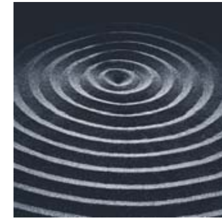
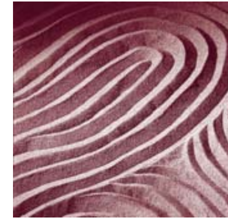
MILLER
THOMSON LLP
Barristers & Solicitors
Patent & Trade-Mark Agents

Scotia Plaza
40 King St. West, Suite 5800
P.O. Box 1011
Toronto, ON Canada
M5H 3S1
Tel. 416.595.8500
Fax.416.595.8695
www.millerthomson.com





TORONTO VANCOUVER WHITEHORSE CALGARY EDMONTON LONDON KITCHENER-WATERLOO GUELPH MARKHAM MONTRÉAL

The Duties and Responsibilities of Corporate directors in Canada - An Update

Commercial Insolvency Reporter

December 2005.

Vol.18, No.2

Jeffrey C. Carhart

This article is provided as an information service only and is not meant as legal advise. Readers are cautioned not to act on the information provided without seeking specific legal advise with respect to their unique circumstances.
© Miller Thomson LLP 1998-2007

• THE DUTIES AND RESPONSIBILITIES OF CORPORATE DIRECTORS IN CANADA — AN UPDATE •

Jeffrey C. Carhart
Miller Thomson LLP, Toronto

The term "corporate governance" entered common parlance after the collapse of Enron Corporation. (Often those words were followed by a third word — "crisis".)

Last year, I wrote a major paper entitled *Corporate Governance and Insolvency and Restructuring Professionals* (published in *The Comparative Law Yearbook of International Business* (Kluwer Law International, 2003)) and which may also be found at www.millerthomson.ca/articles) dealing with a host of corporate governance issues — and, in particular, their impact on the corporate insolvency and restructuring process in Canada.

In that paper, I discussed the following broad subjects:

- The duties and responsibilities of corporate directors in Canada — including a consideration of whether those duties extend to creditors and whether the duty is changed when a company enters the "zone of insolvency".
- The corporate oppression remedy under Canadian law (and the extent to which that remedy is available for lawsuits against corporate directors) as well as other legal grounds upon which attacks could be made on corporate directors.
- The introduction of the *Sarbanes-Oxley* legislation in the United States and its impact in Canada.

My earlier discussion culminated in a consideration of the challenging issues associated with trying to manage a company in a time of crisis through to a successful restructuring.

In recent months, two major Canadian decisions have been released which are of relevance to that overall discussion.

First, in the case of *Peoples Department Stores Inc. (trustee of) v. Wise*, [1998] Q.J. No. 3571 (S.C.J.); rev'd, [2003] J.Q. No. 505 (C.A.) (QL); rev'd, [2004] S.C.J. No. 64 (QL), the Supreme Court of Canada was called upon to analyze the duties of corporate directors in Canada.

Second, in one of his many decisions in the Stelco reorganization, Mr. Justice Farley grappled with the issue of when a company can be considered to be "insolvent" for purposes of qualification for restructuring proceedings under the *Companies' Creditors Arrangement Act* (the "CCAA") — which is, in very general terms, Canada's version of "Chapter 11" of the US *Bankruptcy Code*.

In this article, I would like to examine briefly those two decisions and their impact on corporate governance issues in Canada.

