

## NOMINEE DIRECTORS

# Nominee Directors and Confidentiality: the Canadian Law Perspective

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The increased level of shareholder activism in Canada over the past several years has affected corporate governance in this country in a number of ways. One consequence is that it is more common for directors to be nominated by a particular shareholder (we refer to these directors as “nominee directors”), often as a result of successful proxy contests or settlements of actual or threatened contests. The presence of nominee directors on a board raises questions about the confidentiality of board deliberations and the dual, and potentially conflicting, obligations that nominee directors have to the corporation and the nominating shareholder.

In Canada, directors owe a fiduciary duty to the corporation, not to individual shareholders. Canadian courts have also found that inherent in this duty is a requirement for directors to maintain the confidentiality of corporate information they acquire as such. For nominee directors, these legal principles can conflict with commercial realities as they often have competing duties or loyalties to the corporation and their nominating shareholders. Canadian courts have consistently held that when a nominee director faces such a conflict, their duty to the corporation prevails. For example, communicating confidential information to a nominating shareholder before it has been generally disclosed may breach the nominee director’s duty to the corporation.

This article discusses (i) the duties nominee directors owe to a corporation and to the nominating shareholder, (ii) the circumstances in which courts have found conflicts between these duties that result in a breach of fiduciary

duty by the nominee director to the corporation, and (iii) practical challenges that nominee directors face when dealing with confidential corporate information. This article also provides some considerations and best practices for nominee directors and corporations with nominee directors on their boards.

## Dual Loyalty of Nominee Directors

Under Canadian corporate statutes, directors and officers have a fiduciary duty to “act honestly and in good faith with a view to the best interests of the corporation.”<sup>1</sup> This obligation requires a director to subordinate his or her personal interests to the best interests of the corporation. This duty is owed to the corporation as an entity distinct from its shareholders and cannot be overridden by agreement or by the corporation’s constating documents.<sup>2</sup>

Inherent in the fiduciary duty is an obligation to maintain and protect corporate information that is confidential or proprietary.<sup>3</sup> This obligation prevents directors from using this information to their own advantage.

Nominee directorships present a problem of dual loyalty. Nominee directors owe a fiduciary duty to the corporation but also have relationships with, and sometimes duties to, their nominators. As a result, nominee directors might believe, and commercial realities might imply, that they should share material board information with nominating

<sup>1</sup> *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 [“CBCA”], subsection 122(1)(a) and Ontario’s *Business Corporations Act*, R.S.O. 1990, Chapter B.16 [“OBCA”], subsection 47(1)(a).

<sup>2</sup> *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] S.C.J. No. 64 at paragraph 35 [“Peoples”] and Kevin P. McGuinness, *Canadian Business Corporations Law*, 2nd ed. (Markham, Ontario: Lexis Nexis Canada, Inc.), 2007 at 11.141 [“McGuinness”].

<sup>3</sup> The Supreme Court of Canada (“SCC”) addressed the issue of a fiduciary’s obligation to protect confidential information in *Lac Minerals Ltd. v. International Corona Resources Ltd.* In his decision, Mr. Justice La Forest implied that while a fiduciary duty does not arise in every relationship of confidence, the reverse is unlikely: “it is indeed difficult to conceive of any fiduciary relationship where the right to confidentiality would not exist with respect to such information.” In *Peoples*, the SCC was more explicit, explaining that directors “must maintain the confidentiality of information they acquire by virtue of their position.”

shareholders. While this information sharing may be sanctioned by express or implied consent, or may not result in any harm to the corporation, many boards worry about the privacy of their meetings and deliberations and the dissemination of confidential corporate information to nominating parties.

