COURT OF APPEAL

CANADA
PROVINCE OF QUÉBEC
MONTRÉAL COURT OFFICE

No.: 500-09-007557-986
(500-11-002695-944)

DATE: February 5, 2003

CORAM: THE HONOURABLE J.J. MICHEL ROBERT, J.C.Q.
JOSEPH R. NUSS, J.C.A.
FRANÇOIS PELLETIER, J.C.A.

IN THE MATTER OF THE BANKRUPTCY OF :
PEOPLES DEPARTMENT STORES INC./MAGASINS À RAYONS PEOPLES INC.

CHUBB INSURANCE COMPANY OF CANADA/COMPAGNIE D'ASSURANCE CHUBB DU CANADA
APPELLANT – CROSS-RESPONDENT (Respondent)

vs.

CARON BÉLANGER ERNST & YOUNG INC.
RESPONDENT – CROSS-APPELLANT (Trustee-Petitioner)

and
LIONEL WISE
RALPH WISE
HAROLD WISE
Respondents

DECISION

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1 **THE COURT**, deciding on an appeal of a judgement rendered on December 15, 1998 by the Superior Court, District of Montreal (The Honourable Benjamin J. Greenberg, J.), which allowed the claim up to $4,437,115;

2 After studying the file, hearing and deliberation;

3 For the reasons of Pelletier, J. which accompany the decision filed today in court file 500-09-007536-980 (Lionel, Ralph and Harold Wise vs. Caron, Bélanger, Ernst & Young Inc.), in which Chief Justice Robert and Nuss, J. concur;

4 **ALLOWS** the appeal of Appellant Chubb Insurance Company of Canada/Compagnie d'Assurance Chubb du Canada and **DISMISSES** the cross-appeal of Caron, Bélanger, Ernst & Young Inc., the whole with costs;

5 **QUASHES** the judgement in first instance and renders the judgement which should have been rendered;

6 **DISMISSES** with costs the amended motion of Caron, Bélanger, Ernst & Young Inc.

(s) J.J. Michel Robert
J.J. MICHEL ROBERT, J.C.Q.

(s) Joseph R. Nuss
JOSEPH R. NUSS, J.C.A.

(s) François Pelletier
FRANÇOIS PELLETIER, J.C.A.

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Attorney for Lionel Wise, Ralph Wise and Harold Wise

Hearing dates: May 13 and 14, 2002

COURT OF APPEAL

CANADA
PROVINCE OF QUEBEC
MONTREAL COURT OFFICE

No.: 500-09-007536-980
(500-11-002695-944)

DATE: February 5, 2003

CORAM: THE HONOURABLE J.J. MICHEL ROBERT, J.C.Q.
JOSEPH R. NUSS, J.C.A.
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IN THE MATTER OF THE BANKRUPTCY OF :
PEOPLES DEPARTMENT STORES INC./MAGASINS À RAYONS PEOPLES INC.
and
LIONEL WISE
RALPH WISE
HAROLD WISE
APPELLANTS – CROSS-RESPONDENTS (Respondents)

vs.

CARON BÉLANGER ERNST & YOUNG INC.
RESPONDENT – CROSS-APPELLANT (Trustee-Petitioner)
and
CHUBB INSURANCE COMPANY OF CANADA /
COMPAGNIE D'ASSURANCE CHUBB DU CANADA
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DECISION

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1 **THE COURT**, deciding on an appeal of a judgement rendered on December 15, 1998 by the Superior Court, District of Montreal (The Honourable Benjamin J. Greenberg, J.), which allowed the claim up to $4,437,115;

2 After studying the file, hearing and deliberation;

3 For the reasons of Pelletier, J., in which Chief Justice Robert and Nuss, J. concur;

4 **ALLOWS** the appeal of Appellants Lionel, Ralph and Harold Wise and **DISMISSES** the cross-appeal of Caron, Bélanger, Ernst & Young Inc., the whole with costs;

5 **QUASHES** the judgement in first instance and renders the judgement which should have been rendered;

6 **DISMISSES** with costs the amended motion of Caron, Bélanger, Ernst & Young Inc.

(s) J.J. Michel Robert
J.J. MICHEL ROBERT, J.C.Q.

(s) Joseph R. Nuss
JOSEPH R. NUSS, J.C.A.

