Dalhousie Journal of Legal Studies

Volume 14 Article 4

1-1-2005

A Canadian Solution: Recent Developments in the Law of Directors' Duties in the Context of Financially Distressed Corporations

Carina Neumueller

A CANADIAN SOLUTION: RECENT DEVELOPMENTS IN THE LAW OF DIRECTORS' DUTIES IN THE CONTEXT OF FINANCIALLY DISTRESSED CORPORATIONS

Carina Neumueller†

Abstract

The law of directors' duties in Canada has traditionally not been very concerned with creditors' interests. In the context of corporations who are nearing insolvency, the prevailing view is that the directors owe their fiduciary duty to the company as a whole. That of course begs the question of "who is the company?" Other commonwealth countries have developed significant protections for creditors and with the Supreme Court of Canada decision in Peoples v. Wise, Canada has effectively caught up and surpassed other countries in this regard. The decision made clear that directors of a financially unstable company owe a duty to other stakeholders in the corporation besides shareholders, but this duty is not fiduciary in nature. In addition, the oppression remedy, located in the Canada Business and Corporations Act, is ample means by which creditors interests will receive protection, while it also ensures that directors' discretionary decisions will not be subject to unlimited liability.

† Carina Neumueller (LL.B., University of Trier) is currently enrolled in the LL.M. program at Dalhousie Law School. She would like to thank Professor Khimji for his help with this paper.

I. Introduction

The issue of directors' liability with regard to financially troubled corporations has been the subject of debate in recent years. Unlike the judiciary in other Commonwealth jurisdictions, Canadian courts have traditionally been less willing to consider creditors' interests. The 1998 decision of Greenberg J. of the Quebec Superior Court in *Peoples Department Stores Inc. (Trustee of) v. Wise* signalled a new direction for Canadian jurisprudence.[1] The decision was considered controversial, and the appeal was heard by the Supreme Court of Canada in 2004.[2] The central issue considered was whether directors owe a duty to creditors when a corporation is on the brink of insolvency. If so, is this duty an aspect of the traditional fiduciary duty which directors owe to the company as a whole? Or it is an independent, positive duty owed directly to creditors? These questions had to be answered in light of the existence of the oppression remedy, which, in contrast to other Commonwealth jurisdictions, provides significant protection for corporate creditors in Canada. The Supreme Court of Canada restated that, even when a corporation is in "the nebulous vicinity of insolvency," the fiduciary duty under section 122 (1) (a) of the *Canada Business Corporations Act*[3] remains intact. In sum, the corporations' interests are not to be confused with the interests of its creditors. This decision clarified the issue, lifting the fog and establishing a uniquely Canadian approach which is distinct from the popular Commonwealth approach.

This paper contains five parts. The first part is a general overview of directors' fiduciary duties and the second part examines the impact of insolvency on those duties. The third part reviews the Commonwealth case law, and the fourth part contrasts this case law with Canadian jurisprudence, in particular the *Peoples* decision. The final section proposes that the oppression remedy is a workable solution. This is an approach which should not be interpreted as a defeat of creditors' interests; rather, it is an approach which successfully balances creditor protection on the one side and the viability of directors' decision-making on the other.

---

[1] (1998), 23 C.B.R. (4th) 2004, [1998] Q.J. No. 3571, [1999] R.R.A. 178, 23 C.B.R. (4th) 2004. [*Peoples (QSC)* cited to C.B.R.].

[2] *Peoples Department Stores Inc. (Trustee of) v. Wise,* 2004 SCC 68. 244 D.L.R. (4th) 564, 326 N.R. 267, J.E. 2004 - 2016, 2004 SCC 68 [*Peoples (SCC)* cited to D.L.R.].

[3] *Canada Business Corporations Act,* R.S.C. 1985, c. C-44, as am. [*CBCA*].

II. Directors' Fiduciary Duties

While managing the company, directors are subject to a fiduciary duty. This duty of loyalty has been developed by the common law courts, but is now codified[4] in section 122 (1) (a) of the *Canadian Business Corporations Act* (CBCA) which reads:

> 122(1)(a) [e]very director and officer of a corporation in exercising their powers and discharging their duties shall…act honestly and in good faith with a view to the best interest of the corporation.

The fiduciary duty is a "general standard of behaviour imposed on directors and officers in relation to their dealings with, and on behalf of, the corporation."[5] This duty is owed to the corporation itself rather than to the shareholders directly, and it covers all aspects of the directors' relationship with the corporation.[6] The objective of the fiduciary duty is to deter directors from putting their own interests before those of the corporation. Entrusted with the large task of managing the assets of the corporation, the directors are obliged by their fiduciary duty to act in good faith. In most of the cases where a breach of the duty is found, the fiduciary has made some profit at the expense of the corporation and a diversion of assets has occurred.[7]

Due to the high degree of power and control that directors exercise over the company and given that there is a constant opportunity to engage in self-interested activity, directors are held to the strictest of duties.[8] A contractual duty would not be desirable or feasible, as shareholders cannot be expected to negotiate contracts for themselves at the time of each investment. Likewise, a regular duty of care would not provide a sufficient level of protection for shareholders against the signifi-

---

[4] For background information on the codification of the fiduciary relationship see generally Carol Hansell, *Directors and Officers in Canada: Law and Practice,* vol. 2 (Toronto: Carswell, 1999) at 9-14.

