



Maintaining Board Confidentiality

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The increasing success of shareholder activists in designating or electing directors is altering the composition of public company boards. It is also posing challenges to long-held assumptions about the sanctity of board deliberations and the nature of a director's confidentiality obligations to fellow directors and the company.

The almost certain advent of proxy access will exacerbate these issues because it will inevitably increase the number of shareholder-nominated directors in the board room.

Notwithstanding the theoretical implications of the legal principle that a director, no matter how nominated or by whom, owes fiduciary duties to all shareholders, as a practical matter shareholder-nominated directors are often viewed, and in fact act, as representatives of their shareholder sponsors—what some call "special interest" or "constituency" directors.

The presence of constituency directors in a board room heightens concerns about confidentiality in two important, but often distinct, realms.

First, and most obvious, is maintenance of confidentiality of material non-public information about the company and its performance. The confidentiality of material non-public information is often the subject of company codes of conduct and confidentiality policies (for simplicity, we lump these together under the rubric of "confidentiality policies"). While not without complication in the case of constituency directors, the issues surrounding material non-public company information and its misuse are well understood and do not create a novel board room confidentiality issue.¹

¹ One challenging issue for boards with constituency directors representing activist investors may be effectively precluding material non-public company information from being transmitted by constituency directors to their sponsoring activist investors for investment analysis (not "insider" trading) purposes and subsequently leaking from the activist investors (which arguably had a right to know the information) into informal informational networks of the type so often employed by activist investors (such as the informational network alleged to exist among principals and employees of Galleon Group and other trading firms that dealt in material non-public information).

Second, and perhaps more important to the appropriate governance of the company, is maintenance of the confidentiality of board room discussions and the fabric of trust and collegiality that should exist among directors.

The latter type of information about the board (which we call “material board information”) does not always coincide with the more common category of material non-public information about the company and its operations (which we call “material company information”) and thus may not be covered by the usual code of conduct.

Preserving confidentiality of material company information is often viewed in the context of preventing trading on the basis of the inside information and competitive harm.

However, maintenance of confidentiality of material board information is also critical to prevent the corrosive effect breaches of board confidentiality will have on a board’s deliberative process and the trust and confidence directors have in each other.

As a result, we recommend that boards review, and where appropriate amend, their existing confidentiality policies to make clear that a director’s obligation of confidentiality is not limited to material non-public company information of the sort customarily dealt with under “insider trading” laws, but also explicitly includes material board information.

While effective enforcement of a company’s confidentiality policies with respect to misuse of confidential board information may be difficult, the existence of the policy serves two other important purposes—education of all of the directors as to their confidentiality obligations and creation of a standard of conduct that should have significant moral suasion.

The Rise of the Constituency Director and the Risk of Breaches of Confidentiality

For years, directors of public companies were, by and large, recruited and nominated by the boards or nominating committees of public companies. As such, they were expected to be, and almost always were, included within the board room “tent” from the time of their nomination. However, over the last several years shareholder-nominated directors have been increasing as a result of successful proxy contests and settlement of threatened or actual proxy contests.

Consider the statistics:

- the number of proxy fights has increased from 63 in 2001 to 138 in 2009 as of December 4, 2009;
- the percent of proxy fights that have settled has increased from 17.5 percent in 2001 to 28.5 percent in 2009 as of December 4, 2009;

- the percent of proxy fights in which management was “victorious” — *i.e.*, where the dissident did not gain any seats—has decreased from 55.5 percent in 2001 to 41.5 percent in 2009 as of December 4, 2009; and
- the number of companies in which “dissidents” were successful in seating directors has increased from 30 in 2001 to 87 as of December 4, 2009.

Many shareholder-nominated directors are explicitly or implicitly constituency directors. The number of constituency directors will likely increase when the SEC adopts its now proposed proxy access regime, particularly if the final rule does not require shareholder nominees to be independent of the nominating shareholders.²

Constituency directors commonly view their role on the board as representing their shareholder sponsors, at least to the extent of keeping those shareholders informed with regard to company matters. Indeed, constituency directors can be viewed as the modern analog to the simpler corporate paradigm (which governance activists so frequently draw upon) of a board composed of the principal investors in the company (aka, the “owners” of the company).

As a consequence, constituency directors and their sponsors may think it only natural and appropriate that the directors keep their sponsors informed regarding both non-public company information and non-public board information on the explicit or implicit understanding that the sponsors will not trade on the basis of the information.

