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Interlocking Directorates and Possible Conflict of Interests

Abstract: The aim of this paper is to explore the concept of interlocking directorates in a context of possible misuse of power, especially such as conflict of interest (COI). The paper presents some results of current research made on interlocking directorates. Next it analyzes connections between this phenomenon and COI. One of a basic assumption for this paper is that COI is generally dangerous for a processes of industrial and market development of regions like CEE and therefore all phenomena COI-related (as interlocking directorates) must be well recognized by regional social sciences. The article will refer to such issues as threats to free market rules, violation of trust and formation of industrial elite.

Keywords: interlocking directorates; conflict of interest; elite; superclass; corporate scandal.

Introduction

Globalization with its constant change of distances between societies and social phenomena, has shifted many power relations. From relations between states, through relations between private organizations, to links between markets and cultures. Everywhere some changes of patterns and structure of power can be identified (see: Sklair 2001; Staniszkis 2003; Strange 1997; Wedel 2009). The important question (which gains more and more various answers) is: where is the locus of decision making? Where is the source of most current political and economic processes on a national or international level? This locus is supposed to be a place/mechanism/institution, which makes a powerful impact on many aspects of social life by making its own choices. Some authors point at national political elites, at international organizations, or at large corporations as main locus of decisions. However when more markets and industries become interconnected, the more often researchers point at sources of power that are built within certain new networks either on a national or global scale.

Scholars who explore various aspects of corporate globalization point at process of networking within industry branches as an important factor of building the new locus of decision making. International mergers, hostile takeovers of foreign companies, global cartels, international business associations—these are some methods and ways of global business cooperation and networking. The phenomenon of interlocking directorates is very often at the core of all of these methods. An interlocking directorate exists "when one person affiliated with one organization sits on the board of directors of another organization" (Mizruchi 1996: 271). It is a business practice that leads to building linkages between firms, but also between firms and private foundations. Some of these linkages benefit people involved into interlocking directorates and industry branches they work in. But such links can be destructive for free market rules, free competition and consumers rights as well. Therefore the nature of interlocking directorates may lead to conflict of interest and such collusive behavior as price fixing, market division, oligopoly and other antitrust violations.

The aim of this paper is to present the phenomenon of interlocking directorates in the light of reasons for such practice creation and possible threats it may cause. The analysis touches here this business phenomenon that together with many global changes might be crucial for shaping regional or national business elites. The analysis presented here will reach to some final conclusions and research hypothesis that can be explore further in CEE context.

Interlocking Directorates—Reasons and Benefits

The literature on interlocking directorates (InDi) is quite vast and gives various views on research methods, main aims of InDi research and impact the InDi have on societies, culture, politics and economy. Main paths of research divides into four categories: class hegemony (InDi are an outcome of class-cohesion and elite-related processes—Carroll 2004, 2006; Maclean et. al 2006; Useem 1984), management control (InDi are a method of better corporate governance—Mizruchi 1996), financial control (InDI are a result of close relations between industry firms and banks—Mintz and Schwartz 1981) and resource dependency (InDi help to control resources that exist outside firm and its natural environment—Peng 2001) (see O'Hagan and Green 2002: 51).

Generally all scholars agree that InDi are specific business practice related to a situation when certain individuals are members of board of directors in several companies at the same time (Useem 1984: 38). InDi are "a central case of interpersonal linkage between firms at board level" (Heracleous/Murray 2001: 148). They create linkages between companies and industry branches and have various functions for the company. However one must remember that InDi are created by executives who service more than one company, therefore InDi not only link organizations but mainly individual people. So while InDi are taken into account, firms should be seen as collectives combined of executives and other employees. Therefore InDi are an outcome of individual decision of executives and a company that (as collective) accepts it.

Why People and Organizations Engage in Interlocking Directorates?

One of important questions is—why certain firms and individuals decide to participate in InDi? The answer is—certainly because of some incentives and benefits. The most important and more general benefit from the company's point of view is to lower a level of uncertainty. In a complex and uncertain environment, every possibility to minimize threats or unexpected activity is extremely valuable for companies. Therefore other, fundamental for InDi creation benefits, can be perceived as related to this general rule.

