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Lurking Questions for Board Observers

A recent Federal appellate court decision on potential liability of board observers under the securities laws is a useful reminder that the legal status, rights and obligations of board observers remain unsettled and therefore attention should be paid to those issues at the outset of an observer arrangement.

While shareholders in a company will often negotiate to take board seats as a means to monitor their investment, in many instances investors will also or instead request the right to appoint a board observer. While the details may differ, observers do not have voting rights but typically have the right to attend board meetings, receive board materials and participate in board discussions.

In the recent Third Circuit [decision](#), a majority of the court determined that board observers did not have liability under Section 11 of the Securities Act for misrepresentations about the company's condition ahead of its IPO. Section 11 liability attaches to any person "named in the registration statement as being or about to become a director, [or] person performing similar functions." Although the prospectus conceded that the observers may "significantly influence the outcome of matters submitted to the Board of Directors," the majority focused on three key distinguishing factors in determining that the observers were not covered by Section 11:

1. The observers did not have the right to vote, which is the main mechanism by which directors exercise their management functions;
2. The inability of shareholders to vote the observers out of the office since their observer rights were under a contractual agreement;
3. The absence of a duty of loyalty to the company's shareholders.

The dissenting opinion acknowledged these distinctions, but felt that the admission in the prospectus of "significant influence" implied a more expansive director-like role that met the test of "similar functions."

A recent decision highlights the fact that the legal status, rights and obligations of board observers remain unsettled and should be addressed by the parties at the outset of an arrangement.

Even after this decision, which was limited to the narrow Section 11 question, there is minimal statutory or common law guidance on observers and the relationship is defined almost entirely by the contractual agreement granting the observer right. In entering into such an agreement, parties may wish to address some specific considerations that arise out of the ambiguous legal standing:

» **Fiduciary Duties and Litigation Exposure.**

The predominant view among practitioners is that observers are not subject to the same fiduciary duties as directors. Nonetheless and taking account of the recent court decision, the parties may wish to expressly define the role and function of the observer in a manner that supports that conclusion and reduces the risk that the observer is determined to be a "*de facto* director." The rest of the board should be cognizant of the observer's different status in this regard when the observer participates in board deliberations.

» **Indemnification and Insurance.** The absence of fiduciary duties does not prevent an observer from being named as a defendant in litigation. Because they are not directors, observers do not have the benefit of the indemnification and expense advancement offered to directors by statute and the company's organizational documents and may not be covered by the company's D&O insurance. Any such protection would need to be established in an agreement between the company and the observer.

» **Confidentiality.** In the absence of fiduciary duties, an observer may not be subject

to a confidentiality obligation unless one is included in the agreement. In addition, companies should consider whether observers should participate in certain sensitive discussions given the absence of fiduciary duties.

» **Conflicts and Trading Restrictions.** Unless addressed in the agreement, observers may not be covered by board policies relating to conflicts of interest or trading black-out periods.

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

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