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WHAT IS THE DUTY OF CARE OWED TO CREDITORS IN CANADA

DUTY OF CARE

The traditional common-law view of director's duties are that Directors owe a duty of care to the corporation, and this may encompass shareholders and other stakeholders[1]. In some jurisdictions, including the United States, Australia, and New Zealand, there has been some judgments which expand these duties to encompass creditors: especially when moving towards the context of an insolvency action.

The duty of care requires the exercise of care that an ordinary, careful, and prudent person would use in similar circumstances. This standard in Canada is the same as English, American and other common-law jurisdictions. The duty is typically breached when directors act in a negligent manner, which has deviated from this standard in such a gross faction that it would not be prudent or ordinary.

CANADIAN DUTY OF CARE

In Canada, there are two rulings from the Supreme Court of Canada ('SCC') , the highest Court in the land, which touch on this subject: *Peoples Department Stores Inc. (Trustee of) v. Wise*[2] and more recently *Re BCE Inc.*[3] In *Peoples,* the Supreme Court of Canada examined the issue of director's duties in an insolvency.

[1] *Dovey v. Cory*, [1907] A.C. 446 (H.L)
[2] 2004 SCC 68 [Peoples]
[3] [2008] S.C.J. No. 37, [2008] 3 S.C.R. 560 [BCE]

The *Peoples* case concerned a Trustee in Bankruptcy's ('Trustee') claim against former directors of an insolvent corporation. In this case, the parent company and its subsidiary, had a joint buying policy for inventory, which was sold at both corporations. The downside of this arrangement, was that Peoples essentially provided unsecured assets to its subsidiary. Once the subsidiary went insolvent, Peoples was forced to declare bankruptcy and the Trustee brought a claim against the former directors.

This case started in the trial court in Quebec, and so it was necessary to distinguish the case from the Civil Law context. The SCC, in looking at applicability of the Civil Law, was drawn to article 1457 of the Quebec Civil Law. The SCC found the civil law did not set a standard of conduct. Instead, it incorporated Section 122 of the *Canadian Business Corporations Act*[4]. Therefore, the case was not limited in applicability to the Quebec law, and the standard would be founded in Canadian common-law.

The SCC reviewed Section 122(1)(a) of the *Canadian Business Corporations Act*[5]. This section requires that a director "act honestly and in good faith with a view to the best interest of the corporation."[6] The SCC held that the fiduciary duty prescribed in this section applied only to the corporation, and did not extend to creditors as independent stakeholder. It found that on the basis of a fiduciary duty, there was only a duty to the corporation and not to any other unique group of stakeholders. The court elaborated that when honouring the best interests of the corporation, it may be practical for the directors to consider the interests of other stakeholder.

[4] R.S.C. 1985, c. C-44 [CBCA]
[5] R.S.C. 1985, c. C-44 [CBCA]
[6] Supra, at Section 122

However, in looking to Section 122(1)(b), the SCC held that to, "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances,"[7] included all stakeholders: including creditors. Here, the SCC broadened the scope of the statutory duty of care by applying it to all the facts of the case. This section, along with other statutory fiduciary duties, such as environmental liability, and pension, can cause there to be personal liability on the directors of the corporation. However, it is important to recognize that without these statutory fiduciary duties, this section alone would be struggle to prove liability by a director to a creditor: especially due to the lack of an independent cause of action, which the SCC addressed further in later case law[8]. The court went beyond the statutory duty that was prescribed in Section 122(1)(b), and read in a common-law duty that was owed to creditors among other stakeholders.

BUSINESS JUDGMENT RULE

In paragraphs 44 to 47 of *Peoples*, the SCC states that while this duty is applicable, the Courts need to respect the business judgement rule and allow directors to have this exercise of discretion. Therefore, the threshold for making such a decision is a low one, and can often be surmised as following what is in the best interest of the business. If business decisions have been made in an informed manner, honestly, prudently and in good faith, they will have this defence. However, since the Trustee in *Peoples* did not bring an oppression claim, or a derivative action, this interest was not addressed. Therefore, as further discussed in *BCE* the SCC did not rule out the application of these action for a creditor or other stakeholder.