Firstly, there might be the benefit of establishment a horizontal coordination between companies.[1] Such coordination works when firms might communicate regarding pricing, advertising, research and development. Directors serving both (or more) boards can be a source of this communication. Secondly, there might be also a benefit of vertical coordination.[2] Then an outside director might secure a better pricing, better conditions for supplies, better delivery schedules etc. The third benefit comes from an expertise. When some executives service other firms, the knowledge he or she gets might be used by both sides. Executives can identify alternatives for certain decisions and protect development of company capital. The fourth benefit is reputation. Having a respected people on a board (connected, with vast social networks and high level of social capital) is a signal for the rest of industry as to the wealth or value of this company. Favorable image of firm (built by executives) might be a protection from non-governmental organizations or public institutions at the time of crisis (Schoorman et al. 1981: 244–245).

The InDi phenomenon comes from a long tradition and practice arose in American capitalism where (as researchers such as William Domhoff, Thomas Dye or Michael Useem showed) business expansion is strongly related both to a personal activity of elite members and more general process of corporate centrality. William Domhoff in one of his articles describes how journalistic investigation showed that in the final years of XIX century several banks practically controlled most of American big companies at that time (controlled—meaning that these banks not only had shares of these firms, but through decisions about credits and loans for certain industry shaped external conditions for their business activity). And similarly in 1845 group of 80 men controlled 31 textile companies, which was 20% of American textile market (Domhoff 2005). First InDi were created in USA when market was in a monopoly and concentration of assets phase. For a long time InDi were out of state control, but when administration begun its fight with monopoly and cartels, special regulation was introduced in 1914—The Clayton Act. This Act forbids being a member of board of directors in companies that compete for the same goods or market. Currently in the United States, direct interlocks are illegal under the *Clayton Act*, which has been revised in 1990 by the *Interlocking Directorates Act* in a more restrictive direction (Carbonai/Bartolomeo 2006).

InDi are also an outcome of growing industrial relations. Companies are building their business relations with many entities in order to function properly and successfully—they cooperate with banks, office suppliers and firms from the same industry branch. The nature of contemporary capitalism makes these companies a part of a very complex environment where many professional relations must be sustained at the same time. According to the research conducted by newspaper "USA Today"

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[1] This coordination exists between companies from similar or the same branches of industry. Often between firms that normally would compete for the same market share.

[2] This coordination exists between company and its suppliers (so between noncompetitive companies).

and The Corporate Library organization in 2002, eleven out of fifteen biggest firms in USA have at least two members of board of directors that are engaged also in other companies. This research shows that in the USA 22 000 members of boards and 2000 companies deal with InDi phenomenon.[3]

In this context, InDi might be perceived as a result of a company dealing with a specific "loss of autonomy." Meaning that firms no longer can function successfully without many business links. The nature of capitalism often force firms to merge, to acquire parts of other companies and to cooperate. CEOs cannot focus only on their own firms, they must stay alert and watch other firms daily activity. InDi practice help gathering information and keeping competition at suitable distance (O'Hagan/Green 2002). Therefore in such complex environment firms sometimes choose InDi over merging strategy (Schoorman et al. 1981: 245). InDi might give benefits (like insider information) without costs related to long merging process. So InDi might be seen as a way to minimize some transactional costs in business. For example it's easier to have executives on a board in other firm, than hostile takeover that firm.

There are also some specific conditions favorable for InDi creation:

- when ownership of part of market/environment is for some reasons formally prohibited;
- when ownership is impossible because of resource constrains (ibid.: 245–246).

These conditions are additional factors for firms to search for InDi creation, in order to reduce transactional costs of entering difficult market with many constrains (legal, in resource matter etc.).

