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SPEED READING: TOP 10 ISSUES TO CONSIDER WHEN DESIGNATING DIRECTORS

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Investors who acquire a significant stake in a company sometimes negotiate for the right to designate directors for the target company's board. Director designees can monitor the company's performance and strategic plans, supervise management, advocate the investors' positions on significant corporate decisions or simply add a different perspective in the board room. The use of director designees, however, can also present an array of complex legal and relationship issues that must be managed carefully. This article highlights ten of these issues as they apply to U.S. companies.

The applicability of these issues to any particular situation will depend in part on whether the company is a public, listed company, the form of entity (e.g., corporation v. LLC), the jurisdiction of formation of the company and whether the investor is a private equity buyer or a strategic investor with businesses in the same industry.

The importance of these issues will, of course, also vary depending on the type of designee selected. Some director designees are executives of the designating investor, and are clearly intended to represent the investor's economic interests on the target company's board (for purposes of this article, we call these "Related Designees"). Designating investors typically pay Related Designees a salary. They are frequently used when a private equity investor acquires a portfolio company or a strategic investor takes a stake in a company in connection with an M&A transaction in which the investor receives target shares. A second type of director designee is an individual who is not otherwise affiliated with the designated investor (for purposes of this article, we call these "Unrelated Designees"). Unrelated Designees tend to be appointed by activist investors who are not seeking to acquire control of the target company but who want to establish an independent voice on the target company's board. Unrelated Designees typically would not be compensated by the designating investor.

This article is part of the "Speed Reading" series in which the authors highlight practical tips and recurring issues in M&A transactions and corporate governance. [*Ten Issues to Spot in a Public Company Merger Agreement, 2010 Emerging Issues 4883; Top 10 Issues to Consider When Adopting a Rights Plan, 2010 Emerging Issues 5027; Top 10 Considerations When Doing M&A Due Diligence, 2010 Emerging Issues 5124; Top 10 Issues in Charters and Bylaws, 2010 Emerging Issues 5372*]

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1. Director Designees, the Duty of Loyalty and Conflicts of Interest. Many Delaware cases have considered the question of whether a director is independent.[1] The issue arises regularly in the courts' analysis of what standard of review applies to a board's decision to approve an M&A 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 claim in respect of 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 deferential standard) to the board's decision to approve a transaction. Otherwise, to preserve the deferential standard of review, the board should form a special committee of disinterested and independent directors. Losing the deferential standard of review is undesirable because it means the court may review the entire fairness of the transaction – a path that makes 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:

- Is the director interested in the transaction?
- Does the director derive income from an interested person?
- Does the director have a close family relationship to an interested person?
- Does the director have a social or professional relationship with an interested person over which it would be worth risking her professional reputation?

That being said, the 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/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 (which is a separate inquiry than the independence tests applied by the stock

1 *See, e.g., In re* Walt Disney Co. Deriv. Litig., 731 A.2d 342 (Del. Ch. 1998); *In re* Oracle Corp. Deriv. Litig., 824 A.2d 917 (Del.Ch. 2003); *In re* MAXXAM, Inc., 659 A.2d 760 (Del.Ch. 1995); *In re* Oracle Corp. Deriv. Litig., 824 A.2d 917 (Del. Ch. 2003); Beam v. Stewart, 845 A.2d 1040 (Del. 2004).

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exchanges – see Section 3 *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 herself from board decisions. It is virtually impossible to anticipate all of the scenarios in which such 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 lot 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.

Practice Pointer: Director designees should disclose all matters on which they (individually), or the investor who designated them, 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 a director is independent

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does not preclude a court from ultimately determining that the designee was not independent, but it does 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 "ex ante" conflicts policy to address director designees, the board should have a discussion with legal counsel about the various situations in which conflicts may 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/resignation discussions in the midst of a later transaction.