[5] J. Anthony Van Duzer, *The Law of Partnerships and Corporations*, 2nd ed. (Toronto: Irwin Law, 2004) at 270.

[6] *Percival v. Wright*, [1902] 2 Ch. 421.

[7] *Ibid*. at 273. See also Edward M. Iacobucci, "A Wise Decision? An Analysis of the Relationship between Corporate Ownership Structure and Directors' and Officers' Duties" (2002) 36 Can.Bus.L.J. 337 at 345.

[8] *Teck Corp. v. Millar* (1972), 33 D.L.R (3d) 288 (B.S.S.C.), [1973] 2 W.W.R. 385 [*Teck* cited to D.L.R.].

cant amount of power yielded by directors. Due to directors exercising a level of control "which rises above day-to-day accountability to owning shareholders and which comes under some scrutiny only at annual general or at special meetings,"[9] a fiduciary duty is the best instrument for keeping their powers in check.

Shareholder primacy refers to the fact that the interests of the corporation generally coincide with the interests of the shareholders; namely, maximization of share value. Thus, the fiduciary duty has been interpreted as a duty towards the shareholders collectively, that is, "all of the shareholders, taking no one sectional interest to prevail over the others."[10] In trying to determine what the fiduciary duty requires in any particular case, the court must both consider what the shareholders would have agreed to if they had been permitted to bargain, and define the interests of the corporation in the circumstances.[11] A court will simply ask: "what was the primary or governing purpose of the directors' action?"[12] It will then only intervene if the directors' purpose is improper and does not serve the interests of the corporation. If the directors cannot prove that they acted on reasonable grounds and in the best interest of the company, then a court will be justified in finding that the directors acted for an improper purpose.[13]

The shareholder-primacy rule does not preclude management from taking into account the effect of a particular action on other stakeholders, however. No corporation will maximize share value if it ignores the interests of other stakeholders, including creditors. Some propose a more formalized duty towards the other stakeholders. However, this would seem to be both unworkable and somewhat redundant, given that when a business is operating successfully, other stakeholders interests are incidentally promoted.[14] The existing shareholder-primacy norm already allows a high degree of management discretion. It allows directors to

---

[9] *Canadian Aero Services v. O'Malley and Zarzycki,* [1974] S.C.R. 592, 40 D.L.R. (3d) 371, 11 C.P.R. (2d) 206 [*Canadian Aero Services* cited to S.C.R.]. See also Carol Hansell, *What Directors need to Know – Corporate Governance 2003* (Toronto: Carswell, 2003) at 98-99.

[10] *Palmer v. Carling O'Keefe Breweries of Canada Ltd*. (1989), 67 O.R. (2d) 161 at 168, 56 D.L.R. (4th) 128 (Ont. S.C., Div. Ct.).

[11] Van Duzer, *supra* note 5 at 271.

[12] *Teck, supra* note 8 at 312.

[13] *Teck, supra* note 8 at 315-16.

[14] Van Duzer, *supra* note 5 at 444.

take other stakeholder interests into account though not permitting them to abandon their primary goal of promoting shareholder interests.[15]

The problems which arise out of conflicting interests between shareholders and other stakeholders have been dealt with rather hesitantly by Canadian courts.[16] At some point, creditors may expect directors to address their specific interests. As will be discussed, the more complicated question is, "in addressing those interests, should the fiduciary duty normally owed to the corporation, shift towards other stakeholders."[17]

III. The Impact of Insolvency on Directors' Duties

As we have seen so far, directors owe a fiduciary duty to the corporation as a whole to act with loyalty and in good faith. However, the question of how the usual duty of directors to act in the best interests of the corporation is affected by the insolvency or near-insolvency of that corporation must still be addressed.[18] In the event of insolvency, the question is whether these general rules are still applicable, or whether the duty of the directors must shift away from the corporation and towards other stakeholders, particularly creditors. In other words, when the company is insolvent, to whom should the directors owe a duty?

A codification of the relevant common law tests of insolvency is laid down in section 2 of the *Bankruptcy and Insolvency Act*[19] (BIA), which stipulates that a corporation may be found to be insolvent, if:

> (a) for any reason, the corporation is unable to meet its obligations if they generally become due;

---

[15] Van Duzer, *supra* note 5 at 444. See also Bruce Welling et al., *Canadian Corporate Law: Cases, Notes & Materials,* 2nd ed. (Markham, Ont.: Butterworths, 2001) at 297.

