DAVIES

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Nominee Directors: Fiduciary Obligations and the Limits of Information Sharing

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The corporate life of a nominee director has been characterized as having the potential to be "neither happy nor long."[1]

Although commonplace in Canada, a shareholder's contractual right to nominate a director for election presents distinct challenges for the company, the nominee director and the nominating shareholder alike. On the one hand, a director's overarching duty to act in the best interests of the corporation is in no way attenuated by the director's status as a shareholder's nominee. On the other hand, shareholders often negotiate for a nomination right in order to monitor their investment and have their interests represented in the boardroom.

This tension between fiduciary duties and commercial expectations requires proactive management by all parties. Indeed, as courts and securities regulators increasingly scrutinize board processes and decision-making, it is in the interests of all parties for nominee arrangements to be effectively managed. In particular, a board with a nominee director should establish effective processes to manage conflicts of interest that may arise as a result of the nominee's relationship with the nominating shareholder as well as to provide for appropriate sharing of confidential information between the nominee and the nominating shareholder.

1 *820099 Ontario Inc. v Harold E. Ballard Ltd.*, [1991] O.J. No. 266 (Ont Ct J (Gen Div)).

Key Takeaways

In this *Governance Insights* article, we discuss the fundamental fiduciary considerations that nominee directors, nominating shareholders and companies should bear in mind when negotiating and implementing a director nominee arrangement:

- A nominee is subject to the same fiduciary obligations as other directors.
- A nominee may share confidential information with their nominating shareholder only if the company, whether impliedly or expressly, consents; however, a nominee cannot contractually override their fiduciary obligations to act in the best interests of the corporation.
- A nominee should actively manage conflicts of interest that may arise due to their relationship with their nominating shareholder.
- Even where information-sharing has been sanctioned by the board, a nominee should be mindful of securities laws that prohibit selective disclosure of material non-public information.
- A nominating shareholder who misuses information improperly shared by a nominee may be liable for breaches by the nominee.

We revisit and expand on these considerations under Practical Takeaways in the final section of this article.

A Primer on Nominee Director Duties

Canadian law has not recognized any distinction in responsibilities between a director nominated by a shareholder and a director nominated by management – a nominee director owes the same duties to the corporation as all other directors. These duties include the fiduciary obligation to act in the best interests of the corporation, together with the attendant responsibilities of a director to, among other things, manage conflicts of interest; disclose information affecting vital aspects of the corporation's business (even where such information is confidential information of the nominating shareholder); not misappropriate corporate opportunities; and maintain the confidentiality of corporate information acquired as a director.

Canadian courts have also unambiguously held that a nominee director is, in all circumstances, expected to exercise independent judgment and subordinate the interests of their nominating shareholder to those of the corporation.

To be sure, a nominee is permitted to bring the perspective of a nominating shareholder into the boardroom and to have regard to that shareholder's interests, but not to the exclusion of other relevant stakeholders. Courts have warned nominees who consult with their nominating shareholder that "[t]he line between taking advice and taking direction is a fine one."[2] A nominee should not be a mouthpiece for the concerns of their nominating shareholder.

2 *Wood v C.F.N. Precision Inc.,* 2008 CanLii 19797 (ON SC)

Conflicts of Interest

Like all directors, a nominee is required to manage conflicts of interests that would interfere with the exercise of their independent judgment as a fiduciary. The nature of the relationship between a nominee director and their nominating shareholder can be a potential source of conflict with the nominee's duties to the corporation.

SOURCES OF CONFLICT

The determination of a director's independence is a fact-specific analysis and, in the case of a nominee, requires careful scrutiny of the director's relationship with the nominator. That said, the fact that a director has been nominated by a shareholder does not, in and of itself, compromise the nominee's independence.

Some sources of conflict may be obvious. For example, where a nominee director is also a fiduciary of the nominating shareholder, the nominee will face the challenge of being a "dual fiduciary" whose obligations owed to one beneficiary (e.g., the duty of confidentiality) have the potential to conflict with those owed to the other (e.g., the duty of disclosure). This is not uncommon in the private equity and venture capital space, where a senior officer of a fund may be placed on the board of an investee company. If the interests of the shareholder and the investee company conflict and cannot be proactively addressed through recusal or similar mechanisms, the nominee's dual obligations may be rendered untenable and require the nominee to resign.

