Board Observers Beware: A Discussion of Liabilities and Risks Facing Board Observers from a United States, Canadian, and Italian Law Perspective  
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Introduction

When things go wrong in a company, security holders, creditors, and the corporation itself may all seek out individuals to hold accountable for their losses. Anyone associated with the management of the company becomes a potential target. Confronted with this risk, and the additional obligations and potential criminal penalties that can be imposed under the Sarbanes-Oxley Act of 2002 (including individual fines of up to $5 million and prison terms of up to 20 years), many investors and other persons involved with both private and public companies, are re-thinking their roles in corporate governance and seeking new ways to avoid personal exposure.

One popular alternative that many individuals have chosen is to accept roles as observers or advisors to boards, instead of accepting actual directorships as members of boards of directors. Many board observers attend the full board meetings and participate in the board discussions. Generally, the primary difference between these individuals and actual board members is that they are non-voting. So this raises a question: What are your potential risks and liabilities as a board observer?

As a board observer myself, I found a dearth of information on my potential risks. In answering this question, we reviewed both U.S. and Canadian statutes and case law surrounding these issues. We did not consider cases surrounding outside experts that were specifically hired to advise the board on certain topics, such as financial advisors retained to provide a fairness opinion, and focused our research and discussion on the individuals who attend board meetings and join in board discussions for general purposes.

U.S. Perspectives – Kandace W. Richardson

Sources of Liability and Risks

One of the most unavoidable risks of being a board observer or advisor is the risk of simply being named as a defendant in any legal proceeding relating to the company. Plaintiffs may elect to assert a claim against you in your capacity as a board observer or advisor, as a de facto board member, or as a person performing functions similar to a director.

Assertions against Board Advisors

Our review of U.S. federal and state case law indicates that courts to date have been very favorable in their treatment of board advisors. For example, a case was filed in 2000 in the U.S. District Court for the Southern District of Florida, in which breach of duty claims were asserted against a defendant who responded by asserting that he could not be held liable for breaching a duty of loyalty or care to the corporation because he was not an officer or director of the corporation, but only an advisor to the board of directors. Because the plaintiff corporation did

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not contest the defendant's assertion that he was not a member of the board of directors, summary judgment was entered in the defendant's favor on the basis that he had no fiduciary relationship to the plaintiff corporation.28

Our research found no cases in which individuals were held liable to the corporation based solely upon a claim that the individual breached a fiduciary duty owed to the corporation as a board observer. Thus, having the title of board advisor and not otherwise serving as a corporate officer or director may serve as a first line of defense from liability. Accordingly, unless the plaintiffs make additional assertions of other sources of liability, board observation alone has proved insufficient to establish that an individual is a fiduciary of the corporation.

**Potential Liability as a De Facto Director**

Of course, plaintiffs’ attorneys are crafty, and case law recognizes a more viable alternative for them to pursue claims against a person that is not technically a board member. When a person is not a *de jure* director because he or she has failed to meet the technical requirements for legal election or appointment, then the case law may still recognize the person as a *de facto* director when his or her actions are such that courts have found the person to be a board member in fact. Case law establishes that *de facto* directors have the same fiduciary duties as *de jure* directors. *A de facto* director is one who is in actual possession of the directorship and exercises the functions of the directorship under claim or color of election or appointment.29 The fact that you are not a stockholder is not determinative of whether you are a *de facto* director.30

Case law instructs us on how to avoid becoming a *de facto* director. In 2003, the U.S. Court of Appeals for the Seventh Circuit decided in favor of a defendant that was alleged to have breached her fiduciary duties as a *de facto* director.31 Under the *Forde* case, the corporation's founder and president, who was also a board member, had offered the defendant, Forde, a position on the board of directors. Forde conditioned her acceptance on indemnity insurance and an audit of the corporation's financial condition. The corporation never satisfied these conditions. In the meantime, Forde attended four board meetings, was a vocal participant at the meetings, and had kept minutes for the meetings, referring to herself as "secretary designate," "board member designate" or "guest." The corporation never listed Forde as a director on its annual state filings. The *Forde* Court reasoned that a *de facto* director is someone who assumes an office or position under color of right or title and exercises the duties of office. The *Forde* Court concluded that a *de facto* director must claim her office and that because Forde never claimed that she was a director or officer and the minutes reflected this, she was not a *de facto* director. Therefore, the breach of fiduciary duty claim failed. In summary, the *Forde* case teaches us that we can protect ourselves from liability if we clearly indicate by our actions, the corporate records and in filings made on the corporation’s behalf that we are board observers and not board members.