[16] See for example Forsyth J.'s decision in *Re Trizec Corp*. [1994] 10 W.W.R. 127 (Alta. Q.B.) at 16, (1994), 158 A.R. 33, 21 Alta. L.R. (3d) 435, 20 B.L.R. (2d) 202, [1994] A.J. No. 577 [*Re Trizec* cited to W.W.R.].

[17] See C. Graham W. King, "Extending Fiduciary Principles to the Director-Creditor Relationship: A Canadian Perspective" (2002) 29 Man. L.J. 243.

[18] For a comprehensive discussion see Terence M. Dolan, "Bankruptcy and Insolvency Issues" in M. Patricia Richardson, ed., *Directors' and Officers' Duties and Liabilities in Canada* (Markham: McCarthy Tétrault, 1997) at Chapter 11 and Andrew Keary "The Director's Duty to Take into Account the Interests of Company Creditors: When is it triggered?" (2001) 25 Melbourne U.L. Rev. 315 at 322 [Keary "Director's Duty"].

[19] R.S.C. 1985, c. B-3, [*BIA*].

(b) the corporation has ceased paying its current obligations in the ordinary course of business as they generally become due; or

(c) the aggregate of the corporation's property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient, to enable payment of the corporation's obligations due and accruing due.

When a company is insolvent or near-insolvent, there is little or no equity remaining. It is therefore arguable that the shareholders cease to have any material interest in the assets of the corporation at insolvency. The shareholders' interests may be "considered dormant"[20] since, for practical purposes, they have already lost their investment in the corporation as compared to the creditors, who still have a stake in the company. As the court in *Kinsela v. Russell Kinsela Property Limited* explained:

> in a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. … But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. *It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration*. [emphasis added] [21]

In such a situation, does the directors' duty—once owed to the corporation itself and its shareholders—shift towards the creditors, since they are the true stakeholders of an insolvent corporation? When a company becomes insolvent, do "the best interests of the corporation" still equal "the best interests of the shareholders," or is it the best interests of the creditors that now must be given precedence? Before addressing this issue, it will be helpful to outline the basic differences between shareholders' and creditors' interests when insolvency arises.

---

[20] Wayne D. Gray "*Peoples v. Wise* and *Dylex*: Identifying Stakeholder Interests Upon or Near Corporate Insolvency – Stasis or Pragmatism?" (2003) 39 Can. Bus. L.J. 242.

[21] *Kinsela v. Russell Kinsela Property Ltd. (in Liquidation)* (1986), 4 N.S.W.L.R. 722 (C.A.), [*Kinsela*].

At the insolvency stage, the shareholder stake in the company assets appears to have less priority than the creditor stake. This creates an incentive for the shareholders to encourage the company to engage in risky investments or bargains. Directors may decide to gamble with what could end up being the creditors' funds in the hope of rescuing the company. Or, if the company's financial situation is not yet apparent to outsiders, the directors may decide to take on additional debt in order to pay off the interests of already existing creditors. If either of these strategies succeeds, the corporation will recover and the shareholder value will rise. If the strategies fail, the market value of the company will fall; however, since the shareholders will have already lost their money, it is the creditors who will bear the loss from the directors' decisions during insolvency.[22] In summary, "the onset of insolvency sufficiently alters the motivation of the company and the relative gains of externalising the cost of debt to create uncompensated risk for the creditors."[23]

The creditors, unlike the shareholders will be more interested in conservative investments which would preserve the remaining assets of the company. The traditional argument is that it is the creditors' responsibility to manage the risks which arise out of the corporation's insolvency since they have the ability to protect their interests. For example, creditors have the means to bargain effectively by negotiating contracts which include safeguards such as secured creditor status or increased rates of interest.[24] This is especially true for large financial institutions. Where creditors fail to negotiate properly, directors should not serve as insurers against their poor business judgment. Creditors' interests can be distinguished from shareholders' interests because of the fact that the shareholders' claims vary with the success of the business, while other claims, especially those of the creditors, are fixed.[25] The argument

[22] David Thomson, "Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?" (2000) 58 U.T. Fac. L. Rev. 31 at 33.

[23] Stéphane Rousseau, "The Duties of Directors of Financially Distressed Corporations: A Québec Perspective on the *Peoples* Case" (2004) 39 Can. Bus. L.J. 368 at 382.

[24] Brian Morgan and Harry Underwood, "Directors' Liability to Creditors on a Corporations' Insolvency in Light of the *Dylex* and *Peoples Department Stores* Litigation" (2004) 39 Can.Bus. L.J. 336 at 338. See also Andrew Keary "Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 Mod. L. Rev. 665 at 687 [Keary "Contractarian Concerns"].

