**From *Production Resources* to *Peoples Department Stores***
**A Similar Response by Delaware and Canadian Courts on the Fiduciary Duties of Directors to Creditors of Insolvent Companies**

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In the current environment of increasing scrutiny of corporate behavior after corporate scandals such as Enron and WorldCom, lawsuits brought by creditors or bankruptcy trustees against officers and directors have become more common.[2] The suits are taking center stage, particularly on the dockets of courts in the United States, and receive much public attention.

Against this backdrop, two prominent courts -- the Supreme Court of Canada and the Delaware Court of Chancery -- recently issued widely influential opinions within one month of each other on the subject of whether and to what extent officers and directors of an insolvent corporation owe fiduciary duties to creditors. Despite (or perhaps because of, and in an effort to reign in) the increasing frequency of such suits, both courts held that the concept of fiduciary duty law should not be used to "fill gaps [in the protection of creditors] that do not exist".[3]

This article examines in detail the facts of the *Production Resources* and *Peoples Department Stores* cases and the statutory and legal framework in Delaware and Canada. It then examines each court's analysis of the issues of fiduciary duty, duty of care, the business judgment rule, the impact of insolvency of the corporation and the available remedies for creditors. It notes the striking similarity in the courts' approaches to these issues. Specifically, it notes that where a corporation becomes insolvent, the directors' primary duty remains to the

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[2] See Sabin Willet, "The Shallows of Deepening Insolvency" (2005) 60 The Business Lawyer No. 2 at 549.
[3] *Production Resources Group, LLC v. NCT Group, Inc.,* 863 A.2d 772, 790 (Del. Ch. 2004) [hereinafter *Production Resources*]; see also *Peoples Department Stores Inc. (Trustee of) v. Wise,* [2004] 3 S.C.R. 461 [hereinafter *Peoples Department Stores*].

corporation itself, just as it did when the company was solvent; but the primary constituency whose interests are at stake obviously changes, which is a factor that directors must take into account in making good faith business decisions. This article then considers whether the decisions in *Production Resources* and *Peoples Department Stores* have opened or closed the gap on creditor claims against directors and, in such landscape, what advice may be offered to directors and officers of Delaware and Canadian corporations as to how to operate an insolvent company and make business decisions given the competing interests of stockholders and creditors.

The decisions in *Production Resources* and *Peoples Department Stores* followed inconsistent lower court decisions in Canada, varied results in US courts and much academic commentary as to the scope of director duties and what is appropriate in our societies. Corporate governance is at the heart of the debate as to the appropriate scope of fiduciary obligations of directors. Both statute in Canada and common law in the United States and Canada require directors to act in the best interests of the corporation. While the corporation is solvent, that "best interest" has been viewed as the best interests of the shareholders, who hold the residual interest.

Where the corporation has become insolvent, shareholder equity may have minimal or no value. The residual interest in an insolvency lies with the creditors. To what extent do director duties shift or expand in an insolvency to recognize the shift in the residual economic interest? Both the Delaware Court of Chancery and the Supreme Court of Canada determined that there is no fundamental shift in director duties.

Indeed, notwithstanding that the statutory and/or common law framework for Canadian and Delaware corporations differ in certain material respects, the Supreme Court of Canada and the Delaware Court of Chancery used remarkably similar language in rendering their opinions. For example, both courts recognized (a) that what is in the "'best interests of the corporation' should be read not simply as the 'best interests of the shareholders,'" but rather "[f]rom an economic perspective . . . means the maximization of the value of the corporation"[4]; (b) that the changing economic fortunes of a company often alter what is in the best interests of the corporate enterprise;[5] (c) that as a result of their becoming the residual risk bearers of the insolvent corporate enterprise, creditors have remedies through either oppression claims in Canada or derivative fiduciary duty claims in Canada and Delaware, and the arsenal of fraudulent preference and conveyance claims;[6] (d) that the nature or content of directors' duties do <u>not</u> change when a company enters the nebulous "zone of insolvency;"[7] and (e) that fiduciary duty law should not be used to fill in non-existent gaps where other, existing laws already protect creditors.[8]

The holdings of these two cases differ in a technical sense, with the Delaware Court of Chancery reiterating that fiduciary duties are owed to creditors as well as shareholders and the Supreme Court of Canada holding that no such fiduciary duties are owed to the creditors. The Supreme Court of Canada recognized a duty of loyalty, if not fiduciary duty, to creditors. However, both courts emphasized that the primary duty is owed to the corporate enterprise itself and recognized that upon insolvency, what is in the best interest of the enterprise might change as does the identity of the residual risk bearers, from the shareholders to the creditors, but the

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[4] *Peoples Department Stores*, *supra,* note 3 at 481; accord *Production Resources*, *supra*, note 3 at 791.
[5] *Peoples Department Stores*, *supra,* note 3 at 482; *Production Resources*, *supra*, note 3 at 788.
[6] *Peoples Department Stores*, *supra,* note 3 at 484-485; *Production Resources*, *supra*, note 3 at 792.
[7] *Peoples Department Stores*, *supra,* note 3 at 483; *Production Resources*, *supra*, note 3 at 790 n.56.
[8] *Peoples Department Stores*, *supra*, note 3 at 485-486; *Production Resources*, *supra*, note 3 at 790.

duty itself does not shift away from the corporation Thus, it is not clear that, from a practical standpoint, there is much of a real distinction in the two courts' holdings, nor in the practical advice attorneys should give directors of Canadian and Delaware corporations in the aftermath of *Peoples Department Stores* and *Production Resources*.

That, itself, is a welcome development, given the fact so many entities have both Delaware corporations and corporations organized in a province of Canada among their family tree. Delaware has been and continues to be a leading forum in the United States for reorganizations of insolvent companies and there are an increasing number of cross border insolvencies involving Delaware and Canadian businesses and operations. Advice to directors of North American enterprises will have some consistency.

## I. ***Production Resources*: the Delaware Court of Chancery's Most Recent Pronouncement of the Issue.**

The Delaware Court of Chancery's November 2004 opinion in *Production Resources* is likely the most important pronouncement on the nature of fiduciary duty claims brought by creditors since the Court of Chancery's 1991 opinion in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*[9] Its factual background and legal framework are set forth below to put the holding into perspective.

### A. **Factual Background.**[10]

In 1999, Production Resources Group, L.L.C. ("PRG") installed computer-controlled audio systems for NCT Group, Inc. ("NCT"). NCT failed to pay PRG for the equipment. Presumably because NCT represented that it could not pay the debt, and to avoid litigation, PRG

[9] C.A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991) [hereinafter *Credit Lyonnais*].

[10] The *Production Resources* opinion denied a motion to dismiss the complaint. As such, it accepted all well pled facts as true. The factual background presented herein, therefore, constitutes the facts as recited by the Court, given this legal standard.

agreed to enter into a "resolution agreement" with NCT which provided that in lieu of a full cash payment, PRG would accept from NCT $1,906,221 in cash and 6.7 million shares of NCT stock. After NCT failed to pay and failed to issue and register the stock, PRG sought and obtained a judgment in Connecticut state court against NCT in the amount of $2,000,000 plus interest and costs. PRG thereafter tried, without success, to collect on the judgment in Connecticut.