When a nominee director's duties conflict, the duty to the corporation must take precedence.<sup>4</sup> These directors must do their best to promote the corporation's business and to act in good faith towards it. If the interests of the corporation are subordinated to those of the nominating shareholder, nominee directors may be viewed as conducting the affairs of the corporation in an oppressive manner.<sup>5</sup> Courts have found that when the interests of a nominating shareholder and those of the corporation diverge, the disclosure of confidential information by the nominee may constitute a breach of his or her fiduciary duty.<sup>6</sup>

### When Duties Conflict

Although nominee directors have dual loyalties, being a nominee of a majority shareholder does not in and of itself create a conflict or disentitle the director from voting on a contract in which its nominating shareholder has an interest.<sup>7</sup> Nominee directors are generally presumed to act in accordance with their fiduciary duty to the corporation despite competing allegiances. Notwithstanding these presumptions, Canadian courts have generally found that nominee directors breached their fiduciary duties to the corporation where they:

- failed to maintain an even hand;
- failed to analyze a course of action from the corporation's perspective; or
- failed to disclose information affecting the "vital interests" of the corporation.

<sup>4</sup> *Alvi v. Misir*, [2004] O.J. No. 5088 [Commercial List] at paragraph 57.

<sup>5</sup> *Scottish Co-operative Wholesale Society Ltd. v. Meyer*, [1959] 1 A.C. 324.

<sup>6</sup> *Bennetts v. Board of Fire Commissioners of New South Wales*, (1967) 87 WN (Part 1) NSW 307 ["*Bennetts*"].

<sup>7</sup> *Keating v. Bragg*, [1997] N.S.J. No. 248 (N.S.C.A.) at paragraph 27.

### Failure to Maintain an Even Hand

In serving the corporation, nominee directors cannot actively favour their nominating shareholder over the corporation or other stakeholders. A fiduciary cannot act as a "champion and advocate of one party whom he or she represents and contrary to the interests of the others, but must at all times maintain an even hand."<sup>8</sup>

In the presence of conflicting interests, the Ontario Court of Justice instructed nominee directors to actively disavow the interests of their nominator: "The nominee director's obligation to his 'appointing' shareholder would seem to me to include the duty to tell the appointer that his requested course of action is wrong if the director in fact feels that way."<sup>9</sup> The Court acknowledged that voting against a nominating shareholder could be contrary to the nominee director's personal interests. However, directors must always vote with the best interests of the corporation in mind despite these interests or instructions from a nominating shareholder.<sup>10</sup> The nominee must act with the same commitment to the welfare of the company as an independent director.<sup>11</sup>

### Failure to Analyze a Course of Action From the Corporation's Perspective

When advocating a particular course of action, nominee directors must demonstrate that they conducted a reasonable analysis of the situation from the corporation's perspective.

In *Deluce Holdings Inc. v. Air Canada*,<sup>12</sup> the Court concluded that a nominee director breaches his or her fiduciary duties if advancing the directive of a nominating shareholder is uppermost in his or her mind and minority shareholders are unfairly prejudiced. In the late 1980s, Air Canada had a strategy of investing in regional carriers while permitting them to exercise a certain degree of operational independence. Air Ontario was one example. Air Canada owned 75% of the shares

<sup>8</sup> *McGuinness*, supra note 2 at 11.203.

<sup>9</sup> *820099 Ontario Inc. v. Harold E. Ballard Ltd.*, 1991 CarswellOnt 142 at paragraph 106.

<sup>10</sup> *Ibid.*

<sup>11</sup> *Dairy Containers Ltd. v. NZ Bank Ltd.*, (1995) 7, NZCLC 96, 669 ["*NZ Bank*"].

<sup>12</sup> [1992] O.J. No. 2382 (Ont. Ct. Gen. Div.).

of Air Ontario and the De Luce family owned the remaining 25%. William De Luce was named president.

By the 1990s, Air Canada had changed its strategy and sought to control its regional carriers. Despite receiving favorable reviews, William De Luce was told to resign by Air Canada representatives. When De Luce refused, the Air Canada-controlled board ousted him. The Court determined that the Air Canada nominee directors too obviously disregarded the interests of other stakeholders. Whether there were sufficient reasons to terminate De Luce, the nominees failed to conduct such an analysis and were at all times guided by Air Canada's newly developed corporate agenda. This behaviour was deemed oppressive and in breach of the nominees' fiduciary duty to Air Ontario.<sup>13</sup>

### Failure to Disclose Information Affecting the "Vital Interests" of the Corporation

Nominee directors have an obligation to disclose information in their possession that is detrimental to the interests of the corporation.

