

Third Circuit Clarifies Board Observers Are Not Subject to Section 11 Liability

WRITTEN BY

Barry J. Bendes

It is common for investors in venture capital and private equity transactions, and in other investment arrangements, as a condition to their investment, to have rights to appoint board observers when director representation is not available. An unanswered question has been the extent to which a board observer has liability exposure under Section 11 of the Securities Act of 1933, for example, when a company goes public. Section 11 includes as someone who can be liable in the absence of a due diligence defense a “person who, with his consent, is named in the registration statement as being or about to become a director [or] person performing similar functions....”

In a decision of first impression, on July 23, 2019, the U.S. Court of Appeals for the Third Circuit in *Obasi Investment Ltd. v. Tibet Pharmaceuticals, Inc.*,^[1] answered that question, holding in a two to one decision that a non-voting board observer is neither a director nor a person whose functions are similar to those directors perform. In so ruling, the Court looked to the corporate law definition of director as one who is appointed to direct and manage the affairs of the company and who is subject to fiduciary duties in doing so. Specifically, the Court found that the basic functions of directorships are “defined by their formal power to direct and manage a corporation.” The Court then found that a board observer is not “similar” to a director because he does not have the authority, responsibility or accountability to direct and manage the affairs of the company.^[2] This is so even though the registration statement in this case indicated that the observer defendants could (but did not necessarily have to) significantly influence the outcome of matters submitted to the board for approval.

In reaching its decision, the Court distinguished the situation where a board observer could be found to be subject to the Section 16 short-swing profit provisions of the Securities Exchange Act of 1934 as a person performing functions similar to a director because Section 16 revolves around an insider’s access to inside information as opposed to the purpose of Section 11 of having responsibility for the adequacy of the company’s disclosure.

The decision is binding only in the Third Circuit, which includes Delaware. Nevertheless, the Third Circuit decision should provide a measure of comfort to persons serving as board observers and to organizations that appoint them.

^[1] 931 F. 3d 179 (3rd Cir. 2019).

^[2] On that point, the Court identified three features that differentiated the observers from the ?directors: (1) the observers could not vote for board action; (2) their loyalties aligned with the ?investor representative that designated them rather than the shareholders; and (3) their tenure was not subject to shareholder ?vote and was

set to end automatically.?

RELATED INDUSTRIES + PRACTICES

- [Capital Markets](#)