IN FACT AND IN LAW

Corporate Governance
Securities Law

May 2006

The "Nominee" director and conflicting loyalties.

By André Laurin

REMEMBER

- A director must act in the best interests of the company at all times.
- A director may not favour the interests of the shareholder or the member who arranged for his election if that person's interests differ from the interests of the company.
- A director may not disclose the company's confidential information to the shareholder or the member who arranged for his election unless there is a unanimous agreement of the shareholders or members permitting such disclosure (there can be no such agreement in the case of a reporting issuer).
- A director who possesses information coming from the shareholder or the member who arranged for his election has the obligation, as a director, to disclose to the company any part of the information which relates to a planned transaction or operation likely to have a negative impact on the company.
- A director who serves on the board of directors of a company at the request of a shareholder or a member who employs him may take certain precautions to avoid finding himself in a conflict between his two duties of loyalty.
- These principles and constraints also apply to the boards of directors of non-profit organizations and associations with prescribed representation, subject to some adjustments and nuances.
- A lender which is also a shareholder or member should use a separate agreement providing for access to certain information and rely on a recipient and communicator of information other than its nominee on the board.

1. Context

The interests of a shareholder, investor or member occasionally may differ from the interests of the company of which he is a shareholder or member.

The shareholder or **the member**, in the exercise of his rights in such capacity, may **favour his interests** instead of those of the company, provided that he does not abuse his rights.

However, the situation becomes complicated when a shareholder or member or its representative is a director of the company (a "nominee"). Under the laws governing companies, **the director** has a **fiduciary duty to the company**. This fiduciary duty implies, among other requirements, that the director:

- act in the best interests of the company;
- avoid conflicts between the interests of the company and any other interests, including his own;
- protect the confidentiality of information to which he has access in his capacity as a director;
- not, whether in his own interest or that of the shareholder or the member who arranged for his election, use the company's property or profit from its business opportunities without its consent, or enjoy any such prerogative to the detriment of the company or of its other shareholders or members.

The situation is even more complicated in the case of a person who, as an **employee of a shareholder or member** and at the request of such shareholder or member, is required to act as its representative on the company's board of directors. This nominee is then subject to **two fidciary duties**, the duty arising from his employment relationship and the duty arising from his status as a director of the company. He is responsible towards two principals.

Such examples of complex situations are legion in Canada. Many Canadian **reporting issuers** have one or more controlling shareholders, often families or investment or holding companies. Similarly, representatives of employees or unions sit on many boards of **educational and health-care institutions**. In the case of associations or professional corporations, eligibility criteria may apply, based on geographical origin or field of activities, among other factors.

LAVERY, DE BILLY

BARRISTERS AND SOLICITORS

The co-presidents of Power Corporation have stated that members of the public choose to invest in certain companies in which Power holds a substantial or controlling interest because Power Corporation has a reputation for keeping a close watch and ensuring that certain persons are elected as directors of these companies. This assertion is certainly not unfounded. Similarly, in the United States, many investors will favour companies in which Berkshire (Warren Buffett) invests, for the same reasons.

The recent **rules and guidelines adopted by the Canadian Securities Administrators** have clarified certain independence criteria applicable to directors. However, these rules and guidelines in no way alter the basic duties we have described above. Despite the similarity of certain aspects or certain effects, the notions of fiduciary duty and independence are distinct. Obviously, however, compliance with the CSA independence criteria can have the effect of eliminating certain conflict of interests situations.

