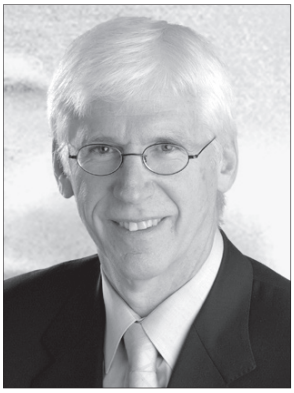
IN FACT AND IN LAW

Directors' and Officers' Liability **November 2004**

Directors Duties Defined:

The Supreme Court of Canada Confirms that Directors Owe No Fiduciary Duty to Creditors



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On October 29, 2004, the Supreme Court of Canada issued its much anticipated decision in the case of ***Peoples Department Stores (Trustee of) vs. Wise****. In a unanimous decision, the Supreme Court confirmed the decision rendered on February 2003 by the Quebec Court of Appeal, ruling that directors are not liable to creditors for losses suffered by a company as a result of decisions made in good faith prior to bankruptcy, even when those decisions may have contributed to the ultimate demise of the company.*

Ian Rose and Odette Jobin-Laberge of Lavery, de Billy represented Chubb Insurance Company of Canada, the liability insurer of the directors of Peoples, before the Quebec Court of Appeal and the Supreme Court of Canada.

The decision in the Quebec Superior Court had stated that Canadian law should move in the direction of what it perceived the law to be in Great Britain, Australia and New Zealand, by recognizing a duty to creditors in such circumstances. The Trial Judge held that directors have a duty not only to the corporation, but also to creditors of the corporation, "if the [corporation] is embarking on a course of action which will inevitably in the short run render it insolvent."

> ***"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."***

The lower Court's decision had been a subject of considerable controversy in legal circles and concern in the business community. While the decision of the Court of Appeal, in refusing to follow the Trial Judge's suggestion that Canadian company law should "evolve" in that direction, had provided some solace, the Supreme Court's decision will certainly be welcomed in the boardrooms of the country.

In its reasons for judgment, the Supreme Court discusses the duties imposed on directors by Section 122 (1) of the *Canada Business Corporations Act* (the "CBCA"), distinguishing between the two distinct duties established there, the *statutory fiduciary duty* and the *duty of care*.

The Statutory Fiduciary Duty: Section 122(1)(a) of the CBCA

While stating that the statutory fiduciary duty under the CBCA requires directors and officers to act honestly and in good faith vis-à-vis the corporation, the Supreme Court clarified this by stating that it is not required that directors and officers in all cases avoid personal gain as a direct or indirect result of their honest and good faith supervision or management of the corporation. In many cases the interests of directors and officers will innocently and genuinely coincide with those of the corporation.

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The Supreme Court adds that the various shifts in interests that naturally occur as a corporation's fortunes rise and fall do not, however, affect the content of the fiduciary duty under s. 122(1)(a) of the CBCA.
At all times, directors and officers owe their fiduciary obligation to the corporation.
The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders.

> ***"Directors and officers owe their fiduciary obligation to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders"***

Most importantly, it rules that the directors' fiduciary duty does not change when a corporation is in the nebulous 'vicinity of insolvency'. According to the Court, that phrase has not been defined and moreover, it is incapable of definition and has no legal meaning.

It goes on to say that 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.

The Supreme Court took pains to point out that the Canadian legal landscape with respect to stakeholders - of which creditors are but one set - is unique, and that, in particular, the oppression remedy of section 241 (2)(c) of the CBCA grants the broadest rights to creditors of any common law jurisdiction.

The Court states that, in its 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, and there is no need to read the interests of creditors into the duty set out in s. 122(1)(a) of the CBCA.

The Statutory Duty of Care: Section 122(1)(b) of the CBCA

Having thus ruled that there was no statutory fiduciary duty to creditors, the Supreme Court then addressed the duty of care, finding that the identity of the beneficiary is more open-ended, and must include creditors.

> ***"In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded."***

The court pointed out that the civil law serves as a supplementary source of law to federal legislation such as the CBCA, and that it is thus appropriate to refer to the *Quebec Civil Code* to determine how rights grounded in a federal statute should be addressed in Quebec.

As the CBCA provides no direct remedy for creditors, the Court referred to the provisions of the *Quebec Civil Code* (Article 1457 C.C.Q.) to determine the applicability of extra-contractual liability in this case. However, the *Civil Code* itself does not set the standard of conduct, but refers back to the law that does - in this case, the CBCA. The Court thus looked to the standards established there to determine whether or not they were breached.

The Court clarifies however, that even if there is a breach, one must also establish causality and damages in order to find the directors liable.

In reviewing the applicable standards, the Supreme Court considers that the characterization of the standard as "objective/subjective" – as was done in *Soper* vs. *Canada*[1] – could lead to confusion. It prefers to call it our objective standard, and makes it clear that the factual aspects of the circumstances surrounding the actions of the director or officer are what is important, not his or her subjective motivation. The Supreme Court thus states that one must not only take into account the primary facts of the case, but also the prevailing socio-economic conditions.

The Supreme Court points out that the emergence of stricter standards puts pressure on corporations to improve the quality of board decisions. The establishment of good corporate governance rules should be a shield, it says, that protects directors from allegations that they have breached their duty of care.

[1] [1998 1 F.C. 124]

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The Court goes on to emphasize the "*business judgment rule*", stating:

> **"Business decisions must sometimes be made, with high stakes and under considerable time pressure, in circumstances in which detailed information is not available. It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post facto*. (...)."**

> ***"Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making,"***

Citing the decision in ***Maple Leaf Foods Inc.*** vs. ***Schneider Corp.***[2] the Court confirms:

> **"The court looks to see that the directors made *a reasonable decision* not *a perfect decision*. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination." (Court's emphasis)**

The Court then states clearly that:

> **"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. In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made."**

The Court then found, in applying these principles to all the evidence, that the decision made by the directors to implement the new inventory policy was a reasonable business decision made with a view to rectifying a serious and urgent business problem in circumstances in which no solution may have been possible, and it dismissed the appeal based on this ground as well.

> ***"The establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care."***

The Reliance Defense: Section 123(4)(b) CBCA

The decision also deals with the reliance defense provided by Section 123 of the CBCA, which provides that directors are not liable if they rely in good faith on advice from professionals such as lawyers or accountants. The Supreme Court reverses the finding of the Court of Appeal on this point, clarifiying that this defense is only available when the person is truly a professional and does not include even someone such as the Vice-President, Finance and Administration, who in spite of his bachelor's degree in commerce and 15 years experience, was not a member of a professional order, subject to its regulatory overview, and did not carry independent insurance coverage for professional negligence.

Conclusion

The Supreme Court ruling clarifies a number of important issues in company law. It provides a clear restatement of the business judgment rule, and will help absolve directors when they act prudently and in good faith on a reasonably informed basis. However, referring specifically to the oppression remedy found in the CBCA and similar provisions of provincial legislation, it also points out that directors are still potentially liable to creditors and other stakeholders of a corporation, particularly when the corporation is in troubled waters financially.

A case comment on the Appeal Court's decision can be found on the Lavery, de Billy website (www.laverydebilly.com).

[2] 1998 42 OR 3rd 177

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