[7] *Ibid*
[8] *Infra* note 14

The SCC in effect found that there is a duty of care owed to creditors, but that this duty of care is easily dischargeable through business judgment and does not rise to the level of fiduciary duty. The duty of care is a broad one which applies to many stakeholders and must encompass creditors.[9]

It is most easily equated with a duty of care found in a tort. This is not a fiduciary duty of care, but rather a duty that must be followed and can be discharged based on circumstances and action. The protection required is not one that rises to the level of a fiduciary duty, as the stakeholders are not in a particularly vulnerable relationship. As long as there is consideration for all stakeholders, within the business decision, then this has been addressed and the duty is discharged without problem.

"VICINITY" OF INSOLVENCY

The SCC did not find that there was a difference in the duty when approaching the vicinity of an insolvency. Rather, that directors should continue to act in a manner that would enhance the viability of the corporation as a whole. From a financial perspective, the best interest of the corporation would be to maximize the value of the corporation[10], and to avoid any ongoing insolvency issues.

The SCC used standards of reasonable care and diligence to define what director's actions violates the remedial statutes. Creditors do not have any kind of remedial provision to protect their interest in statutes. For instance, in the Ontario Environmental Statute[11], the environmental damage that occurred can be remedied. The Supreme Court made it clear in *Peoples*, that Section 122(1)(b)

[9] Peoples, at para 57
[10] *Supra* note 8, at para 42.
[11] *Environmental Protection Act*, R.S.O. Chapter E.19

creates an objective standard, and it refers to the factual matrix of the circumstances. It would require there to be a further subjective test to be applied to the fiduciary duty under Section 122(1)(a): something similar to the statutory insolvent trading provisions in the English and Australian Acts.

The court seems to have imported a tort duty of care into the statutory duty of care which is present in the *CBCA*.

PROVINCE OF ONTARIO CHANGES

Following *Peoples*, the Province of Ontario which had a similar provision of Section 122 (1)(a) and (b) in the *Business Corporations Act (Ontario)*[12] *Section 134-136* amended the act to avoid any room for a similar problem. In Section 134 of the *OBCA*, it added a specific statutory duty of care only to the corporation. It further added in Section 135 expanded protections under the 'due diligence' component. This allows for a statutory defence, rather than reliance on the common-law business judgment rule. This didn't remove the business judgment rule from application, it only created a statutory defence which limited the need for it.

However, there has been some recent jurisprudence which has suggested that the Ontario's modification of the *OBCA*, did not exclude creditors from being owed a duty of care[13].

[12] R.S.O. 1990, CHAPTER B.16 [OBCA]
[13] *Inta*, Note 19

DIRECTORS LIABILITIES IN NON-INSOLVENCY, AND OTHER CAUSES OF ACTION

The business judgment rule was again acknowledged in the Supreme Court of Canada decision in *Re BCE Inc.*[14] The BCE case did not involve a specific insolvency related proceeding, but it did address the issues of directors liabilities, oppression remedy causes of action, and the business judgment rule.

In *BCE*, the SCC considered the interests that are protected under the oppression remedy (a remedy that wasn't considered in Peoples) and discussed the test under it. The court restated its earlier decision in *Peoples*, which requires the directors to consider the best interest of the corporation as a whole. The court stated that, "the duty of the directors to act in the best interests of the corporation comprehends a duty to treat individual stakeholders affect by corporate actions equitably and fairly. There are ***no absolute rules. [Emphasis added]***…the question is whether, in all circumstances, the directors acted in the best interests of the corporation, having regard to all relevant considerations." [15]

The debenture holder's economic interests, which were affected by the decisions of the directors of BCE, were affected by decisions that the board believed were in the best interests of the company. As long as this remained true, and the directors did not act in such a way that was so far removed from reasonability, then their decisions would fall under the business judgment rule and the damages claims of the debenture holders could not be sustained.

