Designated Directors and Designating Investors: Early Planning is Key

By David M. Morris, Lois Herzeca and Julie E. Kamps

Investors often negotiate hard for the right to appoint a director to the board of a corporation in which they have invested.[1] The designating investor believes that the designated director will protect the investor's interests by consulting with the investor on major corporate decisions. This is a situation, however, where investors, the directors they appoint, and the corporations on whose board they serve should all be wary.

Under New York and Delaware law, designated directors (also known as "representative" or "constituency" directors) have the same fiduciary duties as other directors to the corporations on whose board they serve.[2] While designated directors may feel that they are serving the investor who designated them, legally their fidelity runs to the corporation and to *all* of the company's shareholders.[3] Delaware directors owe an "uncompromising duty of loyalty" to the corporations on whose boards they serve.[4] This duty "requires an undivided and unselfish loyalty to the corporation."[5]

There may be times, however, when the director's duty of loyalty to the corporation will conflict with the director's obligations to the investor. Many of these conflicts can be ameliorated—although not eliminated—by advance planning.

Disclosures to the Investor by the Director

What happens when the designating investor expects the designated director to report to the investor on non-public financial results, board discussions, potential corporate actions, and board decisions? On the one hand, the investor specifically sought board representation so that it could keep a watchful eye over its investment and receive exactly this type of report. On the other hand, the designated director has independent fiduciary duties to the corporation and all of its shareholders, which duties are usually understood to include a duty to maintain the confidences of the corporation.[6] There is little law or commentary addressing this situation,[7] but it appears that reporting to the investor should be permissible, as long as it does not harm the corporation or the other shareholders, is not prohibited by a specific corporate policy, and does not result in trading on inside information.

Some of the uncertainty arises from the fact that there is no explicit source for a director's duty of confidentiality.[8] It is usually inferred from either the duty of care, the duty of loyalty, or both. Some corporations adopt a policy of confidentiality or a policy limiting those people who are allowed to speak to outsiders.[9] If such policy is in writing and in sufficient detail, there is an explicit understanding among the directors and the investors as to the limits on disclosure. In many companies, particularly private companies, however, a confidentiality policy and its exact parameters, limits, and exceptions are not explicit or in writing. As a result, disputes may occur concerning how much or to whom a director may reveal information.[10]

The rationale for permitting disclosure by the director to the investor would be that there is usually no harm to the corporation from the disclosure because the investor will keep the information confidential and not use the information for its own exclusive benefit or to the detriment of the corporation. These assumptions may not be true in all cases. There are instances in which the investor's interest will conflict with the corporation's. For example, the corporation may be considering a business opportunity or a potential senior management hire that the investor is also considering. Or, the corporation may be planning a product launch that competes with the investor's business. Or, the investor may be an active trader and may wish to trade on the information it receives. As discussed below, the Securities and Exchange Commission will likely view that investor (and the corporation and the director) as having violated the insider trading laws if the investor trades while in possession of that information.[11]

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Unfortunately, it is not always clear in advance to the director or the corporation whether a particular situation involves a conflict. The director may not know the investor's plans and therefore may be unaware that a particular bit of corporate information is valuable to that investor. The board could vote, for instance, on a proposal to participate in an auction process to acquire a third party and the director may not know that the investor is planning to participate in the same auction process.

Rather than waiting until a conflict, a potential conflict, or a dispute arises, it is preferable to anticipate the issues and address them at the time the director designation is negotiated. There are steps that can be taken at that time to articulate the rights and obligations of each of the parties: the designated director, the designating investor, and the corporation. For instance, the corporate charter or by-law or the shareholder agreement that permits the investor to designate a director could include a provision specifically permitting certain information to be shared with the designating investor. This approach greatly reduces the risk of breach of fiduciary duty in disclosure, because the corporation has explicitly given permission for the disclosure.

