



NOMINEE DIRECTORS: RIGHTS AND RESPONSIBILITIES

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It is common for shareholders of both public and private companies to nominate directors to sit on the companies' boards on their behalf. This commonly occurs when an investor is an institution, when it has the contractual rights to control one or more board seats, or when an investor wishes to appoint an employee or an individual with particular experience to the board.



These “nominee directors”, however, often find themselves conflicted. While the nominating shareholder will naturally expect its nominee director to demonstrate loyalty and advocate on the shareholder’s behalf, the nominee director owes specific legal duties to the corporation that are founded upon good faith, candor, confidentiality and the best interests of the corporation.

This paper examines these responsibilities, particularly as they apply to nominee directors on the boards of Canadian companies, and how these directors can protect themselves from conflict situations.

DIRECTORS’ DUTIES: CANADA VS. THE U.S.

For starters, certain distinctions must be made between the duties of the boards of directors for Canadian and American companies. In the U.S., while the obligation is officially owed to the corporation, in a sale context that duty shifts to maximizing shareholder value. As the Delaware Supreme Court made clear in *Revlon Inc v MacAndrews & Forbes Holdings, 506 A (2d) 173 (1986)*, a board’s decision on the sale of a corporation is governed by the duty to obtain the highest value reasonably available to shareholders. This has become known as the “Revlon duty.” Once a board decides to sell the company, or a sale of the company is inevitable, the directors essentially act as auctioneers.

On the other hand, Canadian company board members must act honestly and in good faith with a view to the best interests of the corporation itself, including in a sale process. This duty is owed to the corporation and all its “stakeholders”—this includes shareholders, but the financial interests of shareholders are not necessarily paramount.

In *BCE Inc. v. 1976 Debentureholders 2008 SCC 69* (“BCE”) the Supreme Court of Canada (SCC) considered, among other corporate law concepts, the duty of loyalty. The SCC affirmed that directors of a Canadian corporation may consider the interests of a variety of stakeholders—including shareholders, employees, creditors, consumers, governments and even the environment—to inform their decisions. The Supreme Court clarified that, unlike the predominant view in the U.S., there is no Canadian



principle that allows one type of stakeholders’ interests (for example, the interests of shareholders) to automatically prevail over all other interests. Instead, what the directors deem to be in the corporation’s best interests in any particular situation is a matter of business judgment.

By deferring to the business acumen of a corporate board, Canadian courts rely on a well-entrenched principle of Canadian corporate law known as the business judgment rule (BJR). The BJR requires a court to show appropriate deference to a good faith decision by directors, provided that the decision is reached on an informed basis and is within a “range of reasonableness.” As such, directors should not be faulted for simple errors of business judgment. In the absence of evidence to the contrary, it can be presumed that a corporation’s directors are acting on an informed basis in good faith and with the corporation’s best interests in mind.

Decisions made by a Canadian board of directors are generally immune from judicial review where:

1. The directors informed themselves (e.g., made reasonable inquiries) on which they could form a business judgment before making their decision.
2. They acted in good faith, in accordance with law and their fiduciary duties.
3. Their decision appeared to have a rational basis when it was made. (It is worth noting that it need not have been the most rational.)

Additionally, the court in BCE noted that, where the corporation is a going concern, directors should consider the corporation's long-term interests in exercising their duties.

A NOMINEE DIRECTOR'S DUTY

The fiduciary duty owed by a corporation's directors extends uniformly to nominee directors; as a matter of law, a nominee director is not simply an agent of his or her appointing shareholder (no matter how much the nominating shareholder would like that to be the case). Rather, a nominee director is an overseer required by law to supervise the corporation's business and affairs, and whose duties are owed to the corporation itself as opposed to the appointing shareholder (or shareholders). These legal principles may conflict with commercial realities, but in Canada, the law is clear.

Canadian courts have generally found that nominee directors may be in breach of their fiduciary duty to the corporation where they:

- Fail to maintain an even hand.
- Fail to analyze a course of action from the corporation's perspective.
- Fail to disclose to the corporation information that impacts the business of the corporation.

