

MinterEllisonRuddWatts

MEMO

To Institute of Directors New Zealand

From MinterEllisonRuddWatts

Date 23 December 2020

Subject: Future Directors Programme - status of “Future Directors”

1. Introduction

- 1.1 Institute of Directors New Zealand (**IoD**) operates a “Future Directors” programme (the **Future Directors Programme**). Its aim is to develop the next generation of directors and to ensure that New Zealand’s director pool is diverse and wide enough to support future economic growth.
- 1.2 Talented individuals interested in governance (each a **Future Director**) can apply to participate in the Future Directors Programme. If selected, they will be invited to become non-voting observers of the boards of New Zealand companies and/or State Sector organisations (each a **Host Board**).¹
- 1.3 The terms of each Future Director’s appointment will be set out in an appointment letter the Host Board provides to the Future Director they have selected. Each appointment letter is expected to include the same terms as are included in the “template” appointment letter IoD has developed for the Future Directors Programme (**Template Letter**).²
- 1.4 The viability of the Future Directors Programme depends on each Future Director not being a deemed director of a Host Board. If a Future Director was a deemed director, they would become subject to duties and obligations set out in the *Companies Act 1993* (the **Act**)³ and in certain other legislation.⁴ Various compliance obligations could also arise for Host Board’s.
- 1.5 This Memo considers whether:
- (a) Future Directors could be at risk of becoming a deemed director of a Host Board if they participate in the Future Directors Programme; and
 - (b) an NZX-listed Host Board could have disclosure obligations under the NZX Listing Rules (**NZX Rules**) when they appoint a Future Director.

¹ References in this Memo to the “Host Board” are references to either the board of the relevant Company / State Sector Organisation or to the Company/ State Sector Organisation itself (as applicable).

² A copy of the Template Letter is set out in Schedule 1.

³ Legislative references in this Memo are to sections in the Act unless otherwise stated.

⁴ Under the *Financial Markets Conduct Act 2013* (**FMCA**), for example, directors and senior managers have duties and obligations that are separate from those imposed under the Act. This Memo only considers the specific issues referred to in paragraph 1.5 and does not consider other legislation or rules that could potentially apply to Future Directors or Host Boards.

2. **Our views**

- 2.1 The risk of a Future Director becoming a director of a Host Board due to participating in the Future Directors Programme is very low. This is because:
- (a) Future Directors will not be formally appointed as directors. Therefore, they can only become a director if the Act deems this outcome;
 - (b) The Act's deeming rules require that a person has decision-making rights with respect to a company or an ability to control some aspect of its decision-making; and
 - (c) Future Directors are not intended to have (and should not in practice have) any decision-making rights with respect to their Host Board or control over any decision-making processes. Without such rights, the Act's deemed director rules cannot apply.
- 2.2 If a Host Board decides to adopt an approach suggested by a Future Director, it will be important to be able to demonstrate that the Host Board's decision has been made independently from the Future Director's influence (i.e. that the Host Board's members have independently turned their minds to the relevant issue and reached their own independent conclusions on how to proceed).
- 2.3 Because a Future Director will not be a director under the Act, a number of provisions in the Act relating to directors (including with respect to remuneration, insurance or confidentiality) will not be relevant. However, as many of the matters covered by such provisions are also relevant to Future Directors (despite them not being directors under the Act), the Template Letter includes terms to address this.
- 2.4 NZX Listed Host Boards will not trigger disclosure obligations under the NZX Rules when they appoint a Future Director because Future Directors will not be either a "Director" or a "Senior Manager" as defined in the NZX Rules.
- 2.5 A critical assumption underpinning our conclusions in paragraphs 2.1 and 2.4, is that each Future Director will be appointed on the same terms as are included in the Template Letter (and that those terms will be followed in practice). This Memo is also subject to various other assumptions set out below.

