policies contain an exclusion which eliminates Outside Position coverage for claims by or on behalf of the Outside Entity and perhaps the directors and officers of the Outside Entity. This type of exclusion is similar to the standard insured versus insured exclusion in D&O policies, but frequently does not have all of the carve-outs to the exclusion which are typically contained within the standard insured versus insured exclusion. More liberal policies do not contain any form of this exclusion.

8. Limit of Liability. Policies differ with respect to the available limit of liability for Outside Position claims. Many policies contain a provision which prevents the insurer from paying multiple limits for a single claim if the insurer issues a D&O policy to both the requesting company and the Outside Entity. Under such a provision, the insurer's maximum liability under both policies combined for any one Outside Position claim would be the largest available limit of liability under either policy. This type of provision may limit or eliminate coverage for Outside Position claims in the requesting company's excess D&O policies since those excess policies are typically triggered only if the full underlying limit is paid in full. If pursuant to such a tie-in of limits provision the primary insurer's maximum liability for an Outside Position claim is less than the primary policy's full limit of liability, then coverage under the excess policy may not be triggered

for an Outside Position loss in excess of the primary insurer's tie-limit since the primary policy's full limit of liability would not be exhausted.

9. Priority of Insurance. Many policies do not expressly address how the Outside Position coverage in the requesting company's policy relates to the coverage afforded under the Outside Entity's D&O insurance program. The common understanding and intent is that the Outside Position coverage in the requesting company's policy is excess of the Outside Entity's insurance coverage, but few policies expressly so state. To avoid potential confusion and disputes in a claims context, such an express excess provision could be added to the requesting company's D&O policy.

10. International Issues. If the Outside Position is with an entity chartered or located outside the United States, far less consistency and certainty exists with respect to the terms and adequacy of the Outside Position financial protection program. Under the indemnification laws of many foreign countries, it is unclear at best and perhaps illegal for the requesting company to indemnify persons serving in an Outside Position. Even indemnification from the Outside Entity may be much less certain since many foreign countries do not have well-defined indemnification laws. In addition, many Outside Entities in foreign countries do not maintain D&O insurance for various reasons. As a result, the existence and quality of the requesting company's Outside Position insurance in that foreign context may be quite important.

A high-quality Side A Excess DIC policy maintained by the requesting company can maximize the coverage protection available for persons serving in an Outside Position. For example, the CODA Policy available from ACE Bermuda Insurance Ltd. includes automatic blanket Outside Position coverage for persons serving as a director or officer of any non-profit or for-profit entity at the direction of the requesting company or as part of the person's duties regularly assigned by the requesting company. That coverage is not subject to any Outside Position insured v. insured exclusion or tie-in limits provision, but is otherwise subject to the many extraordinary coverage enhancements in that policy.

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