2. Legislative sources

In the case of corporations constituted pursuant to the Canada Business Corporations Act, the main provision is found in Section 122 of this Act:

> "*122. (1)* **[Duty of care of directors and officers]** *Every director and officer of a corporation in exercising their powers and discharging their duties shall*
>
> *a) act honestly and in good faith* **with a view to the best interests of the corporation***; [...]*"

In the case of companies constituted pursuant to the *Companies Act* and most other legal persons, the relevant provisions are found in Articles 322, 323 and 324 of the *Civil Code of Québec*:

> "*322. A director shall act with prudence and diligence.*
>
> *He shall also act with honesty and* **loyalty in the best interest of the legal person.**
>
> *323. No director may mingle the property of the legal person with his own property nor may he use for his own profit or that of a third person any property of the legal person or any information he obtains by reason of his duties, unless he is authorized to do so by the members of the legal person.*
>
> *323. A director shall avoid placing himself in any situation where his personal interest would be in conflict with his obligations as a director. [...]*"

The fiduciary duty of an **employee** is set out in Article 2088 of the *Civil Code of Québec*:

> "*2088. The* **employee** *is bound not only to carry on his work with prudence and diligence, but also* **to act faithfully and honestly** *and not to use any confidential information he may obtain in carrying on or in the course of his work.*"

The fiduciary duty of a **mandatary** is set out primarily in Article 2138:

> "*2138. A* **mandatary** *is bound to fulfill the mandate he has accepted, and he shall act with prudence and diligence in performing it.*
>
> *He shall also act honestly and* **faithfully in the best interests of the mandatory,** *and avoid placing himself in a position that puts his own interest in conflict with that of his mandatory.*"

The fiduciary duty of a **provider of services** can be found in Article 2100:

> "*2100. The contractor and the* **provider of services** *are bound to* **act in the best interests of their client***, with prudence and diligence. [...]*"

3. Jurisprudence

Canadian courts have considered the question of directors' conflicts of interest on many occasions. For example, the Supreme Court of Canada's decision in *Wise*[1] analyzed the conduct of directors who had indirect or direct interests as shareholders in two companies they controlled and of which they were also directors. The Court concluded that their fiduciary duties had been fulfilled, that such duties existed for the benefit of the companies and that they did not extend so as to be for the benefit of the creditors.

Two Ontario decisions undoubtedly shed more light on this issue. In both cases, Air Canada was involved as a shareholder. These were the *De Luce* and *Gemini* cases. In the first case, the courts decided that Air Canada's nominees had failed to fulfil their fiduciary duty, while in the second case it was the nominees of a co-shareholder who were the object of a similar conclusion.

De Luce case[2]

In the late '80s, Air Canada had a strategy of investing in regional carriers without exercising exclusive control over them, allowing them a certain degree of operational independence.

Thus, Air Canada had a 75% shareholding in the parent company of Air Ontario, while the De Luce family, through holding companies, had a 25% shareholding. William De Luce assumed the presidency of Air Ontario and directed its operations. The board of directors was composed of seven (7) nominees of Air Canada and three (3) of the De Luce family.

William De Luce and Air Ontario signed a contract of employment for a term of five (5) years expiring at the end of February 1992, which included the possibility of renewal with the consent of the parties. The shareholders were bound by a shareholders' agreement which provided that upon **termination of the employment** of Stanley De Luce (the father) or of William De Luce, whichever occurred later, Air Canada would have the **option of acquiring the De Luce family's 25% interest.**

In the early '90s, Air Canada changed its strategy and sought complete control of regional carriers such as Air Ontario.

In October 1991, William De Luce was informed by Air Canada's representatives that it wanted him to resign. The board of Air Ontario, including its Air Canada nominees, had, until then, expressed **satisfaction with William De Luce's performance.** Faced with William De Luce's refusal to accede to the request that he resign, **the board of directors, on the strength of support by the Air Canada nominees, decided by a resolution of the majority to dismiss William De Luce.**

Judge Robert Blair, then a judge of the Ontario Superior Court of Justice, who subsequently became a judge of the Ontario Court of Appeal, expressed himself as follows:

> "*In my opinion, only a termination effected for the purpose of promoting the best interests of Air Ontario – for whatever reason – can constitute a "termination" within the meaning of the Agreement, such as to trigger Air Canada's right to call the De Luceco shares. (p. 308)*
>
> *[...]*
>
> *As I have indicated, the evidence here strongly supports a conclusion that,* ***in causing the Air Ontario board to terminate the employment of Mr. De Luce, the Air Canada nominees were acting to carry out an Air Canada agenda and made little, if any, analysis of what was in the best interests of Air Ontario.*** *Whether, had they done so, such an analysis might have yielded sufficient reasons from Air Ontario's perspective to carry out the act of termination, is not the point. Not only was there no "reasonable analysis of the situation" from that perspective, the question which was uppermost in the minds of the directors was to effect Air Canada's newly developed corporate objective, it would appear.*

[1] People Department Stores Inc. c. Wise, [2004] 3 R.C.S.