Thereafter, Carole Salkind, the wife of one of NCT's ex-directors, supplied NCT with over $28 million in capital in the form of equity and secured debt, even though she was a legal secretary without apparent means to account for her ability to fund $28 million of capital. As a secured creditor, Salkind obtained liens on all of the company's tangible assets, including the stock of its subsidiaries. Additionally, eight companies affiliated with the Salkind family were retained as paid consultants to the company. While Salkind was not technically a controlling stockholder of NCT, the court noted that she had de facto control over NCT:

> To be clear, Salkind is not technically NCT's controlling stockholder. Nonetheless, she is undisputedly the primary creditor of the company. The company has a history of defaulting on her loans, paying penalties and refinancing them, and her loans have been procured in exchange for convertible notes and warrants that, if exercised, would give her more shares of NCT than are currently outstanding. Furthermore, Salkind allegedly has liens on all the assets of NCT, including the stock of its subsidiaries. In short, it is fairly inferable that Salkind, at her will, can assume practical control over NCT by either exercising her foreclosure rights in default or by converting and becoming a controlling shareholder. In essence, PRG fairly alleges that Salkind is NCT's de facto controlling shareholder and that her interests are being inequitably favored over PRG's and other creditor's interest by a complicit board.[11]

Salkind proceeded to use this position of control to attempt to keep the company afloat and yet not pay the PRG judgment. For example, she made capital infusions into NCT's

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[11] *Production Resources*, *supra*, note 3 at 781.

subsidiaries, rather than NCT itself, so that the cash would not be subject to the judgment. Nevertheless, Salkind took convertible notes from NCT itself as consideration for the cash advances to its subsidiaries.[12] Additionally, the company issued or pledged to Salkind and others more shares of NCT stock than was authorized by NCT's charter -- indeed, billions of shares in excess of what was authorized. Additionally, in violation of Delaware law,[13] NCT did not hold a stockholder meeting for over two years, blaming its inability to afford the proxy materials associated with an annual meeting. The court also noted that, while failing to pay PRG and suffering shockingly large annual losses for five consecutive years, the company paid substantial performance related bonuses to two of its directors.

To protect its rights, PRG filed suit in the Delaware Court of Chancery. In addition to seeking to appoint a receiver for NCT due to its insolvency,[14] PRG alleged that NCT's directors had breached their fiduciary duties owed to PRG. According to PRG, because NCT was insolvent, its directors owed fiduciary duties directly to creditors and creditors, in their own, individual capacity, could sue for breach of fiduciary duty.

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[12] While not noted by the Court, it appears that PRG could have argued that NCT's issuance of the convertible notes was a fraudulent transfer, either due to actual fraudulent intent or because NCT itself (as opposed to the subsidiaries) did not receive "reasonably equivalent value" in exchange for the notes. See 6 Del. C. § 1304. Interestingly, the court did note that creditors typically are protected by, *inter alia*, fraudulent transfer laws.

[13] See 8 Del. C. § 211 (requiring stockholder meetings to be held at least every thirteen months).

[14] PRG sought the appointment of a receiver pursuant to Section 291 of the Delaware General Corporation Law, which permits the Court of Chancery, upon application by a stockholder or creditor, to appoint a receiver for a corporation which is held, after trial, to be insolvent. The appointment of receivers under Delaware state law has become increasingly infrequent in modern times; generally, insolvent Delaware companies either voluntarily file for bankruptcy or state law dissolution or their creditors file an involuntary bankruptcy proceeding. See David A. Drexler, Lewis S. Black Jr. and A Gilchrest Sparks, III, *Delaware Corporate Law & Practice,* § 39.01 at 39-3 (2003) (concluding that Section 291 is, for the most part, a "dead letter"). This aspect of the *Production Resources* opinion, however, is beyond the scope of this article.

**B. Legal Framework in Delaware.**

The common law[15] duties of directors and officers of a solvent corporation are well documented and understood. The primary fiduciary duties of corporate directors of a Delaware corporation are the duties of loyalty, care and good faith.[16] The duty of care requires a director to exercise the degree of care in managing the corporation's affairs that an "ordinarily careful and prudent [person] would use in similar circumstances."[17] Prior to making a business decision, directors must call forth and consider all material information reasonably available to them.[18] The duty of loyalty prohibits a corporate director from engaging in self-dealing or usurping corporate opportunities in the performance of his or her duties as a director.[19] A material financial interest held by a director which conflicts with or is potentially in conflict with the interests of the company directly implicates this duty. The duty of good faith requires directors to act in what they honestly believe to be the corporation's best interest as opposed to any other interest.[20]

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[15] Unlike the federal and common law jurisdictions of Canada, which will be discussed below, the source of Delaware fiduciary duty law is entirely based on common law, not a statute. See generally 8 Del. C. § 141 (providing that the business and affairs of a Delaware corporation are managed by or under the direction of the board of directors, but not specifying the manner in which such directors must exercise their fiduciary duties). See also *Omnicare, Inc. v. NCS Healthcare, Inc*., 818 A.2d 914, 937 (Del. 2003) ("Taking action that is otherwise legally possible, however, does not *ipso facto* comport with the fiduciary responsibilities of directors in all circumstances."); *id.* at 939 ("Delaware corporation law … is based on an enabling statute with the Court of Chancery and the Supreme Court applying principles of fiduciary duty in a common law mode on a case-by-case basis.") (Veasey, C.J., dissenting).

[16] See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986) [hereinafter *Revlon*]; *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 (Del. 1999).

[17] *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

[18] *Paramount Communications, Inc. v. QVC Network, Inc. [In re Paramount Comm. Inc. S'holder Litig.]*, 637 A.2d 34 (Del. 1994); *In re Caremark Int'l. Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) [hereinafter *Caremark*].

[19] See, e.g., *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) [hereinafter *Guth*] (corporate directors' fiduciary duty "requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest").

[20] See *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del. 1994) [hereinafter *Cede*].

In exercising these duties, directors of a Delaware corporation are protected by the business judgment rule. The business judgment rule is a judicially created presumption in favor of the non-conflicted (i.e. disinterested) corporate director that "in making a business decision [he/she] ... acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[21] The Delaware Court of Chancery has held that it is an "elementary precept of corporation law" that "in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith."[22] This is the case even where the court believes that the board decision, in hindsight, is "substantively wrong, or... 'stupid' ... 'egregious' or 'irrational.'"[23] The business judgment rule can be rebutted by a showing of a breach of the duty of care, loyalty or good faith.[24] Once the business judgment rule is rebutted, the burden shifts to the directors to prove the transaction was entirely fair.[25]

It is well settled that the fiduciary obligations of a director of a solvent company are owed to the corporation.[26] Those same fiduciary duties extend to the corporation's shareholders who, as proprietors of the business enterprise, are the ultimate beneficiaries of the corporation's growth and increased value.[27] In contrast, directors of a solvent Delaware corporation owe no

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[21] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) [hereinafter *Aronson*]; accord *Revlon*, *supra*, note 16 at 182-84.
[22] *Gagliardi v. TriFoods Intern., Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996).
[23] *In re Caremark.*, *supra*, note 18 at 967.
[24] See, e.g., *Cede, supra*, note 20.
[25] See, e.g., *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110, 1116 (Del. 1994); *Cede*, *supra*, note 20 at 361.
[26] See, e.g., *Guth*, *supra*, note 19 at 179.
[27] See, e.g., *Revlon*, *supra*, note 16 at 179; *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Aronson*, *supra*, note 21 at 811.

fiduciary obligation to the corporation's creditors.[28] Delaware courts have routinely rejected efforts to expand the fiduciary obligations of directors of solvent companies to creditors, finding that a creditor's rights are fixed by contract with the corporation.[29] Indeed, favoring a creditor over a shareholder of a solvent Delaware corporation might constitute a breach of the director's fiduciary obligations.[30]

When a Delaware corporation becomes insolvent in fact, the class of constituencies to whom directors owe duties expands to include creditors.[31] While certain non-Delaware courts have held that corporate directors no longer owe a fiduciary duty to shareholders upon insolvency, the Delaware decisions are clear that upon insolvency, directors' fiduciary duties expand to include consideration of both creditors and shareholders.[32] This principle was recently reinforced by the Bankruptcy Court for the Southern District of New York, applying Delaware law, which held that Delaware law requires that "[directors] managing a corporation 'in the vicinity of insolvency,'... must consider the best interests of the corporation, and not just the interests of either creditors or shareholders alone."[33]