At the same time, the provision could also protect the corporation (and the director and investor) by limiting both the number and types of individuals at the investor who receive information and the type of information given. For example, recipients might be limited to designated individuals with a role in the investment. The provision might also limit the type of information the investor gets. What limits are appropriate would depend on the specific relationships and facts, but typically might exclude information about areas in which the investor (or its portfolio companies) is known to compete. Depending on the nature of the corporation and the investor, the non-disclosable information might include certain types of strategic or forward-looking business planning, or perhaps R&D or marketing information. The provision could also set out general rules for when disclosure will and will not be made, or restrict the time or manner of disclosure of particularly sensitive items. A provision like this, negotiated and agreed to in advance, helps protect the designated director from unrealistic expectations and perhaps legal claims by both the investor (in case the director does not disclose the information and the investor thought he should) and the corporation (under the opposite circumstance).

As a condition of the disclosure, the corporation, the investor, and the director might enter into a confidentiality agreement. A confidentiality agreement protects both entities and the director. From the corporation's perspective, it ensures that the material it shares with its director is kept confidential and is used only in appropriate ways. By keeping the information away from areas of the investor that are involved in trading and by establishing a policy prohibiting insider trading, the agreement protects the investor and the director from a rogue employee who disregards the policy and trades or from a (false) accusation that the investor's trading unit had access to the confidential information.

A confidentiality agreement would also protect a public corporation from violating SEC Regulation FD (Fair Disclosure),[12] which prohibits selective disclosure and applies to anyone "who is a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information." Thus, the issuer, and the director, need to be sure that the designating investor will not trade on the basis of material nonpublic information disclosed to it by the designated director. Regulation FD specifically permits selective disclosure to "a person who expressly agrees to maintain the disclosed information in confidence."[13]

Disclosures to the Corporation by the Director

Just as designated directors need to approach reporting to the designating investor cautiously, so too do designated directors need to approach making disclosure (or not making disclosures) to the corporation with prudence. In connection with an issue before the board directors have a duty to bring all of their knowledge and skill to bear.[14] This includes a duty to disclose all material information known to the director relevant to the issue before the board.[15]

Under most circumstances, a director has no duty to inform the corporation of information that the director believes would be material to the corporation if there is no issue being presented to the board.[16] For example, the designated director would not be required to inform the board of the investor's confidential information unless there is an issue before the board to which such information is relevant and material. Thus, whether an issue is presented to the board is a determinant of whether the director has a duty of disclosure to the board.

There are situations in which an issue may be squarely before the board, but the designated director may be unable to make disclosure of relevant information because of an obligation of confidentiality to the designating investor. There are a number of common situations in which a conflict like this could arise. For example, if the board is considering acquiring Target, the director may know that the investor is also considering bidding for Target. Or the investor may know nonpublic facts about Target that would affect the desirability of the transaction. In either case, if the director cannot reveal what he knows, the director would have to recuse himself from the board discussion and action,[17] defeating the very purpose for which the investor appointed the director to the board. Moreover, depending on the situation, recusal itself may be tantamount to disclosure of some aspects of the confidential information, or at least be a red flag to the corporation that there is some confidential information available.

These issues can be ameliorated, at least in significant part, if addressed in advance, at the time the designation is negotiated. For instance, a specific provision can make clear the understanding that the designated director will not make any disclosures about the investor to the issuer. Confirming both sides' understanding that the director is not required to inform the corporation of the investor's confidential information may prevent misunderstanding and possible legal claims. Further, a provision could state that if information about the investor is relevant and material to a board issue, the designated director will recuse himself without disclosing the information or even the reason for recusal.

This reinforces and clarifies the parties' understanding, thus avoiding possible disputes where the law is ambiguous. Depending on the nature of the parties' business, it might even be possible to screen the director from certain types of issues that might be particularly conflict-ridden. For example, a director might agree to play no role in acquisitions, or research and development matters, if either of those were particularly sensitive given the nature of the investor's activity. This would avoid the need for case-by-case recusal.