If we're looking for individual reasons of InDi creation, career advancement is quite important. Being a director/executive in two or more firms is definitely strong incentive for many. Individual motives like greed, ambition or even curiosity should be taken into account. But the research made on elite connections in corporate world gives us better sociological explanations for this phenomena. These explanations fall into two categories: "InDi are mainly class driven phenomena" and "InDi are global superclass phenomena." However these categories are concentrating on elitist aspects of InDi, they might give some insights into the motivations of individual executives.

a. InDi as Mainly Class Driven Phenomena

Scholars that concentrate on this issue are mostly followers of scholars like C. W. Mills or W. Domhoff. They analyze world of corporations not simply as business organizations, but rather as specific locus of power in modern western societies.

As Michael Useem (1984) presented, InDi's role can be "cementing ties within upper capitalist class" (see Heracleous/Murray 2001: 149). Useem claims even that the "inner circle" of capitalist class are those who serve on boards of two or more companies. They develop an understanding what is best for their class and business as a whole (see Clawson/Neustadtl 1989: 750).

[3] http://www.usatoday.com/money/companies/management/2002–11-24-interlock_x.htm (access 2.07. 09).

From this perspective, InDi are an outcome of individual choices made by businessmen, who wants to make business community more coherent, while promoting their own interests and boosting their position in an upper class. This view supports thesis that:

> interlocks are the result of the upper class creating cohesion among their group. Board memberships a shared commitment among the ruling capitalists to control commerce. By continually appointing elite individuals to their board of directors, the upper class will always be in control of wealth. Sonquist and Koenig (1976) justify this argument by revealing that only the most prominent and powerful individuals of the business community sit on boards. By excluding other groups, elitists ensure their interests are preserved over time (O'Hagan/Green 2002: 51).

According to this view, InDi are created by ambitious and powerful people, who seek to secure their individual interests. But of course, these interests are preceded by factors like elitists culture those people were grown up in, nature of prestige and common upper class experience (see Domhoff 2006). Meaning, that formation of these interests comes from certain group, class experience which requires that individual men should seek methods of securing personal and common wealth.

b. InDi as Global Superclass Phenomenon

InDi were explored by scholars from 1960's, but the nature of globalization era forces some of scholars to analyze InDi in a light of global and transnational relations. This trend is still in the making, research is still not completely done. Here some proposal is presented to analyze InDi not only as class-driven phenomenon, but also as global superclass one.

The term "superclass" comes from the book by David Rothkopf (2008). The author analyzes "global power elite" and their impact on world economy, culture and politics. He identifies people around the world who are influential on some aspects of life and make decisions that shape things on a global scale. While Thomas Dye wrote in his work on American power elite, that about 32% key positions in business and politics in USA interlock with each other (Dye 2002: 140), Rothkopf sees these networks as global ones:

> Another key factor at work is that the most powerful people are closely connected to other powerful people through networks that reinforce power, access and reach. We have seen how the top board members and managers from the top five companies alone have direct influence over 150 companies and over twenty institutions of higher learning through board, advisory and executive positions (Rothkopf 2008: 302).

The superclass as Rothkopf claims, is a group of about six thousand people living in different countries and being exceptionally influential. They interlock societies and various aspects of activity with their decisions and trends they introduce. But because corporate power and corporate elites are at the core of superclass, process of interlocking of companies is especially important (Rothkopf 2008: 39, 46).

The accumulation of financial capital is crucial to global superclass' existence—as InDi generally make strong impact on possibilities of capital accumulation (Mintz/Schwartz 1981). Firstly on a national then on a transnational level. However as William Caroll discovered in his research, from the mid 1970s to the mid 1990s there was no massive shift from a national to a transnational pattern of interlocking;

> the process of transnational class formation did not fragment national corporate networks but occurred alongside their reproduction. Thus, the transnational network formed a thin superstructure atop rather resilient national bases (Carroll 2007: 4).[4]

This superstructure, as Carroll says, is an outcome of corporate elite struggle to achieve cohesiveness as a world business community. It means that lots of networks (which includes InDi) are national focused. However Carroll support the thesis "that transnational interlocking is less about intercorporate strategic control than it is about constructing a global business community" (ibid), he sees opportunities of further expansion of InDi on a global scale as well.

Therefore although links between boards of directors are not very strong on a transnational level, there are some indications that there is a certain, global critical mass coming from corporate and individual decision of entering InDi.

