

Role of a Board Observer in a VC-backed Company

What are board observation rights?

- Board observation rights are rights granted by a company to an investor to allow for a designated representative to attend and observe all meetings of a company's board of directors.
- These rights are generally requested by an investor who wants to have insight into the company's board activities and actions - when such investor (i) may not want an actual board seat (e.g., certain strategic investors will not take board seats), (ii) is unable to secure actual board representation (e.g., due to insufficient investment size or as a co-investor in a VC financing round), or (iii) wishes to further supplement any existing board representative at such meeting.
- Board observation rights are not provided by law and thus are only available through contractual agreement. Generally, these rights will be included in an investor rights agreement or a side letter between the company and the investor, and such rights may often apply so long as the investor holds a certain minimum percentage of equity in the company.
- A typical form of observer right is attached as Exhibit A.

What rights does an observer have?

Board observation rights depend on the specific contractual language; however, most board observer rights will include the following:

- Board observers generally have the right to attend and observe all board meetings (whether regular or special). In some cases, board observers will also be entitled to participate in the meetings; however, an observer will not have a right to vote. Sometimes these observation rights may also extend to meetings of certain committees of the board.
- Board observers are generally often entitled to receive copies of all notices, written consents and other materials circulated to the board of directors, typically at the same time and in the same manner as the board.
- However, the company will typically have the right to exclude the observers from certain portions of the meetings and/or withhold the sharing of certain board related materials (or portions thereof) (i) that are highly confidential or could result in disclosure of sensitive trade secrets, (ii) that jeopardize the attorney-client privilege (e.g., for litigation related matters), or (iii) if attendance could result in a conflict of interest (e.g., observer is from a strategic investor excluded from discussions on strategic relationship). Such exclusion generally needs to be determined by the company in good faith.
- Investors may request that expenses of an observer be reimbursed similar to a director.
- Generally, the investor is free to appoint their initial observer and any replacement, although in some cases the company may request the right to approve a replacement observer.

What responsibilities does an observer have?

Board observers have no voting power at the board level and are not bound by fiduciary duties (i.e., duty of care and duty of loyalty) to the company as a director would be.

- However, observers may be pulled into lawsuits for these claims, especially if they are actively engaged with the board in the same manner as a director. The observer would generally not be liable in these situations, as they owe no fiduciary duty, but there would be time and cost involved

in defending the lawsuit. In addition, in rare cases where the observer is effectively acting as a director, the observer could be deemed a de facto director and held liable as if he or she were a director.

- Although observers owe no fiduciary duties, investors will on occasion request an indemnification agreement between the company and the observer should the observer be included in a lawsuit due to their participation in board meetings.

Observers are expressly prohibited from voting on board matters; however, observers often will participate in board meetings and discussion, in particular where their observer rights directly provide for participation. This can include providing advice and perspective, but the observer should not participate in any vote. Even where participation is not expressly provided for, boards will often solicit feedback from their observers (with the same caveats about voting). To avoid potential liability discussed above, observers should be careful not to participate to a degree where they could be deemed a director - in particular, they should never participate in any formal or informal vote, should clearly be identified as an observer in minutes and should be careful not to take control of discussions or board meetings.

Observers are generally bound by confidentiality obligations, either through their relationship with the investor or in some cases by written agreement required by the company prior to the observer's participation.

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Exhibit A

As long as Investor owns at least [●] shares of Series [●] Preferred Stock, the Company shall invite a representative of Investor to attend (in person or telephonically) all meetings of its board of directors (the "Board") and any committees thereof in a nonvoting observer capacity and, in this respect, shall give such representative copies of all notices, minutes, consents and other material that the Company provides to the members of its Board at the same time and in the same manner as provided to such members; provided, however, that such representative shall agree to hold in confidence and trust and to act in a fiduciary manner with respect to all information so provided; and, provided further, that the Company reserves the right to withhold any information and to exclude such representative from any meeting or portion thereof if access to such information or attendance at such meeting could adversely affect the attorney-client privilege between the Company and its counsel or result in disclosure of trade secrets or a conflict of interest, or if Investor or its representative is a Competitor, as such term is defined in the IRA