Recent Supreme Court Judgment on Directors' Liability

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On Friday, October 29, 2004, the Supreme Court of Canada released its decision on the appeal in **Peoples Department Stores Inc. (Trustee of) v. Wise**. This long-awaited decision was widely hoped to clarify the duties of corporate directors to creditors.

By way of background, the trustee in bankruptcy of Peoples sued the Wise brothers, former directors of Peoples, for breach of fiduciary duty. In 1998, Mr. Justice Greenberg of the Quebec Superior Court granted judgment in favour of the trustee, holding that directors owe a fiduciary duty to creditors when a corporation is in the vicinity of insolvency. In February 2003, the Quebec Court of Appeal reversed, holding that the directors' duties were owed only to the corporation, representing the interests of shareholders, and that the directors did not breach any duties.

The Supreme Court of Canada has now dismissed the trustee's appeal. In doing so, however, the court has delivered on its much hoped-for clarification of the duties of directors toward creditors, and has bestowed potentially broader rights to creditors than have ever previously been recognized anywhere, within or outside Canada. Most importantly, the court did not tie these rights to a finding that the corporation is operating in the vicinity of insolvency. The court has found that directors always owe a duty of care toward creditors.

The following are a few key findings:

- The court found that directors do not owe a statutory fiduciary duty (or duty of loyalty) under s. 122(1)(a) of the Canadian Business Corporations Act (CBCA) directly to creditors, but only to the corporation;

"At all times, directors and officers owe their fiduciary obligation to the corporation.

- The court went on to state, however:

"The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders".

- This latter statement recognizes that a corporation has many stakeholders:

"We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment".

- The court recognized that the interests of different stakeholders may change, depending upon the financial circumstances of the corporation:

"The interests of shareholders, those of the creditors and those of the corporation may and will be consistent with each other if the corporation is profitable and well capitalized and has strong prospects. However, this can change if the corporation starts to struggle financially. The residual rights of the shareholders will generally become worthless if a corporation is declared bankrupt. Upon bankruptcy, the directors of the corporation transfer control to a trustee, who administers the corporation's assets for the benefit of creditors. ...

In using their skills for the benefit of the corporation when it is in troubled waters financially, the directors must be careful to attempt to act in its best interests by creating a "better" corporation, and not to favour the interests of any one group of stakeholders. ...

In assessing the actions of directors it is evident that any honest and good faith attempt to redress the corporation's financial problems will, if successful, both retain value for shareholders and improve the position of creditors. If unsuccessful, it will not qualify as a breach of the statutory fiduciary duty".

- Hence, although the court did not recognize a fiduciary duty to creditors, it also did not recognize a fiduciary duty to shareholders per se, but only a duty owed to the corporation itself;

- The court went on to discuss the availability of the "oppression remedy" under the CBCA. This remedy permits a "complainant" (which includes a security holder, director, officer and any other person who, in the discretion of a court, is a proper person to make an application) to seek relief from the courts on the basis that the corporation or its affiliates have engaged in oppressive or unfairly prejudicial conduct, stating:

"The oppression remedy of s. 241(2)(c) of the CBCA and the similar provisions of provincial legislation regarding corporations grant the broadest rights to creditors of any common law jurisdiction ...

Section 241 of the CBCA provides a possible mechanism for creditors to protect their interests from the prejudicial conduct of directors. In our view, the availability of such a broad oppression remedy undermines any perceived need to extend the fiduciary duty imposed on directors by s. 122(1)(a) of the CBCA to include creditors. ...

In light of the availability both of the oppression remedy and of an action based on the duty of care, which will be discussed below, stakeholders have viable remedies at their disposal. There is no need to read the interests of creditors into the duty set out in s. 122(1)(a) of the CBCA".

- After having found that the fiduciary duty is owed only to the corporation (taking into consideration all stakeholders) and having affirmed the direct rights of creditors under the oppression remedy, the court went on to find that directors also owe a direct duty of care to creditors under s. 122(1)(b) of the CBCA:

"… unlike the statement of the fiduciary duty in s. 122(1)(a) of the CBCA, which specifies that directors and officers must act with a view to the best interests of the corporation, the statement of the duty of care in s. 122(1)(b) of the CBCA does not specifically refer to an identifiable party as the beneficiary of the duty. Instead, it provides that "[e]very director and officer of a corporation in exercising his powers and discharging his duties shall . . . exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." Thus, the identity of the beneficiary of the duty of care is much more open-ended, and it appears obvious that it must include creditors".

- It is noteworthy that the Supreme Court did not restrict the duty of care to creditors when the corporation is in the vicinity of insolvency - but that the duty is owed at all times.

- In discussing this issue, the court embraced a high standard of care for directors, while at the same time explicitly recognizing what is known as the "business judgment rule":

"Directors and officers will not be held to be in breach of the duty of care under s. 122(1)(b) of the CBCA if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known".

- One of the issues in the Peoples case was whether the Wise brothers could be found liable for inter-corporate financial assistance. The Quebec Court of Appeal held that this could not be improper because such financial assistance was permitted under then s. 44 of the CBCA. The Supreme Court of Canada overturned this part of the Quebec Court of Appeal's ruling, stated:

"The Court of Appeal erred in concluding that s. 44(2) served as a blanket legitimization of financial assistance given by wholly-owned subsidiaries to parent corporations. In our opinion, it is incumbent upon directors and officers to exercise their powers in conformity with the duties of s. 122(1). ...

Although s. 44(2) authorized certain forms of financial assistance between corporations, this cannot exempt directors and officers from potential liability under s. 122(1) for any financial assistance given by subsidiaries to the parent corporation".

- The Supreme Court of Canada has also provided a useful analysis of the "reviewable transaction" provisions of the Bankruptcy and Insolvency Act, disagreeing in part with the Quebec Court of Appeal's legal analysis, but concurring in the result reached in this particular case.

In summary, the decision of the Supreme Court of Canada in Peoples gives explicit recognition to the rights of creditors as stakeholders of a corporation, while at the same time providing directors with wide latitude for honest, good faith informed business judgments. Ultimately, the Wise brothers prevailed on appeal because both the Quebec Court of Appeal and the Supreme Court of Canada held, on the facts of this case, that they had acted honestly, in good faith, without negligence, and that their actions did not cause the corporation's bankruptcy.