

Board Observers' Functions Are Distinct from Directors for Liability Purposes Under Section 11

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Last week, the United States Court of Appeals, Third Circuit issued a ruling in *Obasi Investment Ltd v. Tibet Pharm., Inc* which pronounced that under Section 11 of the Securities Act of 1933, a board observer is not a person “performing similar functions” as a director on a corporate board. Section 11 of the Securities Act allows investors to sue anyone who, with his or her consent, is named in a company’s registration statement as, among other things, a person performing similar functions as a director. By now inserting a demarcation line between the functions of a board observer and a board director (at least in the context of the factual background discussed in the case), ***Obasi Investment Ltd’s* ruling in effect limits investors’ ability to sue board observers under Section 11.**

The plaintiffs (the “Plaintiffs”) in this case sued several entities and individuals, including Tibet Pharmaceuticals, Inc. (“Tibet”), Hayden Zou (“Zou”), and L. McCarthy Downs III (“Downs”). Tibet was a holding company which controlled Yunnan Shangri-La Tibetan Pharmaceutical Group Limited (“Yunnan”), an operating company that manufactured and sold traditional Tibetan medicines. In an attempt to raise funds for those operations, Zou, an individual affiliated with Tibet, engaged Downs, who was a managing director at the investment bank Anderson & Strudwick, Inc. (“A&S”), to have A&S serve as private placement for a Tibet IPO. A&S agreed, and the parties filed a registration statement to bring Tibet public. The registration statement confirmed that in connection with the IPO, Tibet would allow A&S to elect two *non-voting* observers to its board of directors—positions A&S filled with Zou and Downs. Tibet experienced a successful closing and offered 3 million shares to the public at \$5.50 per share. Soon thereafter however, this stock price would plummet as NASDAQ halted trading of the corporation’s stock.

As it turned out, the registration statement omitted material negative information regarding Yunnan’s finances. A few months before filing the registration statement, Yunnan defaulted on a loan from the Chinese government but simply referred to it in the filing as a long-term loan. Before Tibet filed its amended final prospectus, the Chinese government also froze Yunnan’s assets, but still Tibet did not disclose such information. Even after the IPO, Tibet, as intimated by the factual background of the case, failed to repay the loan. This led the Chinese government to auction off Yunnan’s assets, which then resulted in NASDAQ’s halting trading of Tibet’s stock.

The Plaintiffs then sued Tibet, alleging Zou and Downs violated Section 11 in their capacity as board observers named in the registration statement. The trial court was left to decide in a dispositive motion for summary judgment whether Zou and Downs, as individuals named in the registration statement as board observers, were individuals performing similar functions as directors. The trial court acknowledged that while the registration statement affirmed that Zou and Downs would not have the ability to vote on corporate matters, it stated that the two may nevertheless exert significant influence over the outcome of matters submitted to the board of directors for approval. As such, the trial court denied the defendant's motion for summary judgment but granted their motion for interlocutory appeal, which brought the matter before the Third Circuit—which reversed that decision.

To guide its analysis, the Third Circuit delved into an examination of the essence of directorship in the context of corporations. The court reasoned that the functions that typified directorship include: (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. Additionally, the court found that directors owe duties of reasonable care and loyalty, and if shareholders are unhappy with directors, they can vote them out for any reason. The court then went into an analysis of the meaning of the term “similar,” the technicalities of which we do not need to delve into for our purposes. However, in comparing the similarity of functions Zou and Downs would perform relative to board directors, the court reasoned the guiding question is “whether they possess at least some of the core powers and responsibilities that define corporate directorship under the law of corporations.” The court concluded they did not.

The Third Circuit reasoned that three features differentiate Zou and Downs from directors: (1) they cannot vote for board action; (2) they are aligned with the placement agent, A&S; and (3) their tenures are set to end automatically, with no opportunity for shareholders to vote them out. In essence, the court concluded that Zou and Downs lacked the ability to manage the company's affairs—directors' most basic power, and, as agents of A&S, their loyalties are not with Tibet's shareholders. As such, the court found that Zou and Downs are not liable under Section 11.

It is important to note here that the court emphasized that Section 11 is but one part of an overlapping web of civil liability provisions. As such, investors have a multitude of routes by which they can hold various parties liable. However, Section 11 was designed to impose near-strict liability for untruths and omissions made in a registration statement only for a limited and enumerated categories of defendants.

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