There are two primary rationales provided for the expansion of fiduciary duties to include creditors. The first, the trust fund theory, provides that the directors of an insolvent

[28] See *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988) [hereinafter *Simons*] ("Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist."); *Geyer v. Ingersoll Pubs. Co.,* 621 A.2d 784, 787 (Del. Ch. 1992) [hereinafter *Geyer*].
[29] See, e.g., *Katz v. Oak Industries, Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986); *Simons*, *supra*, note 28 at 303.
[30] See *Revlon*, *supra* note 16 at 182-184.
[31] *Production Resources*, *supra*, note 3 at 790-91.
[32] See, e.g., *Credit Lyonnais*, *supra*, note 9 at *34; *Geyer*, *supra,* note 28 at 789; *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1041 (Del. Ch. 1997) (finding that directors of a company on the "lip" of insolvency did not breach their fiduciary duties in preferring the interests of common equity over preferred equity which had a liquidation preference).
[33] *Official Committee of Unsecured Creditors of RSL Com Primecall, Inc. v. Beckoff (In re RSL Com Primecall, Inc.)*, No. 01-11457, 2003 WL 22989669, *8 (Bankr. S.D. N.Y. Dec. 11, 2003).

company hold the company's assets in trust for the benefit of creditors.[34] A second rationale, the "at risk" theory, contemplates that as a corporation approaches insolvency, corporate directors may adopt high-risk strategies to save value for shareholders unless they are tasked with additional duties to creditors.[35] In doing so, directors may put creditors, who at that point are likely the true residual claimants to and beneficiaries of the corporation, at risk if they were solely charged with maximizing value for stockholders.[36]

The *Credit Lyonnais* decision noted that sometimes, the "community of interests that the corporation represents" will diverge from the best interests of stockholders even when the company is solvent, if it is in the "zone of insolvency":

> In managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.[37]

The court posited an example, in its famous footnote 55, wherein a company had but one asset -- proceeds from litigation -- and the expected value of the outcome of that litigation is less than the company's liabilities, but some possibility of a judgment or a settlement in excess of liabilities exists. By implying that "the right (both the efficient and the fair) course to follow"[38] arguably was to accept a settlement at or higher than the expected value -- thereby assuring insolvency and no return for the stockholders -- many read this footnote to hold that creditors

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[34] See, e.g., *Bovay v. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944); *Asmussen v. Quaker City Corp.*,156 A. 180, 181 (Del. Ch. 1931) [hereinafter *Asmussen*]; *American Nat'l Bank of Austin v. Mortgage America Corp. (In re Mortgage America Corp.)*, 714 F.2d 1266, 1268-69 (5th Cir. 1983).

[35] See Donald S. Bernstein and Amit Sibal, *Current Developments: Fiduciary Duties of Directors and Corporate Governance in the Vicinity of Insolvency*, 819 PLI/Comm. 653, 658 (2001).

[36] See *Credit Lyonnais*, *supra*, note 9 at *36 n.55.

[37] *Ibid.*

[38] *Ibid.*

affirmatively have the right to enforce fiduciary duties owed to them by filing suit, as long as the company was in the zone of insolvency.[39]

## C. The *Production Resources* Opinion.

### 1. The Court's *Dicta* Concerning the Zone of Insolvency and the Business Judgment Rule.

In his opinion in the *Production Resources* case, Vice Chancellor Leo Strine Jr. analyzed the underlying basis for the claim by PRG that NCT had breached fiduciary duties to PRG, a creditor of NCT. In doing so, in what amounts to several pages of scholarly *dicta*, he first took issue with the assertion that disgruntled creditors of companies that are solvent but within the zone of insolvency may affirmatively press claims of breach of fiduciary duties owed to them. The Vice Chancellor stated that "*Credit Lyonnais* provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations."[40] This shield helps creditors because "directors, it can be presumed, generally take seriously the company's duty to pay its bills as a first priority."[41] The Court stated that the cases that "[s]omewhat oddly ... read [*Credit Lyonnais*] as creating a new body of creditor's rights law"[42] are "not unproblematic".[43]

The Court noted several fundamental problems in expanding the scope of fiduciary duties to creditors merely because the company is in the zone of insolvency. First, "[a]rguably it

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39 See, e.g., *Official Committee of Unsecured Creditors of Buckhead America Corp. v. Reliance Capital Group, Inc. (In re Buckhead Am. Corp.)*, 178 B.R. 956, 968-69 (Bankr. D. Del. 1994) (denying a motion to dismiss because a complaint alleged that even if the company was not insolvent, it was at least in the zone of insolvency).
40 *Production Resources*, *supra*, note 3 at 788.
41 *Ibid.*
42 *Ibid.* at 787-88.
43 *Ibid.* at 789-790.

involves using the law of fiduciary duty to fill gaps that do not exist."[44] The Court noted that unlike stockholders, creditors can protect themselves with contractual provisions such as covenants and liens on assets. Moreover, creditors are protected by fraudulent transfer laws, implied covenants of good faith and fair dealing, and to a certain extent, federal bankruptcy law.[45] The Court therefore concluded:

> With these protections, when creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant. Having complied with all legal obligations owed to the firm's creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value.[46]

The Court also took issue with the concept that the constituency to whom fiduciary duties are owed fundamentally changes when a company is solvent but in the zone of insolvency, on two different grounds.[47]

[44] *Ibid*.

[45] *Ibid.* at 790. It is worth noting that the Court's observations might not be accurate with respect to all creditors. For example, tort creditors cannot negotiate covenants, and many trade creditors doing small business with debtors cannot afford to and do not operate under complex contracts. Additionally, the law of fraudulent transfers only protects creditors to the extent that the business decision they are challenging in fact was a transfer; if the decision they are challenging is a *failure* to act, fraudulent transfer statutes are unhelpful. Contrast this to the statutory oppression remedy under the business corporations statutes of Canada and its common law provinces and territories, which the Supreme Court of Canada in *Peoples Department Stores* relied upon in holding that an additional remedy for breach of fiduciary duties is unnecessary. The oppression remedy appears to protect creditors in a greater percentage of circumstances than the ability to negotiate covenants and fraudulent transfer law, but Delaware does not have an oppression statute.

[46] *Ibid.*

[47] Interestingly, despite citing *Production Resources* with approval on other points, a federal court in Delaware recently held that in order to maintain suit against officers and directors for breach of fiduciary duty, a liquidation trust comprised of creditors had the "burden to prove that the Director Defendants owed a duty to the creditors by proving that Hechinger was operating *in the vicinity of insolvency*." *Liquidation Trust of Hechinger Inv. Co. v. Fleet Retail Fin. Group (In re Hechinger Investment Co.)*, Civ. No. 00-840-SLR, slip op. at 17-18 (D. Del. July 19, 2005) (emphasis supplied). Given that the discussion of the zone of insolvency in *Production Resources* was *dicta* (albeit

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First, it noted that the zone "is an admittedly confusing one" to define, and is "not a simple exercise", permitting "talented creditors' lawyers [to] ... press for an expansive view".[48] Coupled with the lenient pleading standards, a legal principle permitting creditors to pursue claims against directors if the "company is within some imprecise and hard-to-define vicinity of insolvency" will lead to a proliferation of suits against directors of companies later determined to be solvent but which survive a motion to dismiss.[49] Second, presumably stockholders would not *lose* the right to sue directors of a corporation in the zone of insolvency, which means that directors could be exposed to competing suits arguing for mutually exclusive, indeed polar opposite outcomes.[50] In this regard, the Court noted that while creditors of insolvent corporations are often referred to as the company's residual risk bearers, that is not entirely accurate -- just because a company is insolvent does not mean it cannot, under any circumstances, turn around and leave some benefit for equity. Creditors have no incentive to push the company to take a course of action leading to that result -- all they care about is getting paid as close to full recovery as possible.[51]

Given this tension, the Court took pains to emphasize that faced with competing creditor and stockholder goals, the duties of directors run primarily "to the firm and their duty to responsibly maximize its value, a duty that might require pursuing a strategy that neither the

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scholarly *dicta*), and the many cases that preceded it that referred favorably to the commencement of duties to creditors upon the company's falling into the zone of insolvency, it is likely that the concept will continue to pervade despite *Production Resources* until a more definitive ruling decides the issue.

