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The board observer: considerations and limitations

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Overview

Appointing a board observer has long been a tool in an investor's arsenal. Board observers can represent the interests of the appointing investor by monitoring and participating in the activities and decisions of the company's board of directors. They can observe meetings of the board, ask questions of the other directors and weigh in on key deliberations. By observing the inner workings of a company's board of directors and indirectly influencing board decisions, a board observer can help to monitor—and protect the value of—the appointing entity's investment.

Board observers are distinguishable from board directors in terms of voting power, fiduciary liability, and the source of their rights and obligations. While board observers can indirectly influence a board's decisions by asking pointed questions and providing constructive feedback at board meetings, only members of a company's board of directors have the right to formally vote on matters submitted for approval by the company's board of directors. While members of a board of directors generally have fiduciary duties to the corporation on whose board they serve (including, in the case of corporations organized in Delaware, the fiduciary duties of care and loyalty, including the subsidiary duties of good faith, oversight, and disclosure), board observers do not owe fiduciary duties to the corporations whose boards they observe or to other stakeholders in such corporations. Rather, the rights and duties of board observers are defined by contract between the corporation and the appointing investor.

Board observers have long been pervasive in private companies. According to a January 2024 survey conducted by the National Venture Capital Association, 82% of the surveyed venture capital funds reported utilizing board observers within their governance frameworks, with 21% of such firms planning to increase the number of board observers in the near future. The increased reliance on board observers as a source of governance rights in private companies may be attributed to the increased leverage held by founders (who are increasingly reluctant to cede control in the form of board seats) and the increased size of financing rounds. While the lead investor in a private company financing round may receive the right to designate a member of the company's board of directors, other investors are generally limited to a board observer or the right to receive quarterly updates from management. The prevalence of board observers in the private company context stands in stark contrast to public companies, where board observers are not necessary to ensure a steady flow of information about the company (in light of the company's periodic reporting obligations) or provide a means to influence corporate decision-making (in light of the other methods for exerting influence, such as shareholder activism), are therefore exceedingly rare.

The presence of board observers may benefit both corporations and the investors that appoint them. From a corporation's perspective, the inclusion of board observers in certain meetings may expose the board and management teams to knowledge and experience that is otherwise lacking among the members of the board. From an investor's perspective, this informal position allows the appointing investor to both monitor its investment and influence corporate decision-making, steering the corporation in the direction favored by the appointing investor, without incurring the fiduciary liability of a director for the decision.

Board observer positions may make particular sense in certain contexts or industries. For example, board observer positions may be critical for lenders to distressed companies, which typically do not have representation on the board of directors but require more frequent information updates than the quarterly or monthly reporting of financial performance that lenders typically receive. Board observers appointed by lenders can also bring to the boardroom critical experience in overseeing the implementation of a restructuring plan, which is experience that those elected to the board based on industry experience may be lacking. Additionally, as discussed below, board observer positions may be necessary in consolidated industries as the only means by which a corporate investor can provide insight to, and attend meetings of, the board of directors of a potential or actual competitor, given the Clayton Act's prohibition on interlocking directors.

Access to information

Delaware courts have held that directors of a Delaware corporation generally have unfettered access to corporate information as a matter of law. Board observers, on the other hand, have no rights to corporate information unless set forth in a contractual agreement with the corporation. Such contractual agreements typically grant board observers the right to attend all meetings of the corporation's board of directors and any committees thereof, and to receive all materials provided to the corporation's board of directors and any committees thereof. However, these contractual agreements also frequently contain limitations. The most frequent limit on a board observer's right to access information relates to privileged legal advice. Directors of a Delaware corporation are treated as joint clients with the corporation, and therefore share the attorney–client privilege with the corporation. However, board observers are not formal members of the board, and do not share the attorney–client privilege. In most circumstances, therefore, the sharing of information with board observers would destroy any claim of attorney–client privilege. Accordingly, contracts establishing the information rights of board observers frequently caveat that observers have no right to receive board materials containing privileged information and no right to attend any board meetings at which such information will be discussed. Such contracts also frequently exclude board observers from accessing board materials containing trade secrets or other sensitive information, particularly where the board observer or appointing investor is a potential competitor. Indeed, one of the main competition concerns regarding board interlocks is that the flow of competitively sensitive information from one company to another through a board relationship could inhibit competition or lead to unlawful coordination between competitors.