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28 *Id.*
31 *The Osler Institute, Inc. v. Lois Forde*, 333 F.3d 832 (7th Cir. 2003).
In addition, the U.S. Bankruptcy court in *In re West American Credit Corporation* held that attendance at one directors’ meeting and filing reports with state agencies where there is no evidence of reliance by anyone in any way on the person as a director or officer are insufficient as a matter of law to establish that someone is a *de facto* director of the corporation. Therefore, to be a director, there must be a continuous exercise of the responsibilities of a director in the corporation. This case suggests that a single act in an official capacity may be insufficient by itself to prove that you are a *de facto* director.

**Potential Liability for Board Observers of Publicly-Held Companies**

Section 11 of the Securities Act of 1933, as amended, and Section 16 of the Securities Exchange Act of 1934, as amended, impose certain liabilities on persons that are directors or persons “performing similar functions” to a director. Under Section 11, directors may be held liable for material misstatements or omissions in a registration statement. Under Section 16, a director may be held strictly liable for any profits gained or losses avoided on the purchase or sale of a corporation’s securities within a six-month period.

The U.S. District Court for the Southern District of New York is responsible for the only reported case that considers the meaning of the phrase “performing similar functions” to a director. In the context of an alleged Section 11 violation, the District Court interprets the phrase as imposing liability on individuals who are actually directing the corporation’s affairs, but who reject the formal title of director for the purpose of avoiding liability.

In Section 16 cases, the U.S. Supreme Court has allowed proof that the individual performed the functions of a director even though the person did not have the formal title of director. The Securities and Exchange Commission, or SEC, has indicated that in determining whether an honorary, advisory or emeritus director is a director for Section 16 purposes, the person’s title is not determinative. The SEC provides interpretive guidance on whether such a person is a director for Section 16 purposes and indicates that a person who is an honorary director of a corporation, but does not participate in formulating and deciding policy issues and does not have access to inside information, is not a director under Section 16. In contrast, the SEC advises that emeritus and advisory directors generally should be treated as directors for Section 16 purposes because they usually attend board meetings and assist in policy making and, as a result, have access to material, non-public information. Therefore, board observers and advisors face potential Section 16 liability by attending board meetings and participating in the board discussions. Even more alarming is the SEC's stance that a person who designates or “deputizes” another to be a director also should be deemed a director for purposes of Section 16. This suggests that if a venture capital partnership designates a partner to serve on the board of a public-reporting company, then the venture capital partnership itself may become subject to Section 16.

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32 *Supra* at *11.
37 *Id* at Q.3.
Therefore, from a Section 16 liability standpoint, there may be no benefit to being a board observer with respect to avoiding liability.

**Indemnification and Insurance Considerations**

At times, proving that you are not a director can be a double-edged sword, because if you are successful in proving that you are not a director, but the corporation or insurance provider only indemnifies or covers directors under the liability insurance policy, then, as a board observer, you would not be entitled to indemnification or insurance coverage for the legal fees and costs you incurred in proving your defense. In addition, some state statutes only provide mandatory indemnification for individuals who are directors, officers, employees or agents of a corporation. Many sophisticated board observers and advisors are closing these loopholes by negotiating arrangements for separate indemnification and insurance coverage. Given the risks associated with board observation rights, this is an advisable practice to consider.

**Canadian Perspectives – Samantha Horn**

**Focus on Corporate Governance**

In Canada, too, a number of private equity investors and venture capitalists are choosing to take board observer seats at board meetings in lieu of acting as a director. This is partly due to increasing directors’ and officers’ insurance premiums and the increasing responsibility and liability facing directors. Another factor behind this trend is the prevailing climate of increased focus on corporate governance. For example, a number of Multilateral Instruments introduced earlier this year by Canadian securities regulators, which will apply across Canada, directly impact directors’ responsibilities in Canada. One rule requires CEOs and CFOs of all Canadian public companies to personally certify that the issuer’s annual and interim filings do not contain any misrepresentations or omissions and fairly represent the issuer’s financial condition. Another rule focuses on the composition of audit committees, requiring that they have a minimum of three directors and that each member be independent and financially literate.

