Selecting Directors Designated by an Investor

In his regular column, Frank Aquila drafts a sample memo to a board explaining the primary legal and practical considerations when deciding whether to agree to an investor’s request for board representation.

MEMORANDUM
TO: The Board of Directors
FROM: Frank Aquila
RE: Issues When Selecting Directors Designated by an Investor

As we have discussed, you are in the process of negotiating with the Investor regarding the Investor’s request to designate two individuals to serve as directors of the Company in return for the Investor agreeing not to pursue a proxy contest. Based upon the materials that I have reviewed, the Investor currently holds 9.23% of the Company’s common stock and has filed a Schedule 13D with the Securities and Exchange Commission indicating that it is considering nominating one or more individuals to serve as members of the Board for election at the 2015 annual meeting. Given
the Investor’s recent success in electing several directors to the boards of other public companies in contested situations, a negotiated settlement would be appropriate if you conclude that it is in the best interest of the Company and the stockholders, other than the Investor.

Whether you ultimately agree to provide the Investor with one or two board seats, a key factor in making a final determination will be whether the director designees will be affiliated with the Investor. To the extent that other significant stockholders have concerns regarding the Investor receiving representation on the Board, the extent to which the designee or designees are unaffiliated with the Investor will be extremely helpful.

While there are many aspects to take into account in making this decision, your primary focus at this stage is on the legal and practical concerns that arise should you agree to add directors to the Board who are representing or designated by the Investor. This memo outlines some of these primary areas of concern that you should consider now. Since this memo is addressing practical aspects of this situation, it should be noted that these concerns will arise whether their election to the Board occurs as a consequence of an agreed settlement with the Investor or, without an agreed settlement, because of the Investor mounting a successful proxy contest.

As noted above, the importance of these issues will vary depending on the particular individuals proposed by the Investor and agreed upon by you to serve on the Board. Some director designees may be employees of (or consultants retained by) the designating investor, and are clearly intended to represent the investor’s interests on the board (for purposes of this memo, “Related Designees”). Related Designees are typically paid a salary by the designating investor.

A second type of director designee is an individual who is not otherwise affiliated with the designated investor (for purposes of this memo, “Unrelated Designees”). Unrelated Designees tend to be appointed by activist investors who want to establish an independent voice on the target company’s board rather than having direct representation. These director designees might be retired industry executives, “good governance” advocates or academics. Unrelated Designees are not typically compensated by the designating investor.

1. INDEPENDENCE, THE DUTY OF LOYALTY AND CONFLICTS OF INTEREST

Two threshold issues for you to consider when evaluating whether to add directors proposed by the Investor are the duty of loyalty and the potential for conflicts of interest. The Delaware courts have long considered the question of whether a director is independent. The issue arises regularly in their analysis of what standard of review applies to a board’s decision to approve an M&A or other significant transaction. It also arises in the context of determining whether a demand on the board would be futile for purposes of assessing whether an investor derivative action can proceed. A related issue is whether a director has a conflict of interest such that the director could be susceptible to a breach of the duty of loyalty for an action taken by the director.

Under Delaware law, if a majority of directors is disinterested and independent, a court generally will apply the business judgment presumption (a very beneficial standard) to the board’s decision to approve a transaction. Otherwise, to preserve this standard of review, the board should form a special committee of disinterested and independent directors. Losing this beneficial standard of review is undesirable because it means that the court may review the entire fairness of the transaction. This path would make protracted litigation (and potential settlement) much more costly.

The analysis of whether a director is independent is always highly fact-specific. Factors relevant to a court’s assessment of a director’s independence include whether the director:

a. Is interested in the transaction.

b. Derives income from an interested person.

c. Has a close family relationship to an interested person.

d. Has a social or professional relationship with an interested person over which it would be worth risking his or her professional reputation.

That being said, Delaware courts have indicated that merely having a social or professional relationship with an interested person, without other connections, does not make a director interested, nor does receiving directors’ fees or D&O insurance or indemnification.
When a board includes directors designated by significant investors, the board should consider whether those designees qualify as “independent directors” for state law purposes. This is a separate inquiry from the independence tests applied by the stock exchanges (see section 5 below). Related Designees usually would not qualify as “independent directors” for purposes of voting on a transaction with the designating investor.

