Information Flows Between Nominee Directors and Their Appointing Shareholders

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Minority stake acquisitions are emerging as a global trend in today's business environment. There are many reasons for this: the rise of shareholder activism and activists' pursuit of minority investments in order to influence corporate agendas; increased regulatory and foreign investment oversight of control-stake acquisitions in certain markets and industries; and the heightened competition for acquisition targets, causing many investors to turn to minority investments as a way to deploy excess capital.

Getting a seat at the table through board nomination rights is one of the most common ways for minority investors to maintain oversight of their investment. The ability to do that depends on access to information about the investment, and the commercial reality is that directors nominated by significant shareholders will often convey information back to the shareholders who nominated them. The question is: are nominee directors lawfully permitted to do so?

Delaware Perspective

Although a director may be placed on a board in order to represent the interests of a large shareholder, directors must, in exercising their fiduciary duties, act in the best interests of the corporation and not in the best interests of their nominator. All decisions made by the nominee director must accordingly be taken from that perspective.

The duties of every director, including nominee directors, include a duty to maintain the confidentiality of corporate information. The scope of that duty is not precisely defined, giving rise to uncertainty regarding the legality of information sharing between a nominee director and the nominating shareholder. In a co-authored 2008 article, former Delaware Chief Justice E. Noman Veasey succinctly described the legal tension created by information sharing with nominee directors: such information sharing seems like it "would violate the directors' duty to protect [the company's] confidential information. Yet that result might also seem inconsistent with the parties' understanding that [the nominee directors] were on the board to be the preferred stockholders' eyes and ears and to represent and protect their interests."[1] Information sharing was thought by commentators to be permissible, provided that consent had been expressly or impliedly provided by the corporation.[2]

In the United States, the Delaware courts have considered the issue of information sharing between nominee directors and their nominators. In *Kalisman v. Friedman,*[3] the board withheld information concerning a proposed recapitalization from a nominee director who was also a founding member of the corporation's largest shareholder (OTK). The board did so against the backdrop of the corporation's mounting tensions with OTK, who intended to propose their own slate of directors at the corporation's upcoming annual general meeting. In considering the question of information sharing, Vice-Chancellor Laster of the Delaware Court of Chancery stated, “When a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder’s representative, then the stockholder is generally entitled to the same information as the director.”

The duty of confidentiality in Delaware accommodates information sharing with a nominating shareholder, but that duty continues to prevent the nominee director or the nominating shareholder from exploiting corporate confidential information. Vice-Chancellor Laster has commented in a co-authored article published after the *Kalisman* opinion that:

> Delaware law has developed a rule that accommodates information sharing. To the extent a director misuses confidential information or permits his affiliate to misuse confidential information, the corporation has a remedy against the director for breach of fiduciary duty. The corporation can also require the director’s affiliate to enter into a confidentiality agreement that restricts the use or further dissemination of the information.

Vice-Chancellor Laster explained this accommodation of information sharing as a reflection of practical reality and the fact that any rule to the contrary would be honoured in the breach rather than by observance:

> This rule reflects the practical reality that director representatives in both public and private companies routinely share confidential corporate information with colleagues at their affiliated investment funds. The managing directors of these funds regularly meet to monitor their investments, and they routinely receive reports from their director designees on the performance of their portfolio companies. In most cases, the blockholder directors themselves are managers or fiduciaries of the fund that made the investment, and the managers of the fund are often fiduciaries of the limited partners or other investors in the fund. A bright-line rule against information sharing would create the potential for breaches of duty at two levels: first at the corporate level by preventing the director representatives from engaging in behavior that is currently a normal part of the investment and monitoring process, and second at the fund level by preventing the director who was a fund fiduciary from sharing information that was material to the fund. Such a rule only would be honored in the breach. Rather than an actual rule to guide conduct, a rule against information sharing would put a cause of action in the hands of the corporation to use at its discretion. And if a corporation were to try to enforce it, a seemingly bright-line rule would turn out in practice to involve fact-laden litigation about the degree to which other directors knew about and consented to the sharing or engaged in similar information sharing themselves. The better approach, which Delaware has adopted, is therefore to permit information sharing and allow corporations to address risks by contracting with the affiliate and by enforcing the directors’ fiduciary duties.[4]

While Delaware law permits nominee directors to share information with their nominating shareholder, corporations can consider limiting that information flow on a need-to-know basis. For example, confidentiality policies can be put in place limiting disclosure of information by nominee directors to members of the nominating shareholder’s senior management who are responsible for managing and monitoring the investment in the corporation.

Equally important is that disclosure of information happens only on the clear understanding that the information is confidential and that it may not be used for the benefit or advantage of the nominating shareholder.

The Canadian Perspective

Canadian courts have commented often on the duties of nominee directors generally, emphasizing that the duties are owed to the corporation, not the nominating shareholder, and are the same as those owed by other directors. However, Canadian courts have not provided any guidance on the particular question of whether and in what circumstances information sharing between a nominee director and the nominating shareholder might be permissible in light of the director’s duty of confidentiality.

We would expect Canadian courts to be generous in implying consent for all of the reasons that Delaware accommodates information sharing and that the *Kalisman* decision would be influential in Canada if the issue came before a court.