In other cases, the source of conflict arising from a nominee-nominator relationship may not be as direct. For example, in *Goldstein v Denner* the Court of Chancery of Delaware called into question the independence of a hypothetical director that has been nominated by a "repeat" nominator, such as a shareholder activist, whose strategy includes the cultivation of symbiotic relationships with nominees in which future directorships are tacitly proffered by the nominator as a *quid pro quo* for the directors' cooperation with the shareholder's agenda.[3]

MANAGING CONFLICTS

Both the company and the nominee should proactively identify and manage conflicts to which the director may be subject. Even in the absence of formal changes in the relationship between the nominating shareholder and the nominee, the obligation to assess independence is ongoing and should not be limited to a point-in-time analysis undertaken at the outset of the nomination.

Although conflicts must be identified and managed in the normal course, scrutiny is paramount for transactions in which the nominating shareholder may have an interest that differs from other shareholders. When a conflict transaction of this nature materializes, the company and the nominee director should confirm (i) whether the nominee remains independent of the nominating shareholder, and (ii) if the nominee is not independent, how the parties can best manage the conflict.

Conflicts in corporate transactions can materialize overtly or more subtly. Recent Delaware cases provide instructive examples of how the interests of a company and a nominating shareholder can diverge. Although the duties of a nominee director have been well articulated in Canadian jurisprudence for some time now, Delaware case law offers a fresh application of fiduciary principles to sophisticated commercial transactions. The instances of conflict that have been litigated include situations in which the nominating shareholder has favoured a

3 *Goldstein v Denner*, Del Ch, May 26, 2022.

particular deal because the shareholder had a liquidity need (e.g., an imminent need to exit a large investment) or a need to crystalize a gain by a certain point in time (e.g., to avoid adverse changes in the tax rules), or because the transaction prioritized the return on the shareholder's particular investment in the company (such as preferred shares or debt).[4] Given the case law on the duties of nominee directors in Canada, it is reasonable to think that similar litigation could find fertile soil here in Canada.

In *Manti Holdings, LLC v The Carlyle Group Inc.*, the Delaware Court of Chancery denied a motion to dismiss an action alleging that nominee directors breached their fiduciary duties by favouring a premature sale of the company in the interests of their nominating shareholder, a private equity firm whose investment fund had purchased a stake in the company. The company was one of the fund's remaining investments, and the firm was looking to close the fund imminently. The nominees actively pushed for a sale at a time when it was uncertain whether key customer contracts of the company would be renewed, with the sale price reflecting that uncertainty. The contracts were eventually renewed prior to signing the deal, but the sale price was not refreshed to account for the update. Against the protests of another board member to remarket the transaction, the nominee directors allegedly pushed the company to proceed with the sale as originally priced, in the interests of closing out the fund.[5]

Manti Holdings, together with other recent cases in Delaware, signals increasing shareholder and judicial scrutiny of the role of nominee directors in sales processes. Although the Court's consideration of the facts were limited to the motion before it, and no judicial conclusions were made regarding the conduct of the nominees, *Manti Holdings* presents a cautionary tale: boards must ensure that their sales processes are not tainted by the participation or influence of conflicted directors; and nominee directors must consider the propriety of their involvement in transactions in light of potential conflicts of interest arising from their relationship (fiduciary or otherwise) with their nominating shareholder.

Information Sharing Between Nominees and Nominators

A DIRECTOR'S RIGHT TO INFORMATION

In view of their corporate oversight obligations, directors are granted unfettered access to company records, subject to certain limited exceptions. The fact that a director has been nominated by a shareholder does not, in and of itself, alter the director's information access rights. In a prior *Governance Insights* article we discuss those rare circumstances in which a director's access to information may nonetheless be restricted, including where the documents relate to a matter in respect of which the director has a known conflict.