3. **Future Directors will not be deemed directors under the Act**

General principles

- 3.1 The Act uses an inclusive "director" definition that extends the concept beyond formal director appointments.⁵ A director under the Act will include a person:⁶
- (a) occupying the position of director of the company by whatever name called;⁷

⁵ The full "director" definition is set out Schedule 2. "Formal" director appointments would encompass each director appointed on the registration of a company, and others appointed by ordinary resolution unless the relevant company's constitution provides different appointment rules (see section 153). The Court can also appoint a director, on application by a shareholder, where the directors of a company do not comprise a quorum and it is not possible (or practicable) to appoint a director under company's constitution (see section 154).

⁶ Because the Act uses an inclusive definition, case-law on the meaning of a "director" remains relevant (although the breadth of the Act's director definition means that most situations covered by case-law are already covered). In addition, there is a specific exclusion from the director concept for persons acting in a professional capacity (see section 126 (4)), although this can only apply to stop a person from being a director under the legislative tests summarised in paragraphs 3.1(b) to 3.1(e) (i.e. a professional advisor could still potentially be a director on the basis outlined in paragraph 3.1(a) or if this resulted from the application of case-law).

⁷ Section 126(1)(a).

- (b) in accordance with whose directions or instructions a person referred to in paragraph 3.1(a), or the board, may be required to, or is accustomed to act;⁸
- (c) that exercises (or is entitled to exercise) or controls (or is entitled to control) the exercise of powers which, apart from the constitution of the company, would fall to be exercised by the board;⁹
- (d) to whom a power or duty of the board has been directly delegated by the board with that person's consent or acquiescence, or who exercises the power or duty with the consent or acquiescence of the board;¹⁰ and/or
- (e) in accordance with whose directions or instructions a person referred to above may be required or is accustomed to act in respect of his or her duties and powers as a director.¹¹

3.2 For some of the above categories, the relevant person is only treated as a director for certain specified purposes (generally for director duties and penalties purposes).

3.3 Although the director categories differ slightly, a common theme is that they all contemplate situations where the relevant person has some type of control over the company's decision-making. The relevant person must be carrying out director functions itself or be directing/instructing those that do.

3.4 Case law suggests that substantial control is required for a person to be a deemed director. In *Buzzle Operations Pty Ltd (In Liq) v Apple Computer Australia Pty Ltd*,¹² for example, representatives of the creditor of a financially distressed company were held not to be deemed directors despite them being regular attendees at the company's board (and other) meetings,¹³ and the creditor having significant oversight over the company's commercial dealings. The Court concluded that while the creditor (and its representatives) provided the company with ongoing advice and assistance, the company's directors were still free to exercise independent judgement to decide whether any course of action was in the company's best interests.

Board observers as directors

3.5 New Zealand courts have not considered whether a person could be a deemed director as a result of being a board observer. Nor has the distinction between a director and a board observer been considered in any manner. However, these issues were recently considered by the United States Court of Appeals for the Third Circuit.¹⁴

3.6 In *Obasi Investment Ltd v Tibet Pharmaceuticals, Inc.*¹⁵ (**Obasi**), the Third Circuit was required to determine whether two board observers of a pharmaceutical company (**Tibet**) could be treated in the same way as Tibet's directors when penalties were being assessed for breaches of United States securities laws. This turned on whether the board observers had "*performed similar functions*" to a director. The board observers in question had been appointed by the investment advisor overseeing Tibet's IPO and reported to the investment advisor, rather than to Tibet's shareholders.

⁸ Sections 126(1)(b)(i) and (ii).

⁹ Section 126(1)(b)(iii).

¹⁰ Section 126(1)(c).

¹¹ Section 126(1)(d).

¹² *Buzzle Operations Pty Ltd (In Liq) v Apple Computer Australia Pty Ltd* (2010) 77 ACSR 410.

¹³ The distressed company also provided one of these representatives with an office and this representative regularly met with the company's executives.

¹⁴ The creditor in the *Buzzle* case (see paragraph 3.4) asserted that its representatives attended board and other meetings of the distressed company in an "observer" capacity but the distinction between observers and directors was not considered by the Court.

¹⁵ *Obasi Investment Ltd v Tibet Pharmaceuticals, Inc* (2019) WL 3294888 (3d Cir.2019). A full summary of the *Obasi* case is set out in Schedule 3.