[48] *Ibid.* at 790, n.56. See also *ibid.* at 788, n.52 ("I doubt . . . that there is a magic dividing line that should signal the end to some, most, or all risk taking on behalf of . . . creditors").

[49] *Ibid.* at 790, n.56.

[50] *Ibid.*

[51] *Ibid.* at 790, n.57.

stockholders nor the creditors would prefer."[52] It often is an admittedly difficult task to balance these competing constituencies and determine what, in fact, is in the best interests of the corporate enterprise. Thus, the Vice Chancellor stated that he "doubt[s] the wisdom of a judicial endeavor to second-guess good-faith director conduct in the so-called zone".[53] In a re-affirmation of the business judgment rule in the context of creditor-initiated suits,[54] the Court questioned: "[a]bsent self-dealing or other evidence of bad faith, by what measure is a court fairly to critique the choice [of creditor versus shareholder interests] made through an award of damages?"[55]

In a recently published law review article, the former Chief Justice of the Delaware Supreme Court agreed that *Production Resources* "reaffirms what, in my view, has always been the law -- that directors who make good faith, careful judgment in the honest belief that they are acting in the best interests of the corporation should not fear liability."[56]

2. The Holding: Fiduciary Duties Are Owed to Creditors If the Company is Insolvent, But Creditors Only Have Derivative Standing to Sue.

While the Court's exploration of the zone of insolvency described above will likely have long ranging consequences and be cited in cases and articles around the United States, it is all *dicta*; the Court itself noted that "[f]ortunately, this case does not require me to explore the

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[52] *Id.* (citing *Credit Lyonnais*, *supra* note 9 at *34 n.35). See also *Geyer*, *supra*, note 28 at 789 (directors should "choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation.").

[53] *Production Resources*, *supra*, note 3 at 790, n.57.

[54] See *Angelo, Gordon & Co., L.P. v. Allied Riser Comm. Corp.*, 805 A.2d 221, 229 (Del. Ch. 2002) ("there is room for application of the business judgment rule" in suits commenced by creditors); *Liquidation Trust of Hechinger Inv. Co.*, slip op. at 18 (citing *Production Resources* for the proposition that "the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms.").

[55] *Production Resources*, *supra*, note 3 at 790, n.57. See also *ibid.* at 788, n.52 ("the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms.").

[56] E. Norman Veasey, "What Happened In Delaware Corporate Law And Governance From 1992-2004" (May 2005) 153 U. Penn. L. Rev. 1399, 1430.

metaphysical boundaries of the zone of insolvency."[57] Instead, the Court held that at least at the pleadings stage, PRG successfully alleged that NCT was insolvent in fact. Therefore, the Court applied the "more well-settled line of authority": "[w]hen a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors."[58]

Unlike allowing creditors to sue a company that merely is in the zone of insolvency, the Court held that this "uncontroversial proposition ... does not completely turn on its head the equitable obligations of the directors *to the firm itself*."[59] After all, both before and after insolvency, the directors' focus is to maximize the company's value, either as a going concern or, if appropriate, in a sale; "[t]hat much of their job does not change".[60] Rather, insolvency merely "affect[s] the constituency on whose behalf the directors are pursuing that end."[61] For example, "poor decisions by management may erode the value of the remaining assets, leaving the corporation with even less capital to satisfy its debts in an ultimate dissolution".[62] As a result, "[t]he elimination of the stockholders' interest in the firm and the increased risk to creditors is said to justify imposing fiduciary obligations towards the company's creditors on the directors."[63]

The fact that fiduciary duties are owed to creditors, however, transforms neither the relationship between any particular creditor and the company, nor the nature of the harm if directors fail to carry out their duties. The creditor-company relationship is still governed by

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[57] *Production Resources*, *supra*, note 3 at 790.
[58] *Ibid.*
[59] *Ibid.* (emphasis supplied).
[60] *Ibid.*
[61] *Ibid.*
[62] *Ibid.*
[63] *Ibid.*

contract and other law. Moreover, the Court reaffirmed its holding from a 1931 opinion that "the mere fact that directors of an insolvent firm favor certain creditors over others of similar priority does not constitute a breach of fiduciary duty, absent self-dealing."[64]

Moreover, and perhaps more central to the Court's actual holding, the nature of the harm for breach of fiduciary duties owed to creditors is a harm *to the corporation*, not to any creditor individually.[65] Thus, a suit for breach of fiduciary duties owed to creditors is a classically derivative suit. According to the Court, "[t]he reason for this bears repeating -- the fact of insolvency does not change the primary object of the director's duties, *which is the firm itself*."[66] Thus, while "the firm's directors *are said* to owe fiduciary duties to the company's creditors"[67] and "the increased risk to creditors *is said* to justify imposing fiduciary obligations towards the company's creditors"[68], those duties (as well as duties owed to stockholders) ultimately are subservient to the duties owed to the corporation itself.[69]

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[64] *Ibid.* at 791-92, citing *Asmussen,* supra, note 34. Of course, if such a course of action were pursued today, creditors would have a potential remedy: they could cause such payments to be avoided by filing an involuntary bankruptcy case and a fraudulent conveyance and/or preference lawsuit.

[65] *Ibid.* at 792 ("even in the case of an insolvent firm, poor decisions by directors that lead to a loss of corporate assets and are alleged to be a breaches [sic] of equitable fiduciary duties remain harms to the corporate entity itself.").

[66] *Ibid.* (emphasis supplied).

[67] *Ibid.* at 790-91 (emphasis supplied).

[68] *Ibid.* at 791 (emphasis supplied).

[69] One might reasonably ask whether the Vice Chancellor's language, which uncharacteristically is stated in the passive voice ("are said to owe"; "is said to justify"; "does not completely turn on its head"), implies that he believes that denominating these as fiduciary duties to creditors is either not technically accurate, confusing or not really justified, but has become settled in previous Delaware cases. After all, the Court's comment that creditors are protected by covenants, fraudulent transfer laws and federal bankruptcy law appears equally applicable to insolvent companies as to companies in the zone of insolvency. See *ibid.* at 790. Moreover, the Vice Chancellor states that the rationale for imposing fiduciary duties to creditors on directors of insolvent companies in part rests on "the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk bearers", *ibid.* at 791, a theory he shied away from earlier in the same opinion. See *ibid.* at 790, n.57 ("[o]f course, when a firm is insolvent, creditors do not become residual claimants with interests entirely identical to stockholders, they simply become the class of constituents with the key claim to the firm's remaining assets."). In any event, since the primary duty is to the company itself, and creditors cannot directly sue for breaches of duties owed to them, the phrasing likely is academic in nature.

The derivative nature of these types of claims has two primary impacts. First, before bankruptcy, a creditor who wants to commence such a suit must meet all of the typical requirements of derivative suits. For example, demand must either be refused or excused, and presumably there could be representative plaintiff issues and continuous ownership (in this case, indebtedness) requirements.[70] However, the Court of Chancery's holding that these types of suits are derivative in nature should have much less of an impact on the litigation of such suits once a bankruptcy case has been filed.[71] In a bankruptcy case, a trustee or a debtor in possession (or a post-confirmation liquidation trust) unquestionably has direct standing to bring causes of action for breach of fiduciary duties. Further, the creditors committee can also move to obtain standing to pursue derivative claims.[72] In either case, the issue outside of bankruptcy -- certain disgruntled creditors attempting to challenge the ongoing conduct of a board of directors that remains in control of the company and to receive damages resulting from that conduct -- is rarely encountered in bankruptcy adversary proceedings.