The answer is less straightforward for Unrelated Designees. At this time, it is unclear under Delaware law whether an Unrelated Designee who has no other ties to the designating investor would be independent with respect to voting on a transaction with the investor. On the one hand, it may be best for a board to err on the side of being conservative on this issue because the consequence of making the “wrong” determination is that the validity of the transaction approval process could be placed in jeopardy. On the other hand, being overly conservative could have the effect of disenfranchising a director and the investor who bargained for representation on the board.

When a director does have a potential conflict of interest, the director may need to recuse himself or herself from board decisions. It is virtually impossible to anticipate all of the scenarios in which these conflicts can arise at the time the designation is made, so the board needs to maintain flexibility to address conflicts on a case-by-case basis over time. Conflicts can arise for a variety of reasons, but are especially common when the designating investor is a competitor of the company.

There may be circumstances in which the conflict is so material that recusal is not sufficient and the director may need to resign from the board. These types of situations can put a significant amount of pressure on board dynamics, because they require the directors to police themselves and their meetings. Fundamentally, the issues around conflicts are no different for director designees than for other types of directors. However, the potential for recurrence of difficult conflict questions and animosity at board meetings increases when the designees are Related Designees of an investor whose interests do not always align with the company’s other investors or the designees are Unrelated Designees of an activist investor who is agitating for changes to the company’s policies in contravention of the board’s stated priorities.

Without regard to their relationship to the designating investor that designated them, director designees should disclose all matters on which they individually, or the designating investor, may fail to qualify as independent. This could be accomplished by means of a director questionnaire. If there are multiple potential bases for the director’s independence to be challenged, director questionnaires should be completed with greater frequency than the annual cycle typically used by public companies for proxy statement preparation purposes.

The minutes of board meetings should reflect that the board specifically considered a director designee’s independence and made a determination regarding the designee’s ability to participate in a decision. Having a board determine that a director is independent does not preclude a court from ultimately determining that the designee was not independent. It does, however, create a better process record and ensures that the key facts are memorialized while still fresh in the directors’ minds.

Even though it is difficult to develop a detailed conflicts policy to specifically address director designees, the Board should have a discussion with outside legal counsel about the various situations in which conflicts might arise, the importance of identifying conflicts early through disclosure by the director designee, and potential actions the Board may need to take to deal with conflicts. Briefing the full Board on the issues in advance may help to avoid contentious recusal or resignation discussions in the midst of a later transaction.

The director designee also should receive advice concerning when either abstaining from a vote (as opposed to recusing himself or herself from a meeting entirely), or participating in the vote notwithstanding a conflict, would be appropriate. The latter can be particularly important if recusing himself or herself from a discussion would, in and of itself, reveal confidential information about the designating investor’s strategy. From a Delaware law perspective, if a conflicted director votes on a matter that is approved by a majority of independent directors, the transaction itself may not be voidable but there is a risk of a breach of duty of loyalty claim against the individual director. If and when conflicts do arise, the record of the board meeting at which the matter was considered should carefully reflect the manner in which the conflict was addressed.
2. THE DIRECTOR DESIGNEE’S CONSTITUENT: ALL STOCKHOLDERS OR ONLY THE INVESTOR?

Although a director designee is selected by the designating investor, it is clear under Delaware law that a director of a Delaware corporation is required to act in the best interests of the company and all of the company’s stockholders. This issue is closely related to the independence and conflicts issues discussed above, but frequently comes as a surprise to designating investors, especially activist hedge funds, who expect that their director designees will not be required to consider other investors’ interests in voting on matters such as a change of control transaction or an issuance of additional common stock.

The director designee must maintain not just the right, but also the practical ability to exercise his or her own judgment in board decisions. The director must not be contractually required to implement the designating investor’s instructions, and the director’s compensation and other benefits for acting as the designee should not be affected if the director’s decisions diverge from the investor’s instructions.

