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Activist-Appointed Directors Causing Confidentiality Concerns

By Lindsay Frost April 4, 2016

Corporate boards are becoming more concerned about activist-appointed directors' keeping company information confidential and causing an environment of mistrust in the boardroom. As activist investors continue to win proxy contests and board seats, questions about what information new board members should be allowed to share with their sponsor fund are causing companies to explore the use of confidentiality agreements and codes of conduct as measures to ensure board business remains private.

Activists won or were granted a total of 220 board seats in the U.S. last year, according to data from **FactSet**. So far in 2016, activists have won or been granted 77 board seats. Boards are concerned that these activist directors who win seats will ignore the potential conflict of interest and share sensitive company information with their respective hedge fund or shareholder groups.

"The hedge fund says they are bound by confidentiality too, but as we all know, the more people who have [company] information, the more likelihood of some kind of leak," says **Doug Chia**, executive director of the **Conference Board**. "That poses all kinds of dangers. I'm not sure all companies are really monitoring this or are even able to control it."

Chia notes that there is fear that activist-appointed directors would be more inclined to cause a high-profile leak to the media to advance their funds' interests. These directors could also share confidential information with their funds that increases the company's risk for data breaches and theft of intellectual property.

If companies haven't begun monitoring director communications, they may need to start. In March, **Pershing Square Capital Management** named **Stephen Fraidin** to the board of **Valeant Pharmaceuticals**. As part of the settlement agreement, Fraidin wrote a letter to the now-former CEO, **Michael Pearson**, stating, "I hereby undertake, consistent with my fiduciary duties and confidentiality obligations as a Valeant director, to refrain from communicating to anyone (whether to any company in which we have an investment or otherwise) confidential information I learn in my capacity as a director of Valeant; provided that I may communicate such information to members of my firm, Pershing Square."

Such actions suggest that hedge funds and activist groups may believe they have a right to inside information because they've placed a director on a particular corporate board. To support that position, activists point to the 2013 **Delaware Chancery Court** decision in Kalisman v. Friedman, which states that as long as the information doesn't harm the corporation, "when a director serves as the designee of

a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director."

Maintaining Director Confidentiality

- Comprehensive confidentiality policies
  - Define the scope of confidential information
  - Expressly prohibit both intentional and unintentional breaches of confidentiality
- Include an "agreement to resign" if the director releases confidential information
- Supplement policies with practices including:
  - Periodic reminders regarding confidentiality obligations
  - Tutorials on communicating with news media and investors
  - Regular reviews of confidentiality policy
  - Prompt actions to address leaks, no matter how insignificant
- Promote a healthy level of respectful but vigorous discussion that accommodates opposing viewpoints

Source: Latham & Watkins

But experts say the guidance on what information these activist-appointed directors can share with their respective funds or groups is unclear.

"Whether they got on the board through an insurgent slate or through a settlement with an activist fund, they all have the same fiduciary duty to the corporation, and part of that duty is maintaining the confidentiality of the company's information," says **Joseph Hall**, head of law firm **Davis Polk**'s corporate governance practice. "If the director breaches this, they can be personally liable."

Fostering Mistrust

After the dust settles from a proxy fight or the threat of one, **Joel Trotter**, global co-chair of law firm **Latham & Watkins**'s public company representation practice group, says incumbent directors may be hesitant to open up around these new directors.

"You have confidentiality concerns when someone is newly joining the board," Trotter says. "And, when there is a risk of maintaining the board's ability to safeguard its most sensitive information, it threatens to have a chilling effect on candor within the boardroom and the free flow of information to solve company problems and chart a path forward."

The environment can be tension-filled, which creates a wall between the new board member and his or her board, says Hall.

"The incumbent board members may be more guarded in the conversations they have at the board meetings, but it's important for everyone to keep in mind that it's one board and they have to act as one board to work together and develop that trust that a board needs to have in order to function," Hall says.

Rampant mistrust can result in board members' withholding pertinent information from others. For example, in a February Delaware Chancery Court decision involving **Navlink**, directors **George Chammas** and **Laurent Delifer** claimed fellow board members were attempting to carve up the company for their own benefit and were hiding pertinent financial information from them while sharing it with other directors. The court ordered the company to share certain communications with Chammas

and Delifer, but would not allow open-ended access to all communications between the other board members and management.

Updating Policies,

Reaching Settlements

Companies are taking active steps to ensure that activist-appointed directors abide by the same privacy rules other directors have, sources say.

Steve Balet, managing director of **FTI Consulting**, says even though he's seen boardrooms generally more accepting of investor-appointed directors in recent years, sometimes rules about keeping company information private are written into settlement agreements as a safety measure.

However, Balet says, "there may be some language in settlements that differ, putting more stress on the confidentiality."

Charles Elson, a director on the boards of **Bob Evans Farms** and **HealthSouth**, says that in his experience boards have been welcoming after an activist situation. Elson, who won a board seat at Bob Evans through an activist-nominated slate, says being forced to sign a new confidentiality agreement is "demeaning" to newcomers.

"I find those sorts of agreements problematic; we know it is under our fiduciary duty not to disclose information. I think sometimes forcing [activist-appointed directors] to sign new confidentiality agreements is used to oppress directors," Elson says. "You want to create a cohesive group, and a confidentiality agreement says you don't trust them from the get-go, and that's a terrible way to start."

In light of this, Trotter says some boards prefer to adopt more informal policies or codes of conduct regarding confidentiality. Though still viable under state law, these types of agreements can be more specific to the company's sensitive information.

Adopting a board policy on confidentiality is also an option. Trotter adds that in these policies, the company typically wants to make sure the agreements "expressly govern confidentiality obligations."

However, "even with a policy, you have state law duties of confidentiality directors owe to their companies, but those duties can be different than, say, a written or unwritten formally adopted agreement that describes what the expectations are of directors regarding confidentiality," Trotter says.

For example, in the 2015 case Partners Healthcare Solutions Holdings v. Universal American, the Delaware court held that the company could insist that a private equity fund's nominated director sign a confidentiality agreement as a condition of gaining the seat because the company had sued the private equity fund in an unrelated matter. As a result, the activist director was forced to sign a new confidentiality agreement.

Hall and Balet say some companies are providing new directors with additional Regulation FD training to avoid missteps during general shareholder engagement. Hall says that in his experience, Reg FD training has expanded from once a year to multiple times a year for directors.

"There's still a lot of confusion today about how [Reg FD] works," Hall says. "It's an easy rule for people to state the definition, but not always an easy rule to apply to particular circumstances with shareholders."

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