The second primary impact of the holding that these claims are derivative in nature is that directors can be exculpated from liability under certain circumstances -- the subject described immediately below.

3. Exculpation of Directors From Personal Liability.

While the Court of Chancery in *Production Resources* denied a motion to dismiss most counts of the complaint, it granted pursuant to 8 Del. C. §102(b)(7) the motion to dismiss the

[70] See 8 Del. C. § 327; Ch. Ct. R. Civ. P. 23.1

[71] See Russell C. Silberglied and Kimberly D. Newmarch, "Production Resources Decision: A Retreat from the Law on Fiduciary Duties to Creditors of Insolvent Companies or Merely an Explanation of Standing Requirements?" *The Bankruptcy Strategist*, March 2005.

[72] See, e.g., *Official Comm. Of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 566 (3d Cir. 2003).

count which sought damages for breach of the duty of care. Pursuant to section 102(b)(7) of the Delaware General Corporation Law, a corporation may include in its certificate of incorporation a provision that exculpates its directors from personal liability "to the corporation or its stockholders," for monetary damages for breach of the fiduciary duty of care.[73] The statute makes no express mention of whether such an exculpation clause in a certificate of incorporation also shields directors from personal liability if the suit for personal liability is filed by a creditor.

Prior to the *Production Resources* decision, three non-Delaware federal courts had addressed the issue, and two held that a section 102(b)(7) exculpation clause does *not* shield directors from personal liability for suits filed by the corporation's creditors for breach of the duty of care or waste of the corporation's assets.[74] Those courts reasoned that the statute did not specifically mention creditors and therefore did not cover suits filed by creditors.[75] Additionally, they held that a certificate of incorporation is a contract between a corporation and its stockholders, and not a contract between the corporation and its creditors.[76] Thus, according to those courts, because creditors never contractually agreed to such a provision, the section 102(b)(7) exculpation clause is not enforceable against such creditors.

In *Production Resources*, the Court of Chancery held that a section 102(b)(7) exculpation clause *does* protect directors from suits brought by creditors. The holding was guided by the Court's decision that suits by creditors for breach of fiduciary duties by directors are derivative in nature. Thus, even when a creditor derivatively prosecutes such a suit, it is the corporation's

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[73] 8 Del. C. §102(b)(7).

[74] See *Pereira v. Cogan*, No. 00 CIV 619 (RWS), 2001 WL 243537 (S.D.N.Y. Mar. 8, 2001); *Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, No. 97C7934, 97C6043, 2000 WL 28266 (N.D. Ill. Jan. 12, 2000) [hereinafter *Steinberg*]; but see *Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Int'l., Inc.)*, 208 B.R. 288 (Bankr. Mass. 1997); *Pereira v. Farace*, 413 F. 3d 330 (2nd Cir. 2005).

[75] See *Pereira*, *supra*, note 74 at *10; *Steinberg*, *supra*, note 74 at *8.

[76] *Ibid.*

claim. Therefore, it fits within the literal wording of section 102(b)(7): "to *the corporation* or its stockholders." (emphasis added).

In addition to fitting within the literal wording of the section 102(b)(7), the Court of Chancery also held that the legislative policy behind section 102(b)(7) would be frustrated if the Court of Chancery were to follow the *Pereira* and *Steinberg* decisions. It has long been noted that the policy behind the enactment of section 102(b)(7) was to encourage talented individuals to serve as directors of Delaware corporations, free from fear that they would be held personally liable if their good faith decisions later turned out to have been poor ones.[77] Thus, if the Court of Chancery were to hold that directors might have to pay out-of-pocket damages to creditors who challenged their good faith, disinterested decision making, a section 102(b)(7) exculpation clause would be essentially gutted and ineffective at the time it is most needed. After all, the court reasoned, suits are most likely to be filed when there is a reason to second guess the directors because the company's fortunes turned out poorly, and therefore that is when directors need the protections of section 102(b)(7) the most.

*Production Resources* has already been followed by the United States District Court for the District of Delaware (the "District Court"). In *Star Telecommunications*, the District Court held that *Production Resources* is the law of Delaware that should be followed when deciding issues involving section 102(b)(7) of the Delaware General Corporation Law.[78] Additionally, although neither section 102(b)(7) nor the corporation's charter were mentioned in the complaint filed by the official committee of unsecured creditors, the District Court invoked section 102(b)(7) as a defense on a motion to dismiss the case pursuant to Federal Rule of Civil

[77] E. Norman Veasey, Jesse A. Finkelstein and C. Stephen Bigler, "Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance," 42 Bus. Law. 399 (Feb. 1987).
[78] *Star Telecommunications*, 2004 WL 2980736, at *11.

Procedure 12(b)(6). This holding is for the most part consistent with the Delaware Supreme Court's holding that a case can be dismissed at the pleadings stage by invoking a section 102(b)(7) clause, albeit introducing this outside document converts the motion to dismiss to one for summary judgment; despite the conversion, a plaintiff cannot take discovery on the 102(b)(7) clause unless it has a good faith basis to challenge its authenticity or the propriety of its adoption.[79]

Thus, *Star Telecommunications* makes it clear that if a Delaware corporation's certificate of incorporation contains a section 102(b)(7) exculpation clause, the holding of *Production Resources* is applicable in suits brought in the bankruptcy court. Accordingly, directors are shielded from personal liability for monetary damages for breach of their duty of care regardless of whether such suits are initiated by the corporation, stockholders, creditors or an official committee of unsecured creditors. On June 30, 2005, the Second Circuit Court of Appeals agreed, reversing *Pereira* and citing *Production Resources* with approval.[80] In so holding, the Second Circuit confirmed that (a) suits brought by bankruptcy trustees also are governed by section 102(b)(7), and (b) that courts outside of Delaware will look to *Production Resources* as the authority to apply when confronted with these issues.

## II. Peoples v. Wise: the Supreme Court of Canada Addresses Director Duties to Creditors.

The principal question raised before the Supreme Court of Canada in *Peoples Department Stores* is whether directors of a corporation owe a fiduciary duty to the corporation's

[79] *Malpiede v. Townson*, 780 A.2d 1075, 1091-92 (Del. 2001).
[80] *Pereira v. Farace*, 413 F. 3d. 330 (2d Cir. 2005).

creditors comparable to the statutory duty owed to the corporation. Although the Court put the question before it in such simple terms and decided that no such fiduciary duty exists, it took the opportunity, as did the Delaware Court, to explore in *dicta* the duties and responsibilities of directors of both solvent and insolvent corporations.

The decision of the Supreme Court of Canada was released in late October 2004. Although the Court did not have the benefit of the decision in *Production Resources*, it considered the U.S. approach to the "best interests of the corporation", "the trust doctrine", and the "business judgment rule". It cited with favour an article co-authored by Vice Chancellor Leo Strine, Jr., "Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law", who was about to release his opinion in *Production Resources*.[81] Like the Delaware Court, the Supreme Court of Canada stated that the primary duty of the directors is to act in the best interests of the corporation.

## A. <u>**Factual Background**</u>

Wise Stores Inc. ("Wise") was founded by Alex Wise in 1930 as a small clothing store in Montreal, Quebec. By 1992, through internal growth and acquisitions, it had become a publicly traded company operating 50 locations with annual sales of approximately $100 million. The stores were, for the most part, located in urban areas in Quebec. The founder's three sons, Lionel, Ralph and Harold Wise (the "Wise brothers"), were majority shareholders, officers, and directors of Wise. Together, they controlled 75 percent of the firm's equity.