Corporate Opportunities

Another area that deserves attention in advance of designating a director is corporate opportunities. It is not uncommon for directors to be presented with business opportunities, and it will be important to be able to determine to whom such opportunities belong. In general, the duty of loyalty requires that directors refrain from taking opportunities that belong to the corporation.[18] An opportunity belongs to the corporation if it is presented to the director in his capacity as a director and is within the interest and expectancy of the corporation.[19]

The corporate charter, by-law, or a shareholder agreement could contain a provision specifically addressing the circumstances in which the investor can make use of certain corporate opportunities.[20] Delaware General Corporation Law Section 122(17) permits a corporation to "renounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or one or more of its officers, directors or stockholders."[21] Thus, the corporation could waive its interest in all or some potential transactions, including competitive ones, and agree that the director has no duty to present any opportunities to the issuer.[22]

Voting Restrictions

In addition to issues relating to information transfers and corporate opportunities, designated directors also must consider their independence in the context of deciding whether to recuse themselves from board discussions or board votes involving the designating investor. While there is no *per se* rule prohibiting a conflicted or interested director from voting, the level of judicial scrutiny varies depending on whether each director and the board as a whole were interested in the transaction.

Disinterested directors "neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing . . . ."[23] They enjoy the benefit of the business judgment rule, which *presumes* that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" and puts the burden of proving the contrary on the plaintiff.[24] If the board is not disinterested, then the board will not be entitled to the presumption of the business judgment rule, and the burden will be on the directors to prove (depending on the circumstances) that they met their fiduciary duties and/or that a disputed transaction was "entirely fair," that is, that there was "fair dealing" and a "fair price."[25]

The safest course is often recusal from both discussion and voting.[26] Recusal from voting while participating in discussion can be helpful, but not as helpful as total recusal from the entire issue. And even total recusal—via delegation to a special committee, for example—may not avoid the entire fairness test, although it will shift the burden from the board to the plaintiff.[27]

Assuming that full disclosure of the material details of the conflict is made, recusal is not required, and an investor may prefer to have its designee participant in a significant decision. Indeed, Del. Gen. Corp. L. § 144 envisions that a conflicted director will participate and vote and provides that such transactions are not void or voidable provided they are approved by a majority of disinterested directors or a committee of disinterested directors, or a majority of fully informed shareholders.[28] The consequence of having an interested director participate may range from none, with full disclosure of the conflict (if, for example, the remainder of the board is independent and the investor is not a controlling shareholder)[29] to application of entire fairness review.[30] The possible situations are complex and must be analyzed case by case.[31]

Trading Restrictions

One of the areas necessitating special caution is the securities trading of the designating investor and the designated director. The short-swing profit rules and the insider trading rules both can limit the ability of the investor to trade in a public company's securities once the investor has designated a director to the company's board.

An investor that has designated a director to a public company's board may be subject to Section 16(b)'s short-swing trading rules,[32] which authorizes an issuer to recover any profit realized by directors from a "roundtrip" purchase and sale (or sale and purchase) of any equity security within six months. The Supreme Court, in *Blau v. Lehman*,[33] stated that the investor itself may be deemed a "director" for Section 16(b) purposes if it "deputizes" a person to perform its duties on the board.[34] If the relationship between the designating investor and the director on the board appears to be one in which the investor exercises control over the director, a court could find that the investor itself is a "director" for Section 16(b) purposes.[35]

The investor's intentions regarding the director it is designating are best clarified at the time of the negotiation of the board seat, and then the directorship conducted accordingly, to avoid this issue. If the investor chooses to exercise control over the designated director, it may want to acknowledge that it is acting as a "director by deputization," which would allow the investor to take advantage of the Rule 16b-3(d) exemption.[36] On the other hand, keeping the director's decision-making independent from the investor could avoid the investor's exposure to Section 16(b) entirely.

Designated directors and designating investors must also be aware of the insider trading rules. The SEC has adopted a presumption that traders who possess confidential information have used the information in trading, and thereby violated the rules; the SEC does, however, recognize the effectiveness of information barriers and certain other exemptions.[37] Directors or investors who trade while in possession of material, nonpublic information risk being subject to civil penalties up to three times the profit gained or loss avoided,[38] or even criminal liability.