**The De Facto Director**

In Canada, the definition of "director" is not limited to individuals formally elected or appointed to the board of directors, and neither the governing corporate statutes nor the case law restricts the definition of director in this way. The test to determine whether or not an individual is a director is one of function, not one of name. Two of the Canadian corporate statutes, the Canada Business Corporations Act (which is a federal act and may be used in all provinces) and the Business Corporations Act (Ontario) (OBCA) (for companies incorporated in Ontario) include, in the definition of director, a person that is occupying or acting in the position of director, regardless of the name by which he or she is called. This type of de facto director is, in effect, one who assumes the office of a director without going through the legal formalities of

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38. California Corporations Code §317(d) and Nevada Revised Statutes §78.7502(3) mandate indemnification for directors, officers, employees and agents of a corporation who have been successful on the merits in defense of certain proceedings. In comparison, the mandatory indemnification provisions in Delaware General Corporation Law §145(c) cover only directors and officers.

39. Canada Business Corporations Act s.2(1); Business Corporations Act (Ontario) s. 1(1).
appointment. The courts in Canada have imposed the duties and responsibilities of a director on those who manage the corporation's business and affairs, whether or not they have been duly elected as a director. For example, it is clear in the event of a resignation of all directors, which often occurs in the event of an insolvency or bankruptcy, that the management persons or officers who continue to manage the corporation’s business and affairs are considered to be *de facto* directors at law.

In contrast to the review of U.S. case law above, there are no Canadian cases or statutory sources that address the issue of board observer liability in Canada, although there are a number of somewhat analogous factual situations, discussed below, in which individuals have been found to be *de facto* directors, thus attracting directors' liabilities. These cases all relate to taxing statutes, but there seems to be no reason why the same principles should not apply to other definitions of “director” in other acts which impose directors’ liabilities.

*The Definition of Director at Law*

Although judicial consideration of the definition of “director” is sparse, two cases cast some light on what constitutes a director under Canadian law and are relevant to an analysis of the risks associated with being a board observer. In *Kalef v. R.* the Federal Court of Appeal considered the definition of “director” under the OBCA. The Court described the definition as “passive” in that an individual may be held to be a director even if he or she does not exercise the powers associated with that position:

… if a person is "occupying the position of director of a corporation" he or she is a director. The definition is quite passive. There is no requirement that the person exercise the power of a director or exert direct control over the company's assets in order to be a director.

Another Federal Court of Appeal decision, *Canada v. Wheeliker*, also discussed the scope of liabilities that a director will attract and stipulated that all types of directors could attract liability:

…by using the word "directors" without qualification in subsection 227.1(1), Parliament intended the word to cover all types of directors…, including, amongst others, *de jure* and *de facto* directors.

*Spectrum of Liability*

Where, then, does this leave board observers? To avoid the imposition of directors’ liabilities, board observers in Canada should be careful to ensure that they will not be considered *de facto* directors. The actions that might result in a board observer attracting liability as a director may be viewed as a spectrum of liability. On the one end of the spectrum, to avoid the imposition of liability, a board observer would act as a board observer only and not take part in any discussions, resolutions or other actions of a director. On the other end of the spectrum,
attracting liability as a director, a board observer would act as a de facto director, actively participating in discussions and influencing or controlling the decisions made by the board of directors.

Parton v. Canada is of particular interest to private equity and venture capitalists, as the Tax Court indicated in this case that the evidence showed that advisors representing key investors managed the business and affairs of the corporation, in lieu of a traditional board of directors. This evidence included the fact that the advisors were aware of the financial position of the corporation, and were aware that the relevant tax withholdings were not being remitted to Revenue Canada. In addition, the advisors actively engaged in negotiations with financiers to obtain additional financing for working capital. As such, the Tax Court concluded that the advisors were the directing minds of the corporation and would have been regarded as de facto directors of the corporation, had that been at issue in the case.

Practical precautions

Given that there is no case law or statutory authority on the subject of board observers in Canada, it is advisable for those acting or contemplating acting as board observers to consider the law on de facto directors and take some of the precautions discussed below to ensure they are not seen in law to be acting as de facto directors, particularly since any board observer may not be covered by a directors’ and officers’ insurance policy and is not permitted by law to be the beneficiary of an indemnity from the corporation granting the board observer rights. Listed below are some examples of behaviour which the courts in Canada have found to result in the imposition of liability as a de facto director:

- Influencing or controlling the directors to the point that they are considered "puppets", doing your alleged bidding.44
- Holding yourself out as director or eventually being elected as such or misstating your position (i.e. signing documentation as "director", or allowing yourself to be listed with government authorities as a "director").45
- Participating, or purporting to participate, in purely directorial acts, such as passing resolutions.46
- Taking an active role in meetings, by preparing agendas for board meetings, discussing important issues, recapping the decisions of the meeting, moving a motion, or participating in a court ordered meeting of shareholders.47
- Failing to make it obvious that you clearly do not wish to be treated as a director, or acting as if you have the authority of a director, with some judicial decisions focusing on the subjective beliefs of the alleged director.48

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Board Observers? Do They Exist in Italy?

