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INSIGHT: Consequences of a Board Seat

By Ele Klein and Adriana Schwartz

Representation on the board of directors of a public company has significant advantages for an investment firm looking to maximize, or just simply protect or recover, an investment. But a huge compliance minefield awaits if not thought through beforehand. Seats on a public company board can result from an activist campaign, a private equity investment that has completed an IPO, participation in a private placement of securities in an already public company or even a friendly invitation from an issuer looking for investor representation on its board. However you get there, if a principal or employee of your firm sits on the board of a public company, or any company, the value of understanding the issues that come along with that cannot be understated.

Trading Restrictions and Filing Requirements

Insider Trading

To state the obvious, as a director, your board representative will come into possession of material, nonpublic information (''MNPI'') with respect to the issuer. Regardless of whether that information has been communicated to anyone else at your firm, in the absence of an information barrier walling off the representative from the rest of the firm (which is often not practically feasible), the firm will effectively be restricted from trading while the representative is in possession of MNPI. The law has a notion that the knowledge of an agent is imputed to its principal. Accordingly, since an employee would be viewed as the firm's agent on the board, the employee's knowledge is imputed to the firm for purposes of the insider trading laws. As a practical matter, any questions as to trades made by the firm while an employee is in possession of MNPI, will put the firm in a difficult position to adequately demonstrate to a regulator that the employee did not in fact convey that MNPI to someone at the firm.

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Frequently, the issuer will contractually restrict the firm (and not just the director) to trading under the issuer's insider trading polices and blackout periods. These policies can extend to securities of other public companies and may even require approval prior to trading in permitted periods.

Therefore, these trading restrictions must be evaluated by the firm in light of its need to trade its investments, including during times of inflows of capital and redemptions.

Section 16 of the Exchange Act

Section 16 of the Exchange Act of 1934 (''Exchange Act'') applies to the executive officers, directors and greater than 10 percent beneficial owners of an issuer (with the exception of Foreign Private Issuers) that has a class of voting, equity securities registered under Section 12 of the Exchange Act. The courts have also recognized a doctrine under Section 16(b) when an entity has a representative on an issuer's board of directors representing the interests of the entity, whereby that entity is subject to Section 16 in the same manner as the director. This is the so-called ''director-by-deputization'' doctrine.

Deputization may be found where the firm is acting as a director through its deputy and the director shares confidential information with the firm, the director influences the firm's investment decisions with respect to

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the relevant issuer, or the director's actions as a director are influenced by the firm.

While the SEC has never amended the Section 16 rules to include ''directors-by-deputization,'' they have acknowledged the development of this category of insiders by the courts in Section 16(b) profit disgorgement cases. (See SEC Release No. 34-26333, III. A. 2 (Dec. 2, 1988)). Accordingly, where a firm has a principal or employee on the board of a public company, it will have to analyze the likelihood that it could be deemed to be a director by deputization, whether to make filings under Section 16(a), and how to monitor its trading to not run afoul of the Section 16(b) short swing profit rules.

The main parts of Section 16 are Section 16(a)'s filing requirements, Section 16(b)'s short swing profit rules and Section 16(c), which generally prohibits shorting the issuer's securities, including through options where the insider does not own long the number of shares underlying the option for the life of the option. The principal filings required under Section 16(a) are Forms 3 and 4. In most cases, the Form 3 is required to be filed within 10 days of becoming subject to Section 16 (i.e. upon joining the board or crossing 10 percent beneficial ownership) unless the filing is in connection with the issuer's IPO in which case it will be due on the date the issuer's Section 12 registration is first effective. Form 3 requires disclosure of all ''beneficial ownership'' interests in any of the issuer's equity securities and any derivative securities related thereto. When there is any change in ''beneficial ownership'' of these securities, subject to certain limited exceptions, a Form 4 must be filed with the SEC before the end of the second business day following the day on which the transaction that results in the change of beneficial ownership has been executed. Beneficial ownership for Section 16(a) is defined under the rules as a direct or indirect ''pecuniary interest'' in the subject equity securities which is the ''opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities''. In general, this requires that all transactions in, and certain contractual arrangements related to, an issuer's equity securities or any derivative securities related thereto are required to be disclosed on a Form 4 but for certain limited exceptions (such as gifts and dividends).

