3rd Circ. Decision Limits Liability of Board Observers

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In *Obasi Investment Ltd. v. Tibet Pharmaceuticals Inc.* [1], the U.S. Court of Appeals for the Third Circuit evaluated potential liability of two board observers for material omissions of negative financial information about Tibet Pharmaceuticals in connection with the corporation's initial public offering.

Investors in early- and growth-stage companies often require, as a condition to their investment, the right to designate at least one member of the board of directors or the right to appoint a board observer who will receive information provided to the board and attend meetings of the board in a nonvoting capacity — or in some cases, both. Each right provides the investor with a front-row seat to the operations and management of the company and the investment. However, a formal seat on the board of directors and an observer seat differ in many significant respects.

A recent decision by the Third Circuit serves as an important reminder of these differences, and the obligations that each carry, for investors and companies alike. In a precedential opinion on a matter that previously lacked judicial guidance, the appeals court held that as a matter of law the functions of the defendant nonvoting board observers were not similar to the functions of board directors for purposes of imposing liability under Section 11 of the Securities Act of 1933. While the court was evaluating the differences in the context of an alleged violation of the securities laws, as the court suggests in its opinion, the same principles could very well be applied to other situations.

Board members have fiduciary duties to the corporation and its stockholders. These include a duty of care and duty of loyalty. Simply put, directors must use reasonable business judgment in making decisions on behalf of the corporation, and must not engage in activities that are of self-interest or could be perceived as not in the best interest of the corporation and its stockholders.

When an institutional investor designates a director to the board of a portfolio company, this can create conflicting duties. For example, the director must act in the best interests of the portfolio company when acting as a director on its board, but those actions may not be consistent with how the director would vote if acting on behalf of the investor when voting as a stockholder of the company.

An observer right does not carry the right to vote on matters before the board, because the observer is not an official member of the board. Accordingly, the general understanding has been that observers do not have such fiduciary duties. Some investors, therefore, have preferred holding observer seats to avoid fiduciary duties and the inherent conflicts of interest.

This is particularly true in the case of strategic corporate investment arms. An observer right is still a very beneficial tool for investors, because it gives them the opportunity to attend board meetings and receive timely information to keep apprised of the issues and challenges facing the company, as well as the decisions being made that could affect their investment, and hopefully add valuable insights and assistance to the company's management in an advisory capacity.

From the company's perspective, observer rights do present some challenges. Because these rights traditionally have not carried with them any fiduciary obligations, there may be portions of board meetings or information from which observers should be excluded because it is particularly sensitive or could risk loss of trade secret protection or attorney-client privilege. This can create tension between the company and the investor, but, many of these issues can be addressed contractually.

Investors that seek a seat on the board are generally looking for more than just information and monitoring of their investment. They are looking to actually have a vote on significant matters impacting the management and direction of the company. Often, these board seats come with certain board veto rights — actions that will require the affirmative consent of the director designated by the investors. These investors recognize these rights carry accompanying fiduciary duties and typically seek to have the company indemnify them, and in many cases purchase insurance, to protect them against claims of breach of such duties. [2]

In *Obasi*, Hayden Zou was an early investor in Tibet, and L. McCarthy Downs was the managing director of the investment bank that ultimately served as Tibet's placement agent. Zou and Downs worked together to help Tibet go public, and were listed as nonvoting board observers chosen by the placement agent in Tibet's IPO registration statement.

The registration statement, however, failed to disclose that Tibet had defaulted on a loan from the Chinese government several months before the effectiveness of the registration statement, and instead simply referenced a long-term loan, without acknowledgement of the default. The Chinese government froze and auctioned off Tibet's assets shortly after the IPO closed, prompting the NASDAQ to halt trading, leading to a drastic decline in Tibet's stock price. Zou and Downs were among a number of defendants sued on behalf of a class of investors who alleged, among other claims, that the defendants had violated Section 11.

Section 11 imposes near-strict liability on certain enumerated categories of defendants for untrue statements or omissions of material facts in a registration statement. Individuals subject to such liability include "every person who was a director of (or performing similar functions)" of the issuer. [3] The U.S. District Court for the District of New Jersey in *Obasi* denied the defendants' motion for summary judgment, concluding that in their capacity as nonvoting board observers, Zou and Downs performed similar functions to those of the directors, and were therefore subject to Section 11 liability.

That decision rested heavily on language in the registration statement advising that, despite their lack of formal powers or duties, the board observers "may nevertheless significantly influence the outcome of the matters submitted to the Board of Directors for approval."

On appeal, however, the Third Circuit placed little import on the observers' ability to influence board decisions. Instead, it established that the basic functions of directorship are "defined by their formal power to direct and manage a corporation." In the Third Circuit's view, three features distinguished the board observers from the fundamental powers and responsibilities that define corporate directorship: (1) The observers could not vote for board action; (2) Their loyalties aligned with the placement agent rather than the shareholders; and (3) Their tenure was not subject to shareholder vote.

Accordingly, the role served by the board observers was, as a matter of law, not sufficiently similar to the core powers and responsibilities that constitute the function of directors to impose liability under Section 11, and the appeals court directed the entry of summary judgment in favor of the defendants. It is important to note that the factors cited by the court in making its decision are common to most, if not all, situations where an investor obtains the right to appoint a board observer in connection with its investment in a company.

The court's decision was limited to liability to shareholders under Section 11 arising from omissions in a company's registration statement. However, in a footnote, the court suggested that a more expansive understanding of who is a director might be appropriate in a different context, for example, in assessing insider trading liability under Section 16 of the Securities Act. Nevertheless, the decision offers welcome clarity for a broad class of board observers — and private equity and venture capital funds and other third parties who often designate people to serve in such positions — as it supports the customary industry view that observers do not carry the fiduciary duties that are ascribed to actual board members.

[1] *Obasi Inv., Ltd. v. Tibet Pharm., Inc.,* 2019 U.S. App. LEXIS 21902.
[2] At times, an investor (particularly, investment funds with a larger investment) will seek both a board and an observer sear, so that the investor can include a member of its staff or an additional industry expert who can assist in evaluating matters.
[3] 15 U.S.C. § 77k(a)(3).