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LAWYERS

## Business/Insolvency

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### Directors Duties: Finally Some Guidelines from the Supreme Court of Canada

In today's corporate environment, directors face numerous challenges and pitfalls. Directors must oversee their company's destiny and generate profits. Yet, they constantly have to remind themselves of the array of statutory liabilities which await in cases of failure: personal responsibilities for unpaid wages, taxes, deductions at source and environmental issues to name a few. In the last 25 years or so, the focus on these statutory provisions eclipsed a director's most fundamental duties: the fiduciary duty and the duty of care.

The fiduciary duty imposes upon the director the obligation to act in good faith and honestly with a view to the best interest of the corporation. The duty of care requires that a director, in making a decision, exercise a certain degree of care, diligence and skill.

The origin of these duties date back to the British Common Law. Their very existence is now enshrined in every corporate law which governs this country and yet seldom were they ever reviewed by our courts. That is until a 1998 Québec Superior Court judgment rendered in the bankruptcy of **Peoples Department Stores Inc.** ("Peoples") literally shook the Canadian corporate world.

The trial judge found that directors of Peoples had shown a reckless disregard vis-à-vis their duties owed to the corporation and condemned each of them to pay an aggregate amount of \$4,400,000.00 to the bankruptcy trustee. The trial judge also concluded that the Canadian law should impose upon directors the duty to protect the interests of the corporation's creditors.

Law professors and insolvency lawyers across the country were quick to embrace the trial judge's novel interpretation of a director's duties. Certain decisions in Ontario made favorable reference to the Peoples decision but no other director suffered the same faith as the directors of Peoples. In 2002, the Québec Court of Appeal overturned the trial

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judge's conclusions and clearly stated that the directors had not been responsible for Peoples' bankruptcy.

The Supreme Court of Canada reviewed the matter and its highly anticipated judgment was rendered on October 29, 2004. It sided with the directors and agreed that there had been no wrongdoing on their part.

#### THE FACTS

In the early 1990s, Wise Stores ("Wise") was a publicly trade company operating some 50 junior department stores with annual sales of \$100,000,000.00. The founder's three sons, Lionel, Ralph and Harold Wise were majority shareholders and directors of the company.

Peoples, with its 75 stores, was a division and then became a subsidiary of Marks & Spencer Canada Inc. ("M & S"). Peoples generated sales of \$150,000,000.00 but operated at a loss of some \$10,000,000.00 annually.

In 1992, Wise purchased Peoples for \$27,000,000.00. An important balance of sale was to be paid to M & S over a seven year period. To secure its position, M & S negotiated strict financial restrictions concerning the operations of Peoples. The corporation could not be merged with Wise until the purchase price was fully paid and Peoples was not to provide any financial assistance to Wise. The Wise brothers were appointed sole directors of Peoples.

After the acquisition, management consolidated the administrative and purchasing departments of both

companies and essentially operated them as a single entity. The same individuals dealt simultaneously with suppliers and managed the inventory on behalf of both Peoples and Wise. Parallel bookkeeping and shared warehousing arrangements led to disastrous administrative problems which drained \$10,000,000.00 of equity from the corporations.

Under pressure to resolve the situation, Lionel Wise consulted David Clément, the companies' vice-president of Administration and Finance. Clément recommended that the corporations make better use of the computer systems already in place. Only this required that one of the corporations take on the role of purchasing agent for the group, deal exclusively with the suppliers, manage the inventory and then resell the requisite merchandise to the other corporation's stores. All this could be managed by a single software which would instantaneously control purchases, deliveries and inventory status for all stores. Peoples was designated as purchasing agent for the group under this new procurement policy.

Implemented in February 1994, the new policy eliminated the administrative problems. Unfortunately, it was not well received by M & S. The policy could be used to cause Peoples to finance Wise, a situation which was prohibited under the sale agreement. M & S and Wise agreed to limit to \$3,000,000.00 the sums of money owed by Wise to Peoples and to rescind the new policy at the beginning of the next fiscal year.

In October 1994, as merchandises were massively shipped to the stores to prepare for the Christmas season, Wise's indebtedness to Peoples shattered the \$3,000,000.00 barrier and rose to \$15,000,000.00. To make matters worst, Peoples was performing poorly with lagging sales and the re-emergence of deficits in the millions. M & S could bear no more and sought the appointment of a receiver to control Peoples' assets. To counter act, Wise and Peoples sought refuge behind the **Bankruptcy and Insolvency Act** in order to present a proposal to their creditors. In January 1995, Wise and Peoples instead filed for bankruptcy. The liquidation of Wise and Peoples' assets was sufficient to cover the debts owed to M & S and to the Toronto-Dominion Bank, the only secured creditors. Trade creditors claims went unsatisfied.

The trial judge concluded that in implementing new procurement policy, Peoples' directors breached their

duties to the company. In his opinion, a reasonable person would have realized "that the new process would strip inventory away from Peoples and it would receive in return an account receivable from Wise which likely would not be collected and would be uncollectible." The trial judge later on added that in his opinion the account receivables due by Wise to Peoples caused Peoples' slide into bankruptcy.