The main area of concern when subject to Section 16 is Section 16(b)'s short swing profit rules and the impact it can have on the firm's ability to trade freely. Section 16(b) imposes liability for ''short-swing profits'' from transactions in the issuer's equity securities and any derivate securities related thereto. Statutory insiders must disgorge to the issuer any profits realized as a result of a purchase and sale or sale and purchase of such securities within a period of less than six months. Under Section 16(b), it is possible for an insider to have an actual loss but a ''realized'' profit that is payable under Section 16(b) based on courts' employment of the ''lowest-in, highest-out'' method of calculating Section 16(b) liability. Under this approach, the highest sale price is matched against the lowest purchase price during any six month period, followed by the next highest sale price and next lowest purchase price and so on, until all shares have been included irrespective of the order in which the transactions were executed. Transactions by an officer or director (including a director-by-deputization), unlike greater than 10 percent beneficial owners, may be subject to Section 16 for up to six months after termination of insider status. While a former greater than 10 percent owner may trade freely in the issuer's equity securities once its ownership falls below 10 percent, a former officer or director (including a director-by- deputization) who, prior to termination of insider status, engaged in a transaction that was not exempt from Section 16(b), remains subject to Section 16 with respect to any opposite-way transaction that occurs within less than six months of that transaction.

The profit disgorgement rules are extremely onerous and draconian. They are not enforced by the SEC, instead, cases in this area are overwhelmingly brought by private plaintiff's counsel who receive a percentage of the profits recovered for the issuer. These plaintiff's counsel are therefore incentivized to bring cases even if they are based on novel theories of liability, and possibly for which they see little chance of success on the merits, but for which they might be able to extract even some amount in a settlement.

It is important to consider stock awards and other compensation that the employee director may receive for his service on the board. Such compensation can raise Section16(b) issues as well as fiduciary issues for the firm and tax issues that should be considered and planned for ahead of time.

Schedule 13D Filings

Section 13(d) of the Exchange Act (''Section 13'') requires a ''beneficial owner'' that acquires more than 5 percent of a class of voting, equity securities registered under the Exchange Act to file with the Securities and Exchange Commission a statement on Schedule 13D or Schedule 13G, if eligible. Except in certain limited circumstances, an investment firm must be ''passive'' with respect to an issuer in order to file on Schedule 13G and a firm with a principal or employee on the board of an issuer would generally not be deemed to be passive with respect to the issuer. In this case, the firm would file on Schedule 13D within 10 days of crossing 5 percent. If the firm is already filing on Schedule 13G, it will have to switch to filing on Schedule 13D within 10 days of the date that it no longer holds the position passively (which, depending on the facts, may very well be at some point prior to the time it actually takes the board seat). When required to switch from Schedule 13G to Schedule 13D, from the time that the firm's intent is no longer passive until the expiration of the 10th day after it has filed the Schedule 13D it cannot vote the securities it holds and it may not acquire additional beneficial ownership of any of the issuer's equity securities (or the equity securities of any entity controlling the issuer).

A Schedule 13D filing requires disclosure of the firm's position, the amount of funds used to purchase the securities being reported, any plans or proposals with respect to any change of control of the issuer and certain other matters, the firm's trading history during the prior sixty days, any contracts or arrangements with respect to any securities of the issuer (including potentially debt securities), and it requires that certain agreements related to the foregoing are attached as exhibits to the filing. Amendments to Schedule 13D must be made ''promptly'' upon any material change in the information previously reported. Promptly is not defined in the rules, but has generally be interpreted to mean not more than two business days. An acquisition or disposition of 1 percent or more of the class of securities is deemed to be a material change requiring an amend-

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ment. Another common amendment trigger is any material change to a filer's plans or proposals with respect to the issuer.

Affiliate Status

Under Rule 144 under the Securities Act of 1933, as amended (the ''Securities Act''), an ''affiliate'' of an issuer is defined as a ''person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, such issuer.'' The determination as to whether a person is an ''affiliate'' of an issuer is a fact-specific inquiry to be made upon consideration of the circumstances at hand. A person's status as an officer, director or owner of 10 percent of the voting securities of a company, while not necessarily determinative of whether such person would be considered an ''affiliate'' within the meaning of Rule 144, is one fact which must be taken into consideration (American Standard, SEC No-Action Letter 1972 WL 19628 (Oct. 11, 1972)). Accordingly, most consider a board seat to create a presumption of affiliate status that may be difficult to rebut (even though in reality one board member cannot unilaterally control the company).

