IN FACT AND IN LAW

Directors' and Officers' Liability

March 2003

Peoples Department Stores v. *Wise*: The Directors Are Not Personally Liable in Bankruptcy

By Ian Rose

On February 5, 2003, the Québec Court of Appeal rendered an important decision concerning the liability of directors in the context of a bankruptcy.

In *Peoples Department Stores* vs. *Wise*[1], the Court of Appeal in a unanimous decision reversed the Superior Court decision of Mr. Justice Benjamin Greenberg which had held the directors of the bankrupt Peoples Department Stores Inc. ["Peoples"], as well as their D & O liability insurer Chubb Insurance Company of Canada ["Chubb"] liable to the Trustee in bankruptcy of Peoples under the provisions of the *Canada Business Corporations Act*[2] ["CBCA"] and the *Bankruptcy and Insolvency Act*[3] ["BIA"]. The trial judge had 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 CBCA, when they had put in place a new joint inventory procurement policy which he determined had favoured the parent company of Peoples, Wise Stores Inc. ["Wise"] to the detriment of its subsidiary. He had also found them liable under Section 100 of the BIA, having determined that the new inventory policy constituted a reviewable transaction, and further finding that the consideration received by Peoples for the goods transferred to the parent Wise under the policy was "conspicuously less" than the fair market value of the goods.

The amount of the award was some $4.4 million, plus interest, which had been determined by the judge in first instance to be essentially the value of the inter-company indebtedness at the time of the bankruptcy, less certain adjustments.

The Facts

The Defendants Lionel, Harold and Ralph Wise were three brothers [the "Wise Brothers"] owning the controlling interest in Wise Stores Inc. (Wise), a family business that had gone public a few years earlier. Wise owned a chain of some 50 junior department stores, and in 1992, in a move that later proved to be overly ambitious, it acquired from the British retail giant Marks & Spencer ("M&S") a complementary chain of some 80 similar junior department stores known as Peoples Department Stores. As a division of M&S, Peoples had been accumulating annual deficits in the order of $10 million prior to its acquisition by Wise, and in addition, had been burdened with long term leases which gave it an additional heavy financial obligation.

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[1] C.A.Q. Montréal 500-09-007557-986, February 5, 2003. (A copy of the original decision in French and one unofficial English translation can be found on our website at www.laverydebilly.com)

[2] R.C.S., 1985, c. C-44.

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

When Wise acquired Peoples, the terms of payment required Wise to incur a significant debt load, and at the same time, the conditions of the sale were so restrictive they limited the ability of Wise to obtain the additional credit necessary to ensure the ongoing operations as well as meet its financial obligations to M&S resulting from the acquisition of Peoples.

In an effort to streamline and simplify the operations of the two chains, and benefit from economies of scale, at the same time as eliminating some administrative problems, the directors turned to the vice-president finance and administration, David Clement, who had a degree in business administration and 15 years of experience with the company. Clement proposed the new inventory procurement system, which permitted Peoples to purchase from the North American suppliers for both companies, and Wise to purchase for both from the overseas suppliers. The warehousing was streamlined, duplicate buyers eliminated, and the products would be shipped to the stores on an as needed basis.

The feature of this system that ended up being criticized by the trial judge was that while an entry was made in the inter-company books when the goods were transferred to the stores, actual payment was only made when the goods were sold to the public. Thus over the nine or ten months the system was in place, while some $71.5 million goods were shipped from the Peoples warehouse to the Wise stores, payment in other goods or merchandise was received only for some $59.5 million. Thus at the time of the bankruptcy, although Peoples had not yet paid the suppliers for most of these goods, on the books Wise allegedly owed Peoples some $16 million, for the inventory it had received from Peoples still in the Wise stores.

The Judgment in First Instance

The trial judge found fault with the decision made by the three Wise Brothers to implement the new inventory procurement policy, and stated:

> **"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."[4]**

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) C.B.C.A."[5]**

In the most innovative aspect of his judgment, the trial judge referred to authorities from Australia, New Zealand and the United Kingdom, to conclude that Canadian law should "evolve" in the direction adopted by the courts of those jurisdictions which have held that directors have a duty not only to the corporation, but also to the creditors of the corporation, when the corporation is near to insolvency.

[4] Judgment in first instance at p. 27.

[5] Ibid at p. 31.

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While the decisions cited required that the company be insolvent or near to insolvency, the trial judge found that this duty was owed even "if the company is embarking on a course of action which will inevitably in the short run render it insolvent". He then found that the inventory policy was such a course of action, and held the directors liable to these creditors for the full amount of the inter-company debt, which after adjustments amounted to some $4.4 million.

