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Directors make mistakes

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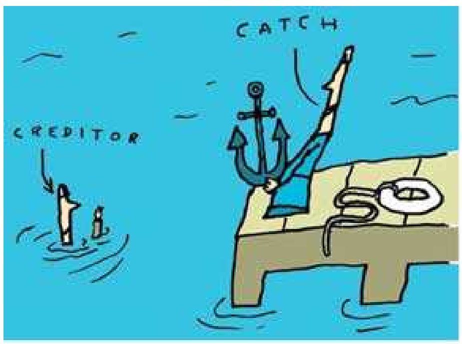

THE QUEBEC COURT OF APPEAL OVERTURNED A LOWER COURT'S FINDINGS AND CONFIRMED THAT DIRECTORS OWE NO DUTY TO CREDITORS

In February, Canadian directors and their insurers let out a collective sigh of relief when the Quebec Court of Appeal reversed a 1998 Superior Court decision in the case of *Peoples Department Stores v. Wise*. In the earlier decision, the trial judge held the directors of the bankrupt Peoples Department Stores Inc. and their liability insurer liable to the trustee in bankruptcy of Peoples, finding the directors' fiduciary duties to the corporation extended to the creditors of the corporation when the decisions they were making might contribute to its eventual insolvency.

The trial judge found the directors liable for their failure to exercise the care, diligence and skill required of them under the provisions of Section 122(1) of the Canada Business Corporations Act (CBCA) when they put in place a new joint inventory procurement policy, which he determined had favoured Wise Stores Inc., the parent of Peoples, to the detriment of its subsidiary. He had also found them liable under Section 100 of the Bankruptcy and Insolvency Act, having determined the new inventory policy constituted a reviewable transaction, and the consideration received by Peoples for the goods transferred to Wise under the policy was conspicuously less than the fair market value of those goods.

The amount of the award was determined by the trial judge in first instance to be essentially the value of the adjusted intercompany indebtedness at the time of the bankruptcy, some $4.4 million plus interest. The decision was criticized for appearing to expand the potential liability of directors by creating a duty to creditors as stakeholders of corporations in financial difficulties. In doing so, the judge referred to precedents and legislation in other countries accepting such a duty, but it had been pointed out that in those jurisdictions there is always a requirement for some finding of self-dealing or benefit derived by the directors for there to be a finding of liability.

In the Wise case, the judge found the three directors liable to the creditors even absent any self dealing or personal benefit. He found fault with the decision to implement a new inventory procurement policy, stating: "It is clear that, in instituting the new domestic inventory procurement policy, the Wise brothers preferred the interests of Wise Stores over those of Peoples. There was a reckless disregard by them of the negative financial implications to Peoples resulting from that new policy." He went on to conclude that in instituting and continuing the policy, "the three Wise brothers failed to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, thereby violating the obligations incumbent upon them in virtue of Section 122(1) CBCA."

In condemning the three directors, the judge refused to accept their defence of having relied on the advice of the officer responsible for this aspect of the two corporations' affairs that had conducted a review of the inventory problems of the two newly related companies and recommended the new policy as a solution. The CBCA expressly permits such reliance as a defence to any claim under Section 122.

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In the most innovative aspect of his judgment, the judge referred to authorities from other commonwealth countries to conclude Canadian law should evolve in the direction adopted by the courts of those jurisdictions that have held that directors have a duty even to the creditors of the corporation in certain circumstances. While those decisions required the company be insolvent or near to insolvency, the judge found this duty was owed even “if the company is embarking on a course of action that will inevitably in the short run render it insolvent.” He found the inventory policy was such a course of action and held the directors liable to these creditors for the full amount of the adjusted intercompany debt.

The judge also reviewed the claim pursuant to provisions of the BIA and concluded to the directors’ liability under that statute as well. He determined the decision to implement and maintain the new inventory procurement policy was a reviewable transaction under Section 100 and there was no fair value received by Peoples for the inventory transferred under that policy. The directors of Peoples, having made the decision, were thus in his view “privy to the transaction” and concluded they should be held liable for the amount of the resulting shortfall, or the same adjusted intercompany debt.

The Quebec Court of Appeal respectfully disagreed with the trial judge on each of the key findings; of particular significance it reaffirmed the business judgment rule, the defence of reasonable reliance on advice to make such decisions, and most important, that directors are not personally liable to creditors in such circumstances: “Without exception, directors are not personally liable to third parties who enter into contracts with such a company. It also follows that the personal liability that the legislators impose on directors benefits in principle and first and foremost the company itself and not a third party.”