On one level, this “leakage” of confidential information may seem unexceptional in that, if the investor were a person not an entity and were a member of the board, the investor would be directly privy to the confidential information.

However, it is not obvious that because an individual investor could have been, but chose not to be, a director should operate to privilege the investor’s representative to breach confidentiality of information received as a director. That the investor’s relationship to the board could have been ordered differently does not mean the difference should just be ignored.

Moreover, the constituency director owes a duty of loyalty to the company and all of its shareholders. It is hard to square that duty with a notion that the director is privileged to ignore the confidentiality of information derived from board room participation for the benefit of certain investors.

² Latham & Watkins LLP has prepared a series of *Corporate Governance Commentaries* on the topic of proxy access which can be accessed [here](#).

Furthermore, in today's world, investors are rarely individuals but rather are entities comprised of a number of individuals. This, in turn, increases the risk that confidential information, whether classic material company information or more amorphous material board information, will find its way into inappropriate hands if there is an exception to confidentiality principles for constituency representatives on the board.

Finally, whether or not the confidential board information actually leaks from or is otherwise misused by the investor, the very fact that board deliberations may not be confidential because of an assumed privilege on the part of a constituency director could also cause the board to become less effective as directors edit their remarks or behavior because of a fear that their colleagues are revealing their discussions to third parties.

Confidential Board Information under Current Law

The problem of directors breaching the confidentiality of board deliberations is not new. In January 2006, for instance, CNET published an article revealing Hewlett-Packard's long-term strategy on the basis of information supplied by an unnamed insider, later identified as then-director George Keyworth. His identity was only uncovered because Hewlett-Packard hired private investigators who surreptitiously gained access to e-mail inboxes of the company's directors and certain reporters from CNET. A contentious series of disputes occurred between HP's chairman of the board, Patricia Dunn, who wanted Keyworth to resign, and Keyworth. Months later, after the smoke cleared, Keyworth resigned as a director, another director resigned in protest about the way Keyworth was treated and Dunn resigned as chairman but remained as a director. The culture of the HP board needed to be rebuilt.

Concerns about director misuse of confidential board information (in contrast to misuse of confidential company information) are not commonly discussed. There are at least two reasons:

- It is hard to determine how large the problem is. The HP-Keyworth saga is one of the rare instances in which the problem became fodder for the media. However, it seems likely that other directors have transgressed in this regard over the years, including constituency directors, many of whom probably revealed confidential board information to their sponsors on a routine basis; and
- A number of commentators do not appear to believe that director misuse of confidential board information is fundamentally problematic. It is telling that in reporting the HP-Keyworth saga, the media focused on HP's misdeeds and not Keyworth's. Others have

even argued that constituency directors should be free to discuss confidential company and board information with their shareholder sponsors.³

Case law regarding a director's duty of confidentiality is sparse. However, courts, including the Delaware Court of Chancery, have recognized the general principle that directors owe a duty of confidentiality as part of their duty of loyalty. This duty requires that directors refrain from disclosing confidential company information to outsiders—especially competitors or potential acquirors—without approval of the board.⁴

However, there are a number of challenges for companies that wish to rely on Delaware case law to protect their confidential board information from leakage out of the board room.

Under Delaware law, for directors to have a duty of confidentiality, the information to be protected must be “confidential,” a status which Delaware courts have determined using a case by case, fact intensive analysis into whether the information was both material and non-public.

There is little case law regarding whether disclosures of confidential board information, in contrast to classic confidential company information, is a breach of the duty of loyalty, and even less case law dealing with the parameters of materiality in the context of confidential board information.⁵

Delaware law is also sparse regarding whether constituency directors are privileged to disclose confidential board information to their shareholder sponsors.

In one of the few cases on this point, the Delaware court found that a director of a private company breached his fiduciary duties when he shared with his shareholder sponsor information that several other shareholders wanted to sell their shares. The sponsor later purchased those shares and thereby gained control of the company. The court found that this information was confidential and that the director violated his fiduciary duties by sharing it with his sponsor.⁶

Delaware courts have not always found an effective remedy where directors misused confidential information. For instance, in one case, the court refused to rescind the sale of a 50 percent stake of a company's equity to a competitor by the defendant directors who had disclosed confidential company information to the competitor immediately prior to the sale. Since the competitor was

³ Marc Weingarten and Erin Magnor, “Second Generation Advance Notification Bylaws” *The Harvard Law School Forum on Corporate Governance and Financial Regulation*. (March 17, 2009)

⁴ This duty of confidentiality also prohibits directors from misusing confidential company information for their own personal gain, even when they are not disclosing it to others, as the Delaware Court of Chancery found when Conrad Black used confidential information he obtained as chairman of Hollinger International Inc. to set up favorable terms to sell his stock. *Hollinger International, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004).