In *BCE*, the SCC reviewed the possibility of an oppression remedy cause of action which can be pursued. Using the duty of care asserted in *Peoples,* the SCC found that Section 122(1)(b) may be

[14] [2008] S.C.J. No. 37, [2008] 3 S.C.R. 560 [BCE]
[15] *Supra* note 11, at para 82.

an appropriate place to find a duty of care towards creditors which could be used in an oppression case. The problem with an oppression case is that under the oppression remedy statute, creditors are a discretionary class and would need to be allowed by the court to bring such an action.

AMERICAN 'REVLON RULE' CASES

In *BCE,* the court reviewed the American approach to conflicts, and the so-called Revlon Rule which is based in American precedent. In the *Revlon Case*[16], the directors of a corporation were faced with a hostile takeover bid. *Revlon* states that in such circumstances, shareholder's interests should prevail over those of other stakeholders: such as creditors. This was elaborated in *Unocal Corp v. Mesa Petroleum*[17], another American case, which found that concerns for non-stakeholders is inappropriate when the corporation is no longer functioning as a corporation, but rather as a shell to be sold to the highest bidder.

The Supreme Court rejected the *Revlon* line of cases, and instead reinforced the duty of the directors not to act in favor of any specific stakeholder. Directors are required to act in the best interest of the corporation, and it is through this duty that they maintain a duty of care to all stakeholders, creditors, shareholders, and anyone else which would wish to keep the corporation functioning at its best. There is no shifting of this duty as the corporation approaches insolvency. The director's duties are all encompassing, and will always serve to better the corporation regardless of the harm that it may be facing.

[16] *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.,* 506 A. 2d 173 (U.S. Del. Super 1985)
[17] *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (U.S. Del. S.C. 1985)

The Supreme Court's view in *BCE* and *Peoples* is contrary to the traditional common-law view that the duty of care is not owed to creditors. In *BCE*, at paragraph 44, the SCC explicitly states that a, "…remedy lies against the directors in a civil action for breach of duty of care. As noted, s.122(1)(b) of the *CBCA* requires directors and officers of a corporation to, 'exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances'. This duty, unlike the 122(1)(a) fiduciary duty, is not owed solely to the corporation, and thus may be the basis for liability to other stakeholders."

In *BCE*, the court found that the directors had considered the interests of the debenture holders, and that they had discharged their duty in accordance with their obligation under the business judgment rule. The directors did not need to consider any other stakeholders in their application: the court gave deference to the directors.

It would be quite difficult for a person to enforce this duty of care, without a derivative action or oppression remedy. Given the availability of the defences, and the lack of another method.

IS THERE A COMMON-LAW DUTY OF CARE OUTSIDE OF QUEBEC

The SCC in both *Peoples* and BCE *found* that there exists a duty of care to creditors due to the wording of Section 122(1)(b). No determination in either case suggested that there was any limitation which would only allow this analysis to be applied to Quebec based cases. There was no civil law which limited the applicability, and the Supreme Court of Canada is the highest court in the land. The only limitation may be in the cause of action.

The fact that Ontario Courts[18] have applied a similar analysis to a duty of care reinforces the concept that these claims could occur outside of Quebec. Even though the Supreme Court states at paragraph 44 of *BCE* that, "a second remedy lies against the directors in a **civil [emp added] action,**" it is likely that this civil right would not limit the applicability of the statute to the rest of Canada. Directors as a whole would have the same duty of care, and the same obligation to discharge it. The SCC cites an earlier decision of *Saskatchewan Wheat Pool v. Canada,* in which it states that the standard can be taken into account in evaluating what can be expected. Further, in *BCE,* the SCC stated at paragraph 45 that an oppression remedy would be valid under the *CBCA* and the Canadian common-law. Therefore, even if the Quebec civil law was to be a basis for exclusion under the concept of the word "another" which was cited in *Peoples* as the basis for the civil law claim under article 1457, the oppression remedy still exists.

Further, the SCC in *Peoples,* at paragraph 58, states that the *CBCA* and article 1457, "does not set the standard of conduct. Instead, it incorporates by reference section 122(1)(b) of the *CBCA."* The actual standard of care is imported from the *CBCA,* and it is only article 1457 which allows for a cause of action by creditors in Quebec to take action under. Therefore, if there is a limitation, it is only on the basis of the cause of action in which the enforcement can take place under.