(s) François Pelletier
FRANÇOIS PELLETIER, J.C.A.

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Hearing dates: May 13 and 14, 2002

REASONS OF PELLETIER, J.

8 At the end of January 1995, retroactive to December 9, 1994, Wise Stores Inc. (Wise) and Peoples Department Stores Inc. (Peoples Inc.) were forced into bankruptcy under pressure from Marks & Spencer Canada Inc. (M. & S.), the Canadian subsidiary of the giant British retailer. At the time of the bankruptcies, Lionel, Ralph and Harold Wise (the Brothers) were the directors of the two bankrupt companies, Wise, the parent company, and Peoples Inc., its subsidiary. They were also the majority shareholders of Wise, which held all the issued and outstanding shares of Peoples Inc.

9 The case before us places the Brothers in opposition to the Trustee in bankruptcy of Peoples Inc. The Trustee claims that the Brothers unfairly favoured Wise to the detriment of Peoples Inc. For this reason he is claiming from them an amount of nearly $28 million which amount he claims corresponds to the unfair advantage from which Wise benefited.

10 Under the terms of an elaborate and detailed judgement, the Superior Court allowed the claim for an amount of $4,437,115. In the opinion of the trial judge, the Brothers contravened the duties imposed on them by subsection 122(1) of the *Canada Business Corporations Act* (CBCA)[1]. In the alternative, he determined that the action from which the unfair advantage arose constituted a reviewable transaction within the meaning of section 100 of the *Bankruptcy and Insolvency Act* (BIA)[2]. According to him, the Brothers are persons who are *privy to the transaction with the bankrupt* within the meaning of subsection 2 of section 100 BIA which, according to the facts of this case, also support the finding.

THE FACTS

11 At the outset Peoples was a chain of department stores founded in 1914. It was an unincorporated division of M. & S., which operated it during the period immediately preceding that giving rise to the dispute. In 1990, the 80 stores in the chain generated revenues in the order of $160 million. The operation was, however, difficult to support due to the continuing accumulation of annual deficits in the order of $10 million. In addition, M. & S. was burdened with long-term leases which gave it additional heavy financial obligations. The trial judge valued these at more than $100 million.

12 M. & S. therefore decided to rid itself of its money-losing division, if possible by means of a cash sale. For this purpose it created Peoples Inc., and transferred the entire Peoples chain to it. The facts relating to the litigation began when the shares of the new company were for sale and Wise was interested in their purchase.

1 R.S.C. 1985, c. C-44.
2 R.S.C. 1985, c. B-3.

13 Founded in the thirties by the uncle and father of Lionel, Ralph and Harold, Wise was in full expansion from 1980, when it was operating 10 stores generating business revenue of more or less $10 million annually. In 1990, with 50 stores, Wise saw its annual revenue climb to $100 million. This rapid expansion, however, left it in a deficit situation respecting liquidity and capital, a serious handicap when the time came to consider purchasing a chain as large as Peoples Inc. This is why, among other reasons, Wise did not present the profile of the ideal purchaser that M. & S. was seeking for its troubled division.

14 In 1992, the parties nonetheless came to an understanding on a sale price of $27 million, the payment of which was to be made by instalments staggered, with respect to a first instalment of some $14,239,000, from June 1, 1993 to June 21, 1994 and, with respect to a second instalment of $12,761,000, over at a subsequent 7-year period ending in June 2000.

15 Wise was indebted for the entire price because, as indicated previously, it did not possess the liquidity required for a transaction of this size. The TD Bank therefore agreed to make it a loan covering the initial payment of $5 million to be paid at closing.

16 To deal with its later undertakings toward M. & S., Wise relied on profits to be made by group operations. The trial judge described the sale using the term «*full leverage buyout*».

17 The sale price was made up of two components. The first, valued at $11 million, consisted of the amortized value in the financial statements of leasehold improvements, equipment and furniture, and the second, representing the balance of $16 million, of merchandise in inventory. M. & S. depreciated the latter by 30% in order to allow Peoples Inc. to operate at a profit during the first year. This strategy of course had the indirect consequence of making more certain the payment of the substantial instalment that M. & S. expected to receive in 1994.

18 The forecasts of M. & S. respecting the profitable nature of operations to be made by the moving of inventory thereby depreciated did occur in the first year of the Wise management. The trial judge held in this respect that they were artificial profits.