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[81] William T. Allen, Jack B. Jacobs and Leo E. Strine, Jr., "Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law" (2001) 26 Del. J. Corp. L. 859. Vice Chancellor Strine's co-authors in this article are former Chancellor Allen, who authored the *Credit Lyonnais* decision cited *supra,* note 9, and Justice Jacobs of the Delaware Supreme Court.

In 1992, Peoples Department Stores ("Peoples") had been in business continuously in one form or another for 78 years. It had operated as an unincorporated division of Marks & Spencer Canada Inc. ("M & S") until 1991, when it was incorporated as a separate company. M & S itself was wholly owned by the large British firm, Marks and Spencer plc ("M & S plc"). Peoples' 81 stores were generally located in rural areas, from Ontario to Newfoundland. Peoples had annual sales of about $160 million, but was struggling financially. Its annual losses were in the neighborhood of $10 million.

By late 1991, M & S plc, the British parent company of M & S, had decided to divest itself of all its Canadian operations. Wise was the longtime interested purchaser of M & S and a deal was reached.

Wise incorporated a company, 2798832 Canada Inc., for the purpose of acquiring all of the issued and outstanding shares of Peoples from M & S. The parties entered into a share purchase agreement, with a purchase price of $27 million.

The amount of the down payment due to M & S at closing, $5 million, was borrowed from the Toronto Dominion Bank (the "TD Bank"). According to the terms of the share purchase agreement, the $22-million balance of the purchase price would be carried by M & S and would be repaid over a period of eight years. Wise guaranteed all of the obligations of 2798832 Canada Inc. pursuant to the terms of the share purchase agreement.

To protect its interests, M & S took a security interest over the assets of Peoples (subject to a priority in favour of TD Bank) and negotiated strict covenants concerning the financial management and operation of the company. In particular, Peoples could not be amalgamated with Wise until the purchase price had been paid. This prohibition, in addition to others, was presumably intended to induce Wise to refinance and pay the remainder of the purchase price as early as possible in order to overcome the strict conditions imposed upon it under the share purchase agreement.

On January 31, 1993, 2798832 Canada Inc. was amalgamated with Peoples. The new entity retained Peoples' corporate name. Since 2798832 Canada Inc. had been a wholly-owned subsidiary of Wise, upon amalgamation, the new Peoples became a subsidiary directly owned and controlled by Wise. The Wise brothers were Peoples' only directors.

Following the acquisition, Wise attempted to rationalize its operations by consolidating the overlapping corporate functions of Wise and Peoples. The joint operation of Wise and Peoples did not function smoothly.

Parallel bookkeeping combined with shared warehousing arrangements caused serious problems for both Wise and Peoples. Both the Wise' and Peoples' stores experienced numerous shipping disruptions and delays, and inventory records were incorrect and unreliable.

To address the problems, the Wise brothers agreed that they would implement a joint inventory procurement policy (the "new policy") whereby the two companies would divide purchasing responsibility. Peoples would make all purchases from North American suppliers and Wise would make all purchases from overseas suppliers. Peoples would then transfer to Wise what it had purchased for Wise from North American suppliers, charging Wise accordingly. Similarly, Wise would transfer to Peoples what it had purchased for Peoples from overseas suppliers, charging Peoples accordingly. Approximately 82 percent of the total inventory of Wise and Peoples was purchased from North American suppliers, which inevitably meant that Peoples would be extending a significant trade credit to Wise.

The new policy was implemented on February 1, 1994. The new policy was the cause of the claims against the Wise brothers following the collapse of the businesses.

By June 1994, financial statements prepared to reflect the financial position of Peoples as of April 30, 1994 revealed that Wise owed more than $18 million to Peoples. M & S was concerned about the situation and insisted that the new policy be rescinded. An agreement was executed on September 27, 1994, effective July 21, 1994, which provided that the new policy would be abandoned as of January 31, 1995. The agreement also specified that the inventory and records of the two companies would be kept separate, and that the amount owed to Peoples by Wise would not exceed $3 million.

In September 1994, in light of the fragile financial condition of the companies and the competitiveness of the retail market, the TD Bank announced its intention to cease doing business with Wise and Peoples as of the end of December 1994. Following negotiations, however, the TD Bank extended its financial support until the end of July 1995.

In December 1994, the Wise brothers presented financial statements showing disappointing results for Peoples in its third fiscal quarter. Three days later, M & S initiated bankruptcy proceedings against both Wise and Peoples. A notice of intention to make a proposal was filed on behalf of Peoples the same day. Nonetheless, Peoples later consented to the petition by M & S, and both Wise and Peoples were declared bankrupt on January 13, 1995, effective December 9, 1994.

The assets of Wise and Peoples were sufficient to cover in full the outstanding debt owed to TD Bank, satisfy the entire balance of the purchase price owed to M & S, and discharge almost all the landlords' lease claims. The bulk of the unsatisfied claims were those of unsecured trade creditors.

Following the bankruptcy, Peoples' trustee filed a petition against the Wise brothers. In the petition, the trustee claimed that they had favoured the interests of Wise over Peoples to the detriment of Peoples' creditors, in breach of their duties as directors under s. 122(1) of the *Canada Business Corporations Act* ("*CBCA*").[82]

The Quebec Superior Court found the Wise brothers liable under the *CBCA* and held that directors' duties under s.122 of the *CBCA*, which require them to take reasonable care and to act in good faith with a view to the best interests of the corporation, are owed to creditors in the vicinity of insolvency.[83] The Quebec Superior Court found that the Wise brothers breached that duty. The Wise brothers appealed. The Quebec Court of Appeal allowed the appeal.[84] It was not persuaded by considerable precedent from other jurisdictions suggesting that such duty shifted to creditors of insolvent or "near insolvent" businesses. The Trustee obtained leave to appeal to the Supreme Court of Canada.[85]

These decisions set off an intense academic debate as to the scope of director duties in Canada and the extent to which they do or do not or should or should not shift to different stakeholders when a company is insolvent or in the vicinity of insolvency. The matter has now been settled by the Supreme Court of Canada, with obiter remarkably similar to that of the Delaware Court.

## B. Legal Framework In Canada

The case came before the Supreme Court of Canada on the issue of whether directors owe a duty to creditors under the *CBCA*. As described above, the duties of directors of Delaware corporations are established by common law. Duties of directors of corporations incorporated

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[82] R.S.C. 1985, c. C-44.
[83] (1998) 23 C.B.R. (4th) 200, [1998] Q.J. No. 3571.
[84] [2003] R.J.Q. 796, 224 D.L.R. (4th) 509, 41 C.B.R. (4th) 225, [2003] R.J.Q. 796.
[85] For a comprehensive analysis of the decisions of the Quebec Superior Court and the Quebec Court of Appeal, see Janis P. Sarra, "Wise People, Fiduciary Obligation and Reviewable Transactions; Directors' Liability to Creditors" in Janis P. Sarra, ed., *Annual Review of Insolvency Law* (Toronto: Thomson Carswell, 2003); Edward M. Iacobucci, "Directors' Duties in Insolvency: Clarifying what is at Stake" (2003) 39 Can. Bus. L.J. 398.

federally under the *CBCA* or under the business corporations statutes of the common law provinces and territories of Canada are set out in the respective business corporations statutes. That directors must satisfy a duty of care is a long standing principle of the common law in Canada, although the duty of care has been reinforced by statutes that set more demanding standards.[86] The appeal before the Supreme Court of Canada focussed on the statutory rather than the common law duties owed by directors.[87]

Subsection 122(1) of the C*BCA* establishes two distinct duties to be discharged by directors and officers in managing, or supervising the management of, the corporation:

> "122(1) 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; and
>
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[88]

The Supreme Court of Canada reviewed these duties and their availability to creditors. It did so in the context of Canadian corporate law. As the common law requires in Delaware[89], directors in Canada by both statute and common law must act honestly and in good faith, with due care, diligence and skill. They must respect the confidence and trust that have been reposed in them to manage the assets of the corporation in pursuit of its objects. They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain

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86 *Peoples Department Stores, supra*, note 3 at 489.
87 *Ibid.* at 481.
88 For similar provisions in provincial legislation, see for example, Alberta *Business Corporations Act*, R.S.A. 2000, c. B-9, s. 122; Manitoba *The Corporations Act*, R.S.M. 1987, c. C225, s. 114(2), (3); Ontario *Business Corporations Act*, R.S.O. 1990, c. B. 16, s. 134.
89 See discussion at Part I.B, above.

personal benefit. They must serve the corporation selflessly, honestly and loyally.[90] If they fail to do so, they may be held accountable by the corporation itself or by its trustee in bankruptcy, or through a derivative action by shareholders or creditors. Any deference to business judgment is to be accorded only when directors have made a decision and exercised their judgment in an informed and independent fashion, after a reasonable analysis of the situation and acting on a rational basis with reasonable grounds.[91]

One of the distinctive features of Canadian corporate law is the availability of the oppression remedy, in addition to derivative claims for breach of director duties which are also available in the United States. The oppression remedy changes considerably the landscape for director duties in Canada, as compared to the United States.

Section 241(2) of the *CBCA* (and similar provisions of business corporation statutes in the common law provinces)[92] allows a "complainant" to apply to the court for an order if:

> the court is satisfied that in respect of a corporation or any of its affiliates
>
> (a) any act or omission of the corporation or any of its affiliates effects a result,
>
> (b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or
>
> (c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner
>
> that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.

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[90] *Peoples Department Stores*, *supra*, note 3 at 477.

[91] *UPM –Kymmene Corp. v. UPM-Kymmene Miramichi Inc.,* [2002] O.J. No. 2412, 2002 Carswell Int. 2096, 27 B.L.R. (3d) 53 (Ont. S.C.J.) at 126.

[92] For similar provisions in provincial legislation, see for example, Alberta *Business Corporations Act*, *supra*, note 88 at s. 242; Ontario *Business Corporations Act*, *supra*, note 88 at s. 248; British Columbia *Business Corporations Act*, S.B.C. 2002, c. 57, s. 227.

A "complainant" is defined as a security holder or former security holder, a director and officer or a former director and officer, the Director appointed by the government to administer the statute, or "any other person who, in the discretion of the Court, is a proper person to make an application".[93]

The Court has extremely broad powers under s. 241(3) of the *CBCA* to make such orders it thinks fit if it concludes that oppressive conduct has occurred. For instance, the court may make interim or final orders:

(i) restraining the conduct complained of;

(ii) appointing a receiver or receiver-manager;

(iii) liquidating and dissolving the corporation; and

(iv) compensating an aggrieved person.

Much of the litigation under the oppression remedy concerns disputes between majority and minority shareholders in closely held corporations. However, it has also been used to grant relief to creditors as well as shareholders, including orders compensating aggrieved creditors for the oppressive conduct of directors. 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 creditor as a complainant invoking the oppression remedy.[94]

The Supreme Court of Canada noted in *Peoples Department Stores* the particular Canadian corporate law landscape;

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[93] *CBCA, supra*, note 82 at s. 238; see also Ontario *Business Corporations Act, supra,* note 88 at s. 245; Alberta B*usiness Corporations Act*, *supra*, note 88 at s. 239, where the definition of "complainant" includes "a creditor" provided leave is granted by the court..

[94] *Peoples Department Stores*, *supra*, note 3 at 484-485.

> The Canadian legal landscape with respect to stakeholders is unique. Creditors are only one set of stakeholders, but their interests are protected in a number of ways. Some are specific, as in the case of amalgamation: s. 185 of the CBCA. Others cover a broad range of situations. 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: see D. Thomson, "Director, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?" (2000), 58 *U.T. Fac. L. Rev.* 31, at p. 48. One commentator describes the oppression remedy as "the broadest, most comprehensive and most open-ended shareholder remedy in the common law world": S.M. Beck, "Minority Shareholders' Rights in the 1980s" in *Corporate Law in the 80s* (1982), 311, at p. 312. While Beck was concerned with shareholder remedies, his observation applies equally to these of creditors.
>
> 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.[95]

The two instruments, statutory director duties and the oppression remedy, are aimed at different kinds of conduct, although the facts in a particular case may give rise to breaches of both.[96] Within this corporate landscape, the Court considered the statutory duties of directors under s. 241 of the *CBCA*.

## C. <u>The Decision in Peoples Department Stores</u>

The Court considered s. 122(1)(a) and s. 122(1)(b) of the *CBCA* as creating two distinct duties, designed to secure different ends, which had to be addressed separately. The first duty was referred to in the *Peoples Department Stores* case as the "fiduciary duty", the duty under s.

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[95] *Ibid.* at 484-486.

[96] For a comprehensive discussion, see E. Iacobucci and K. Davis, "Reconciling Derivative Claims and the Oppression Remedy" (2000) 12 S.C.L.R. (2d) 87.

122(a) to act honestly and in good faith with a view to the best interests of the corporation. The Court held that it is better described as the "duty of loyalty", incorporating American terminology. However, throughout its decision, the Court used the expression "statutory fiduciary duty" for purposes of clarity when referring to this duty under the C*BCA*.

The second duty was referred to in the Peoples case as the "duty of care", the duty under s. 122(b) to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances". Generally speaking, this "duty of care" imposes a legal obligation upon directors and officers to be diligent in supervising and managing the corporation's affairs.[97]

The following is a summary of the consideration by the Supreme Court of Canada of these two duties.

1. <u>The Statutory Fiduciary Duty: Section 122(1) (a) of the CBCA</u>

The statutory fiduciary duty requires directors and officers to act honestly and in good faith in respect of the corporation.[98] The Supreme Court of Canada described such duty of the directors as one to maximize the value of the corporation:

> Insofar as the statutory fiduciary duty is concerned, it is clear that the phrase the "best interests of the corporation" should be read not simply as the "best interests of the shareholders". From an economic perspective, the "best interests of the corporation" means the maximization of the value of the corporation… [99]

The Court stated 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

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[97] *Peoples Department Stores*, *supra*, note 3 at 476.
[98] *Ibid.* at 477.
[99] *Ibid*. at 481.

the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments, and the environment.[100]

However, at all times, directors and officers owe a 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 stakeholder, although those interests fall within the consideration of the directors in seeking to maximize the value of the corporation.[101]

Unlike the Delaware Court, the Supreme Court of Canada stated that the statutory fiduciary duty does not extend to creditors. However, like the Delaware Court and using similar language, it dismissed the concept of any shifting duties when a corporation is in the vicinity of insolvency. It recognized that there will be various shifts in interest that naturally occur as a corporation's fortunes rise and fall, without altering the fiduciary duty of the directors:

> The directors' fiduciary duty does not change when a corporation is in the nebulous "vicinity of insolvency". That phrase has not been defined; moreover, it is incapable of definition and has no legal meaning. What it is obviously intended to convey is a deterioration in the corporation's financial stability. 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.[102]

In *Production Resources*, Vice Chancellor Strine described the "zone of insolvency" as an "admittedly confusing one" to define and "not a simple exercise."[103] The Supreme Court of Canada took this concept to its logical conclusion and declared the "zone of insolvency" to be "incapable of definition" and as having "no legal meaning".

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[100] *Ibid*. at 482.
[101] *Ibid*. at 482-483.
[102] *Ibid*. at 483.
[103] See *supra*, note 48.