Conscious of the likelihood of an appeal, given the importance of the issues, the trial judge also reviewed the claim pursuant to provisions of the BIA, and concluded to the directors' liability under that statute as well. He determined that the decision to implement and maintain the new inventory procurement policy was a reviewable transaction under Section 100 of the BIA, and that there was no "fair value" received by Peoples for the inventory transferred under that policy. The Wise Brothers as 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 short-fall, or the inter-company loan (less adjustments).

Several important issues were raised by the decision, among the most important being:

Under the CBCA:

- How do directors address the competing interests of a parent and a subsidiary in a corporate group?
- Do directors owe a duty to creditors as stakeholders of a corporation?
- What are the parameters of exoneration of directors for decisions made by the director when relying in good faith on statements made by persons within the corporation whose profession lends credibility to statements made by them?
- Was a wholly-owned subsidiary entitled to provide financial assistance to its parent, even if deemed not in the best interests of the subsidiary, given Section 44(2) (c)[6]?

Under the BIA:

- Was the decision to implement the new inventory policy a reviewable transaction?
- What should be taken into account in determining the consideration received?
- How much less than fair market value is "conspicuously less"?
- What is meant by "persons privy to the transaction"?
- How should the discretion under Section 100 be exercised by the court, and what criteria should be applied?

The Decision in Appeal[7]

After noting that the decision of the trial judge was "clearly the result of serious thought and considerable and careful work"[8], Mr Justice François Pelletier, speaking for the unanimous bench, goes on to state that his opinion differs on several of the questions raised by the appeal. Before doing so, he underlines the fact that the Superior Court, as well as the Trustee, had recognized the good faith of the Wise Brothers in adopting and implementing the new joint inventory procurement policy that was at the origin of the transactions giving rise to the Trustee's claim. He then turns to the analysis of the provisions of the two statutes on which that claim was based.

[6] Now repealed.

[7] The judgment was rendered in French, and all quotations in English are from our unofficial translation which can be found on our website at www.laverydebilly.com.

[8] Paragraph 60 of the decision in appeal.

Liability under paragraphs 122(1) (a) and (b) of the *Canada Business Corporations Act*

In reviewing some of the basic principles of company law, Mr. Justice Pelletier states:

> "66. Companies enjoy a legal personality that is unique, i.e. distinct from the natural persons who act for them[9]. From this fundamental idea flows a number of consequences. Thus, 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. It is therefore with this in mind that we should read subsection 122(1) CBCA on which the judgment rendered rests:
>
> > 122(1) Every director and officer of a corporation in exercising their powers and discharging their duties shall
> >
> > (a) act honestly and in good faith with a view to the best interests of the corporation; and
> >
> > (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.
>
> (...)
>
> 71. From the outset and like the appellants, I believe that the judgment rendered merged into one the two duties set out in paragraphs 122(1) (a) and (b). This confusion is not of great importance here because it does not have any impact on the conclusions which I have reached."

Regarding the fiduciary duty, he states:

> "72. 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 analyzed 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, he reaffirms the principle that:

> "74. In applying the rules which 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[10]:"

[9] Art. 298 and 309 C.C.Q.; CBCA, subs. 15(1); *Salomon* vs. *Salomon & Co.*, [1897] A.C. 22; M. and P. Martel, *La compagnie au Québec – Les aspects juridiques*, Montréal, Wilson & Lafleur Martel, 2002 at p. 1-3 to 1-6 and 1-24 to 1-25; A. Morisset and J. Turgeon, *Droit corporatif canadien et québécois*, Brossard, Les Publications CCH/FM, 1991 at p. 509 and ff. (Authorities cited in the decision in appeal.)

[10] *Crevier* vs. *Paquin*, [1975] S.C. 260 at p. 265 (Cited in the decision in appeal).

He concludes as follows, referring to the business judgment rule:

> **"83. 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 that 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'[11]."**

It is important to note that Mr. Justice Pelletier also exonerates the Wise Brothers under Section 123(4) CBCA. This Section provides:

> **"123. […]**
>
> **(4) A director is not liable under section 118, 119 or 122 if he or she has relied in good faith on:**
>
> **[…].**
>
> **(b) a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him or her."**

The Wise Brothers had not only obtained the advice of the vice-president finance and administration, David Clement, regarding the inventory policy: the policy was actually his recommendation. While the trial judge seems to have disregarded this, Mr. Justice Pelletier correctly reestablishes it as a valid cause of exoneration of the Wise Brothers under Section 122 CBCA in making the decision to adopt and implement the new inventory policy.