- 3.7 The Third Circuit held, by a majority, that the board observers did not perform a role similar to that of Tibet's directors. The Court took three main factors into account in reaching this conclusion, which were that the board observers:
- (a) could not vote for or against actions of the Tibet's board;
 - (b) did not have interests that were aligned with Tibet or its shareholders – their interests were instead aligned with the investment advisor that appointed them; and
 - (c) had fixed term appointments that terminated automatically and could not be voted out by the shareholders.
- 3.8 Some clear parallels can be drawn between the board observers in *Obasi* and Future Directors:
- (a) like the board observers in *Obasi*, Future Directors will have no voting or decision-making rights in relation to their Host Board;
 - (b) Future Directors will not have any relationship with the Host Board's shareholders. They are not appointed by the Host Board's shareholders and are instead appointed by the Host Board itself under a contractual arrangement that is facilitated by IoD. IoD is a third party that, like the Future Directors, is not related to any of the Host Boards; and
 - (c) each Future Director will be appointed for a fixed term (of between 12 and 18 months), and his or her observer rights will terminate automatically at the end of that period.
- 3.9 A degree of caution needs to be exercised in applying the *Obasi* case in New Zealand. The issue in *Obasi* was relatively discrete (i.e. whether the board observers had a role similar to directors) and involved a situation where the relevant legislation did not include a specific director definition. However, the case is useful in setting out the key distinctions between a director and a board observer.
- Future Directors will not be deemed directors if they are appointed on the same terms as are set out in the Template Letter (and those terms are followed)*
- 3.10 The Template Letter was developed by IoD to set out the intended relationship between a Future Director and his or her Host Board. Its terms have been drafted to minimise the risk of a Future Director inadvertently becoming a deemed director. This includes terms:
- (a) making it clear that the Future Director's appointment is made as part of the Future Directors Programme;
 - (b) providing for the Future Director's appointment to terminate automatically at the end of a fixed period;
 - (c) that tightly scope of the Future Director's role, limiting this to attending Host Board meetings as a non-voting observer, developing experience on how a corporate board operates, and having discussions with the Host Board (if invited to do so);
 - (d) that expressly prohibit the Future Director from having voting rights, management rights or administration rights with respect the Host Board and from being delegated any such rights;
 - (e) giving the Host Board the right to, for any reason, exclude the Future Director from Host Board meetings and/or to withhold sensitive information; and
 - (f) confirming that the Future Director will be engaged as an independent contractor and is not a Host Board employee.
- 3.11 To be a deemed director, a person needs to have some form of control or influence over the decision-making of the relevant company. However, the terms of the Template Letter (as summarised above and set out fully in Schedule 1) effectively preclude a Future Director from having any such rights. Accordingly, as long the appointment letters Future Directors receive from Host Boards include the same terms as the Template Letter, and those terms are followed in practice, the risk of a Future Director becoming a deemed director under the Act is very low.

- 3.12 This is a sensible outcome and accords with the reasons why the Future Directors Programme was established in the first place. The Future Directors Programme aims to give Future Directors exposure to governance and board decision-making (through their non-voting observer roles) without the responsibilities, obligations and duties that come with being a director. Each Future Director is being appointed to learn how to be a director – not to actually be one.

Care should be taken if a Future Director has experience not already represented on a Host Board

- 3.13 While the Future Director appointment letter goes a long way to establishing that Future Directors are not deemed directors, issues could still arise if the terms of the appointment letter are not followed in practice. If a Host Board acted on the instructions of a Future Director (or was accustomed to so acting), there would still potentially be a deemed director sensitivity. It will therefore be important that the Host Board can demonstrate its decision-making is independent.

- 3.14 Care may be needed where a Future Director has expertise that is not already represented on the Host Board, and the Host Board intends to adopt the approach suggested by their Future Director in dealing with a particular issue. In such circumstances, it will be helpful if the Host Board can demonstrate that they have:

- (a) turned their minds to the relevant issue(s);
- (b) considered the information available to them regarding the issue;
- (c) treated any input received from a Future Director as his or her personal view only (as opposed to a direction that the Host Board act in a particular manner);
- (d) made their own independent judgements on how to proceed; and
- (e) where practicable, sought independent advice on the relevant issue(s) from a third-party advisor.