Vice Chancellor Strine held that the "fiduciary duty of directors should not be used to fill gaps that do not exist. The Supreme Court of Canada found no gap to fill as well:

> 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. Moreover, in the circumstances of this case, the Wise brothers did not breach the statutory fiduciary duty owed to the corporation.[104]

The Court found that the Wise brothers did not breach their statutory fiduciary duty. In seeking to maximize the value of the corporation, the Court described the statutory fiduciary duty of directors as the pursuit of "a better corporation". In *820099 Ontario Inc. v. Harold E. Ballard Ltd.*,[105] Mr. Justice Farley held that, in resolving a conflict between majority and minority shareholders, it is safe for directors to act to make the corporation "a better corporation". [106] The Supreme Court of Canada adopted that same expression and found that the Wise brothers did not breach their statutory fiduciary duty in seeking to make both Wise and Peoples "better corporations".[107]

2. <u>The Statutory Duty of Care: Section 122(1) (b) of the *CBCA*</u>

Unlike 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 Court commented that the duty of care in s. 122(1)(b) of the *CBCA* does not specifically refer to an identifiable party as

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[104] *Peoples Department Stores*, *supra*, note 3 at 486.
[105] *Ibid*. at 481.
[106] *Ibid*.
[107] *Ibid*.

the beneficiary of the duty. Importantly, the Court stated that the identity of the beneficiary of this duty is much more open ended and it appears "obvious" that it must include creditors.[108]

The statutory duty of care under s.122(1)(b) is characterized as an "objective standard", what a reasonably prudent person would do in comparable circumstances, and the factual aspects of the circumstances surrounding the actions of the director or officer are important.[109]

As in Delaware, deference is given to the directors under the business judgment rule. The Court held as follows:

> The contextual approach dictated by s. 122(1)(b) of the CBCA not only emphasizes the primary facts but also permits prevailing socio-economic conditions to be taken into consideration...Canadian courts, like their counterparts in the United States, the United Kingdom, Australia and New Zealand, have tended to take an approach with respect to the enforcement of the duty of care that respects the fact that directors and officers often have business expertise that courts do not. Many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made. 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*. Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the "business judgment rule", adopting the American name for the rule.[110]

A director and officer will not be held 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

[108] *Ibid*. at 488.
[109] *Ibid*. at 491.
[110] *Ibid*. at 491-492.

> 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.[111]

The court was clear. "Perfection is not demanded". Rather, the decisions made by the directors must be reasonable business decisions in light of all the circumstances about which the directors knew or ought to have known.

The Court found that the Wise brothers, in exercising their business judgment, met the requisite standard of "a reasonable business decision" based on the business judgment rule and did not breach the duty of care.[112]

## D. Opening or Closing the Gap on Creditor Claims Against Directors?

The Supreme Court of Canada clarified the fiduciary duties of directors of Canadian corporations, as did the Delaware Court of Chancery in its jurisdiction. Directors of corporations do not owe a separate fiduciary duty to creditors of a corporation in an insolvency situation. In Delaware, there is a fiduciary duty to creditors, but duties do not shift to creditors in an insolvency scenario, but rather expand to include shareholders and creditors. The nature of the duties do not change. In Canada, there is no such statutory fiduciary duty owed to the creditors, whether the corporation is solvent or not. The duty remains to the corporation and does not shift in an insolvency.

In considering the s. 122 (b) "duty of care", the Supreme Court of Canada stated that such duty extends to creditors. To what extent does such statement in obiter open the floodgates for

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[111] *Ibid*. at 493.
[112] *Ibid*.

claims by creditors against directors? The Court acknowledged that the civil law serves as a supplementary source of law to federal legislation such as the *CBCA*. Otherwise, the Court states that "the CBCA does not entitle creditors to sue directors directly for their breach of duties".[113] The Court relied on specific provisions of the *Quebec Civil Code* that gave creditors a right to bring an action for alleged breaches of statutory duties of care in Quebec. Article 1457 of the *Quebec Civil Code* requires a person to abide by rules of conduct imposed on him by "circumstances, usage or law, so as not to cause injury to another".[114]

There are no similar statutory provisions in the common law provinces and territories of Canada. The Supreme Court of Canada did not indicate in its reasons to what extent the s. 122(b) "duty of care", although it extends to creditors, could be actionable by creditors in common law jurisdictions. Directors may be sued for breach of such duty by the corporation (or the trustee in bankruptcy of the corporation for the benefit of the creditors). The cause of action of the corporation against the directors could be taken up derivatively by the creditors or other stakeholders of the corporation, if the proper steps are taken. Section 239 of the *CBCA* permits a "complainant"[115] to apply to a court for leave to bring an action in the name and on behalf of a corporation for the purpose of prosecuting the action on behalf of the body corporate. The complainant may be a creditor, if considered by the court to be a proper person to make the application.

Which leaves open the question: has *Peoples Department Stores* opened the floodgates for claims against directors or not?

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[113] *Ibid*. at 475 and 487.
[114] *Ibid*.
[115] See *supra*, note 93.

One suspects that the Supreme Court of Canada did not think it was opening the floodgates by denying a fiduciary duty to creditors and, while acknowledging a duty of care, relying on the *Quebec Civil Code* in order to make it actionable by a creditor. It made no accompanying common law analysis. To the contrary, it stated that in light of both the availability of the oppression remedy and of an action based on duty of care (derivatively if not directly, other than in Quebec), there was no need from a policy point of view to give creditors more than they already have by expanding the more onerous statutory fiduciary duties of directors to creditors. The answer will be in the future application of the *Peoples Department Stores* case.

## III. Advice for Directors of an Insolvent Company

Advice to directors of an insolvent business on either side of the border is the same. Directors have taken on the task of attempting to maximize the "value" of the corporation. In doing so, they must act prudently and on a reasonably informed basis and in the best interests of the corporation, without conflict and without regard to any outside or personal interest of such director. Courts will not interfere with the proper exercise of business judgment.

Some may say this puts the bar quite low for director conduct. As long as a director is acting honestly and reasonably, and without conflict, his or her judgment need not be perfect. Deference to business judgment provides protection for errors in judgment, but does not shield directors from liability for negligence or lack of due diligence in the decision making process.

Upon insolvency, or perhaps near insolvency, it is clear from an economic standpoint that in calling forth sufficient information to enable themselves to act in the best interests of the corporate enterprise itself on a reasonably informed basis, directors should strive to understand what is in the best interests of creditors, who in essence are the residual risk bearers of the corporation at that juncture. This is not to say that directors must pay heed only to what creditors desire: it is clear in Canada that no fiduciary duty is owed to the creditors, and in Delaware, a fiduciary duty is owed to both stockholders and creditors. However, understanding the realities of a company's economic situation and its options likely is the key to business decision making in an insolvency scenario, and thus a directors' duty of care to the corporate enterprise itself might well be judged by his or her understanding of the economic realities and the thought he or she gives to the range of options available to the corporation and their impact on all constituencies, including creditors.

When viewed in this light, the recognition in *Production Resources* of fiduciary duties to creditors of insolvent corporations and the rejection of such a concept in *Peoples Department Store*s should not effect the standard for corporate decision making in Delaware and Canada. Rather, the largest affect of *Production Resources* should be in after-the-fact litigation and who has standing to bring litigation. Standing is found in Canada through derivative claims and the oppression remedy and in Quebec, directly through the *Quebec Civil Code*. However, the great majority of such litigation is pursued after a bankruptcy case has been filed, by a trustee in bankruptcy for the benefit of the creditors. At such point, standing is typically no longer an issue.[116] As a result, the existence or non-existence of a fiduciary duty to creditors is likely a distinction with no practical difference.

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[116] See *supra*, note 71.