Problem of Conflict of Interest

COI can be defined as double-loyalty situation, when man or organization being connected to at least two various institutions, has objectives that cannot be fulfilled at the same time and with the same benefits for both sides (Lewicka-Strzałecka 2005: 7). Usually COI is related to public-private dilemma, when someone represents both public and private interests, which are in a way contradicted. COI can be seen in "wide" and "broad" perspective (see Stankiewicz/Burdziej 2011). In the *wide* one, there is an actor who is loyal not only to his official institution, but also to a certain other actor/institution, which generates competing interest and impact. Therefore there is always someone standing behind the actor who is in the COI. And there always is an unofficial tie between them. Example: civil servant from the ministry of finance while working on some specific bank law regulation, hides that in fact he/she works also as expert for one of the bank that will be seized by this regulation. According to the *broad* perspective, actor is in COI when represents a more general belief/idea, that stands in a contradiction to his official duties or concepts embedded within his official position. Example: civil servant from the ministry of agriculture because of his/hers ecological ideas and beliefs, finds it difficult to comply with some requirements of his/hers duties which demand a support for GMO companies.

COI might also be defined as "a situation in which an individual has two separate and competing interests, and it is unclear which interest will win out if it comes down to it" (Council of Foundations 2006). Situation close to COI is so-called "the duality of interest:"

> A more neutral term for a conflict of interest that may exist when a board member or an employee of the foundation is affiliated with an organization seeking a grant from the foundation. An affiliation exists if the

[4] W. Carroll writes: The reach of today's TNCs and of financial markets may be global, but the governance of corporations and the life of the haute bourgeoisie remain in important ways embedded in national and regional (including transatlantic) structures and cultures (Carroll 2007: 3).

person has an official role as a director, trustee, officer or employee of the organization, or an unofficial role such as significant donor, volunteer, advocate or advisor (ibid.).

But still we deal here with a duality of loyalty. When InDi are taken into consideration we must be aware that such duality is essential.

Generally speaking, the phenomena of InDi seems to be problematic on two levels—for economic reasons (InDi might destroy free-market balance by helping to build monopoly) and for ethical reasons (InDi might lead to conflict of interest). On economic level, InDi are related to corporate centrality. William Domhoff describes how networks of American corporation are concentrated around certain bank, insurance company or even office supplier (like 3M which is extremely important for modern InDi in USA). This concentration follows the InDi practice (Domhoff 2005). But as some researchers point—InDi may lead not only to growing industrial interrelations, but also to such collusive behavior as price fixing, market division, oligopoly and other antitrust violations. Personal relations between boards of directors, situation when same individuals work for several firms, is often dangerous for the fair market game.

The matter of strength, quality and real impact of linkages between companies sharing same executives on their boards, is an interesting issue. It is difficult to assess whether COI occurs or not. Interlocks between competing firms are called *direct interlocks*. However linkages between boards may even take a shape of "weak ties" (in terms of Mark Granovetter concept) or "indirect linkage." For example, when two executives from different firms are members of the same country club, the tie between them is not clear. We don't know, whether it influences their behaviors, do they exchange information about their companies, do they try to influence their business decisions? (Schoorman et al. 1981: 246). This difficulty is expressed by two, Italian scholars:

Interlocking directorates occur regularly across industries and have often been praised, since they mobilize a scarce resource: the expertise of senior managers and directors of large corporations. However, the plurality and co-occurrence of positions in the company boards is a usual suspect of violation of perfect competition and market concentration, especially in the case of direct interlock (Carbonai/Bartolomeo 2006).

InDi and COI—some examples

InDi are a corporate practice, however it's important to stress here that people serving on boards of several companies very often are members of other networks, outside these companies. Therefore they can be members of boards of NGOs, members of country clubs, business clubs etc. Those connections are also significant to the COI situation. Lately we have been hearing a lot about "corporate scandals" and this term become more and more popular. Those scandals had various "faces" and different shapes, but a lot of them were InDi-related. Below a short list (and description) are presented. Although we must underline that this is not a typology, but rather an open proposal of InDi-related list of COI.