- 3.15 To reinforce the independence of their decision making, a Host Board could also consider requiring that the Future Director leave the room when the Host Board passes resolutions, or it should at least be made sufficiently clear in some manner that the Host Board alone has resolved to follow a certain course of action. This is particularly so for Host Board documentation such as minutes.

- 3.16 An alternate approach might be for this issue to be dealt with through the Future Director selection process. A Host Board could simply decide, as a matter of policy, not to select Future Directors to fill gaps in knowledge and/or experience at the Host Board level.

4. The Template Letter includes terms designed to cover off various issues that are covered off for directors under the Act

- 4.1 Because a Future Director will not be a director under the Act, a number of provisions in the Act relating to directors (including with respect to remuneration, insurance or confidentiality) do not apply. However, as many of the matters covered by such provisions are also relevant to Future Directors (despite them not being directors under the Act), the Template Letter has been drafted to address this.

Remuneration

- 4.2 The Act requires that directors certify that their remuneration arrangements are “fair” to the company¹⁶ and also that they follow certain procedures regarding the authorisation of director remuneration.
- 4.3 Future Directors are not directors, so there is no requirement to follow the procedures set out in the Act relating to Host Board remuneration, for example the duty to enter particulars of any payment to a director into the interests register,¹⁷ and the duty on the directors who vote in favour

¹⁶ Section 161.

¹⁷ Section 161(2).

of a payment to a director to certify that the payment is fair to the company¹⁸. As independent contractor advisers, the Host Board may remunerate Future Directors in the way they consider appropriate, consistent with the process for other contractors and advisers.

- 4.4 The Template Letter contemplates that Future Directors will be paid a fee and reimbursed for expenses. It will be up to each Host Board to set an appropriate fee (if one is to be paid) and to be able to justify this if it is questioned.
- 4.5 It will also be important that, where possible, Future Directors are not paid from the same pool of funds as directors, as this would be a factor in favour of them being deemed directors (although this factor, of itself, will be insufficient to cause any material concerns).

Insurance

- 4.6 The Act places certain restrictions on the ability to indemnify or effect insurance for director and employees.¹⁹
- 4.7 As Future Directors will not be directors or employees, these restrictions will not apply. The Template Letter therefore contemplates that the Host Board may take out such insurance, and provide such indemnities, for the benefit of Future Directors as the Host Board considers appropriate.

Confidentiality

- 4.8 The Act includes confidentiality provisions that restrict a director's use and dissemination of company information he or she obtains as a director.²⁰
- 4.9 Future Directors will generally be provided with the same information as their Host Board. This will include confidential information which could conceivably be used by a Future Director (or their associates) for personal gain.
- 4.10 As the confidentiality provisions in the Act will not apply to Future Directors, this matter has been addressed in the Template Letter through the inclusion of express confidentiality obligations that will apply to the Future Director.

5. The appointment of a Future Director will not trigger a disclosure obligation under the NZX Rules

- 5.1 Host Boards that are NZX listed have continuous disclosure obligations under the NZX rules. These obligations include a duty to promptly and without delay release information regarding any decision to change a "Director" or a "Senior Manager".²¹ An issue therefore arises whether a Host Board's decision to appoint a Future Director could trigger disclosure obligations under the NZX Rules.
- 5.2 Under the NZX Rules, a person will be a "Director" where either:²²
- (a) they are a director for the purposes of section 126(1)(a) of the Act, meaning he or she occupies the position of company director by whatever name called; or
 - (b) he or she does not meet the requirements in paragraph 5.2(a) but occupies a position that is "comparable with" that of a company director.

¹⁸ Section 161(4).

¹⁹ Section 162(1).

²⁰ See section 145.

²¹ Rule 3.20.1(a). This disclosure obligation applies regardless of whether the Director or Senior Manager appointment will become effective at a later date.