The director designee also should receive advice concerning when abstaining from a vote (as opposed to recusing herself from a meeting entirely), or participating in the vote notwithstanding a conflict, would be appropriate. The latter can be particularly important if recusing 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 still 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 reflect carefully the manner in which the conflict was addressed.

2. The Director Designee's Constituent: All Investors or Only the Designating Investor?. Although a director designee is selected by the designating investor, a director of a Delaware corporation technically is required to act in the best interests of all investors. This issue is closely related to the independence and conflicts issues discussed above but frequently comes as a surprise to designating investors, especially private equity funds, who expect that their director designees on the boards of portfolio companies will not be required to consider other investors' interests in voting on matters like the timing of an initial public offering or change of control transaction.

Practice Pointer: If the designating investor's interests are aligned with other investors, then the designee's receipt of voting instructions from the designating investor should not be problematic in practice. However, if the designating investor's interests diverge from other investors, then the director must maintain not just the right but also the practical ability to exercise her own judgment in board decisions. The director must not be contractually required to implement the designating investor's instructions, and the

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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. If the parties intend that the director should be able to act on the investor's instructions without regard to other investors, which is often the case for a privately-held portfolio company with Related Designees, then the parties should consider forming the entity as a limited liability company and causing the director and the designating investor to disclaim any fiduciary obligation to other investors.

3. Stock Exchange Independence Requirements. Different stock exchanges prescribe corporate governance requirements that may be relevant to director designees, including director independence requirements.[2] For example, the NYSE's Listed Company 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 exchange's independence tests focus on the relationships between the designee and the target company, not the relationships between the designee and the designating investor, such that 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 certain committees (e.g., audit and compensation) 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 (e.g., if the company is a dual-class company in which a majority of the voting power of the company is held by a class of super-voting shares that has also designated a majority of the directors on the board).

Practice Pointer: Public companies with designated directors should be attentive to stock exchange requirements when appointing the designees to committees. The company may need to consult with its listing agent if it is not clear whether a designee would be considered independent. Some exchanges also prescribe rules governing related party transactions between a director (or a relative or controlled company of a director) and the company. For example, the London Stock Exchange requires investor

2 NYSE Listed Company Manual Section 303A.02(a); NASDAQ Stock Market Listing Rules 5005(a)(19) and 5605(a)(2).

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approval for certain large related party transactions and fairness opinions for certain smaller related party transactions. In cases where a company expects to complete additional transactions with a designating investor, such as exercising a call option or a right of first refusal over any of the designating investor's businesses, the company should consider carefully whether the investor approval or fairness opinion requirements would apply to those follow-on transactions.

4. 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 board room or in board packages. Director designees, however, raise special issues. To what extent can they share such information with the investor who designated them? Can they brief the investor on recent developments concerning the company? Can they consult with the investor and take instructions regarding how to vote on particular matters? In the case of private equity portfolio companies, can the fund's designees on the board share the information with the fund and in financial reports to the fund's limited partners?

There is no bright-line guidance on this topic in the Delaware cases or statutes. Therefore, many practitioners 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 antitrust regulators have begun to scrutinize more closely of late.

Practice Pointer: A company may want to develop an explicit policy regarding information sharing by director designees with investors. The policy could be set forth in the company's organizational documents or a shareholder's agreement. The policy could also be less formal, like a board policy. For example, the company could adopt a policy that the company secretary will identify which board materials are "appropriate for sharing with designating investors". In addition, the company should consider whether information supplied to designating investors should also be made available to other

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investors of the company to ensure that 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. The latter approach is likely to be more effective in a private company. In a public company, 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 the 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 generally is not permitted to disclose any investor information to the company and that the director designee can recuse 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.

5. Insider Trading Rules. Directors of public companies 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 designating 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.

Practice Pointer: The company should ensure that any trading restrictions are clearly communicated to the designating investor, not just the director designee. The company may also want to require that the designating 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

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restrictions and investor agreement provisions providing for the loss of the director designation right if the investor's stake falls below a specified level.

