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Corporate Directors: Pay Close Attention to Your Liability to Creditors – Overview of *Peoples*

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In late 2004, the Supreme Court of Canada rendered a unanimous decision in *Peoples Department Stores Inc. (Trustee of)* v. *Wise,*[1] a judgement much anticipated in the business community.

What makes this case significant is that the highest court in the land used it to shed new light on the duties and liabilities of company directors some thirty years after its decision in *Canadian Aero Service Ltd.* v. *O' Malley*.[2]

> The *Peoples* decision modernizes and clarifies this area of the law by establishing the following:
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> * In determining the best interests of the company in performing their "duty of loyalty" (their fiduciary duty), directors can take into account the interests of stakeholders such as shareholders, employees, suppliers, creditors, consumers, governments and the environment.
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> * Directors do not owe a duty of loyalty to the company's creditors by virtue of the fact that the company enters the "vicinity of insolvency."
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> * The American "business judgment rule" applies in Canadian law, protecting "reasonably informed" decisions of directors against *a posteriori* judicial scrutiny.
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> However, this decision may cause directors some anxiety in that it apparently establishes that they can incur direct extracontractual liability towards a company's creditors should they breach their duty of care and prudence.

THE FACTS

Broadly, the facts are as follows:

The directors of Peoples Department Stores Inc. ("Peoples"), a federal business corporation wholly owned by Wise Stores Inc. ("Wise"), were the three Wise brothers, who were also the directors and majority shareholders of Wise.

In order to rationalize the operations of their two overlapping companies, the Wise brothers adopted a joint inventory procurement policy pursuant to which Peoples purchased all its merchandise from North American suppliers (*i.e.*, 86% of the total), and Wise purchased its merchandise from overseas suppliers (the other 14%). The merchandise purchased by Peoples for Wise was transferred to Wise, but Peoples did not seek immediate payment. This resulted in an inter-company loan being established that reached $18 million, which Wise was unable to repay. Wise went bankrupt while it still owed a balance of $4.44 million. Peoples also had to close its doors. Its trustee in bankruptcy sued the Wise brothers for that amount, specifically alleging that they had breached their fiduciary duty and their duty of care under section 122 (1) of the *Canada Business Corporations Act* ("CBCA") by favouring the interests of Wise over those of Peoples.

The trial judge held that the fiduciary duty and the duty of care under section 122 (1) of the CBCA extend to a company's creditors when a company is insolvent or in the vicinity of insolvency. He found that the implementation by the Wise brothers, in their capacity as directors of Peoples, of a corporate policy that affected both companies was detrimental to the interests of the creditors of Peoples. The Wise brothers were therefore found liable and the trustee was awarded $4.44 million in damages.

The Court of Appeal of Québec allowed the appeals by the Wise brothers and their insurer. The Court of Appeal expressed reluctance to follow the trial judge in equating the interests of creditors with the best interests of the corporation when the corporation was insolvent or in the vicinity of insolvency, stating that an innovation in the law such as this is a policy matter more appropriately dealt with by Parliament than the courts. In this case, the Court exonerated the Wise Brothers, seeing in their conduct not a guilty breach of their duties, but an honest error in business judgement.

The Supreme Court of Canada affirmed the decision of the Court of Appeal when it ruled that the Wise brothers were not liable towards Peoples' creditors, although it fell short of fully espousing the legal reasoning advanced by the Court of Appeal.

But the Supreme Court then conducted an in-depth examination of the duties incumbent on directors of federal corporations under section 122(1) CBCA, and drew several conclusions.

LESSONS

The following rules can be extrapolated from the *Peoples* case:

- In order to determine if a matter is in "the best interests of the corporation," the board of directors can legitimately take into account the interests of stakeholders, such as shareholders, employees, suppliers, creditors, consumers, governments and the environment.

- That fact that the company enters into the "vicinity of insolvency" has no effect on the substance of directors' fiduciary duty to the corporation. If their attempts to remedy the company's financial situation prove unsuccessful, that cannot be viewed as a breach of that duty.

- Directors' duty of care, if breached, may result in extracontractual liability towards the corporation's creditors, on the basis of the principles enunciated in Article 1457 CCQ.

- Compliance with the rules of corporate governance should serve as a shield to protect directors against allegations that they have breached their duty of care, but it is no guarantee of immunity.

- Canadian courts must exercise restraint with respect to corporate business decisions, and avoid *a posteriori* scrutiny of such decisions. The "business judgment rule" protects reasonable decisions taking into consideration what the directors knew or should have known.

The only criticism, and it is significant, that can be levelled against *Peoples*, is the confusion that it engenders between directors' duty of care and their extracontractual liability to creditors. In practice, however, that confusion may have limited repercussions only for the following reasons:

- The "business judgment rule" and the rules of corporate governance, for distribution companies, will shield directors by reducing the risk that they will be found to have breached their duty of care.

- Creditors who wish to sue directors for a breach of their duty of care, must prove a causal relationship between the directors' fault and the damages they have sustained, which will require proof of very specific facts.

- Corporations can still indemnify and hold their directors harmless for breach of duty of care.

Despite all this, it will now be much more difficult for directors sued by their company's creditors to have these cases dismissed, as in the past, due to absence of any legal relation. The moment and allegation of breach of the duty of care appears in the proceeding, directors will be bound to defend themselves on the merits. As seen earlier in a recent decision of the Superior Court,[3] the Court refused a motion for dismissal, declaring the following:

> *[TRANSLATION] With respect to defendant, it is alleged that, in his capacity as director, he failed in his duties to plaintiff in that he did not see to it that the company made its payments under the terms of the agreement. (...) This is an allegation of breach. As the Supreme Court reminded us in* Peoples Department Stores Inc. (Trustee of) *v.* Wise*, 2004 SCC 68, a corporate director has a duty of care to the creditors of the company and can be held liable for damages in the event of a breach.*

(**Editor's Note:** The complete analysis of this case by the same author entitled "Corporate Directors: Pay Close Attention to Your Liability to Creditors – Extrapolating from *Peoples*" is also available on line at: http://www.fasken.com/PaulMartel_BeyondResults_Spring2005 .)

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1) 2004 SCC 68, available online at http://www.lexum.umontreal.ca/csc-scc/en/pub/2004/vol3/html/2004scr3_0461.html – The bench consisted of six judges, the seventh, Justice Iacobucci, did not participate in the judgement.
2) Note that the fiduciary duties of directors and officers impose strict obligations. *Canadian Aero Service Ltd. v. O'Malley*, [1974] S.C.R. 592, p. 609-610 confirmed that directors and officers can even be required to report profits that they realized, whether or not at the expense of the company.
3) *McGill University Hospital Centre (The) v. Fitzpatrick*, C.S.M. No. 500-17-018702-038, December 17, 2004. online at http://www.canlii.org/qc/jug/qccs/2004/2004qccs17619.html.