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Constituency Directors – Controlling the Information Flow

With the increasing prevalence of directors designated by specific stockholders being added to boards (and the possibility of even more if proxy access regimes take hold), companies must find the right balance of rights and restrictions to address the access that a director designee and the designating stockholder have to company information.

A growing number of public companies have recently added directors who are designees of activist hedge funds or other financial investors, often following a proxy contest or as a result of the settlement of a threatened or pending contest. These companies are now facing difficult questions about the flow of confidential information to and through these "constituency" directors, complicated by the perception or reality that these designees may be acting on behalf of or favoring the interests of their sponsors. A number of recent Delaware decisions have addressed this information flow and highlight two key questions that companies must grapple with:

(1) To what extent are directors, regardless of provenance, entitled to full and equal access to corporate information?

(2) Are directors designated by investment funds or other sponsors permitted to share information received in that capacity with their sponsors?

In the recent *NavLink* decision, VC Noble addressed statutory demands by two directors under §220 of the Delaware corporation law for access to emails and documents of the company that they believed had been unfairly withheld from them while being shared with other directors. The court, citing Delaware precedent, stated that a "director who has a proper purpose…has 'virtually unfettered' rights to inspect books and records … at least equal to that of the remainder of the board. Management cannot 'pick and choose' the specific information each director receives." The court described this access right as concomitant with the directors' fiduciary duties and ability to fulfill those obligations. It is not limited to communications in a formal board setting and includes fair opportunity to participate in all board meetings and reasonable and timely access to employees and information. However, the right is not unrestricted, with any demand needing to be reasonably related to the director's role. Applying these principles, the court ordered the company to share with these directors communications between the board secretary and other directors regarding board meeting minutes, between the company and a contract counterparty about key agreements being considered by the board, and between management and outside counsel relating to scheduling the annual meeting, but denied the directors' request for broad access to all communications among board members and between the other board members and management (sought to prove that the other board members were colluding, including by holding secret pre-meetings, to exclude them from board business and discussions) and open-ended access to all communications relating to the company's operating plan.

While the right to information for directors may be broad, the director's fiduciary duties include an obligation to maintain the confidentiality of any information received in the director capacity. A breach of this confidentiality obligation exposes a director to a fiduciary duty claim, one that may not be eligible for exculpation or indemnification.

This simple proposition gets complicated where a director is designated for board nomination by a stockholder. Perhaps surprisingly to some, Delaware law seems to set a default principle that, absent prohibitions to the contrary, such a director may be permitted to share information with the fund that designated or nominated her. In *Kalisman*, VC Laster held that a principal of a hedge fund that served as a director of a public company in which the fund owned 14% could not be denied access to company information (including attorney-client

privileged material) based on a fear that he would convey the information to the fund. The court noted in dicta that, "When a director serves as the designee of a stockholder … and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director." Of note, the case-law does not provide clear guidance as to when a director is deemed to act as the "stockholder's representative" (e.g., how to treat a nominally independent director identified by an activist investor for nomination?) and leaves open the possibility that a company may deem it appropriate to prohibit such a transmission of some or all confidential information (e.g., a company could choose to allow sharing of business and financial information for purposes of analysis by the shareholder, but not information about board deliberations or decisions). Of course, a stockholder who receives information from a director is not free to share the information with others and is exposed to insider trading risk if it trades while in possession of material non-public information received through its director.

Facing these realities and uncertainties, companies with constituency directors may want to consider combinations of policies and agreements applicable to the director and/or her sponsor to supplement basic fiduciary duties in order to manage confidentiality, information use and insider trading concerns that arise from the broad access rights of the director and, by extension, the sponsor. Whether these policies or agreements can be imposed, as opposed to agreed upon, may be a function of the specific circumstances such as a legitimate concern about a conflict (see, e.g., *Universal American* where the court held the company could insist that a designee director sign a confidentiality agreement as a condition to being seated because the nominating stockholder was engaged in litigation with the company). In certain circumstances, such as an issue of direct adversity between the company and the nominating stockholder, a withholding of limited information or use of a special committee may be permissible to limit or delay information flow to the designee director on the specific issue of adversity.

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With the increasing prevalence of directors designated by specific stockholders being added to boards (and the possibility of even more if proxy access regimes take hold), companies must find the right balance of rights and restrictions to address the access that a director designee and the designating stockholder have to company information. Even if the company or the rest of the board perceives the designee as being "hostile" or not aligned with the other directors and the company's other stockholders, the ability to restrict access must take account of the Delaware principle that favors director rights to review the company's books and records. A full understanding of the director's legal rights, and the various techniques that can be used to mitigate resulting risks, is an important element of the onboarding process for these constituency directors.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland author or your regular Kirkland contact.

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