[2] Deluce Holdings Inc. v. Air Canada, 8 B.L.R. (2d)

I am satisfied that such conduct could be found, at law, to be unfairly prejudicial to and to have unfairly disregarded the interests of De Luceco as a minority shareholder, as those interests are set out in the unanimous shareholders' agreement". (pages 311 and 312)

Gemini case[3]

In 1987, PWA (Canadian) and Air Canada formed a limited partnership ("Gemini") for the purposes of operating a new joint reservation system. Covia also joined the partnership. The units were allocated on the basis of 33% each and 1% for the general partner. The three principal limited partners also each owned one third of the shares of the capital stock of the general partner, a corporation, and elected three nominees each to the general partner's board of directors. Both Canadian and Air Canada entered into a Hosting Agreement with Gemini granting it exclusive rights to the use of its system for airline ticket reservation purposes. Among other provisions set out in the agreement, it was to end two (2) years after the cessation of the limited partnership link between Canadian and Gemini. Moreover, the partnership agreement provided for the dissolution of the partnership if the general partner became insolvent.

The general partner had an urgent need for an additional injection of money from the limited partners and shareholders of the general partner.

Canadian was having its own financial difficulties. It thus sought an alliance with American Airlines. However, such an alliance implied that Canadian would use the same reservation system as American Airlines, namely Sabre.

Canadian's nominees on the board of Gemini's general partner also participated in the negotiations with American Airlines.

Canadian's nominees did not disclose the negotiations with American Airlines to Gemini or to the general partner and, by their absence from the meetings of the board, prevented a decision from being made regarding a cash call for Gemini, or more precisely, for the general partner. Canadian invoked the insolvency of the general partner and called for the dissolution of the limited partnership, but the courts did not grant its demand. Commenting on the decision of the trial judge, the Court of Appeal, with Judge Griffiths writing for the majority, expressed the following view:

"In this case, however, the trial judge was completely justified in finding a breach of fiduciary duties on the part of the nominees representing PWA because they failed to disclose that part of the negotiations with AMR which affected the Gemini Partnership in a vital aspect of its business. Indeed, the transaction with AMR contemplated a serious loss to the Partnership, the loss of the hosting service. As well, the trial judge was justified in finding that these nominees, as part of a negotiating team, actively pursued the transaction with AMR, knowing that it would injure the Gemini Partnership and strengthen Sabre, a nominee competitor."

The Ontario Court of Appeal made a **distinction** between the elements of the planned transaction that were likely or unlikely to have **a negative effect on Gemini.** In the context of the planned transaction, it was Canadian's **eventual withdrawal** from the reservation agreement (the above-mentioned **Hosting Agreement**) that presented a risk of negative impacts on Gemini. Consequently, according to the Court of Appeal, Canadian's nominees did not have to disclose the planned transaction with American Airlines to Gemini, either per se or as a whole, but did have a duty to disclose Canadian's planned withdrawal from the reservation agreement.

4. Precautions and available measures

In such a context:

- How can the legitimate interests of the investors, shareholders or members be reconciled with the nominee's obligations?
- What precautions should be taken by the nominee, and especially by a nominee who is also an employee of the shareholder or of the member, or by the shareholder or the member?