[25] Van Duzer, *supra* note 5 at 445.

against the need for a fiduciary duty towards creditors is bolstered by legislation, such as the BIA and section 241(2)(c) of the CBCA (the so-called "oppression remedy"), which accounts for creditors' interests.

The argument against the protection of creditors' interests, however, falters on a critical fact; simply put, it is often true that by the time insolvency law becomes relevant, there are few assets remaining that the creditors can salvage. It is important to remember that the contract intended to safeguard creditors will only reflect the risks perceived at the time the negotiations were entered into, and may fail to be effective against unforeseen risks. A question then arises as to whether these common traps of contractual protection are enough to justify the establishment of a new fiduciary duty for directors towards creditors in the event of potential or actual insolvency. The corollary to this proposal is that once fiduciary duty towards creditors is found to exist, one must then determine at what precise time this duty should arise. Must the corporation be truly and deeply insolvent, or is it enough if the corporation is "at the vicinity of insolvency," a phrase used by some commentators which is itself problematic for its lack of precision.[26] Attempting to find the exact point in a corporation's life where only the creditors have an economic interest in the company amounts to an almost insoluble problem. As Christopher Nicholls explains:

> it brings to mind a variation of Zeno's paradox…before a company becomes insolvent, there must be an earlier moment when it is almost insolvent. Before that moment, there must be still an earlier point in time when the firm is *almost* almost insolvent. And so on.[27]

An extension of the fiduciary duty towards creditors thus seems not only unnecessary, as there are already creditor protection mechanisms available, but may also lead to the problem described above, that is, determining *when* exactly the duty would be triggered. Another possible solution would be the creation of a directors' duty towards the company's creditors at all times when making business decisions. This however, would put too high a stress on directors: not only would they have to

[26] See, for example, Edward M. Iacobucci, "Directors' Duties in Insolvency: Clarifying what is at Stake" (2003) 39 Can. Bus. L.J. 398 at 408.

[27] Christopher C. Nicholls, "Liability of Corporate Officers and Directors to Third Parties" (2001) 35 Can. Bus. L.J. 1 at 34. See also Keary "Director's Duty", *supra* note 18 at 326-27.

act in the interests of the corporation, but they would also have to take into account the interests of the creditors which, as we have seen, might be very different from the company's interests. Indeed, it can be argued that having to balance all the stakeholders' interests at all times would cause directors to act *too* conservatively, out of fear they may breach their duty to at least one group of stakeholders. This uncertainty might make directors avoid making the kind of resolute decisions that are required to maximise profits and shareholder value.[28] In other words, "inefficiencies may result in so far as managers shy away from decisions, fail to trade or assume responsibilities, desist from establishing effective lines of control and delegate decisions to parties less well positioned to decide relevant issues."[29] Thus, it would seem that the imposition of a new duty on directors is not the solution to the problem, nor would a new duty lead to better corporate management. Rather, it would initiate a standard of accountability that would not be enforceable, or desirable in practice.

IV. Commonwealth Jurisprudence

A significant body of jurisprudence from Australia, New Zealand and the United Kingdom has dealt with the question of whether directors should owe a fiduciary duty towards creditors and, if so, when this duty will arise. It should be noted that the approaches generally employed in other Commonwealth jurisdictions contrast sharply with the practice of Canadian jurisprudence which, until recently, has been more reluctant to recognize a duty.

A review of existing case law reveals that other Commonwealth courts have taken divergent views on the nature of the duty owed by directors to creditors. They have tended to take one of two stances on the issue: some courts perceive the duty as an aspect of the traditional fiduciary duty to act honestly and in good faith in the interests of the corporation. Other courts tend to see it as an independent duty owed directly to creditors founded either on ordinary principles of directors' duty of

[28] Keary, "Contractarian Concerns" s*upra* note 24 at 681.

[29] Vanessa Finch, *Corporate Insolvency Law – Perspectives and Principles* (Cambridge: University Press, 2002) at 544.

care.[30] Both of these approaches are relatively recent. The traditional approach to directors' duties has been to include the shareholders' interests and to exclude the interests of the creditors. Indeed, creditors' interests have been excluded from the duty even where the creditors' stake in the company's assets is much larger than the shareholders' stake, which is often the case in most modern businesses.[31]

This view changed radically in 1976, when Mason J. in the High Court of Australia case of *Walker v. Wimborne* held that, "the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and its creditors."[32] Mason J. emphasized that the best interests of the company was not restricted to shareholder interests but included creditors' interests as well. In discharging their duty to the corporation, directors should have regard both for the interests of the company and its creditors. Mason J's judgment should not be overstated. A duty owed to creditors directly and individually was not established in this case. Rather, *Walker v. Wimborne* seems to stand for the similar ratio as in *Kinsela*. Street C.J. in *Kinsela* writes: "the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors."[33] Both *Walker v. Wimborne* and *Kinsela* seem to indicate that insolvency only alters the relative weight given to shareholders' interests as opposed to creditors' interests, but does not give rise to a separate fiduciary duty owed to creditors.

