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BOARD DIRECTORS AND BOARD OBSERVERS

Board observers are individuals (who may have relevant business experience or expertise) that have a right to attend board meetings and provide input to board directors and management, without actually being a board member. Board observer arrangements are typically negotiated by investors as a condition of their investment and locked in through a contractual agreement with the company.

The main concern shareholders may have when board observer arrangements are negotiated, is the loss of control of the company. Board observer arrangements are increasingly common as part of companies’ corporate governance framework. It is imperative to distinguish the role of board observers from the function of board directors to provide companies and investors sufficient guidance in structuring board observer arrangements and to shed some light on the benefits and challenges of structuring such board observer arrangements.

# BOARD DIRECTOR

The board of directors is vested with the power to manage the company’s business and is given the authority to exercise all powers of the company other than those reserved to the shareholders as specified in the Companies Act (Cap. 50) or the constitution. Board directors have a right to vote in all board meetings and matters submitted for a vote and may directly influence the management and direction of the company. Board directors owe fiduciary duties of care and loyalty to the company, and if shareholders are dissatisfied with the board director, they may remove the board director through a vote. However, board directors do assume significant burden and owe fiduciary duties to the company, including a duty of care and loyalty, whereby a breach of fiduciary duties could result in civil or criminal liabilities.

# BOARD OBSERVER

The general position is that board observers do not owe fiduciary duties and obligations to the company. As such, some investors would prefer to hold board observer seats to avoid fiduciary duties and conflict of interests. Board observers are permitted to attend and observe in board meetings and to receive timely information provided to the board to keep informed of issues that could affect the investment in the company. While board observers are not permitted to vote on matters submitted for a vote, board observers may share their opinions on matters submitted to the board and may significantly influence the outcome of matters submitted for the board’s approval. Investors may request that the board observed be reimbursed similar to a board director.

Board observers are expressly prohibited from voting on matters submitted for a vote. Board observers may be excluded from meetings if it is the best interest of the company to do so, to preserve proprietary or privileged information or if there is a potential conflict of interest. Board observer rights are provided pursuant to a contractual agreement and their loyalty lies with the investor rather than the shareholders. This also means that shareholders do not have the powers to remove board observers. If the board observer agreement does not include confidentiality obligation or provisions relating to conflicts of interest, board observers may not be bound by such an obligation that is ordinarily imposed on board directors.

# LESSONS FROM KEY JURISDICTIONS

# Basic principles of corporate law should provide sufficient guidance in structuring board observer arrangements. While there is little case law or legal authority in Singapore addressing the distinction between board observers and board directors, we turn to judicial guidance in key jurisdictions (i.e. the United States of America and the United Kingdom) to understand the distinctions as applied by the different courts.

# Obasi Investment Ltd. v Tibet Pharmaceuticals, Inc. No. 18-1849 (3d Cir. 2019) (“Third Circuit Decision”)

# In the recent Third Circuit Decision, the US Court of Appeal determined that the functions of the non-voting board observers were, as a matter of law, different from the core powers and responsibilities of the function of board directors for purposes of imposing liability under Section 11 of the Securities Act 1933 (“Section 11 SA”). Section 11 SA imposes liability on persons “*named in the registration statement as being or about to become a director, [or] person performing similar functions*”. The Third Circuit placed little importance on the board observers’ ability to “*significantly influence the outcome of matters submitted for to the Board of Directors for approval*”, instead, emphasis was placed on three features establishing that the board observers liable under Section 11 SA: (1) The board observers did not have the right to vote; (2) The absence of a duty of loyalty to the company’s shareholders; and (3) The board observers’ tenure were not subject to shareholders’ vote.

# Standish v The Royal Bank of Scotland plc & others [2019] EWHC 3116 (“Standish”)

The Standish case confirmed that where board observers “*gave instructions to the directors that the directors felt obliged to follow*" in relation to business decisions, and the directors act in accordance with those instructions, the board observers may be regarded as shadow directors in relation “*to those matters where he gives instructions*”, thereby incurring duties and obligations. The court established that duties owed by shadow directors are limited in extent to the subject matter of their instructions. The court provided further support for this view that when shadow directorship (and nothing else) “*is relied on as the source of the fiduciary duty, it is only the acts of instruction which can form the foundation for any fiduciary duties that he may owe*”. Without this relationship, it is apparent that a shadow director will not be liable for breach of duty.

**Contractual Protections**

While there is no legal requirement to have a contractual agreement between the board observer and the company, clearly drafted agreements can preempt uncertainty in relation to the board observer’s role, limit their exposure to liability, and protect the company’s best interests. In any case, if board observer arrangements are introduced to the company’s corporate governance, there are a few considerations that should be taken into account, as follows:

1. scope of board observer duties and obligations;
2. term of service;
3. remuneration and expenses;
4. information and participation rights;
5. confidentiality and privilege;
6. intellectual property protection;
7. conflicts of interest;
8. indemnification; and
9. governing law and jurisdiction.

Board observer arrangements can provide invaluable expertise and input to the company’s board and management. While such arrangements are mostly defined by contract, companies should ensure that the agreement governing such arrangements are drafted with precision and cover the key issues that are of importance to the company. As board observer arrangements continue to be sought by investors, we will continue to monitor the development of law in this area as they unfold.

Please do not hesitate to contact us if you require any clarifications or have any questions about drafting your board observer agreement.



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