3. CONFIDENTIALITY OBLIGATIONS; REGULATION FD

In most circumstances, as one component of their fiduciary duties, directors are required and expected to protect the confidentiality of information shared in the boardroom or in board packages. Director designees, however, raise special issues and questions, for example:

a. To what extent can they share confidential information with the designating investor?

b. Can they brief the investor on recent developments concerning the company?

c. Can they consult with the investor and take instructions regarding how to vote on particular matters?

Unfortunately, there is no bright-line guidance on this topic in the Delaware cases or statutes. Therefore, many counsel recommend a pragmatic approach to the effect that, unless the company has an explicit policy to the contrary, a director designee can provide confidential information to the designating investor so long as doing so does not harm the company or the other investors. Harm could result if insider trading or a self-interested transaction results from the information sharing, but usually practitioners assume no harm would result from merely sharing information on a confidential basis for the purpose of getting voting instructions.

That being said, one aspect of “use restrictions” that is difficult to police is the concept that a private equity investor may take general information about an industry or operational processes learned from its director designee on the board of one portfolio company and apply it to a different portfolio company. This could erode competition among portfolio companies and is an issue that lately antitrust regulators have begun to scrutinize more closely.

The Company may want to develop an explicit policy regarding information sharing by director designees with the Investor. The policy could be set forth in the Company’s organizational documents or the settlement agreement with the Investor. The policy could also be less formal, like a board policy. For example, the Board could adopt a policy that the Company Secretary will identify which board materials are “appropriate for sharing with designating investors.” In addition, the Board should consider whether information supplied to designating investors should also be made available to other investors of the Company to ensure that all investors are treated equally.

The Company may also want to enter into a confidentiality agreement and/or use restriction agreement with specific individuals associated with the Investor with whom the director designee will be permitted to share the information. Limiting access to particular individuals within an organization may not address insider trading liability for the organization as a whole, although having confidentiality agreements in place will help to address potential Regulation FD issues.

There are also situations in which a director designee technically would be required to disclose information to the Company. This tends to be a bigger issue for Related Designees who, as a result of their capacity as employees of the designating investor, may be more likely to have confidential information of that investor. If the Investor wishes to avoid the potential for being required to make such disclosures, the Investor and the Company should enter into an agreement stating that the director designee generally is not permitted to disclose any investor information.
to the Company and that the director designee can recuse himself or herself without explanation from any Board discussions in which such disclosures might otherwise be required.

Alternatively, the Investor and the Company could pre-agree that certain topics will be considered in committees that do not include the director designee, avoiding the need for an affirmative disclosure and/or recusal decision by the director designee. In any event, these and other related issues will need to be addressed in any settlement agreement with the Investor.

4. INSIDER TRADING RULES

Directors are usually subject to restrictions (such as trading policies and black-out dates) for their own trading in the company’s shares. In part, this is because directors often have inside information about material developments, such as earnings information. If a director designee is permitted to share information with the designating investor, the investor should also be subject to black-outs and other trading restrictions. In practice, even without a contractual agreement with the Company regarding trading by the Investor, the Investor needs to be very careful regarding the timing of its trades in relation to when it could be suspected of having inside information from its director designee.

The Company should ensure that any trading restrictions are clearly communicated to the Investor, not just the director designee. The Company may also want to require that the Investor disclose its trades to the Company, even where the trades would not be required to be disclosed in an SEC filing or other public filing, so that the Company can monitor the timing of the trades. Such disclosures will also facilitate the enforcement of standstills, lock-ups, orderly selling restrictions and investor agreement provisions providing for the loss of the director designation right if the Investor’s stake falls below a specified level. This should also be covered in the settlement agreement with the Investor.

5. STOCK EXCHANGE INDEPENDENCE REQUIREMENTS

Different stock exchanges prescribe corporate governance requirements that may be relevant to director designees, including director independence requirements. Since the Company is listed on the New York Stock Exchange, we need to look at the NYSE’s Listed Company Manual. The Manual establishes two tests for director independence: a bright-line test and a facts-and-circumstances test.