The New Zealand courts have also considered this issue. In the 1995 case, *Nicholson v. Permakraft (NZ) Ltd,*. the Court of Appeal first emphasized that:

> the duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider *inter alia* the interests of creditors. For instance, creditors are entitled to consideration, in my opinion, if the company is insolvent, or nearly insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardize its solvency. [34]

---

[30] *Ibid*. at 499.

[31] See Jacob Ziegel, "Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective" (1993) 43 U.T.L.J. 511 at 517.

[32] [1976] 50 A.L.J.R. 446 at 449.

[33] *Kinsela, supra* note 21 at 732.

[34] [1985] 1 N.Z.L.R. 242 at 249.

Cooke J. went on to state that, "the directors of a company, when declaring a dividend, owe a duty not only to the company but also to its creditors"[35]. This statement leaves it somewhat unclear as to whether Cooke J. intended to create a separate duty owed to creditors, or whether the duty to creditors is part of the larger duty owed to the corporation generally. In the more recent case of *Dairy Containers Ltd. v. NZI Bank Ltd.; Dairy Containers Ltd. v. Auditor-General* however, Thomas J. cleared up some of the ambiguity when he held that, "a company owes a duty to creditors at least where the company is insolvent or nearly so."[36] From this jurisprudence, it seems that the New Zealand courts have held that the interests of an insolvent (or almost insolvent company) are in fact the interests of existing creditors.

In the United Kingdom, jurisprudence has gone a long way toward recognizing that the best interests of the corporation may include more than simply the rights of the shareholders. Moreover, several decisions show that creditors have been recognized as legitimate stakeholders in a corporation that is insolvent or nearly insolvent. Yet, as we have seen in other jurisdictions, the United Kingdom courts have struggled with the nature of this duty. Do directors owe a direct duty to creditors, or is this duty subsumed under the broader duty owed to the company? Buckley L.J. in *Horsley & Weight Ltd. (Re)*, points out that:

> [i]t is a misapprehension to suppose that the directors of a company owe a duty to the company's creditors to keep the contributed capital of the company intact….It may be somewhat loosely said that the directors owe an indirect duty to the creditors not to permit any unlawful reduction of capital to occur, but I would regard it as more accurate to say that the directors owe a duty to the company in this respect. [37]

In contrast, Lord Templeman stated in *Winkworth v. Edward Baron Development Co. Ltd.* that in his opinion:

> the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts….A duty is owed to by the directors to the company and to the creditors of the company to

[35] *Ibid*.

[36] N.Z.L.R. 701 (H.C.) at 216-17 (1994) (Lexis).

[37] [1982] 1 Ch. 442 (C.A.) at 453-54.

> ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.[38]

Lord Templeman, unlike Buckley L.J., seems to recognise a direct duty owed to creditors, in addition to the general duty owed to the corporation itself. However, he does not frame this duty as fiduciary; rather, Lord Templeman considers the duty to arise out of contractual obligations.[39] This was also clarified in the House of Lords decision in *Kuwait Asia Bank EC v. National Mutual Life Nominees Ltd.*[40] and in the more recent case of *Yukong Line Ltd. of Korea v. Rendsburg Investments Corp. of Liberia*, where Toulson J. explicitly rejected the possibility of a direct duty owed to creditors. He ruled that:

> In my judgment he does not owe a direct fiduciary duty towards an individual creditor, nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company.[41]

To summarize, in the United Kingdom the prevailing view seems to be that the fiduciary duty is owed only to the corporation. However, in the event of near insolvency, directors should also take into account the interests of creditors. Accounting for creditors' interests is "part and parcel of the more general duty owed by directors to act in the best interests of the corporation."[42]

The experience in Australia, New Zealand and The United Kingdom contrasts sharply with the Canadian jurisprudence detailed below.

V. Canadian Jurisprudential Developments

Since the 1885 case of *Bank of Toronto v. Cobourg, Peterborough and Marmora Railway Co.*[43] it was settled law in Canada that directors owe no duties to the creditors of a corporation. No fiduciary or trust relation

---

[38] [1987] 1 All. E.R. 114 (H.L.) at 118.

[39] See also Thomson, *supra* note 22 at 42.

[40] [1990] 3 All E.R. 404.

[41] [1998] 4 All E.R. 82 (Q.B.D.) at 99.

[42] Morgan and Underwood, *supra* note 24 at 347-48.