Mr. Justice Pelletier refuses moreover to recognize that creditors are "stakeholders" in the relationship that must exist between the corporation and its shareholders, even in the context of a bankruptcy. He refuses to follow the trial judge's suggestion that Canadian company law should "evolve" in the direction of certain others jurisdictions such as Australia, New Zealand and the U.K. that have moved in that direction:

> **"93. Secondly, and with respect, 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.**
>
> **94. In 1978, Canadian law was the object of a complete reform without the legislator explicitly accepting the principle of general liability of directors toward third parties. I say apparently because such an about-face with respect to traditional thought would, in my opinion, require a clear and explicit text. This is nowhere to be found in the statute which was adopted by Parliament[12].**

[11] John L. Howard, "Directors and Officers in the context of the Canada Business Corporations Act", in *Meredith Memorial Lectures, Canada Corporations Act*, Toronto, Richard De Boo, 1975, p. 282 at p. 303. (Cited in the decision in appeal.)

[12] *An Act to amend the Canada Business Corporations Act*, S.C., 1978-1979, c. 9.

95. 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. This is the case in the area of fundamental rights enshrined in the *Canadian Charter of Rights and Freedoms*. 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.

96. 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."

Mr. Justice Pelletier then adds that the provisions of the CBCA regarding financial assistance from a wholly owned subsidiary[13] should not have been set aside by the trial judge, and as they specifically authorized the financial assistance that resulted from the new joint inventory procurement policy, they should also have protected the Wise Brothers in the circumstances of this case.

Liability under subsections 100(1) and (2) of the *Bankruptcy and Insolvency Act*

Having set aside the trial judge's findings under the CBCA, Mr. Justice Pelletier then proceeds to examine the judgement in first instance from the perspective of the *Bankruptcy and Insolvency Act.* In this regard, he notes that all parties agreed the Wise Brothers, Wise and Peoples Inc. were not at arms length. He also agrees that the new joint inventory procurement policy, implemented within 12 months preceding the bankruptcy, constituted a reviewable transaction under Section 100 BIA, which reads:

"100. (1) Where a bankrupt sold, purchased, leased, hired, supplied or received property or services in a reviewable transaction within the period beginning on the day that is one year before the date of the initial bankruptcy event and ending on the date of the bankruptcy, both dates included, the court may, on the application of the trustee, inquire into whether the bankrupt gave or received, as the case may be, fair market value in consideration for the property or services concerned in the transaction.

(2) Where the court in proceedings under this section finds that the consideration given or received by the bankrupt in the reviewable transaction was conspicuously greater or less than the fair market value of the property or services concerned in the transaction, the court may give judgment to the trustee against the other party to the transaction, against any other person being privy to the transaction with the bankrupt or against all those persons for the difference between the actual consideration given or received by the bankrupt and the fair market value, as determined by the court, of the property or services concerned in the transaction."

However, disagreeing with the manner in which the trial judge applied the law to the facts of the case, Mr. Justice Pelletier states that by artificially isolating certain elements of the transaction that he deemed reviewable, the trial judge made an error of appreciation in the value of the consideration received by Peoples. The trial judge had concluded that Peoples received no consideration - that the accounts receivable were "neither collected nor collectible" - and in this finding the judgment in first instance was "affected with a manifest and overriding error".[14]

[13] Section 44 (2) of the CBCA, since repealed.

[14] Paragraphs 126 and 155 of the decision in appeal.

In fact, Mr. Justice Pelletier points out, when the transaction was viewed as a whole, as it should have been, 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 were made, the difference was reduced to $4,437,115, or only some 6% of the entire transaction value. In finding that this was not "conspicuously less" than fair market value, Mr. Justice Pelletier found that the decision in first instance was not justified on this point.

Furthermore, even if the consideration had been determined as "conspicuously less" , Mr. Justice Pelletier goes on to conclude that the Wise Brothers were not "persons privy to the transaction". In reaching this conclusion, he reviews the meaning of the word, and concludes that in interpreting the statute to have a consistent meaning in English and in French, one must use the meaning of the word "privy" that is closest to the French wording, ("personnes ayant intérêt") or persons deriving some benefit from the transaction. As the Wise Brothers were not personally involved in the transaction, and derived no direct benefit from the transaction, he concluded that they were not persons privy to the transaction, and thus should not be found liable under this provision either.

After reviewing all the aspects of the demise of Peoples, Mr. Justice Pelletier attributes it to many factors other than the inventory policy, to conclude that the trial judge was not justified to have found that the bankruptcy was a direct result of the new joint inventory procurement policy. He then states that in finding against the Wise Brothers, the trial judge failed to take the good faith into consideration, nor that they had received no direct benefit from the inventory policy, and furthermore, he ignored the fact that Peoples had received substantial consideration for the assets delivered to Wise. He thus concludes:

> **"155. (...) 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.**
>
> **156. 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 the, in this case, purely indirect, interest which results from the mere fact of their being the majority shareholders of Wise."**

The case was pleaded in Appeal on behalf of Chubb by Ian Rose of *Lavery, de Billy*.

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