PEOPLES DEPARTMENT STORES v. WISE

THE FACT SITUATION

The essential facts in the *Peoples* case were as follows:

- In mid-1992, Wise Stores Inc. ("Wise Co.") acquired Peoples Department Stores Inc. ("Peoples Co.") from Marks & Spencer Canada Inc. — as part of Marks & Spencer's overall exit from the Canadian market.
- Both Wise Co. and Peoples Co. were in the "junior department store" business.
- After the sale, Peoples Co. was a subsidiary of Wise Co. Also, generally speaking, Peoples was in better financial shape than Wise Co.
- Three brothers in the Wise family were the majority of the directors of Wise Co. and these same three brothers were the only directors of Peoples.
- The acquisition of Peoples Co. was "fully leveraged" and a significant amount remained owing to Marks & Spencer after closing. In early 1993, Wise Co. completed a share offering which resulted in a $15 million personal gain for the Wise brothers.
- In early 1994, the three Wise brothers decided to implement a new inventory purchasing policy (the "Inventory Policy") for Peoples Co. and Wise Co. whereby, among other things:
    - Peoples Co. began purchasing all inventory within North America for both Peoples Co. and Wise Co.

- When Wise Co. needed inventory, it thereby incurred debt to Peoples Co. (instead of the third party suppliers) and, in turn, Peoples Co. incurred what could be described as disproportionately high debt to the third party suppliers.
- The arrangements between Peoples Co. and Wise Co. were not reduced to writing and, among other things, Wise Co. did not pay interest on its debt to Peoples Co. and Peoples Co. had no security interest of any kind on the inventory which it transferred to Wise Co.

- The Inventory Policy was contrary to the terms of the sale with Marks & Spencer and it demanded revised terms (including personal guarantees from the Wise brothers) when it learned of the Inventory Policy.
- Meanwhile (as a result of various factors, including the entry of Walmart into the Canadian market), the financial situation of Peoples Co. and Wise Co. deteriorated through the 1994 calendar year and, in short, both companies ended up bankrupt in January 1995.
- At the effective time of the bankruptcy, Wise Co. owed approximately $16 million to Peoples Co. as a result of inventory purchased by Peoples Co. in accordance with the Inventory Policy.
- In the bankruptcy realization, the assets of Wise Co. generated approximately $31 million and the assets of Peoples Co. generated approximately $37 million. As a result, the bank was paid out and almost all indebtedness owing to Marks & Spencer and the landlords was paid. However, approximately $21.5 million in trade debt went unpaid.

THE TRIAL DECISION AND THE QUÉBEC COURT OF APPEAL DECISION

In a careful decision, Mr. Justice Greenberg held, in part, that the Wise brothers had failed to meet the duties impressed on them as corporate directors in instituting the Inventory Policy — in short, that they had failed to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

In doing so, Greenberg J. held, among other things, that:

- The Wise brothers did not properly direct their minds to the credit-worthiness (or lack thereof) of Wise Co. or, in effect, what the financial consequences would be for Peoples Co., in deciding to implement the Inventory Policy.
- The effect of the Inventory Policy was to strip hard assets (inventory) away from Peoples Co. in exchange for an account receivable from Wise Co. — a company who was struggling financially and thus unlikely to make good on that receivable.
- No monitoring was ever done to follow-up on the financial effects of the Inventory Policy on Peoples Co. (or to monitor the level of the indebtedness).

The Québec Court of Appeal reversed Greenberg J.'s decision and held that the directors had not breached their fiduciary duties. The Québec Court of Appeal also held that the fiduciary obligations of directors are owed only to the shareholders and that any extension of such fiduciary obligations to creditors would have to be effected by legislative amendment.

THE SUPREME COURT OF CANADA DECISION

The Supreme Court of Canada decision affirmed the decision of the Québec Court of Appeal to the effect that the directors had not breached their fiduciary duties in implementing the Inventory Policy. However, certainly anyone who walks away from the decision thinking that directors cannot be sued by creditors in Canada is badly mistaken.

In that regard, although the Supreme Court did not dwell on these topics in detail, the court made it crystal clear that creditors of a corporation can sue directors of that corporation under both the derivative action provisions of the Canada *Business Corporations Act* (the "CBCA") and the (very broadly worded and very broadly based) oppression remedy provisions of the CBCA — as discussed in detail in my earlier article.