There has been some recent jurisprudence which has suggested that the Ontario modification of the *OBCA,* did not exclude creditors from being owed a duty of care. In *Festival Hall Developments Ltd v. Wilkings*[19], an Ontario Judge sustained a claim by a creditor and commented that a duty of care to creditors could be sustained in the common-law, if not by statute. There is

[18] *Downtown Eatery (1993) Ltd v. Ontario,* 2001 CarswellOnt 1680 (Ont CA)(WL Can)
[19] *Festival Hall Developments v. Wilkings,* 2009 CarswellOnt 3312 (Ont. SCJ) (WL Can) [Festival Hall]

some other case law as well which suggests a similar opinion[20]. While some of the other jurisprudence in this area came before *Peoples* and *BCE,* they are on point in that they show that the courts have implied a duty of care in similar pieces of legislation. For instance, *Sidaplex* cites the *Business Corporations Act (Alberta)*[21] in finding a similar duty of care.

POSSIBLE RAMIFICATIONS

The law in relation to the duty of care towards creditors is murky at best in Canada. While the SCC has had the final word on the existence of a duty of care, it has left the applicability unclear. Whether there would be a clear cut cause of action may be unclear, and the common-law may allow for such a cause of action.

If creditors were found to be individual stakeholders, and directors had a duty to them, it would create a host of problems which cannot be readily dealt with. For instance, if a director had a duty to maximize profits for the shareholders, and not to act against the interests of the creditors, which would be more important.

What is more realistic, is remedial legislation which stops directors from breaking laws which can harm the public, but does not force directors to be protecting every single stakeholder at once. For instance, the bar against insolvent trading should be enforced. Laws against allowing directors to liquidate assets, or act contrary to normal business practise would serve to honor business judgment.

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[20] *Sidaplex-Plastic Suppliers Inc. v. Elta Group Inc.,* 1995 CanLii 7419 (Ont. Gen. Div: Commercial List) [Sidaplex]
[21] *Business Corporations Act,* RSA 2000, c B-9

The SCC has imported a tort level duty of care into the *CBCA*. This duty of care preserves the interest of the creditors, but does not rise to the level of a fiduciary duty. While creditors need to be addressed and honoured, their stake in a corporation is not high enough that it deserves to be paramount over shareholders.

A fiduciary relationship is reserved for the most intimate and vulnerable positions at law. A director's obligation is so due to his or her power to control the direction of a corporation. The court will always give deference to the decisions of a director, and will only in extreme circumstances of neglect find that there has been a violation of the duty.

Conclusion

The SCC recognized a duty of care to creditors in both *Peoples* and *BCE*. This is problematic, as there are very limited causes of action which can be enforced by this duty. The SCC in its own judgement, recognized that there is no independent cause of action which can be brought and that this duty of care can only be enforced through a derivative or oppression remedy case. However, there are problems with this pursuit in that both cases require the enforcement of the rights of the corporation, and not the rights of the creditors in primacy. Further, the courts must first allow a derivative action to proceed, and oppression remedy cases can only be brought by creditors as discretionary claims under s238(d) of the *CBCA*. However, directors due not owe a fiduciary duty to creditors.

Directors remain in control of the corporation, whether the corporation is insolvent or moving towards the insolvency zone. While the corporation owes a duty of care to its creditors, it is a weak one, as the creditors are encompassed and cause of action is limited.

This is different from other approaches from the United States, England, and Australia. In Canada, there is no change in the duty that is owed to the corporation based on the financial status of the corporation. Whether the corporation is facing a hostile takeover, insolvency, or is operating in its normal day to day business, the director's duty will be to the corporation. The SCC only recognized at a basic level that there exists a duty of care to creditors in the operation of the company, but that it subsumes or is paramount to any other.

At its core, this duty of care is on the level of a tort duty of care. However, this duty can be discharged by business judgment. The court presumes that directors, acting in the best interest of the company, are correct.

Therefore, while the duty exists, it is still unclear in Canadian jurisprudence what the ultimate need and applicability of the duty is.

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