²² See definition of "Director" in Part A of the NZX Rules.

5.3 The NZX Rules define the term "Senior Manager" by reference to the definition used in the FMCA,²³ which provides that a Senior Manager:

"in relation to a person (A), means a person who is not a director but occupies a position that allows that person to exercise significant influence over the management or administration of A (for example, a chief executive or a chief financial officer)."

5.4 Given their intended terms of appointment (as set out in the Template Letter), it is hard to see how a Future Director will be either a Director or a Senior Manager of a Host Board under the NZX Rules. Specifically, as noted above:

- (a) a Future Director will not be a director under the legislative tests in the Act;
- (b) a Future Director's role is not comparable with the role of a director – he or she will have no voting rights, no relationship with a Host Board's shareholders and will be appointed for a fixed period only;
- (c) each Future Director will be expressly prohibited (through their appointment letter) from participating in decision-making, management or ongoing administration of the Host Board; and
- (d) a Future Director will not be employed by his or her Host Board and will not be a member of its senior leadership/management team (i.e. a CEO, CFO etc).

5.5 As Future Directors will not be Directors or Senior Managers under the NZX Rules, their appointment will not trigger disclosure obligations under the NZX Rules.

6. Further Information

We would be happy to elaborate on the comments in this letter if that would be of assistance. If you have any questions, please contact us.

Yours faithfully

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²³ See definition of "Senior Manager" in Part A of the NZX Rules.

Schedule 1 – Template Letter

[Date]

[Candidate Name]

[Address]

Dear [Candidate Name]

APPOINTMENT AS A “FUTURE DIRECTOR” OF [COMPANY]

On behalf of [Company] (“Company”, “we” or “us”), we are pleased to offer you the position of “Future Director” (**Future Director**). We are making this offer to you as part of the Future Directors Programme administered by Institute of Directors New Zealand.

If you accept our offer, you will be appointed as a Future Director on the terms set out below.

Commencement and term

Your appointment as a Future Director will start on the date we receive a counter-signed copy of this letter (“**Start Date**”) and will continue until it terminates in accordance this letter (“**Term**”). Your appointment will terminate:

- (a) automatically, on the date that is [Number of months] months following the Start Date;
- (b) if you notify us in writing that you no longer wish to be a Future Director, in which case you will stop being a Future Director from the date specified in your notice (such date being not less than one month following the date of your notice);
- (c) if we notify you in writing that we wish to terminate your role as a Future Director for any reason, in which case you will stop being a Future Director from the date specified in our notice; or
- (d) with immediate effect, if you die or become permanently incapacitated.

Your role as a Future Director

Your role will involve you attending, in a non-voting observer capacity, all regularly scheduled meetings of the Company’s board of directors (“**Board**”) to provide you with an understanding of the affairs of the Company and to help you gain experience regarding the operation of a corporate board (the “**Approved Purposes**”). The Board may also invite you to participate in discussions relating to the Company from time to time.

In no event will you:

- (a) be deemed to be (or otherwise be treated as) a director of the Company, a member of the Board, or an officer of the Company;
- (b) have any voting rights with respect to the Board or the Company, or any power to cause the Company to take (or not take) any action;
- (c) have your attendance taken into account when determining whether a quorum is present at any Board meeting;

- (d) be delegated any authority to carry out actions on behalf of the Board or the Company;
- (e) have any role, powers, rights, or responsibilities with respect to the Company's management or administration activities; or
- (f) have, or be deemed to have, or otherwise be subject to, any duties (fiduciary or otherwise) to the Company or its shareholders or any duties (fiduciary or otherwise) otherwise applicable to the directors of the Company, except as expressly set out in this letter.

It is preferred that you attend all Board meetings in person. However, if this is not possible, you may participate in the relevant Board meeting by video conference or audio.

Unless the Board determines otherwise (in its absolute discretion), you will be provided with all documents, notices and any other information the directors of the Company receive in relation to Board meetings, as well as any proposed written resolution of directors and documents relating to such written resolutions.