## THE SUPREME COURT JUDGMENT

Contrary to the trial judge, the Supreme Court concluded that the new policy was a reasonable business decision made with a view to rectifying a serious problem affecting the operations of both companies. It is legitimate for directors to attempt to redress a corporation's financial problems.

The Supreme Court referred to the fiduciary duty as a "duty of loyalty". The duty requires that directors respect the trust and confidence of the shareholders who have appointed them to office. To achieve this goal, the directors must:

- Avoid conflict of interests with the corporation.
- Avoid abusing their position to gain personal benefit.
- Maintain the confidentiality of information disclosed to them in their capacity as directors.

The operations of Wise and Peoples were negatively affected by an inventory management problem. With the help of the company's Vice-President of Administration and Finance, the Wise brothers conceived and implemented a solution which ultimately resolved the situation.

They were thus motivated by the desire to make Wise and Peoples "better corporations". This motivation, in the absence of fraud, dishonesty and personal benefit on the part of the directors, is perfectly in sync with the duty of loyalty.

Traditionally, to act in the best interests of a corporation was portrayed as acting in the best interests of its shareholders. This over simplification does not fairly represent the complex modern reality in which corporations operate. Directors' decisions affect the interests of different groups who deal with these corporations: shareholders, employees, creditors, clients, governments and the community (including environmental issues). It has sometimes been said that these different groups were stakeholders in the affairs of a corporation.

It is thus legitimate for directors to consider the consequences of their decisions on one of these competing interests. But stakeholders' interests should not be confused with those of the corporation. A corporation's best interests are essentially always the same: to make it profitable, thriving and competitive. Groups of stakeholders have competing interests whose relative importance tend to shift according to each situation. It would be impossible for directors to properly manage the affairs of a corporation if their loyalty was to be directed at one group of stakeholders or another depending on the circumstances. Accordingly, the Supreme Court rejected the notion that directors' fiduciary duties were suddenly owed to the corporation's creditors as the corporation approached the vicinity of insolvency. A difficult concept for directors to respond to considering that the phrase "is incapable of definition and as no legal meaning".

Yet, even if their duties are owed to the corporation, directors, in their attempts to create a better corporation, cannot unfairly favor the interests of one group of stakeholders to the detriment of others. Even without a fiduciary duty owed to them, these groups of stakeholders are protected by law. A group or individual who have been unfairly prejudiced by the action of the directors can always seek the intervention of the court by bringing an oppression remedy claim<sup>1</sup>.

Even if it is said that the new procurement policy was adopted with a view of the best interests of Peoples, what can be said of the Wise brothers' failure to anticipate M & S' adverse reaction (the policy was after all a breach of the Sale Agreement covenants) and the impact on the corporation's cash flow and the inter-corporate indebtedness between Peoples and Wise? After all, the trial judge concluded that the new policy had caused Peoples' slide into bankruptcy. Surely directors are accountable for their bad decisions? Well not necessarily so. This is where the duty of care comes in.

The duty of care requires that directors act prudently on a reasonably informed basis. Directors must make reasonable business decisions. They do not have the burden of creating the perfect solution to all problems.

It was generally held that now the duty of care was a relaxed subjective standard. The directors had to be guilty of gross negligence or willful blindness to trigger their liability. The Supreme Court has raised the standard to an

objective level. As the Court puts it: "The emergence of stricter standards puts pressure on the corporations to improve the quality of board decisions. The establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care."

Nevertheless, the Supreme Court recognizes that courts are usually ill equipped to properly analyze the pros and cons of a particular decision. It reiterated a long standing and international approach by courts to avoid second guessing corporate decisions considering the business expertise of directors which is not shared by lawyers and judges. But judges are capable of reviewing the context and manner in which decisions were taken in order to determine "whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be reasonable business decision."

In other words, the decision must be an informed decision. Provided that the directors chose a solution within a range of reasonableness, after taking cognizance of the relevant information with reference thereto, their decision will be exempt from judicial review unless it can be shown that directors rejected "a particular alternative [which] was definitely available and clearly more beneficial to the company than the chosen transaction."

Directors across the country should be relieved to learn that they are still allowed to err without automatically triggering their personal liability.

Unexpectedly, the Supreme Court held that the duty of care was owed to all parties injured by the directors' breach, including the corporation's creditors.

As for the new procurement policy, the Court accepted the directors' position that it constituted a reasonable business decision made to cure serious and urgent problems affecting inventory management. More importantly, the Court rejected the trial judge's conclusions that the new policy had caused Peoples' insolvency. Far more important problems affecting the industry, such as a difficult economic environment and the recent arrival of Wal-Mart in Canada, were responsible for Peoples' downfall.

## CONCLUSION

As the topic of corporate governance seems to be on everyone's mind, this decision from the Supreme Court

could not come at a better time. It modernizes our understanding of directors' basic duties owed to the corporation and sets clear guidelines for directors to follow. It also preserves the fundamental protection offered to honest and well intended directors who have acted prudently and on an informed basis. Our business environment is better of today than it was six years ago when the original decision first came out.

<sup>1</sup> The Province of Québec's **Companies Act** does not provide for an oppression remedy similar to those found in other statutes across the country. The debate continues in this Province as to the extent of protection offered to stakeholders under the law.

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