[43] (1885) 10 O.R. 376 (Ch.).

existed between these two parties, and this traditional view had been followed by the courts for almost 110 years. However, in 1994 the case of *Re Trizec Corp*.[44] seemed to signal a move away from the conventional analysis. Forsyth J. wrote:

> …a specific duty to shareholders becomes intermingled with a duty to creditors when the ability of a company to pay its debts becomes questionable. However, a wholesale transfer of fiduciary duty to creditors does not occur at the stage of proceedings where an arrangement is sought as opposed to a case where liquidation occurs.[45]

This passage seems to suggest that whenever there is a transition from solvency to insolvency, there is also a shift in the directors' fiduciary duty, from being owed to the corporation itself to being owed to the creditors. Consequently, directors are required to balance both the interests of the creditors and the company when making business decisions. Unfortunately, Forsyth J. did not elaborate on this point. He did not explain how directors would reconcile conflicting interests of creditors and shareholders. Although the judgment was a marked departure from previous case law, this hesitant and rather vague Canadian approach could hardly be considered a landmark decision when compared to the clear judgments by the other Commonwealth courts.

1. *Peoples* – the Trial Decision

Following the tentative decision in *Re Trizec Corp*, the bold decision of the Québec Superior Court in *Peoples Department Stores Inc. (Trustee of) v. Wise*[46] in 1998 seemed to change the landscape drastically. The case arose out of the bankruptcy of Wise Stores Inc. ("Wise") and its wholly owned subsidiary Peoples Department Stores Inc. ("Peoples"). The trustee in bankruptcy of Peoples brought an action against the three Wise brothers who were majority shareholders, officers and directors of Wise, and the only directors of Peoples. The trustee claimed that the Wise brothers, as directors of Peoples, had favoured the interests of

[44] *Re Trizec, supra* note 16.

[45] *Re Trizec, supra* note 16 at 139.

[46] *Peoples (QSC), supra* note 1.

Wise over Peoples to the detriment of Peoples' creditors. The trustee advanced the argument that the Wises' actions amounted to a breach of their duties as directors under section 122 (1) of the CBCA. Greenberg J. agreed with this argument and found the Wise brothers liable for breach of their fiduciary duty. In so finding, he relied heavily on the Commonwealth decisions referred to above and held that the fiduciary duty under section 122 (1) (a) of the CBCA extends to the creditors of a company when the company is insolvent or in the vicinity of insolvency. He clearly favoured the school of thought which contends that the creditors replace the shareholders as the true stakeholders of the corporation when the financial situation nears insolvency. Greenberg J. seemed to follow the propositions made by Jacob Ziegel, who as early as 1993 had opined on this issue:

> …at least where a company is insolvent or near to insolvency, …the directors' duties lie not only towards the companies shareholders, but that they also are bound to act in the best interests of the company's creditors. …[I]t is not unreasonable, in exchange for the benefit of limited liability, to impose a duty on directors not to sacrifice creditors' interests when the going gets rough….If the company is insolvent, only the creditors still have a meaningful stake in its assets.[47]

While he recognized the need to provide some form of protection for creditors in financially distressed corporations, Greenberg J. did not reveal the precise nature of the duty. He left open to interpretation whether insolvency leads to a separate duty owed directly to creditors, or whether insolvency simply changes the way in which the duty owed to the company should be displayed. Nevertheless, he referred strongly to the development in other Commonwealth countries and made it obvious that "Canadian Corporate Law should evolve in that direction."[48]

2. *Peoples* – the Appellate Decision

The Wise brothers appealed to the Québec Court of Appeal. Pelletier J.A., writing for the Court, reversed the decision of Greenberg J. on all

---

[47] *Supra* note 31 at 511 and 530.

[48] *Peoples (QSC)*, *supra* note 1 at 200.

counts.[49] Pelletier J.A. refused to accept Greenberg J.'s opinion that in an insolvent or almost insolvent corporation the interests of creditors are equal to the best interests of the corporation. He explicitly rejected the shift of duty proposed by Greenberg J.. Pelletier J. A. reasoned that there was nothing in the history of the CBCA to justify an expansion of directors' liability to third parties. He wrote that "it was not the role of the judiciary to modify the traditional meaning given to the expression 'the best interest of the corporation' in order to create a new liability regime, since this was the jurisdiction of the legislator."[50] Pelletier J.A. did, on the other hand, recognize that the creditors' interests in the management of a corporation might increase as the corporation nears bankruptcy.[51] Most importantly, Pelletier J.A. held that the duty of directors to act in the best interests of the corporation requires that they protect the legitimate interests of *all* the shareholders. In effect, the Court of Appeal recognized that in the event or in the vicinity of insolvency the interests of creditors gain importance, but clearly refrained from extending the fiduciary duty owed to the corporation towards a legal protection of creditors' interests.[52]

3. *Peoples* – the Supreme Court of Canada Decision

The trustee sought leave appeal to the Supreme Court of Canada, which was granted on August 28, 2003.[53] On Friday October 29, 2004 Major and Deschamps JJ., writing for the Court, dismissed the appeal and held in favour of the three Wise brothers. They wrote:

> [i]nsofar as the statutory fiduciary duty is concerned, it is clear that the phrase the 'best interests of the corporation' should not be read 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. However, the courts have long recognized that various other factors may be relevant in determining what directors should consider in soundly managing

---

[49] *Peoples Department Stores Inc. (Trustee of) v. Wise* (2003), 224 D.L.R. (4th) 509, 41 C.B.R. (4th) 225 (Que. C.A.).