6. Antitrust/Competition Law

If the designating investor and/or its director designee will remain involved in the company's industry through a competing business, three issues may arise:

1. The U.S. 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.
2. Even in the absence of a formal director interlock, a close relationship between a director and a competitor may lead regulators to conclude that the director is acting as a conduit of competitively sensitive information to the competitor.
3. Finally, even if there is no formal director interlock and the director subjects 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 the transaction out of concern that there are too many connections between the competitors.

Practice Pointer: 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 such information. The firewalls could be limited to information relating to the specific areas of overlap and the specific categories of information that the regulators are likely to be most concerned about (e.g., pricing, cost of goods sold and material strategic information). The parties should bear in mind, however, that firewalls alone may not be sufficient to make the regulators comfortable with a relationship between competitors and that the existence of director designees may delay or even prevent regulatory approval of a transaction.

7. Disclosure Obligations (Exchange Act Sections 13(d) and Section 16). All directors of U.S. public companies are required to disclose their trading in shares of the company under Section 16 of the Exchange Act. Similar requirements may also arise in other jurisdictions. Section 16 and Section 13 disclosure obligations may also apply to significant investors (10% plus investors in the case of Section 16 and 5% plus

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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 designating 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.

Practice Pointer: 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 (which otherwise would not have applied unless the investor owned more than 10% of the company's shares).

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 designating 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.

Practice Pointer: 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 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. Even if the company is private, not public, it may be necessary for management to be prepared to discuss (in connection with an IPO road-show or even just in informal discussions with other investors) the value added by director designees to justify management fees paid to private equity investors.

9. Corporate Opportunities. Directors of a Delaware corporation generally cannot take opportunities presented to a director (in her capacity as a director) that are within the interest and expectancy of the corporation. The use of director designees can

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muddy this water a bit: It is not always clear when corporate opportunities presented a designee should be deemed to preclude the designating investor (or, in the private equity context, its other portfolio companies) from pursuing the opportunity.

Practice Pointer: The company's organizational documents or shareholder's agreement can make clear that the director designee is not required to present to the company corporate opportunities identified by the designating investor without reliance on the company's information. In most contexts, this may be the cleanest approach when coupled with a use restriction on the director's and the designating investor's ability to use company information because it minimizes the likelihood of confusion about who can pursue an opportunity. A related issue is that the company's organizational documents can clarify when, if ever, the director designee is required to share information of the designating investor with the corporation.

10. D&O Insurance and Indemnification. *Practice Pointer*: Director designees should ensure that the company has policies in place and that the director's coverage is not affected by her capacity as a designee. Ideally, any such insurance and indemnification would be available to the designee notwithstanding the agreements/determinations as to conflicts of interest, information sharing, etc. discussed above. Many Related Designees will be covered directly by the designating investor's D&O policies, whereas an Unrelated Designee may not be entitled to access that coverage and may want to have a separate indemnification agreement with the designating investor.

Conclusion. There are some risks associated with designating a director. Many transaction documents fail to address these risks, leaving the company's board and in-house counsel to muddle through the issues after the designation has taken effect. Even private equity funds that confront these issues regularly in connection with taking minority stakes in portfolio companies may not have established guidelines to address these issues. Accordingly, any deal team should raise these issues early to clarify the parties' mutual understanding and avoid later disputes. From a legal perspective, establishing clear guidelines for the director designee may also reduce the risk of subsequent investor litigation.

Corporate Governance: Law and Practice, Chapter 6 "Corporate Governance Guidelines for Board Practices and Procedures"

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Corporate Governance: Law and Practice, Chapter 7 "Board Structure and Processes"

Corporate Compliance Practice Guide, Chapter 13 "Creating Ethics Awareness and Laying the Groundwork with the Board of Directors, Officers and Employees"

Corporate Compliance Practice Guide, "Corporate Governance and the Role of the Board of Directors in Corporate Compliance"

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