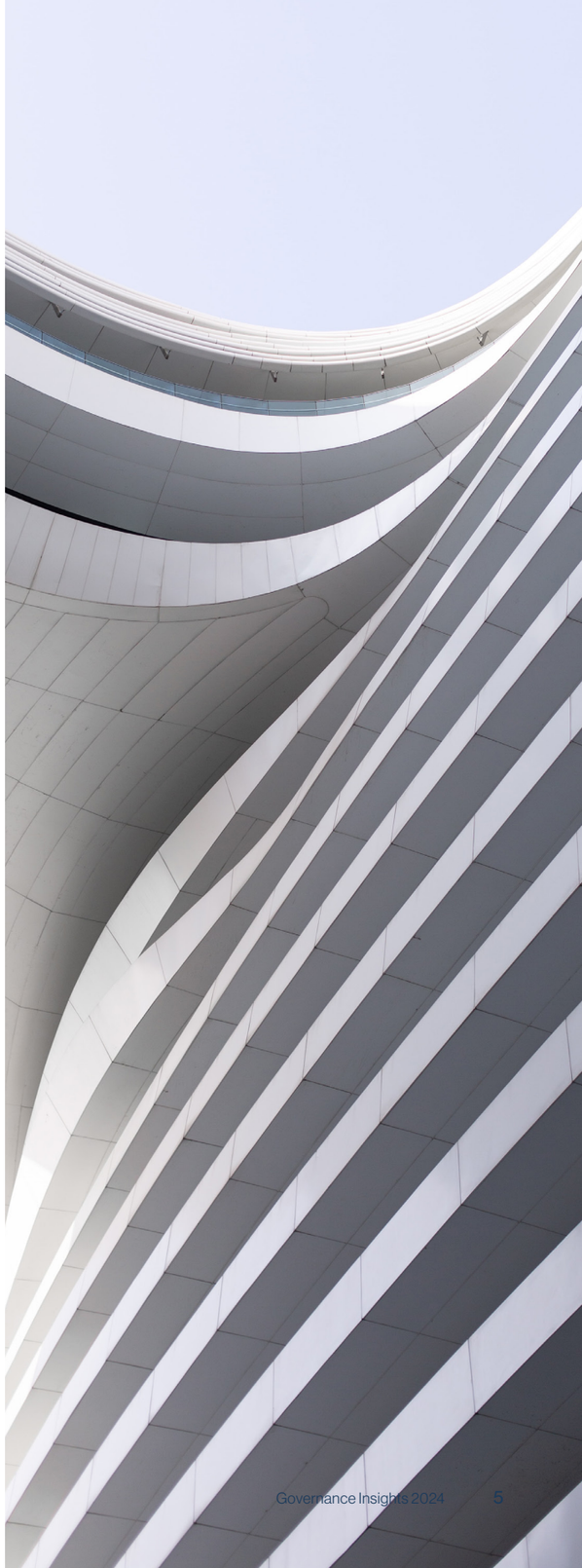
CONFIDENTIALITY AND INFORMATION SHARING

A director's fiduciary duties include an obligation to maintain the confidentiality of corporate information received in the course of their directorship. This obligation is often repeated in, and may be informed by, the company's code of conduct or an agreement between the company and director that addresses the latter's confidentiality obligations.

This rather straightforward requirement can, however, sit uncomfortably with the expectations of a nominating shareholder for whom access to information is a principal reason for securing the nomination right. For its part too, the company may regard the nomination arrangement as a means by which, through the nominee, it can obtain and utilize the expertise of the nominating shareholder and gauge a key stakeholder's alignment with important decisions. Accordingly, a certain amount of information sharing between the nominating shareholder and the nominee director is often desirable and permitted in practice.

As a matter of best practice, any sharing of non-public information should be undertaken with the corporation's consent. If the parties intend to permit communication from the nominee to the nominating shareholder, they should consider expressly agreeing to terms that allow for appropriate communication. However, even under the sanction of a formal agreement, the licence to share information can never be absolute or unconditional. As we discuss below, the sharing of confidential information must be exercised in accordance with the nominee's fiduciary obligation to act in the best interests of the corporation, the need to protect the corporation's privilege in certain communications and the restrictions imposed by securities laws against tipping material non-public information.

Note that Canadian and Delaware corporate law as it relates to information sharing differ in important respects. Unlike Canada's default rule against information sharing, the Delaware bench has acknowledged that certain nominee-nominator relationships give rise to an effective right of the nominee to share information with the nominating shareholder (including where the nominee acts as a dual fiduciary of the company and the nominating shareholder). But even so, the Court of Chancery has warned that nominee directors "use and share information at their own risk, and they can be liable for breach of fiduciary duty if they use the information or permit it to be used for an improper purpose."[6]



4 See *Goldstein*; *Manti Holdings, LLC v The Carlyle Group Inc.*, Del Ch, June 3, 2022; *Firefighters' Pension System of The City of Kansas City, Missouri Trust v Foundation Building Materials, Inc.*, Del Ch, May 31, 2024.

5 *Manti Holdings*.

6 *Hyde Park Venture Partners Fund III, L.P., v FairXchange, LLC*, Del Ch, March 9, 2023. See also *Icahn Partners LP v Francis deSouza*, Del Ch, January 16, 2024.

CONTRACTING FOR INFORMATION SHARING RIGHTS

Generally, the parties should memorialize a corporation's consent to information sharing in a written agreement that establishes the terms on which the nominee director may share confidential material with the nominating shareholder. The nominee and the nominating shareholder will want to ensure that the communication of corporate information is undertaken with clear consent from the corporation. The corporation, too, will want to ensure that any information sharing is conducted appropriately with a view to its best interests. Although the parties may be able to rely on implied consent in certain circumstances, a written agreement will usually be the best option.