In the 1993 decision of *PWA Corp. v. Gemini*, the Ontario Court of Appeal found that nominee directors cannot withhold information affecting a "vital aspect" of the corporation's business.<sup>14</sup> In 1987, PWA Corp. ("PWA"), Air Canada and a third party formed a limited partnership ("Gemini") for the purposes of operating a new joint reservation system. Each partner was allocated 33% of Gemini's units. The remaining 1% was allocated to the general partner, a corporation owned by the limited partners with a board consisting of nominees of the limited partners. After experiencing financial difficulties, PWA began secret negotiations with American Airlines ("AMR"). An alliance with AMR would eliminate PWA's need for Gemini. PWA's nominees never informed the Gemini board of these developments.

The Ontario Court of Appeal found that the duties of the various nominee directors were complex. The fact that PWA and Air Canada were sophisticated corporations and competitors meant that the nominees were

under no duty to disclose strategies that would disadvantage their respective airlines. Yet, the Court found that the PWA nominee directors breached their fiduciary duties by failing to disclose the part of their negotiations with AMR that would result in the loss of Gemini's hosting service. This would affect a vital aspect of Gemini and result in a "serious loss to the partnership."<sup>15</sup> Once PWA had decided Gemini was expendable, "its representatives on the board of the General Partner had an obligation to clearly indicate to the partnership its desire to negotiate an exit."<sup>16</sup>

### Handling Confidential Information With Care

Where the interests of a nominating shareholder and those of the corporation diverge, the disclosure of confidential information by the nominee may constitute a breach of his or her fiduciary duty.<sup>17</sup> Nominee directors must protect a board's confidential information where the interests of the board and corporation so require.<sup>18</sup> A director must not compromise or surrender his or her integrity and independence by favouring one group's distinct interests.<sup>19</sup> In other words, nominee directors cannot act as a mere channel of communication or listening post on behalf of the groups or individuals that nominated them.

In Canada, there are statutory restrictions on what information can be accessed by shareholders. Subsection 144(1) of the OBCA outlines a variety of corporate records that shall "be open to inspection by the directors" during normal business hours.<sup>20</sup> Included are accounting records and records containing minutes of meetings and resolutions of the directors and any committee thereof.<sup>21</sup> Subsection 20(4) of the CBCA grants directors similar rights.<sup>22</sup> However, pursuant to subsection 145(1) of the OBCA, shareholders and creditors of an OBCA corporation have no statutory right to view accounting records or minutes of meetings and resolutions of the

<sup>15</sup> *Ibid.* at 143.

<sup>16</sup> *Ibid.* at 144.

<sup>17</sup> *Bennetts*, supra note 6.

<sup>18</sup> *Ibid.*, also cited by Kevin McGuinness in *Halsbury's Laws of Canada – Business Corporations*.

<sup>19</sup> *Ibid.*

<sup>20</sup> OBCA, ss. 140 and ss. 144.

<sup>21</sup> *Ibid.*

<sup>22</sup> CBCA, ss. 20(2) and ss. 20(4).

<sup>13</sup> *Ibid.* at paragraph 57.

<sup>14</sup> *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.*, [1993] O.J. No. 1793 (C.A.) at 143.

directors and any committee.<sup>23</sup> The CBCA has a nearly identical provision.<sup>24</sup> This suggests that the statutes view these documents as confidential to the board.