While the Delaware General Corporation Law ("DGCL") does not set forth a duty of confidentiality, directors of a Delaware corporation are subject to the fiduciary duty of loyalty, which generally requires them to maintain the confidentiality of information obtained through their service on the board. Board observers, who do not have fiduciary duties to the corporation, are not subject to any such confidentiality obligations as a matter of law. Just as the primary source of a board observer's right to access information is the privately negotiated contract, the primary source of a board observer's obligation to keep that information confidential would be that same contract. And while the National Venture Capital Association's model provision for the establishment of board observer rights previously included language requiring board observers to act in a "fiduciary manner" with respect to the information disclosed to them, this language was removed in 2020. Instead, the confidentiality obligations of a board observer will often be negotiated using the company's standard form of nondisclosure agreement.

Liability of board observers

Fiduciary duty liability

Members of a board of directors generally have fiduciary duties to the corporation on whose board they serve, and claims may be brought in the name of such corporation against any director who breaches such fiduciary duties. However, as noted above, board observers in a Delaware corporation do not owe fiduciary duties to the corporation and, therefore, do not face exposure under this theory of liability.

Securities law liability

This distinction between board observers and members of the corporation's board directors also minimizes their liability with respect to securities law. In 2019, the US Court of Appeals for the Third Circuit, in *Obasi Investment Ltd. v. Tibet Pharmaceuticals, Inc.*, found that board observers could not be held liable under Section 11 of the Securities Act of 1933 for misrepresentations regarding the financial condition of Tibet Pharmaceuticals, Inc. in connection with the company's initial public offering. Section 11 of the Securities Act of 1933 imposes liability on anyone who, with his or her consent, is named in a registration statement as, among other things, a person performing similar functions as a director. The court held that the company's board observers could not be held liable under Section 11 as the role and legal liabilities of Tibet's board observers were dissimilar to those of directors, noting that the board observers did not have the right to vote, did not have a fiduciary duty to shareholders and could not be voted out by shareholders.

While *Obasi* may give board observers some comfort, the Securities and

Exchange Commission ("SEC") has suggested that any individual may be considered a director for purposes of Section 16 of the Securities Exchange Act of 1934 if the individual "functions as a director." In a 2002 amicus curiae brief to the US Court of Appeals for the Second Circuit, the SEC noted that a "person's title is not determinative" of whether he or she is a director. However, where an individual does not have the title of a director, merely having access to nonpublic information about the corporation and assisting the board in formulating policy is not enough for the SEC to label that individual as a director.

Insider trading liability

Board observers and the entities that appoint them should also be mindful of compliance with Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, which prohibit fraud in connection with the purchase and sale of securities. Entities with a right to appoint a board observer to attend meetings of a corporation's board of directors frequently hold significant economic interests in such corporations. Whether these economic interests are in the form of equity securities or debt securities, the appointing investor's ultimate goal is to enhance the value of that economic interest and ultimately sell it for a favorable return. By attending board meetings, board observers will frequently become privy to material nonpublic information ("MNPI"). If a board observer or appointing investor proceeds to trade securities of the corporation while in possession of MNPI about that corporation without disclosing such MNPI to the purchaser of the securities, it could constitute fraud in connection with the sale of securities and expose the board observer or appointing investor to liability under the federal securities laws or equivalent state laws regarding insider trading. While board observers are generally not covered by trading "blackout" periods under a corporation's insider trading policy, as a matter of law, the observer and appointing investor will not be able to trade in the corporation's securities while in possession of MNPI. Accordingly, if an appointing investor desires flexibility to trade in the securities of the corporation, it would be prudent for the appointing investor's board observer to stop attending board meetings or terminate their board observer position.

Indemnification

While the range of potential sources of liability is more limited for a board observer than for members of a company's board directors, the absence of fiduciary duties does not prevent an observer from being named as a defendant in litigation. For example, a board observer who misuses confidential information could be held liable for basic negligence. And while Delaware courts will generally defer to a director's business judgment (as long as the director was acting in good faith, exercising reasonable care, with the reasonable belief that the director was acting in the best interests of the company), no such deference would be afforded to actions by a board observer. Additionally, while the DGCL provides that a director shall be fully protected in relying in good faith on company records, no such protection would be available as a statutory matter to a board observer.