Information-sharing arrangements with a nominating shareholder ordinarily focus on regulating the types of information that a nominee director may share with the nominator and the manner in which disclosure can be made. The details of any such agreement will be fact-specific and highly negotiated but will often address one or more of the following issues: (i) the nominating shareholder's obligation to treat the information as confidential; (ii) whether the nominee is responsible for the nominating shareholder's misuse of the information; (iii) restrictions on the use of the information by the nominating shareholder; (iv) limits on the representatives of the nominating shareholder who have access to the information; (v) limitations on information sharing regarding matters that engage conflicts of interest; and (vi) limitations on sharing privileged materials.

THE LIMITS OF INFORMATION SHARING: FIDUCIARY OBLIGATIONS

Regardless of the terms of any contractual information-sharing arrangement agreed between the parties, a nominee may be liable for breaches of fiduciary duty if they share information for a purpose other than the best interests of the corporation. Accordingly, the nominee must consider the purpose of the disclosure in each instance, not only to ensure that it complies with the terms of any contractual information-sharing arrangement, but also to consider whether it comports with their duties to the corporation.

THE LIMITS OF INFORMATION SHARING: TIPPING AND INSIDER TRADING

In the case of a public company, a nominee's disclosure of confidential information to the nominating shareholder raises selective disclosure (tipping) concerns. Securities legislation prohibits a public company director from disclosing material non-public information of the company to another person unless such disclosure is made in the "necessary course of business" (NCOB).

Determining whether a given communication will be made in the NCOB should not be considered a perfunctory or simple endeavour. The Ontario Capital Markets Tribunal (Tribunal) has stated that the word "necessary" in the NCOB exception elevates the criteria for selective disclosure beyond a mere business purpose or business rationale to something that is "essential," "indispensable" or "requisite" to the business.[7] Significantly, the Tribunal also noted that it should not be taken to have thus far concluded "that in all factual situations the NCOB exception is limited to a consideration of what may be in the necessary course of the *issuer's* business" (emphasis added). In so doing, the Tribunal left the door open to a finding that selective disclosure may be defensible where made in the necessary course of the tipper's business (such as, for example, the nominee's business), although caution is recommended until the limits of this opening have been tested in further decisions. For further reading, refer to our more detailed discussion of the NCOB exception to the prohibition against selective disclosure (here).

7 *Kraft (Re), 2023 ONCMT 36.*

As a recipient of confidential information, a nominating shareholder may receive material non-public information of the company and is prohibited from trading in the company's securities on the basis of it, subject to limited exceptions.

Practical Takeaways

— **A nominee is subject to the same fiduciary obligations as other directors.** The fact that a director has been nominated by a shareholder does not alter or otherwise attenuate the director's duties to the corporation. The nominee must act in the best interests of the corporation, subordinating the interests of the nominating shareholder to those of the corporation. The stringent demands of the nominee's duties may come as a surprise to nominating shareholders and nominee directors alike, who may expect that the nominee should represent and advocate for the interests of the shareholder. Director education is crucial for good governance, starting with onboarding sessions and materials that clearly outline the nominee's responsibilities.

— **A nominee may share confidential information with their nominating shareholder only if the company, whether impliedly or expressly, consents; however, a nominee cannot contractually override their fiduciary obligations to act in the best interests of the corporation.** A nominee director must maintain the confidentiality of corporate information received in the course of their position as a director. Absent the corporation's consent (whether express or implied), a nominee director is prohibited from sharing confidential information with the nominating shareholder.