If an investment firm is deemed to be an affiliate of an issuer, all of the securities of that issuer held by the firm and its affiliates will be deemed ''control securities.'' In order to sell control securities, an affiliate must sell pursuant to an exemption from the registration requirements of the Securities Act or a registration statement under the Securities Act. The most commonly used exemption in these circumstances is Rule 144.

Rule 144 provides a safe harbor exemption from registration. The requirements of Rule 144 differ for affiliates and non-affiliates and with respect to control securities that are restricted securities and those that are not. Affiliates are generally required to comply with the following requirements of Rule 144 when selling securities of an issuer that has been an SEC reporting company for at least 90 days:

- A minimum six month holding period for restricted securities;
- Current public information regarding the issuer must be available before the sale can be made (this generally means that the companies have complied with the periodic reporting requirements of the Exchange Act);
- The number of securities sold by an affiliate under Rule 144 in any three-month period cannot exceed the greater of: (i) 1 percent of the outstanding shares of the class being sold and (ii) the average weekly trading volume of the security on all U.S. national securities exchanges on which the securities trade during the four calendar weeks preceding the sale;
- The sales must generally be made in ordinary brokerage transactions and neither the seller nor the broker can solicit orders to buy the securities; and
- A Form 144 disclosing certain information with respect to the seller and the shares being sold, must be filed with the SEC prior to selling (but if the sale involves less than 5,000 shares or the aggregate dollar amount is less than $50,000 a Form 144 need not be filed).

Control securities can also be resold in private transactions in reliance on another commonly used exemption, the so-called Rule 4(a)(1½) exemption. This is an exemption not specifically provided for under the Securities Act but which the SEC has recognized. The exemption requires the purchaser to be sophisticated (an ''accredited investor'' would qualify) and to be purchasing the securities for the purpose of investment and not with a view toward distribution. Securities acquired in this type of transaction from an affiliate of the issuer would not be freely saleable in the hands of the purchaser, but instead would be ''restricted securities'' for which the purchaser would need its own resale exemption or registration in order to resell.

Director Fiduciary Duties/Conflicts of Interest/Corporate Opportunities under Delaware Law

Fiduciary Duties

Under Delaware law, directors owe a duty of care and loyalty to all shareholders, not just the shareholder that designated the director to sit on the board. This means that, as a director, a representative of an investment firm must consider what is in the best interest of all shareholders, not just the firm. Directors can face personal liability and monetary damages if he or she breaches these fiduciary duties, so they must understand and evaluate these duties prior to taking a board seat. Board designees must be careful not to breach their duty of loyalty by taking for themselves or the firm business opportunities belonging to the issuer. In this regard, it is important to consider whether investments that may be made by the firm could be viewed as business opportunities belonging the Issuer.

The duty of loyalty also contains an obligation to maintain the confidentiality of sensitive information. In the absence of a prohibition on information sharing, the investment firm would generally be entitled to the same information as its director, but the issuer may require that the firm enter into a confidentiality agreement restricting the use or further dissemination of confidential information. The investment firm may not share any such information with its fund investors if that information is not in the public domain.

Conflicts of Interest

Directors have to be careful to avoid breach of fiduciary duty claims from conflicts of interest as well. These could come up where the employee director's or the investment firm's interests diverge from the interests of the company and its stockholders as a whole. For example:

- When the company and the investment firm are entering into a transaction between themselves or directly competing with each other.
- The decision whether, when, and under what terms and conditions to sell, merge or liquidate the company, if the investment firm has different exit timing horizons or stands to obtain different consideration in the transaction (by virtue of holding debt or preferred stock or otherwise) than other stockholders of the company.

There are steps that may be taken to reduce the likelihood of breach of fiduciary duty claims being successfully brought, like disclosing the conflict fully to the board of directors of the company. The board can then appoint a special committee comprised entirely of dis-

interested and independent directors to consider and vote upon the matter, obtain the approval of a majority of the disinterested stockholders, and/or the board member can recuse themselves entirely from the board's deliberations relating to the transaction or decision at issue and abstaining from voting on the matter.

As a practical matter, most of these issues should be manageable if there is favorable exculpation and indemnification language in the issuer's charter and D&O insurance coverage.

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