⁵ But see *Disney v. The Walt Disney Co.*, 2005 Del. Ch. LEXIS 94 (Del. Ch. June 20, 2005) in which the Delaware Chancery considered the materiality of confidential board information by looking at Disney's Director Confidentiality Policy (see discussion below).

⁶ *Agranoff v. Citicorp Venture Capital, Ltd.*, 1999 WL 219650 (Del. Ch. April 12, 1999).

given board seats, the remaining directors were left in the awkward position of having to discuss company policy with the competitor's own constituency directors.⁷

Corporate Confidentiality Policies

Confidentiality policies restricting the flow of at least certain kinds of confidential information to company outsiders are common but hardly universal. Although these policies historically were often drafted to ensure that employees did not reveal trade secrets, it is becoming far more common for them also to deal with confidential company information. However, we do not think even an express prohibition on disclosing confidential company information is sufficient clearly to protect confidential board information. Accordingly, we recommend that companies review their confidentiality policies to ensure that they expressly cover not only director misuse of confidential company information *but also* director misuse of confidential board information. While, as we discuss below, an express prohibition on the misuse of confidential board information is not a self-enforcing solution, it will create an unequivocal standard that all directors, including constituency directors, not reveal confidential board information to any third parties, including sponsors of constituency directors.

Common Flaws in Confidentiality Policies

Many confidentiality policies contain certain weaknesses regarding director misuse of confidential information. Here are some of the more glaring weaknesses we have observed in many confidentiality policies:

- Many policies use vague definitions of confidential information, such as:
 - only discussing proprietary information about the company and not expressly considering scenarios involving director misuse of confidential board information;
 - relying on the definition of “confidential information” from the New York Stock Exchange (NYSE): “[a]ll non-public information that might be of use to competitors or harmful to the company if disclosed.” This definition, in our view, is inadequate. Not only is it framed more in terms of competitive harm than in terms of the necessity for confidentiality in the board room (and throughout the company without regard to its affect on competition), but also it begs the question whether trading on non-public company information or publicizing non-public board information (as occurred in the HP situation) is “harmful” to the company and, if so, in what way; and/or

⁷ *Blommer Chocolate Co. v. Blommer*, 1992 Del. Ch. LEXIS 202 (Del. Ch. September 21, 1992).

- including material company information in definitions of confidential information, but not expressly covering material board information.
- Many policies do not fully prohibit directors from misusing confidential information. For instance, policies may prohibit directors from disclosing confidential information to third parties, but may be silent regarding whether directors can use confidential information for their own benefit or for the benefit of others.

Suggestions to Fix Confidentiality Policies

Well-drafted confidentiality policies should include at least the following four basic elements:

- A broad definition of “confidential information” that covers all relevant information, including material board information;
- A list of examples regarding what types of information are confidential, which should include items such as board deliberations and board dynamics so that directors clearly understand that confidential board information is covered by the policy;
- An unambiguous statement that directors may not disclose confidential information to any other party, including principals or employees of any business entity which employs the director or which has sponsored the director’s election to the board, or misuse it in any other fashion, including by using it for their or someone else’s benefit; and
- A very narrow set of circumstances in which directors are authorized to discuss confidential information, *i.e.*, when required by law or when authorized by the board.

One good example that companies may wish to consider is The Walt Disney Company’s director confidentiality policy:

“Pursuant to their fiduciary duties of loyalty and care, Directors are required to protect and hold confidential all non-public information obtained due to their directorship position absent the express or implied permission of the Board of Directors to disclose such information. Accordingly,

- (i) no Director shall use Confidential Information for his or her own personal benefit or to benefit persons or entities outside the Company; and
- (ii) no Director shall disclose Confidential Information outside the Company, either during or after his or her service as a Director of the Company, except with authorization of the Board of Directors or as may be otherwise required by law.

“Confidential Information” is all non-public information entrusted to or obtained by a Director by reason of his or her position as a Director of the Company. It includes, but is not limited to, non-

public information that might be of use to competitors or harmful to the Company or its customers if disclosed, such as:

- non-public information about the Company's financial condition, prospects or plans, its marketing and sales programs and research and development information, as well as information relating to mergers and acquisitions, stock splits and divestitures;
- non-public information concerning possible transactions with other companies or information about the Company's customers, suppliers or joint venture partners, which the Company is under an obligation to maintain as confidential; and
- non-public information about discussions and deliberations relating to business issues and decisions, between and among employees, officers and Directors."