You will be sent all such notices and documents when they are sent to directors of the Company, unless the Company determines otherwise in its absolute discretion.

Notwithstanding the forgoing, you may be excluded from access to a Board meeting, or portion thereof, for any reason deemed appropriate by the Board.

Your obligations and responsibilities as a Future Director

Throughout the Term, you must comply with all charters, policies, codes and procedures adopted by the Company, as well as such other requirements or policies as the Board may specify from time to time. You will be provided with access to all such information to allow you to fulfil these obligations. You also agree to comply with any reasonable directions of the Company or the Board concerning your role as a Future Director.

You must disclose any relationships you have with the Company *[(and its wider corporate group)]* and relevant private or other business interests to the Board.

You agree to consult with the Chair before accepting any directorships of companies, or taking any other action, relevant to your position as a Future Director.

If your circumstances change after the Start Date and you become obligated to disclose information to the us under this letter, you will notify us within 2 business days of that change.

Mentoring and education

We will assign you a Board member to act as your mentor during the Term. You are also expected to educate yourself on an ongoing basis to ensure that you can appropriately and effectively perform your Future Director role.

Fees and expenses

As consideration for your input as a Future Director, you will be paid a fee of \$*[Amount]* per annum plus GST (if applicable). Such fee will be paid to you less any deductions required by law, and at the times determined by us in our absolute discretion.

We will also reimburse you for any reasonable out-of-pocket costs and expenses you incur, provided that such costs and expenses are approved by us in advance in writing.

Insurance

As a Future Director, you will not be exposed to the same range of potential legal liabilities as the Company's directors.

We agree, however, to effect and maintain insurance for your benefit under the terms of our existing directors' and officers' liability insurance policy (noting that you will be neither a director nor an officer of the Company due to your appointment).

[Securities Dealing Policy

The Company's Securities Dealing Policy governs the ability for the Company's directors and employees to deal in listed securities in the Company.

As part of your role, you will receive material information in respect of the Company and it is important that you comply with the Securities Dealing Policy. By counter-signing this letter, you agree to comply with that policy (as amended from time to time).]

Employment

You will carry out your Future Director role as an independent contractor, and that this letter does not create (nor is intended to create) a relationship of employer and employee, principal and agent, or partnership, between you and us.

You also acknowledge that:

- we will not seek to employ you; and
- you will not seek employment with the Company,

during the Term and for a period of **[Number of months]** months thereafter.

Confidentiality

During the Term you will receive information regarding the Company that is not publicly available ("**Confidential Information**"). You agree that you will:

- (a) apply the highest standards of confidentiality to the Confidential Information and not, at any time, disclose any Confidential Information to any third party, except as required by law;
- (b) comply with all our policies relating to Confidential Information; and
- (c) not use the Confidential Information for any purpose other than the Approved Purposes.

At the end of the Term you agree to immediately return to us all physical property, materials and documents that contain Confidential Information. You also agree that you will, if we request you do so, destroy all electronically stored Confidential Information within your possession or control.

Personal Information

Any personal information we have received from you in connection with your appointment may be used or disclosed by us to comply with any law or listing rule or for corporate governance purposes.

You may ask for access to the personal information that we hold about you in your capacity as a Future Director. To find out what sort of personal information we hold, or to make a request for access, you should contact the Company Secretary. If, for any reason, the Company Secretary is unable to provide you with personal information, we will advise you why.

Miscellaneous

This letter is governed by, and shall be construed in accordance with, the laws of New Zealand and you submit to the non-exclusive jurisdiction of the New Zealand courts in respect of all matters arising from this letter.

Please confirm your acceptance of these terms by countersigning this letter (where indicated below) and returning a copy to us.

Please do not hesitate to contact us if you any questions.

Yours sincerely

[*Chair or other authorised person*]

for and on behalf of [*Company*]

Acceptance of appointment as a Future Director

I, [*Candidate Name*] confirm that I have read your letter dated [*date*] and accept appointment as a Future Director on the terms and conditions set out above.