What is clear is that in Canada, as in Delaware, information sharing is permitted if the corporation consents. Consent could be express, provided in advance on a blanket basis by way of shareholders agreement or a board policy, or provided on an ad hoc basis in response to particular information requests. Consent could also be implied from the circumstances. An implied consent may arise in a situation where it is the reasonable expectation of the parties involved that the nominee director will report to the nominating shareholder information learned at board meetings (which could include, depending on the circumstances, a situation where the nominee director is nominated pursuant to a nomination agreement between the nominating shareholder and the corporation). We would expect Canadian courts to be generous in implying consent for all of the reasons that Delaware accommodates information sharing and that the *Kalisman* decision would be influential in Canada if the issue came before a court. However, in our view, unless there is clearly implied consent for the nominee director to share confidential corporate information with the director's nominator, then explicit consent should be sought from the corporation.

We note that any consent to information sharing, whether express or implied, is unlikely to be viewed by a Canadian court as unconditional. As is the case under Delaware law, any information sharing will be subject to the nominee director's overriding duty of loyalty to the corporation, making the nominee director potentially responsible for any misuse of the information by the nominating shareholder. The nominee shareholder should therefore take care that appropriate arrangements are in place at the nominating shareholder to ensure that disclosure of the information is limited to those with a need to know and that the information will not be misused to the detriment of the interests of the corporation.

Securities Law Considerations

In circumstances where confidential information is material and the corporation on whose board the nominee director sits is a Canadian reporting issuer, the disclosure of that information to the nominating shareholder raises the question of whether the prohibition of "tipping" under securities laws is engaged.

Under anti-tipping rules, a person in a special relationship with a reporting issuer, such as a nominee director, may not disclose material facts or material changes about the issuer to another person, until such information has been generally disclosed, other than in the "necessary course of business."

What constitutes the "necessary course of business?" This exception has been broadly interpreted by regulators who have noted that the exception "exists so as not to unduly interfere with a company's ordinary business activities," also recognizing that disclosure of material information to controlling shareholders may in some cases fall under this exception.[5]

Canadian securities laws equally presume that nominee directors share information with their nominating shareholder, requiring, for example, a shareholder with board representation to obtain an independent valuation for purposes of engaging in a transaction under Multilateral Instrument 61-101—*Protection of Minority Security Holders in Special Transactions,* in order to address information asymmetries that may exist between significant and minority shareholders.

While the nominee director may be able to share material undisclosed information with the nominating shareholders, those shareholders are prohibited from further sharing of that information or trading in the issuer's securities until the information is generally disclosed.

Altogether, we believe that information sharing between nominee directors and nominating shareholders does not offend the anti-tipping prohibition under Canadian securities laws in light of the "necessary course of business" exception—so long as information sharing is done confidentially and narrowly, with limited scope. While the nominee director may be able to share material undisclosed information with the nominating shareholders, those shareholders are prohibited from further sharing of that information or trading in the issuer's securities until the information is generally disclosed.

Managing Conflicts

Managing conflicts of interest can be challenging for a nominee director who shares information with the nominating shareholder; for example, where the shareholder may be considering a transaction involving the corporation, information sharing may not be possible, and the nominee director's participation in board discussions may have to be limited. Another way that conflicts may materialize is under the "vital aspect" principle whereby a nominee director may be required to disclose to the corporation information she has that is confidential to the nominating shareholder, if that information goes to a vital aspect of the corporation. Resignation may be the only way to manage that conflict of interest.

Conclusion

While there is greater clarity in Delaware on information sharing, Canadian courts have not yet pronounced on this issue, and nominee directors will accordingly need to tread with care. It's also inevitable that there will be many variations in fact patterns that may affect this general approach to information sharing between directors and the shareholders that nominated them.

From the corporation's perspective, we expect that, in many cases, it will be helpful to understand the views of large-block shareholders as conveyed through their nominee director. This type of open communication practice is consistent with the Institute of Corporate Directors' (ICD) shareholder engagement model.

In the ICD's latest guidance for Canadian listed companies, boards of directors are encouraged to engage directly with significant shareholders on corporate and board governance matters, with the ICD predicting that engaging with shareholders will ultimately lead to improved communications, fewer proxy battles and other contentious matters. If the ICD's prediction is realized, it will be interesting to see the impact of integrated engagement practices like board nomination rights on broader governance trends.

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[1] E. Norman Veasey and Christine T. Di Guglielmo, "How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors," 63 The Business Lawyer 762 (May, 2008) at 774.

[2] "When there is no express consent, the ability of a director to share confidences depends on whether the consent can be implied by the circumstances." Cyril Moscow, "Director Confidentiality," 74 Law and Contemporary Problems 196 (2008) at 205. The author notes (at 205) that in closely held corporations, implied consent is easier to find, and questions (at 207) whether the consent of shareholders could be implied in circumstances where a nominee director was put on a board following a proxy fight. Similarly, consent could also be implied in circumstances where the board seat was part of an investment agreement with an institutional shareholder.

[3] C.A. No. 8447-VCL, April 17, 2013.

[4] J. Travis Laster and John Mark Zeberkiewicz, "The Rights and Duties of Blockholder Directors," 70 The Business Lawyer 33 (Winter 2014/2015) at 54-55.

[5] See National Policy 51-201 Disclosure Standards.