"Tipping" is also prohibited.[39] Thus, the director who conveys confidential information to the investor should be sure that the investor is not going to use that information to trade, as there could be personal liability for the director himself as a "tipper," even if he does not personally trade in the company's securities. Depending on the circumstances, liability under this theory might even extend to the corporation, if it permitted the director to disclose to the investor, knowing that the investor would trade on the information.

As discussed above, it is safer to address these trading issues in advance, and to put confidentiality provisions and trading restrictions in place when the director is first designated.

Conclusion

Investors acquiring significant equity positions in a company typically try to negotiate agreements which will allow them to protect their investment—the most desirable protection is often thought to be the right to designate a director to the company's board. Although it may seem that a designated director will benefit the investor, such a designation carries with it considerable risks and uncertainties. Many of these risks, and much of the uncertainty, can be ameliorated by careful planning and by including in the investment documentation provisions that specifically address the issues of confidentiality and disclosure of information, corporate opportunities, and insider trading.

Notes

1. The article assumes that the investor is not a controlling shareholder, although many of the same principles would apply to a controlling shareholder.

2. *See*, *e.g.*, Williamson v. Cox Communications, 2006 WL 1586375, at *4 n.49 (Del. Ch. June 5, 2006) ("[a]s directors . . . the individual defendants owed fiduciary duties to the Company"); 1 R. Franklin Balotti & Joseph A. Finkelstein, The Delaware Law of Corporations and Business Organizations, 3d ed. § 4.16 [E][2] (2003 & 2008 supp.) ("the duties of directors designated by large stockholders are clear: under Weinberger, they still owe the corporation and its shareholders 'an uncompromising duty of loyalty'") (hereinafter cited as "Balotti, § __"); 1 Edward P. Welch, Andrew Turezyn, and Robert S. Saunders, Folk on the Delaware General Corporation Law, 5th ed. § 141.2.1.7 ("[T]he law does not recognize a special duty on the part of directors elected by a special class to the class electing them. Rather, the law demands directors' fidelity toward the corporation and all its shareholders.") (hereinafter cited as "Folk, § __); cf. Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984) ("It is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director."), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

3. *See* supra note 3.

4. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (directors owe an "uncompromising duty of loyalty").

5. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

6. *See* ABA Committee on Corporate Laws, Corporate Director's Guidebook, 5th ed., pp. 26-27 (2007) (hereinafter cited as "Corporate Director's Guidebook").

7. *See*, *e.g.*, Joseph Hinsey, The Constituency Director, posted on The Harvard Law School Corporate Governance Blog, *http://blogs.law.harvard.edu/corpgov/2008/1/14/the-constituency-director/* (noting that not much has been written about constituency directors); Marc Weingarten & Neil P. Horne, Be Careful What You Wish For - Considerations When Obtaining Board Representation, Schulte, Roth & Zabel LLP Activist Investing Developments, at 4, Spring 2006; Cyril Moscow, The Representative Director Problem, 16 Insights 12 (June 2002); Balotti, § 4.16[E].

8. Thanks to José Bano, an LLM student in Mr. Morris' seminar on corporate governance at Fordham University School of Law, for his contributions to this paragraph.

9. *See*, *e.g.*, Code of Conduct for the Board of Directors of Sears Holding Company, available at *http://www.searsholdings.com/govern/board.htm; Wyndham Worldwide Board of Directors Corporate Governance Guidelines, available at http://www.wyndhamworldwide.com/docs/WYN_Corporate_Governance_Guidelines.pdf.*

10. In the well-known incident involving Hewlett-Packard, management suspected a leak on the board and hired private investigators to attempt to determine the source of the leak. The investigators' use of illegal methods resulted in Hewlett-Packard facing multi-million dollar liability, individuals resigning from their positions, as well as criminal indictments. *See*, *e.g.*, Benjamin Pimental, HP to pay $14.5 million to settle spying scandal, SF Chronicle, Dec. 7, 2006, available at *http://www.sfgate.com/cgibin/article.cgi?f=/c/a/2006/12/07/BUG34MRDGB10.DTL&type=business; see generally Folk, § 141.2.1.5.*

11. *See* infra notes 38-40 and accompanying text; *see also* SEC v. Warde, 151 F.3d 42, 45, 47 (2d Cir. 1998) (upholding criminal conviction of trader who was tipped by a corporate director about a threat of a hostile takeover); Securities and Exchange Commission Litigation Release No. 20132, SEC v. Barclays Bank PLC and Steven J. Landzberg, 07-cv-04427 (S.D.N.Y. May 30, 2007) (announcing $10.9 million settlement of insider trading charges against Barclays and one of its bond traders who served on multiple creditors' committees and used material, non-public information obtained in that capacity to trade).