[50] See also Rousseau, *supra* note 23 at 390.

[51] Rousseau, *supra* note 23 at 79.

[52] See also Morgan and Underwood, *supra* note 24 at 357-58.

[53] [2003] S.C.C.A. No. 133.

> with a view to the best interests of the corporation….*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 creditors or those of any other stakeholders*. [emphasis added] [54]

The Supreme Court thus explicitly distanced itself from the other Commonwealth jurisprudence, which recognizes a shift in the duty whenever a corporation enters a state of insolvency. Rather, the Supreme Court states that in resolving competing shareholders' and creditors' interests, directors are obliged to act honestly and in good faith with a view to the best interests of the corporation, and that they must be careful not to favour the interests of any one group of stakeholders. Where it is evident that the purpose of the directors was to create a "better" company, they will not be held liable for breach of duty. This will be the case even if their attempt is unsuccessful, and regardless of whether the corporation is in the "nebulous vicinity of insolvency". The court found that this phrase is "incapable of definition and has no legal meaning."[55] Major and Deschamps JJ. clearly rejected the need to read the interests of creditors into the fiduciary duty under section 122 (1) (a) of the CBCA. They pointed to the availability of other means through which the stakeholders can protect their interests. One example of such a tool is he oppression remedy in section 241 (2) (c) of the CBCA, which is unique to the Canadian legal landscape. The decision of Major and Deschamps JJ. clarifies this point:

> Creditors are only one set of stakeholders, but their interests are protected in a number of ways….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….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. [56]

[54] *Peoples (SCC)*, supra note 2 at paras. 42-43.
[55] *Ibid*. at para. 46.
[56] *Ibid*. at paras. 48-49.

In most countries, the statutory remedies are available only to members of the corporation, to shareholders only.[57] By underlining the importance of the oppression remedy, The Supreme Court of Canada acknowledges the differences between Canadian and Commonwealth legislative remedies, and this decision leads the way for future cases concerning directors' liability towards creditors. Due to this landmark decision, the courts will most likely have to consider the question of whether a creditor falls within the definition of "complainant" found in section 238 of the CBCA. In light of the Supreme Court decision, Canadians may well see the courts become more willing to recognize creditors' standing as complainants. Given the importance of the oppression remedy, a brief overview of that remedy and its availability to creditors of a corporation follows below.

VI. The Oppression Remedy

Since its introduction as part of the CBCA in 1975, the oppression remedy has been described as the broadest, most comprehensive and most open-ended remedy in the common law world. Through the means of this statutory remedy, shareholders and certain other corporate stakeholders can ensure that their interests are fairly protected in the context of corporate action and decision making.[58] It has influenced not only the content of a claim for relief, but also who may claim relief and what remedies can be sought. The more traditional remedies, such as the shareholders' derivative action, have been significantly displaced by the flexible and procedurally simple oppression action.[59] Due to the recent recognition given to creditors by the Supreme Court in *Peoples*, in this section I focus on the term "complainant" itself rather than explain in which circumstances the powers of the directors of a corporation have been exercised in a manner that is "oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder [or] creditor," as per section 241 of the CBCA.

---

[57] See for example the Australian *Corporations Act 2001*, chapter 2F, part 2F.1, section 235.

[58] G. Blair Cowper-Smith, "Shareholders' Statutory Remedies" in M. Patricia Richardson, ed., *Directors' and Officers' Duties and Liabilities in Canada* (Markham: McCarthy Tétrault, 1997) at 75.

[59] Van Duzer, *supra* note 5 at 327. See also King, *supra* note 17 at 256.

The key provisions in the CBCA are sections 238, 241 and 242, and as noted, section 238 of the CBCA defines the class of persons entitled to apply for relief from oppression. Subsections 238 (a) and (d) are particularly applicable to creditors. Subsection (a) defines "complainant" as "a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates," whereas the broader subsection (d) includes, "any other person who, in the discretion of a court, is a proper person to make an application under this Part."

Major and Deschamps JJ. stressed creditors' interests increase as a corporation nears insolvency. This should impact the discretion of a court when granting standing to a creditor as a "proper person" under paragraph 238 (d) of the CBCA. By doing so, both secured and unsecured creditors are recognized as possible parties to an oppression action. This explicit inclusion of creditors stands in contrast to the traditional reluctance of the courts to exercise their discretion to permit an action brought by a creditor, even though section 241 (2) expressly refers to the interests of creditors. In most of the instances in which creditors have been denied standing, it was argued that the creditor's interest in the affairs of the corporation was too remote, that the creditor was not in a position analogous to that of a minority shareholder, or that the creditor had no particular legitimate interest in the management of the company.[60] Given that creditors can now gain standing, directors of insolvent companies may be personally liable under the oppression remedy if creditors are treated unfairly, even if the directors made their best efforts to act in the best interests of the company. The decisions of the directors must have a proper corporate purpose that takes into account the reasonable expectations of the corporation's creditors in the circumstances under consideration.