Problem of Enforcing Board Confidentiality Policies

Although companies can and should revise their confidentiality policies, they do not have practical self-help remedies at their disposal. Consider these options:

- **Removal from the Board.** Unlike employees who may be fired for breach of a confidentiality policy, a board cannot fire any of its members. To remove a transgressing director from the board, a company must obtain shareholder approval, which would require a special meeting, in some circumstances a higher vote than a majority of the quorum and/or "cause." These hurdles make removal a proverbial "non-starter."
- **Advance Resignation Letters.** Companies could adopt a director resignation policy that would require directors to sign a resignation letter effective if the director violates the confidentiality policy. However, utilization of the advance resignation presumably would require an internal process that functions, and has the appearance of functioning, fairly to determine whether the director had, in fact, violated the confidentiality policy. Moreover, the sponsors of constituency directors might well question the invocation of an advance resignation in situations they deemed unimportant or aberrational.
- **Amended Bylaws.** Companies could amend director eligibility provisions in their bylaws so as to:
 - prevent directors who violated confidentiality policies from being eligible to serve in future years; and/or
 - prevent shareholders who nominated those directors from nominating other candidates for a period of time.

Application of such a bylaw might face the same type of "legitimacy" challenges as enforcement of an advance resignation. Moreover, the validity of such eligibility standards

under state law, particularly one purporting to deny shareholders a right to nominate directors, is not clear.

Because of the challenges of timely enforcement, the probabilities are that many boards confronted with evidence of a breach of their company's confidentiality policy by a director (in a manner that does not violate "insider" trading laws and thereby implicate civil and criminal violations of law) will most likely forebear immediate action and instead:

- Not re-nominate the offending director;
- Threaten to "expose" the offending director if a shareholder signals an intent to re-nominate the director; and/or
- Conduct "sensitive" board business through committees on which the offending director does not sit.

Bottom Line Benefits of Appropriate Board Confidentiality Policies

Notwithstanding the challenges to enforcing a board confidentiality policy, we believe companies should review and, if necessary, revise their confidentiality policies as discussed above. The benefits of having a comprehensive board confidentiality policy include:

- Directors, including constituency directors, would more fully understand their obligations regarding the nature and scope of their confidentiality obligations as a director, including, in particular, with respect to board information as well as company information;
- Likewise, sponsors of constituency directors would be forewarned about the nature and scope of the board confidentiality policy and its express application to them; this would avoid later claims about "changing the rules" and help set appropriate expectations;
- By adopting a comprehensive board confidentiality policy, the company would help create a basis for moral suasion that should lead to voluntary director adherence to the policy, including by constituency directors and their sponsors; and
- Delaware courts do look to a company's own contracts and policies in analyzing whether information is confidential. For instance, in one case, The Walt Disney Company tried to ensure that certain documents containing information on preliminary board deliberations would be given "confidential" treatment. The court found it significant that Disney's confidentiality policy bars directors from disclosing such information and found that those documents were "confidential."⁸

⁸ *Disney v. The Walt Disney Co.*, 2005 Del. Ch. LEXIS 94 (Del. Ch. June 20, 2005).

Conclusion

The increasing frequency with which constituency directors are seated on boards of directors highlights the difficulties that boards face in maintaining the sanctity of their deliberations and the confidentiality of material board information.

Constituency directors and their sponsors may think that it is permissible for the director to share material board information with the sponsor. As a result, boards may rightly worry about the privacy of their deliberations and become less effective.

While directors have a duty of confidentiality, Delaware case law is sparse regarding the contours of the duty. Case law is undeveloped regarding whether and under what conditions disclosures of confidential board information is a breach of this duty and whether constituency directors are allowed to disclose confidential board information to their sponsors. In addition, Delaware courts have not always found an effective remedy to punish directors for breaching their duty of confidentiality.

Companies should review and revise as appropriate their confidentiality policies so that they cover all material information (including material board information). Policies should clearly state that, unless required by law or authorized by the board, directors may not disclose confidential information to anybody, including their sponsors, or otherwise misuse such information.

Although companies may encounter problems with enforcement, they should benefit by adopting a comprehensive confidentiality policy. Directors will better understand their confidentiality obligations, companies can instill a board culture of voluntary adherence to and monitoring of the confidentiality policy, and courts can look at the confidentiality policy when analyzing a duty of confidentiality claim.

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