"Corporate Scandals 1"—Financial Misuse

The Western world entered XXI century not only with 9/11 aftermath, but also with huge corporate scandals like Enron and Tyco, which proved that "a substantial feature of those scandals was the lack of independence on corporate boards." Both corporations were a model example of negative sides of InDi. On such interlocking boards, members not only served on one another's boards but also, apparently, served one another's interests as well (Council of Foundations 2006). Multilayered ties and complex networks with too many loyalties and too many possibilities to profit, were in a final outcome deadly for the companies and their shareholders.

It seems that companies that use InDi practice are more prone to misuse of corporate finance. David Rothkopf relates in his work to a research from 2006 that showed that boards affected by InDi phenomenon are more inclined to grant generous "golden parachutes" and grand bonuses to its executives. And they spend this money even if a company suffered substantial financial losses at that time (Rothkopf 2008: 73). This was an exact case in both Enron and Tyco.

Big companies more often deal with InDi—in fact the bigger firm is, the more complex network its executives are entangled into (see Mintz/Schwartz 1981). In Enron case, specific interlocking relations with audit companies boosted misuse of "creative accountancy" and helped to hide losses. One of the face of corporate scandals that leads to financial misuse, are stock options-related COI. It even seems that COI comes almost solely from the idea of stock options:

> By allowing its board members to have stock options companies are theoretically dangling a carrot in front of them that they will chase on the way to company improvement. The theory is that by allowing these options board members will also be compelled to drive the company's stock as high as possible. It is also seen by many as a necessary bonus and a way to tie board members to their company's success in a way that would not otherwise be possible. But the reality is often a stark contrast to this ideal. In many cases CEOs and other corporate board members "springload" or "backdate" their stock options so that they will take effect right before the stock is set to go up due to news only they are privy to. This of course is the equivalent to robbing their own shareholders blind. That is the line, the temptation. To pull in more money for yourself and deny that much more to the shareholders (Radcliffe 2010).

InDi create networks among executives and other companies. They base on social capital of individual. And while this capital might be use for company's good (by providing necessary information or prestige), it often leads to simple misuse of power—like acting in a way that benefits individual while hurting company and shareholders.

Corporate Scandals 2—Cartels

Cartels are today one of the most harmful way to act in business, if we take society's and consumers' needs. However for many companies cartel is a good choice of making business, especially on a global scale. For example in 1990's for many years The Vitamin Cartel among pharmaceutical firms existed, promoting higher prices of vitamins around the world (Bernd 2002; Hackenbroch 2002). InDi phenomena might be useful in cartel creation.

Companies wishing to cartelize a market may try to compensate for an absence of trust among independent companies by creating interlocking directorates, which can create trust at several levels (Carbonai/Bartolomeo 2006).

Trust is one of the most important problems for every cartel. The lack of trust between cartel members usually lead to dissolution of behind-the-scenes agreement.[5] InDi are an organized way to minimize violation of individual trust. Famous cartels like the diamond cartel or DuPont-General Motors cartel worked due to relying on InDi (Rothbard 1995). As Davide Carbonai and Giovanni di Bartolomeo discovered, in Italy insurance companies used InDi to support a large cartel that dominates the national market. Cartels stability was there assured by the trust generated by the InDi.

With placing a director on a cartel partner's board, each cartel member has an observer in place who can monitor activities such as plans to reduce price, expand capacity, or introduce new products that could undermine the cartel agreement (Carbonai/Bartolomeo 2006: 18).

So cartels by usage of InDi lowered degree of competition on a certain market. InDi helped to violate free-market rules and customer rights at the same time. However from the company point of view, InDi helped to lower transactional costs by minimization a possibility of trust violation.

Corporate Scandals 3—Corruption and Revolving Door

Third way that links corporate scandals with InDi is "revolving door." This practice known as moving professionals between world of business and politics. Revolving door works all around—politicians move to private companies of certain industry branch, businessman are appointed to government institutions, or politicians become lobbyists (*A Matter of Trust…* 2005). In fact often revolving door practice is condemned because it creates opportunities for corruption. InDi also definitely facilitates moving through revolving door and create personal links that can be used in a future. They boost social capital and networking skills, which are crucial for revolving doors.