Notwithstanding the numerous changes in Italian corporate law in recent years, the topic of board observers has not been discussed by commentators, much less in courts. Therefore, guidance for observers can be found only in statutes, general principles and corporate practices.

Under the new Italian Corporate Law directors and Statutory Auditors are the only individuals entitled to attend corporate meetings. Because board meetings are covered by a general confidentiality requirement Italian corporate practice has generally interpreted these principles rather conservatively.

For example, in certain cases even the presence of counsel to the corporation has been argued to be prohibited. Even more controversial is, and almost invariably prohibited, is the presence of counsel to committees of directors and non-executive directors. Therefore, under the current Italian restrictive corporate practice, observers would probably not be allowed in most cases.

Board Observers? Let’s Give It Try

Notwithstanding the likely resistance, we are of the opinion that the absence of a specific prohibition towards observers leaves open the possibility of using observers. This risk is worth taking since the worst case scenario would simply be for the observer to be subsequently qualified, by a court for example, as a director.

To introduce observers in the corporate governance of a corporation, one should take particular care in defining their role, rights, compensation, etc. in the By-laws of the company.

As a minimum, the by-laws should:

(a) describe the appointment procedure;
(b) specifically exclude observers from the quorums for a Board meeting to be validly held and adopt resolutions;
(c) describe the procedure to remove an observer;
(d) clarify whether and to what extent observers have access to Board minutes, corporate documents, etc.; and
(e) set observer’s compensation, either directly or by means of a formula.

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49 Some of the changes arise as a response to the international and Italian corporate scandals of recent years, others are the result of the world-wide increased focus on corporate governance and of the need to simplify and render more competitive Italian corporate law.
50 On January 1, 2004 an new corporate law came into force, which is the first all-encompassing review of Italian corporate law principles since 1942.
51 Statutory Auditors (“Sindaci” in Italian) are auditors appointed by the Company to carry out some basic auditing functions. Although most often Statutory Auditors are members of auditing firms, they should not be confused with external auditors, since their roles, duties, and liabilities are entirely different.
Also, in no event should observers take an executive role\textsuperscript{52}.

Once the concept of observer has been incorporated into the by-laws then they need to take some precautions in performing their functions. At a minimum, the same precautions suggested earlier in the Canadian perspectives should be taken.

As an additional precaution, more typical of to the importance of formalities which is typical of Italian corporate practice, observers should take extra care that minute books reflect accurately their presence and role in Board meetings.

For example, observers should be listed and referred to in all instances with such title and not in any other way. In addition, the minutes should underline and highlight their role in the minutes as advisors and should clarify, when listing the casted votes, that observers have not expressed a vote in favor or against a resolution.

This is because, especially in large corporations or in corporations with multiple shareholders, the minutes become very important in case of conflict. Well kept minutes may be conclusive evidence in court that the observer has acted consistently with his/her advisory duties (rather than as a director).

\textit{Liability as Observer}

As indicated, the practice of observers has not been used so far in Italy, so the scope of observers liability can only be assessed under general principles.

In our opinion, in the worst-case scenario Italian courts would deem observers equivalent to directors. In most cases it is likely that a court would reach such conclusion.

The new Italian Corporate Law, however, clearly distinguishes the liability of executive and non-executive directors, setting forth different duties (and liabilities) for each category. Generally speaking, non-executive directors must seek information and reasonably assess the information provided by the executive directors.

Since observers do not perform an executive role, as a worst-case scenario, they should be subject to the liability of non-executive directors. As previously noted, however, the treatment of observers as non-executive directors is only a worst-case scenario.

In the best-case scenario observers should be only subjected to the much stricter general standard of liability in tort, where burden of proof is on the plaintiff; and a stricter nexus is required.

\textit{Conclusion}

There appears to be some space to introduce the use of observers in Italian corporate practice. If this step if to be taken, one should carefully define all aspects of the role of observers

\textsuperscript{52} Top ranking executives in Italy are generally members of the Board of Directors. This is certainly the case for CEOs who are almost invariably directors and take the title of “Managing director.”
in the by-laws and then carefully follow the precautions listed above in the day-to-day activities. Although an observer’s seat is not without risk, the risk is no greater than the risk associated with a non-executive director’s position.