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TRICK OR TREAT: Are Observer Directors Really Directors in Disguise?

An increased number of corporations appear to be now considering or implementing the practice of utilizing "observer" or "advisory" directors who are not formally elected as directors but who participate at board meetings as non-voting attendees. A corporation's apparent goal in adopting this practice is to insulate the "observer" from the liability exposures of being a director while still benefiting from that person's insights and expertise. Although not uncommon in some countries, this practice historically has not been popular in the United States.

As explained below, use of observer or advisory directors raises problematic liability and financial protection issues and should be cautiously evaluated before persons are asked to serve in that capacity.

A. Liability Exposure

U.S. legal authority has generally recognized that a person who is not technically a duly elected director, but who performs similar functions or otherwise fulfills a comparable role with the company will be treated as a de facto director and thus held to the same liability standards and exposures as a duly elected director. This concept is enunciated in several court decisions as well as, for example, Section 11 of the Securities Act of 1933, which allows a shareholder who alleges misrepresentations in a securities registration statement to sue not only directors and certain officers, but also any "person performing similar functions."

Generally speaking, if a person attends board meetings, is an active participant in board discussions and generally "looks like a director and acts like a director," U.S. courts will likely treat that person as a director for purposes of imposing liability for director wrongdoing. This is especially true if the corporation publicizes the involvement by the "observer," thereby encouraging corporate constituents to rely on the contributions of the "observer." On the other hand, someone who attends a board meeting as a pure observer, not speaking or otherwise participating in board decisions, is unlikely to be subjected to director liability.

Stated differently, in order for this practice to achieve the desired liability limitation, the corporation must be deprived of the very benefits which it seeks to attain by recruiting the "observer"--i.e. the person's reputation and active involvement in board deliberations. The greatest danger from this practice occurs when the "observer" seeks to minimize his/her involvement in order to maximize the potential for liability limitation, but a court nonetheless views the "observer" as a director. The very conduct which was undertaken to reduce liability

(i.e. minimizing involvement) would then be strong evidence that the "observer" failed to satisfy his/her director responsibilities, thus increasing liability.

B. Financial Protection

Because the "observer" will contend he/she is not a director for liability purposes, the "observer" may not be treated as a director for indemnification and insurance purposes, in which case the "observer" will have no mandatory indemnification or insurance protection absent special arrangements. To avoid that undesirable result, the Board should adopt a special resolution mandating indemnification protection for such persons and the D&O insurance policy should be endorsed to include such persons as insureds in their capacity as "observers." Underwriters will likely require evidence of special indemnification protection as a condition to granting this coverage extension. If the "observer" desires outside position coverage from his/her employer, similar amendments to that coverage should also be obtained.

About the Author:

Dan A. Bailey is the Chair of the Firm's Directors & Officers Liability Practice Group and represents and consults with directors and officers, corporations, insurance companies, and law firms across the country. In addition to advising Boards and drafting most of the D&O insurance policies in the market, he has represented clients or served as an expert witness in many of the largest D&O claims for more than 30 years. He is co-author of Liability of Corporate Officers and Directors, a leading treatise on the topic, has published dozens of articles and speaks at more than 20 seminars a year on the subject.

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