[*Candidate Name*]

Date

Schedule 2- Definition of “director” (section 126)

126 Meaning of director

- (1) In this Act, director, in relation to a company, includes—
- (a) a person occupying the position of director of the company by whatever name called; and
 - (b) for the purposes of sections 131 to 141, 145 to 149, 291A to 293, 298, 299, 301, 318(1)(bb), 383, 385, 385AA, 386A to 386F, and clause 3(4)(b) of Schedule 7,—
 - (i) a person in accordance with whose directions or instructions a person referred to in paragraph (a) may be required or is accustomed to act; and
 - (ii) a person in accordance with whose directions or instructions the board of the company may be required or is accustomed to act; and
 - (iii) a person who exercises or who is entitled to exercise or who controls or who is entitled to control the exercise of powers which, apart from the constitution of the company, would fall to be exercised by the board; and
 - (c) for the purposes of sections 131 to 149, 291A to 293, 298, 299, 301, 318(1)(bb), 383, 385, 385AA, 386A to 386F, and clause 3(4)(b) of Schedule 7, a person to whom a power or duty of the board has been directly delegated by the board with that person’s consent or acquiescence, or who exercises the power or duty with the consent or acquiescence of the board; and
 - (d) for the purposes of sections 145 to 149, and clause 3(4)(b) of Schedule 7, a person in accordance with whose directions or instructions a person referred to in paragraphs (a) to (c) may be required or is accustomed to act in respect of his or her duties and powers as a director.
- (1A) In this Act, **director**, in relation to a company, does not include a receiver.
- (2) If the constitution of a company confers a power on shareholders which would otherwise fall to be exercised by the board, any shareholder who exercises that power or who takes part in deciding whether to exercise that power is deemed, in relation to the exercise of the power or any consideration concerning its exercise, to be a director for the purposes of sections 131 to 138.
- (3) If the constitution of a company requires a director or the board to exercise or refrain from exercising a power in accordance with a decision or direction of shareholders, any shareholder who takes part in—
- (a) the making of any decision that the power should or should not be exercised; or
 - (b) the making of any decision whether to give a direction,—
- as the case may be, is deemed, in relation to making any such decision, to be a director for the purposes of sections 131 to 138.
- (4) Paragraphs (b) to (d) of subsection (1) do not include a person to the extent that the person acts only in a professional capacity.

Schedule 3 – Obasi Investment Ltd v Tibet Pharmaceuticals, Inc

Background

The *Obasi* case concerned a pharmaceutical company (**Tibet**) that undertook an initial public offering (**IPO**). The issue considered in the case was whether two non-voting board observers of Tibet (Zou and Downs (**Z&D**)) could be treated the same way as Tibet's directors in relation to an alleged breach of United States securities laws.

The placement agent Tibet chose to assist with the IPO was given the right to appoint two board observers so that it had oversight of Tibet's board activities while the IPO process was ongoing. The placement agent selected Z&D to be the board observers. Zou was an early investor in Tibet and Downs was the managing director of the placement agent.

Z&D worked together to help Tibet go public and were listed as non-voting board observers in Tibet's IPO registration statement. While the registration statement made it clear that Z&D were not directors of Tibet (and the Z&D did not sign the registration statement as such), it also noted that Z&D:

“...may nevertheless significantly influence the outcome of matters submitted before the Board of Directors for approval.”

It later became apparent that the registration statement omitted certain key information relating to an operating company Tibet effectively controlled (**Yunnan**). Yunnan had defaulted on a loan to the Chinese Government a few months before the registration statement became effective and that default led to a judgment requiring repayment of the loan within 60 days. While the registration statement referred to there being a “*long term loan*”, it did not mention the default or the default judgment.

Shortly before Tibet filed its amended final prospectus for the IPO, the lender froze all of Yunnan's assets. This was not disclosed in the prospectus and the IPO closed shortly thereafter.

The lender auctioned off Yunnan's assets shortly after the IPO closed. This prompted NASDAQ to halt trading in Tibet's shares which sent the share price plummeting.