Both tests focus on material relationships between the director and the company, but they are not the same tests applied by the Delaware courts. The NYSE’s independence tests focus on the relationships between the director designee and the company, not the relationships between the designee and the designating investor. Therefore, even a Related Designee could qualify as independent for this purpose. Material relationships that can impact the director independence tests include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. (The NASDAQ standards are similar but not identical to the NYSE standards.)

The consequence of a director failing to be “independent” within the meaning of an exchange’s rules is that the director may not be permitted to serve on the audit or compensation committees and, to maintain its listing, the company may have to increase the size of its board to offset the non-independent directors with more independent directors. Certain exceptions, such as the NYSE’s “controlled company” exception, may apply (for example, if the company is a dual-class company in which a majority of the voting power of a company is held by a class of super-voting shares that has also designated a majority of the directors on the board).

6. DISCLOSURE OBLIGATIONS (EXCHANGE ACT SECTION 13(D) AND SECTION 16)

As you are well aware, all directors of US public companies are required to disclose their trading in shares of the company under Section 16 of the Exchange Act. Section 16 and Section 13 disclosure obligations also apply to significant investors (10% or more investors in the case of Section 16 and 5% or more investors in the case of Section 13).
Investors who file Schedule 13Ds are required to disclose their control intent vis-à-vis the Company. There are situations in which such disclosures could be impacted by the existence of a director designee. For example, the investor would need to determine whether it has formed a group with the director designee such that it could be required to disclose actions by, or the intent of, the designee in its beneficial ownership statements.

Designating investors should take care to structure their arrangements with a director designee to avoid, as much as possible, any implication that their relationship triggers additional disclosure or Section 16 disgorgement obligations for the designating investor. If the director designee is a Related Designee and it is clear that the designating investor “controls” the director designee, then the designating investor may be deemed to be a deputized director and should seek board approval for trades within six-month windows to avoid becoming subject to the Section 16 disgorgement rules. These rules otherwise would not have applied unless the Investor owned more than 10% of the Company’s shares.

7. ANTITRUST/COMPETITION LAW

If the Investor and/or its director designee is otherwise involved and will remain involved in the Company’s industry through a competing business, the following issues may arise:

a. The US antitrust laws prohibit interlocking directorships. In other words, an officer, director or owner of a business may not serve as a director of a competitor.

b. Even in the absence of a formal director interlock, a close relationship between a director and a competitor may lead antitrust regulators to conclude that the director is acting as a conduit of competitively sensitive information to the competitor.

c. Even if there is no formal director interlock and the director subjects himself or herself to firewalls that restrict the flow of information from one competitor to the other, the existence of the director designation rights may cause the antitrust regulators to delay or prohibit the consummation of a transaction out of concern that there are too many connections between the competitors.

If the Investor and the Company are concerned that a director designee could be viewed as a conduit for competitively sensitive information among competitors, they should consider adopting firewalls intended to restrict the designee’s access to this information. The firewalls could be limited to information relating to the specific areas of overlap and the specific categories of information that the antitrust regulators are likely to be most concerned about (such as pricing, cost of goods sold and material strategic information). The parties should bear in mind, however, that firewalls alone may be insufficient to make the antitrust regulators comfortable with a relationship between competitors, and that the existence of director designees may delay or even prevent regulatory approval of a transaction.

8. INVESTOR RELATIONS AND PROXY ADVISORY SERVICES REACTION

Analysts, proxy advisors and other investors may not see the value in adding a director designee to the Board. Indeed, they may be concerned about the potential for conflicts of interest and undue influence by the Investor. These concerns can have an impact on the Company’s share price and may also impact the outcome of director elections and other investor votes.

It may be beneficial to prepare talking points about the value that the director designee brings to the Board. Those talking points could form the basis for a discussion with ISS, Glass Lewis or other proxy advisory services, as well as other significant investors, directors and members of management. In addition, the Company should ensure that the director designee complies with the Company’s board policies regarding service on multiple boards and other director qualification criteria.

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I look forward to discussing this at your convenience.

F.J.A.