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## 3rd Circ. Says Board Observers Not Same As Directors

By **Rachel Graf**

Law360 (July 23, 2019, 10:08 PM EDT) -- The Third Circuit threw out on Tuesday investors' last remaining claim against two men allegedly liable for misrepresentations about a company's financial well-being ahead of its public debut, finding that board observers, who don't have voting rights, are distinct from directors.

In a precedential opinion, two members of a three-judge panel cleared L. McCarthy Downs III and Hayden Zou of wrongdoing related to the holding company Tibet Pharmaceuticals Inc.'s initial public offering in 2011. The duo was among a number of defendants accused of hiding material information ahead of the IPO, including the company's need to repay a loan that it ultimately defaulted on, according to court documents.

The only remaining claim against Downs and Zou on appeal was brought under Section 11 of the Securities Act of 1933, which is limited to any defendant "named in the registration statement as being or about to become a director, person performing similar functions, or partner." Unlike the district court, the Third Circuit determined the pair's responsibilities as board observers didn't qualify them as people "performing similar functions" to a director.

"We believe this gives some clarity to the roles of the board observer and why they shouldn't be held liable under this strict liability of the securities laws under [Section 11]," Downs' attorney, Neil Hartzell of Freeman Mathis & Gary LLP, said Tuesday.

Downs was a managing director at the investment bank that helped Tibet go public, and Zou was an early investor in the company, according to court documents.

They both worked on the IPO and were ultimately appointed board observers by Downs' investment bank, which helped raise capital as Tibet's placement agent, according to the Third Circuit. As board observers, they were unable to vote on company affairs but "may nevertheless significantly influence the outcome of matters submitted to the board of directors for approval," according to Tibet's registration statement.

Still, the Third Circuit said Tuesday the two entities are distinct from each other.

In addition to being affiliated with the placement agent rather than with the company itself, Downs and Zou can't vote on company affairs like board members can, and they can't be voted out of their positions like board members can be, according to the panel majority.

"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," the panel majority said. "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."

U.S. Circuit Judge Robert Cowen disagreed with his two colleagues' interpretation of the word similar, finding it too narrow.

"A person may be named as performing similar functions to a director even if he or she does not possess the directors' formal power to direct and manage a corporation, and the responsibilities and duties that accompany those powers," Cowen wrote.

The Third Circuit appears to be the first federal appellate court to consider the issue.

"This decision provides welcome clarity in an area of law that previously lacked judicial guidance," Zou's attorney Michael Tremonte of Sher Tremonte LLP said by email Tuesday.

U.S. Circuit Judges Thomas Hardiman, Anthony Scirica and Robert Cowen sat on the panel for the Third Circuit.

Counsel for the investors didn't respond Tuesday to requests for comment.

The investors are represented by Laurence Rosen and Keith Lorenze of the Rosen Law Firm.

Downs is represented by A. Neil Hartzell of Freeman Mathis & Gary LLP.

Zou is represented by Michael Tremonte and Justin Gunnell of Sher Tremonte LLP.

The case is Obasi Investment Ltd. et al. v. Tibet Pharmaceuticals Inc. et al., case number 18-1849, in the U.S. Court of Appeals for the Third Circuit.

--Editing by Janice Carter Brown.

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