Importantly, board observers do not benefit from the indemnification and expense advancement afforded to members of a company's board of directors by statute and the company's organizational documents. While the DGCL provides that a company's certificate of incorporation may eliminate the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, such a provision would not typically impact the personal liability of a board observer who is not a director. The cost of defending oneself against even the most frivolous lawsuits can be significant, and it is therefore wise for board observers to secure some form of insulation against this expense.

Insurance

In certain cases, the contractual arrangement with a corporation that allows an investor to designate a board observer may require the corporation to add the board observer to its director and officer insurance policy. However, this approach is uncommon—particularly in the case of private companies—where insurance policies typically contain an "insured versus insured exclusion" of coverage for matters where certain parties covered by the policy (which would include any board observer covered by such insurance) are suing each other.

The most likely source of insulation against the cost of defending claims against a board observer would be an insurance policy purchased by the investor appointing the board observer. If the appointing investor is a private equity or venture capital firm and the firm has purchased general partner liability insurance, the board observer will generally be covered under this policy. The appointing investor may also offer to provide the board observer with indemnification and expense advancement similar to the indemnification and expense advancement afforded by the company to members of its board of directors.

Increased regulatory focus

Section 8 of the Clayton Act prohibits a person from serving on the board of directors of two competing business entities. It has been interpreted broadly to prohibit different individuals from sitting on the board of directors of two competing business entities as representatives of the same corporate investor. However, Section 5 of the Federal Trade Commission Act (which prohibits "unfair methods of competition") may prohibit arrangements involving interlocking directorates that violate the "spirit" of the competition laws, even where not expressly prohibited by the Clayton Act. To avoid running afoul of the ban on interlocking directorates, many corporate investors that wish to invest in a potential or actual competitor will request the right to have an individual representative attend and observe meetings of the board of directors of the company, rather than the right to elect an individual to serve on the company's board of directors. However, this practice is increasingly being scrutinized by regulators.

In December 2023, the Federal Trade Commission ("FTC") and the Antitrust Division of the Department of Justice ("DOJ") jointly released guidelines ("2023 Merger Guidelines") describing the factors and frameworks the agencies often utilize when reviewing mergers and acquisitions. Guideline 11 specifically addresses the anticompetitive risks that stem from partial or minority acquisitions that provide an investor with rights in the target, including the right to appoint a board observer to the target company's board of directors. The FTC and Antitrust Division of the DOJ warned that such acquisitions can present significant competitive concerns by giving the appointing investor an ability to influence the target company's competitive conduct, giving the appointing investor access to nonpublic, competitively sensitive information and reducing the incentive of the appointing investor to compete. Notwithstanding speculation that the new Trump administration would rescind the 2023 Merger Guidelines, new leadership at both the FTC and DOJ has indicated that these guidelines will remain in place.

Further, in a January 2025 statement of interest, these same agencies argued that board observers should be subject to the same prohibitions that would apply if they were serving as directors. While that statement of interest was filed in the final days of the Biden administration, the two Republican commissioners (including the new Chairman) concurred in the statement, signaling that this position may persist under the new administration.

The Committee on Foreign Investment in the United States ("CFIUS"), an interagency committee that investigates the national security implications of certain transactions involving foreign investments in the US, has also recently increased oversight regarding the use of board observers. While CFIUS regulations previously required filings only for transactions that could result in *control* of a US business by a foreign person, the Foreign Investment Risk Review Modernization Act of 2017 broadened the scope of transactions subject to CFIUS review to include *noncontrolling* investments by foreign investors in US companies whose business involves critical technologies, critical infrastructure or sensitive personal data. This includes transactions that afford the foreign investor with the right to appoint an observer to the company's board of directors or access to any material nonpublic technical information in the possession of the company.

Conclusion

Before accepting a board observer seat, companies and individuals should consider the implications. While the liability profile for a board observer is more benign than the potential liability for a director, the access to and possession of material nonpublic information may limit flexibility to transact in the company's securities and expose the board observer to claims under multiple theories of liability, without affording the board observer certain protections that are available to directors as a matter of common law or statute. The potential for the board observer or appointing investor to influence the target or access certain information may also result in scrutiny from regulators.

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