The non-disclosure of key information regarding the loan led to a class action being launched against Tibet and certain other defendants (including Z&D). The class action alleged that those parties had breached section 11 of the *Securities Act 1993* (US), which enabled relief to be sought where untruths or omissions were made in a registration statement. Under that section relief could be sought against persons named in the registration statement as being (or being about to be) a director, and against persons performing “*similar functions*”.

The question for determination was whether Z&D, could be described as being persons performing “*similar functions*” to a director due to their board observer roles.

Findings

At first instance the District Court²⁴ concluded that there was a “*genuine issue of material fact as to whether [Z&D] could be viewed as people performing similar functions to a director*”. The District Court focussed, in particular, on the registration statement and the comments in it that “[Z&D] could influence the entire board”. The District Court reasoned that “[Z&D] arguably had more influence than any individual board member, who could only cast a single vote.”

The District Court ultimately left the issue for the Third Circuit to determine and certified the following question for the purposes of the appeal:

“Can Defendants be potentially liable under Section 11 of the Securities Act of 1933, each as a ‘person performing similar functions’ to a director, in light of Defendants’ role as board observers who could (but did not necessarily have to) significantly influence the outcome of matters submitted to the board of directors for approval?”

²⁴ *Dartell v Tibet Pharm* 2017 WL 1944106 (DNJ May 10 2017).

The Third Circuit's decision started with a discussion of the functions that evidence directorship. It was noted:

"What functions, then, typify directorship? "The whole of the directors collectively form the board of directors. Acting as a board, directors are the corporation's agents.... The board manages the corporation's affairs by: (1) selecting senior officers; (2) controlling executive compensation; (3) delegating administrative authority to officers; (4) making high level corporate policy; (5) deciding financing and capital allocation; and (6) supervising the "welfare of the whole enterprise."

This led to the Third Circuit finding that:

"As we have explained, the function of a board of directors is to direct and manage the company's affairs. Individual directors do this by formal voting. And because each director bears part of the ultimate responsibility for the company's fate, each owes duties of care and loyalty and may be voted out for mismanagement (or for no reason at all). Zou and Downs's roles, as described in the registration statement, are not "of a like nature or kind," Similar, Oxford English Dictionary 59 (1st ed. 1933)."

In justifying its conclusion, the Third Circuit pointed to 3 specific factors that distinguished Z&D's role from that of Tibet's directors:

"Three features differentiate Zou and Downs from directors. First, and most fundamentally, Zou and Downs cannot vote for board action. Second, they are aligned with the placement agent, A&S, not Tibet. And third, their tenures are set to end automatically, with no opportunity to vote them out. Without the ability to manage the company's affairs, Zou and Downs lack directors' most basic power. As agents of Tibet's placement agent, their loyalties aren't with Tibet's shareholders—and loyalty to shareholders is as vital to directorship as the power to manage. And unlike Tibet's directors, their tenure is not subject to shareholder vote. Add to that the registration statement's express provision for directors' fiduciary duties, with no similar provision for Zou and Downs."

Z&D's positions as observers were also compared to a hypothetical investment analyst, where the Third Circuit reasoned that there would be "no argument" that such persons would be directors:²⁵

"Consider a hypothetical investment analyst for a research firm. Like Zou and Downs, he owes no duties to the issuer and is affiliated with a different entity. He might also enjoy special access to the issuer's board and management. Cf. Regulation FD, 17 C.F.R. § 243.100 (seeking to curtail special access to non-public information). Or he might not. But either way, access to managers and directors alone does not make a person a quasi-director. Consider the analyst's power to influence the issuer's board. It might be substantial, depending on the analyst's reputation and influence in the industry. Or it might not. In either case, he has the same "power" Zou and Downs do—the "possibility" of "significantly influenc[ing] the outcome of matters submitted to the Board of Directors for approval." App. 178. The analyst's influence—his power to persuade—might even "impact [the issuer's] shareholders' ability to impact decisions related to [its] operations." *Id.* Or it might not. But no one would argue that our hypothetical analyst is in any meaningful way "similar" to a board member."

²⁵ The Act (section 126(6)) expressly excludes persons acting a professional advisory capacity from being a deemed director for most (but not all) purposes.