We should first recall that no rule, no policy and no measure can replace a nominee's concern for acting with integrity and loyalty. As shown by the Enron affair, there can be an appearance of compliance with the rules without the objective of integrity being met. **The primary real precaution is conduct by the nominee that shows a good understanding of his obligations, a concern for honouring those obligations, constant vigilance and the exercise of good judgment.**

But to avoid any confusion about one's intentions, there is nothing wrong with taking additional precautions. Here are some **pertinent examples**:

For a shareholder or member of a company (other than a reporting issuer):

- Use a **unanimous agreement** to transfer to the shareholders or members some of the powers that may be transferred to shareholders and require higher or lower levels of support for various types of decisions according to the importance of the decision (e.g. the strategic plan);
- Insert provisions in the by-laws or in an **administrative resolution** providing for the disclosure of the same information to the shareholders or members as is disclosed to the directors and authorizing the directors to make such disclosure;
- **Do not disclose confidential information to the nominee** on projects likely to conflict with the company's interests.

For a shareholder or member (including a reporting issuer):

- In the case of a **loan** by the shareholder or the member to the company or an advance of funds to the company, provide, in the agreement setting out the obligations of the parties, for the company to provide certain information and honour certain commitments ("restrictive covenants");
- In the case of a subscription for shares or a membership, include in the **subscription or membership agreement** certain conditions regarding the disclosure of information (preferably, the explicit consent of all the other shareholders or members should be obtained);
- Appoint a **contact person distinct** from the nominee to look after the interests of the shareholder or the member;
- In the case of **holding companies** (e.g. SGF, Fonds de solidarité, …) which do not exercise control, arrange for the election of directors who are not employees.

[3] PWA Corporation v. Gemini Group Automated Distribution Systems Inc., 10 B.L.R. (2d)

For the company itself:

- Ensure that the chair of the board and the secretary of the company do their best to avoid placing a nominee in a conflict of interest situation by taking precautions, for example:
  - by **informing** the nominee, before transmitting any document or information to him, of the **risk** of a conflict for him arising out of a matter which must be referred to the board and of the advisability of obtaining an **independent** and confidential **opinion** regarding what he should do in this specific situation;
  - by avoiding the transmission of any relevant information or document to him before such opinion is obtained;
- Establish **rules** in advance **with shareholders** or members who intend to arrange for the election of nominees;
- Adopt a policy and guidelines for the directors which include specific provisions or operating parameters covering nominees;
- Provide **training** to the directors on the notions of "in the best interests of the company" and "conflict of interest" and on the best ways to prevent non-compliant conduct; integrate the essentials of this training into a directors' **manual** or guide.

For the nominee:

- **Disclose** any real or potential **conflict** of interest immediately, abstain from voting on the matter which presents the conflict and avoid taking cognizance of documents or information relating to the matter; if mere disclosure of the conflict may, in itself, constitutes a disclosure of confidential information or a breach of the fiduciary duty to the shareholder or the member who arranged for the nominee's election to the board of the company, resign from the board, in the case of a material conflict of interest, or obtain an opinion from an independent external legal adviser on the proper course of action;
- **Do not disclose** confidential information or documents of the company to the shareholder or to the member who arranged for his election;
- Obtain a **written acknowledgment, by the shareholder** or the member who arranged for his election, of the parameters of his independence, including specific acknowledgements that his fiduciary duty to the company takes precedence over his fiduciary duty to the shareholder or member and that the fact of honouring his obligations as a director can in no case constitute a breach of any obligation to the shareholder or member;
- Obtain a clear and broad **indemnification commitment** from the shareholder or the member who arranged for his election.

These precautions, although not exhaustive, are nevertheless a good way to guard against regrettable faux pas or unfortunate mistakes. A well-informed nominee will take the precautions that the circumstances dictate for him, whether separately or concurrently.

Conclusion

In most cases, the interests of the shareholder or of the member who arranged for the nominee's election should correspond to the best interests of the company. Nonetheless, the nominee should study the situation carefully before executing an "order" of the shareholder or the member and avoid any action that could constitute an abuse of rights or "oppression" vis-à-vis the company or other shareholders or members.

Precautions must and can be taken to avoid problems.

We invite you to consult our other bulletins and publications, especially our bulletin entitled "Corporate Directors: Suggested Precautions" (November 2005). You can access it from our web site or obtain a hardcopy version by contacting the author's assistant.

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