12. 17 C.F.R. § 243.100 (Westlaw 2008).

13. *Id.* at § 243.100(b)(2)(ii).

14. *See* Balotti, § 4.18 (directors "may" have a duty to disclose information to other directors).

15. *See*, *e.g.*, Corporate Director's Guidebook, p. 21.

16. *See*, *e.g.*, Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 181 & n.187 (Del. Ch. 2005) ("Absent special circumstances in which the board would have reason to expect earlier disclosure, however, a director has no duty to disclose his interest in a transaction until he seeks board approval of the transaction") (citing Metro Commc'n Corp. BVI v. Advanced Mobilecomm Tech., Inc., 854 A.2d 121, 153 (Del. Ch. 2004) (no fiduciary duty to make disclosures to stockholders except when requesting stockholder action); Raskin v. Birmingham Steel Corp., 1990 WL 193326, at *5 (Del. Ch. Dec. 4, 1990) ("The state law duty of candor arises when the board elects to or has a duty to seek shareholder action. If the board does not seek shareholder action … it has, in my opinion, no distinctive state law duty to disclose material developments with respect to the company's business.")); Odyssey Partners, L.P. v. Fleming Companies, Inc., 735 A.2d 386, 413 (Del. Ch. 1999) (majority shareholder owed a duty of disclosure to board only because it requested board action); Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1276-77 (Del. 1994) (board and controlling shareholder obligated to disclose only when they seek shareholder action.); Malone v. Brincat, 722 A.2d 5, 11 (Del. 1998); *see also* Balotti, § 4.18.

There is one unreported case holding that a director who stole from the company breached a duty to inform the company of his fraud, but this is an exception, explainable by its unusual facts, rather than the rule. *See* Hoover Indus., Inc. v. Chase, 1988 Del. Ch. LEXIS 98 (Del. Ch. 1988).

17. *See*, *e.g.*, Corporate Director's Guidebook, p. 21.

18. Guth, 5 A.2d at 510.

19. *Id*.

20. *See*, *e.g.*, Allied Waste Industries Inc. Third Amended and Restated Shareholders Agreement, filed 12/24/03, at Section 3.4.

21. *See* 8 Del. C. § 122(17) (Westlaw 2008).

22. A typical clause might be: "The parties expressly acknowledge and agree that: (i) Director or Investor has the right to, and shall have no duty (contractual or otherwise) to refrain from, directly or indirectly engaging in the same or similar business activities or lines of business as the Company or any of its subsidiaries, including those deemed to be competing with the Company or any of its subsidiaries; and (ii) in the event that Director or Investor acquires knowledge of a potential transaction or matter that both the Corporation or its subsidiaries, on the one hand, and such Director or Investor, on the other hand, might reasonably be deemed to have pursued or had the ability or desire to pursue if granted the opportunity to do so, such Director or Investor shall have no duty (contractual or otherwise) to communicate or present such corporate opportunity to the Company or any of its subsidiaries, as the case may be, and, notwithstanding any provision of this Agreement to the contrary, shall not be liable to the Company or any of its subsidiaries or any holder of common stock of the Company for breach of any duty (contractual or otherwise) by reason of the fact that such Director or Investor, directly or indirectly, pursues or acquires such opportunity for itself, directs such opportunity to another Person, or does not present such opportunity to the Company or any of its subsidiaries."

23. Aronson, 473 A.2d at 812.

24. *Id*.; *see also* Balotti § 4.19.