Importantly, the Supreme Court of Canada also noted the relevance of a company entering the "zone of insolvency" to a consideration of whether a creditor could mount an attack on corporate directors un-

der the oppression and derivative action provisions of the Corporate statutes. In that regard, in part, the court noted that (at para. 49):

> The fact that creditors' interests increase in relevancy as a corporation's finances deteriorate is apt to be relevant to, *inter alia*, the exercise of discretion by a court in granting standing to a party as a 'complainant' under s. 238(*d*) of the CBCA as a 'proper person' to bring a derivative action in the name of the corporation under ss. 239 and 240 of the CBCA, or to bring an oppression remedy claim under s. 241 of the CBCA.

In terms of the duties owed by corporate directors under s. 122 of the CBCA (which is worded in a way similar to that of the corresponding section of the Ontario *Business Corporations Act*) the court held that there really are two distinct duties.

First, the Court held that there is a statutory "fiduciary" duty which the court also refers to as a "duty of loyalty". The court held that this is a duty owed to the corporation itself and the court did state that the interests of the corporation cannot be confused with the interests of other stakeholders — such as creditors — when the corporation is in the vicinity of insolvency. In effect, the court said that, at all times, the duty is owed simply to the corporation itself.

What then, in the court's view, would constitute a failure to meet such a fiduciary duty of loyalty? The court seems to say that in order to establish such a breach, you would need to find evidence of a personal interest or an improper purpose in a decision by corporate directors. In the *Peoples v. Wise* case, the improper purpose would seem to have been to use the superior credit-worthiness of a more solvent company (Peoples Co.) to bootstrap the ability of a less solvent company (Wise Co.) to transact business. (Indeed, when one considers the enormous personal windfall which the directors realized from the share offering just before the Inventory Policy was introduced, personal interests seem to be involved as well.)

The Supreme Court of Canada held that the fiduciary duty of loyalty is analyzed subjectively — *i.e.*, a consideration of the subjective motivations of the directors is required.

The Supreme Court of Canada held that there is a second "duty of care" which — unlike the fiduciary duty of loyalty — is measured objectively. In analyzing whether particular conduct met the standards of the duty of care, the courts will examine the factual circumstances as well as socio-economic conditions in considering the decisions of the directors. In that regard, the court focused on the fact that the directors would not be held to be in breach if they acted prudently on a reasonably informed basis. In the *Wise* case, the Inventory Policy was put forward by the comptroller, although it was unclear as to just how much real careful analysis had ever been put into the design of the plan.

As such, the court recognized a "business judgment" approach, which has been followed in America for many years and which effectively holds that the court will not "second guess" business judgments which were made honestly and on the basis of reasonable information.

It may be noted that even if it could have been said that the Inventory Policy was not extremely prejudicial to Peoples Co. and Wise Co. at the time the policy was first put in place (and, of course, even that proposition seems very questionable) then it would seem that there must have come a point when it was obvious that the Inventory Policy had ceased to be justifiable on any fair basis and should have been discontinued. Yet the directors sat back and did nothing (about the Inventory Policy) as the two companies fell towards insolvency. As Professor Janis Sarra of the University of British Columbia noted in an excellent 2003 paper entitled "Wise People, Fiduciary Obligation and Reviewable Transactions" which she wrote after the Court of Appeal decision but before the Supreme Court of Canada decision, the introduction of the Inventory Policy:

> ...was not a "one time" decision. Even accepting that the effect of this decision was not immediately foreseeable, at some point prior to the bankruptcy, the directors must have understood that the [Inventory P]olicy was draining cash from Peoples [Co.] and did not amend or halt the policy.