Usually the practice of revolving door is presented as harmful to public goods and public interests. Like in the interesting case of Tom Donohue, who as President of US Chamber of Commerce at the same time served on several boards of American corporations and was involved in political campaigns of US Republicans (Morgenson/Justice 2005). One of COI was discovered regarding climate legislation that supposed to put restrictions on coal companies. While 19 of the companies' on the Chambers' board were supporting this climate legislation and only four (including three coal companies) were against it, the US Chamber staff continued to take a "hard-line position on the issue." The source of problem was COI between Tom Donohue's role as President of the US Chamber of Commerce and his role as an 11-year member of the Union Pacific Railroad's Board of Directors, the company who was strictly against climate legislation. It seems that in this case;

[5] Like in the case of price fixing agreement between Sotheby's and Chrisitie's. The dissolution of agreement was partly caused by lack of trust and not-enough strong motivations of the two deputies that conducted price fixing on their bosses orders (Mason 2004).

Donohue who is resisting calls from his own board members to stop fighting against federal climate policy, is being richly compensated by Union Pacific, a company which—along with some of its key businesses partners—is vigorously fighting against federal climate policy (Altman 2009).

Another example of combining revolving door, InDi and corruption is the case of American corporation PWC (Public Warehousing Corporation), which supplied US Army in Iraq (PWC supplied mainly food). PWC was accused by US Dept. of Justice of fraud and corruption, but before that accusation, it has been using for a long time InDi procedure (common directors with other company—the Sultan Center—which had link to military officials and knowledge on Middle east region) and revolving door procedure (hiring and contracting ex-military official) (Chatterjee 2010).

Of course the revolving door practice is not directly linked to InDi and corruption. Unfortunately quite strong assumption based on certain examples can be made—that linkages built between executives who cross-serve same companies, might be used in a harmful way. And relocation from private to public (or reverse) facilitates it.

Conclusions

InDi have become a quite popular way of business reducing transactional costs and power/corporate elite connecting. As researches conducted in many countries (USA, Canada, Italy, Belgium, UK, France) have shown, InDi have gained substantial impact on how industries and business branches are performing. While both benefits (lower transactional costs, better communication, knowledge exchange) and threats (COI, cartels, corporate scandals) were present at the same time.

Therefore it seems that InDi should be further explored also in the context of CEE countries business and politics.[6] Reasons (some are rather hypothetical and require separate studies) for that are as follows. Characteristic feature of systemic transformation from communism to capitalism was often an imitation of procedures and schemes typical for Western economies, but at the same time local features (like a power of informal networks and clientelism) often have prevailed in economy (and politics). Studies of InDi in many countries proved that informality plays a great role in possible threats (like COI) creations. Therefore the more studies over InDi in CEE region should taken into account following problems:

- As many scholars proved (Staniszkis 2001; Wedel 2007, 2009; Zybertowicz 2005, 2008), post-communist countries are generally more prone to blurring boundaries of private/public sphere and legal/illegal actions. Networks that InDi create can strengthen the negative power, that these already blurred boundaries have on society and economy. Probably InDi between firms and NGOs'/private foundations' boards might be used to generate political and economic capital.
- InDi are especially suitable for markets that put some restrictions on business (CEE region might be perceived as such). So InDi can be used probably as a method of entering local markets for foreign companies.

[6] See works done on Polish networks between business and politics—Batorski 2006, 2007 and Drąg 2001.

- InDi can be used in CEE countries to make business community more coherent. It probably can be important factor for corporate elite formation.
- InDi practice as related to COI and various misuse of power, can be possibly harmful for the process of building strong economies in a region.

Finally, InDi phenomenon should be research in the context of CEE region, because networks built around it might evolve into new, specific locus of power (a *constellation of interests* as John Scott put it—Scott 1990). Hypotheses is here that maybe outside such constellations a real power in corporate *field* doesn't exist.

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