The duties of a director to the corporation are not diminished by virtue of having been nominated by a shareholder, and, therefore, should the interests of the appointing shareholder differ from the corporation's, the nominee director must proceed cautiously and in the sole interest of the corporation entrusted to his or her care. As discussed below, it may be appropriate for a nominee director to recuse him or herself from transactions or contracts that could give rise to an actual or potential conflict.

CONFLICTS OF INTEREST

There are certain situations where nominee directors have specific rights and responsibilities, and they must remain aware of them in order to avoid breaching their duties.

The first is where a conflict of interest arises between the nominating shareholder and the corporation. In such an instance, the director has a statutory duty to disclose his or her interest (be it in a proposed transaction or contract) when the director first becomes interested. The director must make this disclosure in writing or at a board meeting and request that his or her interest be entered into the minutes of the meeting. While the level of detail required will depend upon the circumstances, the disclosure must explain both the nature and extent of the director's interest and enable the remaining directors to make an informed judgment and properly assess the interests of the corporation on the basis of the declared relationship.

For nominee directors of a public corporation, additional considerations arise as a result of securities law requirements. Canadian securities laws require directors engaged in an insider bid or related-party transaction to make certain disclosures to shareholders. The board must, for instance, disclose the circumstances of its approval process, including the establishment of a special committee of directors, if applicable, along with any contrary views of directors on the proposed transaction.

Concerns about conflicts of interest may make it prudent for directors to recuse themselves from board discussions in some circumstances. In a change-of-control scenario, for example, if a nominating investor has a unique or special interest in the transaction, the board may determine that the nominee shareholder should not participate in discussions or vote on the transaction.





CONFIDENTIALITY

In addition to the duty to avoid conflict of interest, directors of Canadian companies have a duty to the company to maintain confidentiality. If a nominee director becomes aware of significant information at a board meeting, for example, he or she may not necessarily be able to immediately share this information with his or her appointing shareholder.

In a private company with only a few large shareholders, this may not be a practical concern. It can become an issue, however, when a private company is widely-held and has many smaller shareholders or the company is publicly listed.

Nominee directors of public companies must also take care not to fall offside insider trading prohibitions on “tipping” by disclosing non-public information to an investor. Under Canadian securities laws, it is an offense for an appointing shareholder to purchase or sell an issuer’s securities with knowledge of material information that has not been generally disclosed. Likewise, it is an offense for a nominee director to inform, outside of the necessary course of business, his or her appointing shareholder of a material fact or change in respect of the issuer before that fact or change has been generally disclosed.

Should a nominating shareholder receive non-public information from its nominee director, the shareholder should make sure that there are sufficient safeguards in place, such as a “restricted list” to ensure no trades are made. If the shareholder trades in these securities for unrelated reasons (for example, where the investor is a financial institution with various divisions), it should

establish a wall between the nominee director and the trading division to ensure no material undisclosed information is transmitted.

STRATEGIES FOR AVOIDING A BREACH OF DUTY

Shareholders and nominees alike should consider a number of strategies for ensuring the director is able to fulfill his or her duties properly and free from conflict.

Under Canadian law, a director cannot “waive” fiduciary duties (or have them waived by the corporation). However, in the private company context, it is possible for the shareholders to adopt a unanimous shareholders agreement (“USA”), whereby the powers and duties of the directors are taken away and vested instead in the shareholders themselves. This effectively relieves the directors from potential liability, but also takes away their powers—in many ways, this structure is akin to a member-managed Delaware LLC.

Subject to a USA, no provision in a contract, article, bylaw or resolution can relieve a director from his or her duty to act in accordance with Canadian corporate law statutes—or from liability for breaching that duty.

Clear, current and enforced board policies that address sharing information with shareholders, insider trading and corporate opportunities, will help mitigate risk by clarifying directors’ responsibilities with respect to confidentiality and conflict of interest.

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