Indeed, as noted above, the Inventory Policy was in violation of the "post-closing" arrangement with Marks & Spencer and when Marks & Spencer found out about the Inventory Policy they objected to it strenuously. As a result, it was agreed by Wise Co. that the Inventory Policy "would be abandoned as of January 31, 1995". Also, at that time, revised priority arrangements were entered into with the Bank and the Wise brothers were required to enter into supplementary security arrangements with Marks & Spencer. Surely, these facts set out a record of the fact that the Wise brothers were alerted to — and

seemingly acknowledged — the fact that the Inventory Policy was "wrong" well before the bankruptcies and yet those directors did nothing about the Policy *vis-à-vis* the ordinary creditors.

The Supreme Court of Canada holds (at para. 68):

> ...[W]e agree with the Court of Appeal that the *implementation of the new policy* was a reasonable business decision that was made with a view to rectifying a serious and urgent business problem in circumstances in which no solution may have been possible.... [Emphasis added.]

Again, even if it could be argued that the *implementation* or the "introduction" of the Inventory Policy was "a reasonable business decision" (which does not seem right) what about later when it was clear that the Inventory Policy was no longer appropriate? Wasn't a fresh "business judgment" required at that time?

RE STELCO

Stelco Inc. (and some of its subsidiaries) filed for protection under the *Companies' Creditors Arrangement Act* (the "CCAA") on January 29, 2004 ([2004] O.J. No. 549 (S.C.J.) (QL)).

One of the fundamental requirements of a company seeking such protection is that the company is "insolvent" (unless certain other situations exist — such as the company being formally bankrupt or subject to proceedings under the *Winding-Up and Restructuring Act*).

In early March, the United Steelworkers of America challenged whether Stelco could fairly be said to be "insolvent" on January 29th ([2004] O.J. No. 1257 (S.C.J.) (QL)).

Justice Farley noted that there is no definition of "insolvent" or "insolvency" within the CCAA. He then considered the definition of insolvent person" in the *Bankruptcy and Insolvency Act* (the "BIA") which sets out three alternative tests:

a) an inability to meet obligations as they become due;
b) a ceasing of the payment of current obligations in the ordinary course of business as they generally become due; or
c) an aggregate valuation of property which, on a "fairly conducted sale" would not be sufficient to discharge obligations becoming due.

As has been widely reported, Stelco's main problem, on entering CCAA protection, was a deficit in its pension plans — which was looming but which had not yet "crystallized". Stelco had other serious business problems although — and again as widely reported — those problems have been significantly alleviated by the surge in steel prices which has occurred during Stelco's CCAA proceeding — and which has seen the company generate large operating profits.

In short, Farley J. found that Stelco qualified as an "insolvent company" within the meaning of the CCAA. In doing so, he endorsed the three alternative tests laid out in the BIA but held that in the case of branch a) — an inability to meet obligations as they become due ([2004] O.J. No. 1257 at para. 26 (S.C.J.) (QL)):

> ...a financially troubled corporation is insolvent if it is reasonably expected to run out of liquidity within reasonable proximity of time as compared with the time reasonably required to implement a restructuring....

CONCLUSION

In summary, at this time, the Supreme Court of Canada has made it clear that creditors may sue directors under the derivative action and oppression remedy provisions of Canada's corporate statutes — and that the fact that the company was in the "zone of insolvency" at the time at which the decisions being challenged were made is a "relevant" factor in that regard. In turn, Farley J. has put forward a new definition of when a company could be said to be within that "zone of insolvency" — at least for purposes of the CCAA — namely, when it has reached the point where the company can "reasonably [be] expected to run out of liquidity within reasonable proximity of time as compared with the time reasonably required to implement a restructuring".

The Supreme Court has also made it clear that corporate directors face two duties under s. 122 of the CBCA: first, a fiduciary "duty of loyalty" which is measured subjectively — and which duty is always owed to the corporation and, second, a duty of care which is measured objectively and which necessitates a "business judgment" analysis in the American tradition.

[*Editor's note*: Jeffrey C. Carhart is a partner at Miller Thomson LLP and practises in the area of corporate insolvency and corporate finance in the firm's Toronto office.]