Although this development challenges traditional corporate law notions about who corporate managers are responsible to the Supreme Court decision should not be seen as a defeat of creditors' interests. Rather, it can be seen as an enhancement to the position of creditors when they are seeking relief under the oppression remedy. Historically, a creditor has only been considered a "proper person" if the conduct of

[60] For a good summary of existing case law see Ziegel, *supra* note 31 at 528-29 and Thomson, *supra* note 22 at 50-51, as well as VanDuzer, *supra* note 5 at 337-340.

the directors constituted a breach of the underlying expectation arising from the circumstances in which the creditor's relationship with the corporation arose. After *Peoples*, it is clear that granting standing to a creditor complainant becomes increasingly likely as the corporation's financial situation deteriorates. Therefore, the oppression remedy can be seen as a better instrument for protecting creditors' interests than a claim of breach of fiduciary duty under section 122 (1) (a) of the CBCA. The oppression remedy, unlike suing for a breach of fiduciary duty, avoids the onerous determination of the precise point in time when the corporation is "nearing insolvency". Expectedly, the protection offered by the oppression remedy does not depend on the state of solvency at all, but it is, "triggered by the oppressive conduct alone and not by some combination of dereliction of duty *and* near-insolvency."[61]

One might argue that the broad scope of the oppression remedy is an incentive for creditors to convert every action against the corporation into an oppression action. But given the fact that creditors do not have standing as of right to bring an oppression remedy in every situation, such an outcome is very unlikely. It is still at the discretion of the court to grant creditors standing as a complainant under section 238 of the CBCA, however, in light of *Peoples,* a creditor's chances of being granted standing increase when the corporation is in financial distress. The need to consider one's chances of being granted status as a complainant will prevent claimants from abusing the broad discretionary remedies.

The Supreme Court of Canada obviously took these nuanced issues into account when they spoke in favour of the oppression remedy and when they rejected the extension of the fiduciary duty to creditors. The Supreme Court has presented the oppression remedy as a workable solution which balances the need for creditor protection on the one hand, while protecting directors discretion from constant potential liability on the other.

---

[61] Thomson, *supra* note 22 at 48.

VII. Conclusion

The Supreme Court of Canada decision in *Peoples* has given a clear direction for future developments in the area of directors' duties. The choice has been between developing the law of directors' fiduciary duties to include a duty benefiting creditors in the event of insolvency or near insolvency, or using the oppression remedy as a means to protect creditors' interests. Although the Supreme Court has recognized that by the time creditors can make use of their traditional contractual or insolvency remedies there is often little money left in the corporation, it has nonetheless ruled in favour of the oppression remedy and against the extension of the fiduciary duty towards corporate creditors. It has emphasized that directors owe the common law fiduciary duty to the corporation only, and that one must be careful not to intermingle creditors' interests with those of the company.

A review of the Supreme Court's decision in this case supports the conclusion that it is a balanced and appropriate ruling. Stated simply, acknowledgement of a duty owed by directors to take account of the interests of creditors when the corporation is insolvent or nearing insolvency is not necessary for the protection of creditors' interests. A distinct duty owed to creditors would have put them in a better position than the shareholders who do not have any contractual remedies if the corporation fails and they lose their investments. Moreover, the danger of such a statutory duty is that directors might start to act overly cautious, and fail to take even the most reasonable risks.[62] In any case, the oppression remedy is sufficiently broad to capture all directorial behaviour that was not in the best interests of the corporation. In a sense, it is even broader in scope than the fiduciary duty. While bad faith is a requirement for an actionable breach of fiduciary duty, however it is not an essential element for an oppression action, and such an action can consequently be applied to a much broader spectrum of behaviour.[63] It would have been superfluous to develop a whole new concept of fiduciary duty for the protection of creditors given that their interests are already protected.

---

[62] See also Keary "Contractarian Concerns", *supra* note 24 at 682-83.

[63] Janis Sarra, "The Corporate Veil Lifted: Director and Officer Liability to Third Parties" (2001) 35 Can. Bus. L.J. 55 at 62.

The Supreme Court of Canada has demonstrated Canadian independence from the Commonwealth jurisprudence and has acknowledged the uniquely broad statutory oppression remedy available in Canada as a sufficient tool for creditor protection. It confirms the traditional corporate notion that directors owe their duties only to the corporation, regardless of the corporation's financial situation, and it provides a resolution for Canadian corporate directors with regards to whose interests should be privileged while making business decisions.