Regarding the directors’ duty to act in good faith (the fiduciary duty) the Court of Appeal stated: “The fiduciary duty, or *devoir de loyauté*, does not relate to the quality of the directors’ management but rather to their personal acts. The law requires that they be loyal towards those who have entrusted to them the mission of managing the pooled assets. This type of duty relates more to the motivation of directors rather than the consequences of their actions. Put another way, integrity and good faith are analysed as a function of the reasons which cause the directors to act and not in light of the actual results of their actions.”

As for the duty of care, it reaffirmed the principle that: “In applying the rules that result therefrom, the courts have traditionally recognized the difficulties of analyzing a posteriori decisions made by directors in the heat of the moment. Their right to make mistakes has thus been recognized.” Referring to the business judgment rule, it concluded: “If we consider the question in a traditional perspective, which tends to make the interest of the company coincide with that of the majority of shareholders in the pursuit of the objects for which the company was formed, we must, however, conclude the Brothers did not incur any liability under paragraph 122(1) (b) and that the adoption of the new inventory procurement system constitutes at most an ‘honest error of business judgment.’ ”

The Court of Appeal also exonerated the directors under the reliance defence provision of Section 123(4) CBCA, finding they were justified in relying on the advice of their vice-president finance and administration when deciding to adopt and implement the new inventory policy.

Most important, the Court of Appeal refused to recognize creditors as stakeholders in the relationship that must exist between the corporation and its shareholders — even in a bankruptcy. Refusing to follow the trial judge’s suggestion that Canadian company law should evolve in the direction taken by the other jurisdictions, Justice Pelletier of the Court of Appeal stated: “I believe that in advocating the adoption of this theory under Canadian law, the judge in first instance encroached upon the powers of the legislator when he established a general regime of liability of directors on behalf of third parties who were harmed by the management acts of the directors. I am not inclined to follow him in this step.”

He continued: “It is true that the role of the courts has evolved during the past few decades and that judges are sometimes given a role similar to that which our democratic system has traditionally entrusted to elected officials. … It is worth remembering, however, that it is only by exception that courts are called upon to change the rules of law, or even to create them, since their fundamental role consists rather in applying them and sanctioning the wishes expressed in the law.

“In this case, I therefore believe that it is not up to the courts to decide on the advisability of an evolution of company law that the legislator did not believe appropriate to put in place in its reform.”

Having set aside the trial judge’s findings under the CBCA, the Court of Appeal proceeded to examine the issues from the perspective of the BIA. Accepting that the new joint inventory procurement policy constituted a reviewable transaction under Section 100 BIA, the appeal court nevertheless stated that by artificially isolating certain elements of the transaction he deemed reviewable, the trial judge made an error of appreciation in the value of the consideration received by Peoples. He concluded Peoples received no consideration at all, that the accounts receivable were “neither collected nor collectible.”

In fact, the Court of Appeal points out, when the transaction was viewed as a whole, some $59,499,749 in property or cash had been received by Peoples for some $71,543,059 in inventory transferred to Wise. After other adjustments, the difference was reduced to $4,437,115, or 6% of the transaction value. In finding that this was not conspicuously less than fair market value, the Court of Appeal considered the trial decision unjustified on this point.

Furthermore, the Court of Appeal concluded the directors were not “persons privy to the transaction” as they derived no benefit from the transaction, and thus should not be found liable under this provision even if the consideration had been determined as “conspicuously less.”

After reviewing all aspects of the demise of Peoples, the Court of Appeal attributed it to many factors other than the inventory policy, to conclude that the trial court was not justified to have found the bankruptcy a direct result of the new joint inventory procurement policy. It stated that in finding against the directors the judge failed to take into consideration their good faith, that they had received no direct benefit from the inventory policy, and that Peoples had received substantial consideration for the assets that had been delivered to Wise.

It concluded: “The act on which the finding of liability is based, namely the adoption of the new joint inventory procurement policy, does not have the gravity the trial judge makes it out to have and that, contrary to his perception as he states it, this act was also not the true cause of the bankruptcy of Peoples Inc.

“In such a context, and with the utmost respect for the opinions expressed by the trial judge, I believe that the exercise of the discretionary power conferred by subsection 100(2) BIA does not require a finding personally against the Brothers, even if we take into account, in this case, the purely indirect interest which results from the mere fact of their being the majority share-holders of Wise.”

The trustee has filed an application for leave to appeal the decision to the Supreme Court of Canada.

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