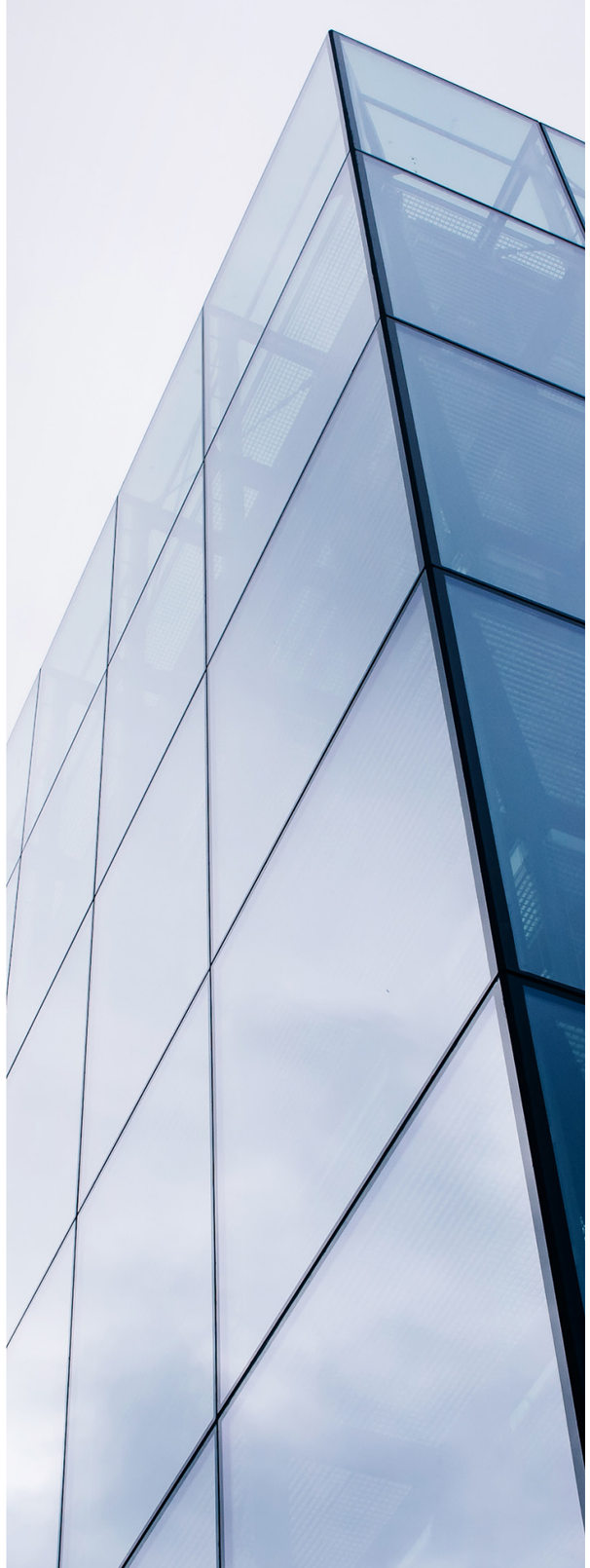
Parties will often agree to a nomination right with a view to the benefits that accrue from an information-sharing arrangement: the company may want the nominee and the nominating shareholder to meaningfully consult so that the company can leverage the expertise of the shareholder; and the shareholder may benefit from consultation as a means to monitor and influence its investment. As a matter of best practice, parties that wish to permit the nominee director to share confidential information with the nominating shareholder should enter into a written agreement that sets out the terms under which disclosure may be made. Even where the corporation agrees to an information-sharing arrangement, the nominee director is subject to the overriding obligation to ensure that information is shared only with a view to the best interests of the corporation and not for an improper purpose.

— **A nominee should actively manage conflicts of interest that may arise due to their relationship with their nominating shareholder.** The nominee's fiduciary duties include an obligation to avoid conflicts of interest with the corporation. Whether a director should deliberate or vote in respect of a given corporate matter will depend, among other things, on whether the director is sufficiently independent – that is, free from conflicts of interest that could reasonably be expected to interfere with the exercise of their independent judgment as a fiduciary. Both the corporation and the nominee should consider whether the nominee's relationship with the nominating shareholder may lead to a real or perceived conflict. Where the nominating shareholder's interests in respect of a transaction diverge from those of other shareholders, the board should consider appropriate steps to ensure any conflicted nominee does not participate in,

or otherwise influence, deal negotiations. An active and independent committee of the board remains an essential tool in the transactional governance toolkit for managing these conflicts.

— **Even where information-sharing has been sanctioned by the board, a nominee should be mindful of securities laws that prohibit selective disclosure of material non-public information.** In the case of a public company, both the company and the nominee director must ensure disclosure of material non-public information to the nominating shareholder is made in compliance with the rules against selective disclosure, including the requirement that disclosure occur only in the "necessary course of business."

— **A nominating shareholder who misuses information improperly shared by a nominee may be liable for breaches by the nominee.** In addition to potential insider trading liability for misusing material non-public information, nominating shareholders should be wary of acquiescing in, encouraging or knowingly benefiting from breaches of fiduciary duty by the nominee director. Although not discussed in detail in this article, a nominating shareholder that knowingly misuses confidential information obtained in breach of the nominee's fiduciary duty may be subject to a number of potential grounds for liability, including knowing assistance in breach of fiduciary duty.



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