The prospect of a nominee director passing confidential corporate information on to a nominating shareholder could be grounds for a corporation to withhold information from that director. This was the case in *Bennetts*, where a director requested classified information to further the interests of the group that elected him.<sup>25</sup> *Bennetts*, an Australian case and common law authority on nominee directors, has been widely cited by Canadian legal commentators. The New South Wales Board of Fire Commissioners was comprised of a president and four members elected by different groups. When the board's finance committee wished to appeal a union award, one of the board members, who was also a member of the union, requested a document relied upon by the finance committee. The president said he would make the document available on an undertaking that its contents would not be disclosed to the union.<sup>26</sup> The board member rejected those terms and commenced a suit arguing that the board was not entitled to refuse to produce the document. The Court found that a director has no right to view a classified document where the purpose is to carry out a misconceived duty in favour of an individual shareholder.<sup>27</sup>

However, there is Canadian case law suggesting that boards cannot bar access to documents if there is mere speculation the director intends to improperly communicate the information to shareholders. The British Columbia Supreme Court stated that if a director is statutorily entitled to certain company information, the purpose for which he requests that information is irrelevant.<sup>28</sup> Similarly, the Alberta Court of Queen's Bench held that directors are not required to state their purpose when requesting documents and documents cannot be withheld from directors when the alleged improper purpose, in that

case attempting to bolster a rival corporation, is a "leap in logic or at best, is speculative."<sup>29</sup>

These decisions do not completely foreclose the possibility that a corporation might be entitled to withhold information or documents from nominee directors. The British Columbia Supreme Court cautioned that "should it ultimately be shown [that the director's purpose] is harmful or damaging, the respondent at that time perhaps might have a remedy."<sup>30</sup> Thus, while the director's purpose may be irrelevant to whether they are statutorily entitled to the information, the corporation may be able to prevent access if it can be proven that the director intends to harm the corporation.

The law is also clear that a director breaches his or her fiduciary duties by obtaining any property or business advantage belonging to the corporation.<sup>31</sup> Courts have found that when nominee directors use corporate information to profit on a personal level, the breach is considered more severe than communicating confidential information to nominating parties.<sup>32</sup>

## Securities Law

Canadian securities laws, through insider trading provisions, seek to prevent those in a special relationship with a reporting issuer, such as directors, from disclosing confidential information.<sup>33</sup> This practice is known as "tipping." For example, subsection 76(2) of the *Securities Act* (Ontario)<sup>34</sup> provides that:

No reporting issuer and no person or company in a special relationship with a reporting issuer shall inform, other than in the

<sup>23</sup> OBCA, ss. 145(1).

<sup>24</sup> See CBCA, ss. 20(2) and ss. 20(4).

<sup>25</sup> *Bennetts*, supra note 6.

<sup>26</sup> *Ibid.*

<sup>27</sup> *Ibid.*

<sup>28</sup> *Johnston v. West Fraser Timber Co. Ltd.*, [1980] B.C.J. No. 1688.

<sup>29</sup> *Tyler v. Envaco Inc.*, 2012 ABQB 631 at paragraphs 25 and 63.

<sup>30</sup> *Ibid.*

<sup>31</sup> *Canadian Aero Service Ltd. v. O'Malley*, [1974] S.C.R. 592.

<sup>32</sup> *Levy-Russell Ltd. v. Tecmotiv Inc.* [1994] O.J. No. 650 (Ont. Ct. of Justice).

<sup>33</sup> According to section 76(5) of the Act, a "person or company in a special relationship with a reporting issuer" includes an insider, affiliate, officer and director of a reporting issuer. It also includes any person or company that learns of a material fact or material change from another person in a special relationship with the reporting issuer and ought reasonably to have known that the other person was in such a relationship.

<sup>34</sup> R.S.O. 1990, Chapter S.5, s. 76(2) [the "Act"].

necessary course of business, another person or company of a material fact or material change with respect to the reporting issuer before the material fact or material change has been generally disclosed.<sup>35</sup>

Under section 1 of the Act, “material fact” is broadly defined as any fact that “would reasonably be expected to have a significant effect on the market price or value of the securities.”<sup>36</sup> Similarly, “material change” includes any “change in the business, operations or capital of the issuer” that would have a significant impact on the market price.<sup>37</sup>

Additionally, the Act explicitly references decisions “made by the board of directors” to implement such a change.<sup>38</sup> Nominee directors must accordingly be mindful of their obligation not to disclose material undisclosed information to third parties – including his or her nominating shareholder.

