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Third Circuit Discusses Important Differences Between Board Observers and Directors

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The Third Circuit recently issued an important decision for private fund advisors who serve on corporate boards. In a precedential decision on a matter of first impression, the Third Circuit distinguished the role of nonvoting board observers from the function of formal corporate directors. And while the decision was issued in the context of liability for alleged violations of the securities laws, the Third Circuit suggested the analysis may apply more broadly to other situations involving board observers.

The case, *Obasi Investment Ltd. v. Tibet Pharmaceuticals, Inc. et al*, began in New Jersey federal court as a class action lawsuit alleging Tibet Pharmaceuticals failed to disclose certain information about its financial health prior to its IPO. Two of the defendants, Downs and Zou, claimed they were merely observers to Tibet's board and therefore should not be found liable for any misconduct of the company board. The trial court judge granted summary judgment in the duo's favor on all counts except a violation of Section 11 of the 1933 Securities Act, stating that the question presented a novel issue ripe for an appellate court.

On appeal, the Third Circuit threw out the last remaining Section 11 claim against the two defendants stating that board observers are not the same as directors. A claim under Section 11 can be brought against any person "named in the registration statement as being or about to become a director, person performing similar functions, or partner." The issue before the Third Circuit was whether the board observers were "person[s] performing similar functions" to directors.

As board observers, Downs and Zou were unable to vote on company matters but, according to the registration statement, "may nevertheless significantly influence the outcome of the matters submitted to the Board of Directors for approval." Nevertheless, the Third Circuit pointed to three features that distinguished the board observers from directors:

1. The observers could not vote on board matters;
2. The observers were loyal to the placement agent rather than the shareholders; and
3. The tenure of the observers was not subject to shareholder vote.

In rejecting the plaintiffs' primary argument, the Third Circuit held their interpretation of the word "similar" to be too narrow, determining that even if a person is named as performing similar functions to a director, that person still may not "possess the directors' 'formal power to direct and manage a corporation, and the responsibilities and duties that accompany those powers.'" After comparing the responsibilities of Downs and Zou to those of a director, the Third Circuit held that the role of the board observers was not sufficiently "similar" to that of a director to find liability under Section 11.

The Third Circuit's opinion provides some helpful guidance on the distinction between nonvoting board observers and formal corporate directors. In connection with their investments in companies, private fund advisors often are given the right to hold one or more of the board of director seats or, alternatively, appoint a nonvoting board observer with informational rights. There are several significant differences between the two. For example, directors have voting – and sometimes veto – rights, but also owe certain fiduciary duties to the company and its shareholders and must be careful not to engage in activities that could be viewed as self-interested or not in the best interest of the company and its shareholders. In addition, a member of the private fund advisor who also sits on the company's board of directors must navigate potential conflicts of interest between their duties to the company and the private fund. Board observers, on the other hand, have access to important and timely information, and while they do not have voting rights, board observers, unlike directors, do not owe fiduciary duties. The Third Circuit's decision – distinguishing board observers from formal directors for purposes of liability in at least some contexts – is another data point for private fund advisors to consider when weighing the pros and cons of appointing one of its members as a formal director or a nonvoting board observer.

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