25. *See* Weinberger, 457 A.2d at 711; *see also* ATR Kim Eng Fin. Corp. v. Araneta, 2006 WL 3783520, at *1 (Del. Ch. Dec. 21, 2006) (applying entire fairness analysis to action of directors who were employed by chairman of the board who dominated the board and the directors). While entire fairness is a heavy burden, courts do find that transactions in which there was fair dealing and a fair price pass the strict review. *See*, *e.g.*, In re Cysive, Inc. S'holders Litig., 836 A.2d 531 (Del. Ch. 2003) (evaluating management buy-out under entire fairness standard and finding that transaction was entirely fair).

26. *See* Corporate Director's Guidebook, pp. 22-23.

27. *See* Kahn v. Lynch Commc'n Systems, Inc., 638 A.2d 1110 (Del. 1994).

28. *See* Del. Gen. Corp. L. § 144. *See also* Lynch, 638 A.2d at 1117 (stating rule that despite approval by disinterested committee, entire fairness test applies with burden shifted to plaintiff).

29. *See* Benihana, 891 A.2d at 177 ("Even if [two directors] were 'interested' . . . their conflicts would not vitiate the approval . . . by the disinterested and independent majority. Because a majority of the disinterested and independent directors approved the [transaction], the interested nature of that transaction does not render it either void or voidable solely for that reason, provided the material facts as to [any director's or officer's] intent were disclosed or known to the [board].").

30. *See*, *e.g.*, Weinberger, 457 A.2d at 710-11.

31. *See*, *e.g.*, Benihana, 891 A.2d at 185 ("[s]atisfying the requirements of § 144 only means that the . . . transaction is not void or voidable solely because of the conflict of interest. . . . [E]quitable common law rules requiring the application of the entire fairness standard on grounds other than a director's interest still apply.").

32. The SEC's view is that directors by deputization are *also* subject to Section 16(a)'s reporting requirements. *See*, *e.g.*, Interpretive Release on Rules Applicable to Insider Reporting and Trading, SEC Release No. 3418114, 1981 WL 31301, at *5 (Sept. 24, 1981).

33. 368 U.S. 403, 409-10 (1962).

34. *Id*. at 410 ("Lehman Brothers would be a 'director' of Tide Water, if as petitioner's complaint charged Lehman actually functioned as a director through Thomas, who had been deputized by Lehman to perform a director's duties not for himself but for Lehman.").

35. In Dreiling v. American Express Co., 458 F.3d 942 (9th Cir. 2006), the Ninth Circuit Court of Appeals addressed the question of whether a shareholder with a board designee is a "director by deputization" for purposes of determining both whether the Section 16(b) short-swing trading rules and the Rule 16b-3(d), 17 C.F.R. § 240.16b-3, exemption apply. The Dreiling Court upheld allegations that American Express could be an undisclosed or secret director by deputization (thus subject to Section 16(b)), but, found that "specific board approval of an insider-issuer transaction must be done with knowledge of the director's status" or the transaction is ineligible for the Rule 16b-3(d) exemption. Dreiling, 458 F.3d at 955. In other words, being deemed an undisclosed director by deputization by a court left the shareholder exposed and without the protection of the Rule 16b-3(d) exemption.

36. 17 C.F.R. § 240.16b-3(d) (Westlaw 2008). Rule 16b-3(d) applies to transactions between an issuer and its officers and directors to exempt such transactions from the short-swing profit rule, provided that (i) the transaction is approved by the board or a committee comprised of two or more non-employee directors; (ii) approval is obtained from the stockholders; or (iii) the officer or director holds the equity securities for at least six months. *See*, *e.g.*, Tinney v. Genesco Commc'n, Inc., 502 F. Supp. 2d 409, 419 (D. Del. 2007).

37. For example, Rule 10b5-1 permits certain pre-planned trading while in possession of material, nonpublic information. *See* 17 C.F.R. § 240.10b5-1 (Westlaw 2008).

38. 15 U.S.C. § 78u-1(a) (Westlaw 2008).

39. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983) ("a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach"); *see also* 15 U.S.C. § 78u-1(a). 561864