The Ontario Securities Commission (“OSC”) has commented on the severe impact of tipping and the vulnerable position of directors. In *Rankin (Re)*,<sup>39</sup> a case involving illegal tipping by a Managing Director at RBC Dominion Securities, the OSC outlined how both the insider trading and tipping provisions of the Act protect equal opportunity of investors by preventing those with confidential information from gaining an advantage.<sup>40</sup> Capital market efficiency and integrity is damaged even when the tipper does not profit personally. The OSC imposed harsh sanctions on Rankin, including a permanent ban on becoming a director or officer of a reporting issuer, to “ensure the future protection of investors and capital markets by taking away any opportunity Rankin may have to ever again engage in similar conduct.”<sup>41</sup>

### Considerations and Best Practices for Nominee Directors, Shareholders and Corporations

Nominee directors can minimize the risk of liability arising from their dual loyalties by

following some of these suggested guidelines and practices:

- refrain from actively favouring (or being perceived as actively favouring) the interests of nominating shareholders where those interests conflict with those of the corporation;
- conduct a reasonable analysis from the corporation’s perspective prior to advocating courses of action and maintain records of the analysis conducted and steps taken;
- disclose information to the board affecting the vital interests of the corporation;
- consider and comply with statutory limitations placed on information-sharing with shareholders; and
- inform nominating shareholders that directors owe an overriding duty to the corporation.

Nominating shareholders must also be aware of the potential liability associated with inducing a nominee director to breach his or her fiduciary duty to the corporation. While Canadian law is not well developed in this area, British and American cases have found that the general immunity of a nominating shareholder does not apply where the shareholder interferes in the management of the corporation or causes the directors to breach their duty towards it.<sup>42</sup> The Ontario Court of Justice has held that a director assuming a nominee role may be the beneficiary of an implied undertaking by their nominating shareholder to indemnify. Therefore, if a nominating shareholder instructs or otherwise causes such a breach resulting in damage to the corporation, the shareholder could be liable to the corporation for the losses concerned.<sup>43</sup>

Corporations can protect their confidential information by adopting confidentiality policies that restrict the flow of certain information to outsiders. Policies should be clear, concise and contain a carefully worded

<sup>35</sup> Ibid.

<sup>36</sup> Ibid., s. 1.

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

<sup>39</sup> (2008), 31 OSCB 3303.

<sup>40</sup> Ibid. at paragraph 28.

<sup>41</sup> Ibid. at paragraphs 33 and 36.

<sup>42</sup> McGuinness, supra note 2 at 11.148, citing *Kuwait Asia Bank EC v. National Mutual Life Nominees Ltd.*, [1990] 3 W.L.R. 297 at 319 (P.C.), per Lord Lowry and *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. S.C. 1970).

<sup>43</sup> *Mogil v. Abelson*, 1992 CarswellOnt 150.

definition of “confidential information.” This definition should encompass both material non-public information as well as information that is the subject of board meetings and deliberations. If a confidentiality issue arises, the courts may look to the policy to determine how the concept of “confidential information” has been defined and better assess the alleged breach.<sup>44</sup>

It is also advisable to outline a clear standard with respect to what information, if any, nominee directors can disclose to their nominating shareholders. Nominee directors

should also be routinely informed of their confidentially obligations and the restrictions on insider trading and tipping.

While the increased presence of nominee directors on the boards of Canadian public corporations creates complexity and risks when it comes to the dual, and potentially conflicting, obligations that nominee directors have to the corporation and the nominating shareholder, a well-informed board can take appropriate actions to address this complexity and effectively mitigate these risks.

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<sup>44</sup> In *Disney v. The Walt Disney Co.*, 2005 Del. Ch. LEXIS 94, at 10-14 (Del. Ch. June 20, 2005), the Court of Chancery gave significant weight to the fact that the company’s confidentiality policy prohibited the disclosure of certain information.