19 One feature of the transaction was that M. & S. hoped to be paid very quickly, as much as possible within the negotiated term. Through restrictive clauses, it wished to strongly encourage Wise to find another lead lender to refinance the acquisition price. This was the reason for the unusual nature of certain aspects of the agreement. Thus, Peoples Inc. saw its ability to borrow diminish in relation to the reduction of the balance of the debt which, in other circumstances, would seem illogical. Along the same lines, Wise was not permitted to merge with Peoples Inc. as long as the price was not completely paid. This was a major constraint from the point of view of Wise, which was counting on the total integration of operations to exploit the potential advantages of the acquisition to the maximum.

20 We must therefore conclude that M. & S. reluctantly gave up its initial objective of making a cash sale. In reality, it deliberately limited the flexibility of its purchaser with the intent of putting it in a situation in which it would be forced to get rid of harmful constraints to the proper conduct of business.

21 At the request of M. & S., it was not Wise that acquired Peoples Inc., but a wholly owned affiliate, 2790-8832 Canada Inc. Wise, however, guaranteed the sale price.

22 As part of the sale, the Brothers intervened with various landlords and assisted representatives of M. & S. so effectively that M & S succeeded in freeing itself almost entirely of the considerable obligations incurred when Peoples was only one of its administrative divisions. In some cases, the landlords insisted on obtaining letters of guarantee from M. & S.

23 On January 31, 1993, 2790-8832 Canada Inc. and Peoples Inc. merged to form a new entity. It kept, however, the name Peoples Department Stores Inc. Wise held all the shares.

24 It was no secret to anyone that Wise itself intended to merge with Peoples Inc. as soon as the sale price was paid. While waiting for that day, it gradually integrated the operations and management services of its new subsidiary. Thus, as of 1992 there was only one accounting department, one purchasing department and one finance department. The two companies were operated separately, however, which had the effect of doubling the workload of certain employees, and in particular that of the buyers. Because of the existence of separate budgets and inventories, they had to oversee the purchase of often identical merchandise for each chain. This duplication was the source of numerous administrative errors.

25 In addition, beginning in the spring of 1993, it was decided to reorganize the receiving, shipping and warehousing of the inventory. The implementation of this decision led to many additional unforeseen difficulties. There was the potential for error at each of the too numerous steps to be taken for a product to move from a supplier's warehouse to its destination on the shelf at a Peoples Inc. or Wise store. Merchandise to be used for one chain was recorded by mistake as being for the other, thereby causing false entries in the inventory registers. The already difficult task of the buyers was made even more burdensome.

26 Seeking a solution, the buyers asked the warehouse employees to do a physical inventory count. Although it had the tendency to lessen the risk of error, this new task was onerous and had its own disadvantages. It disturbed the regular distribution activities and delayed deliveries to the some 125 points of sale. The buyers now had to do their job in the dark.

27 All these disruptions affected the financial stability of the group because they caused both a reduction of sales volume and the creation of unnecessary debt through the purchase of excess products.

28 To come to grips with the growing difficulties, Lionel Wise, principal director of the Wise group and Peoples Inc., spoke to David Clément, vice-president, administration and finance, for Wise. Clément, who had a Bachelor of Commerce degree, had worked for Wise since 1980. He developed solution that was relatively simple, at least in theory. His proposal consisted in integrating the inventory management of Wise and Peoples Inc. into a single database as if the two entities were only one company operating some 125 stores. Peoples Inc. was therefore entrusted with all the purchasing required to operate the two chains, at least with respect to so-called domestic purchases, meaning those made in North America. Wise would pay Peoples Inc.

upon receipt of merchandise in its stores and was in addition put in charge of purchases made abroad on behalf of the two chains since Peoples Inc. did not purchase outside North America before the acquisition. It would not thus have had the necessary financial tools for this type of operation.

29 Around the month of December, 1993, the Brothers submitted the concept of the Clément proposal to the buyers. They saw it as the solution to their problems. Encouraged by this reaction, the Brothers agreed to proceed with it without conducting a study of the indirect effects that it might cause. They effectively put themselves in the hands of Clément and determined that the proposal would be implemented beginning February 1994.

30 On April 27, 1994, at a meeting of the audit committee of Wise in which Kenneth Stevenson, vice-president of Coopers & Lybrand participated, Lionel Wise reported on the new joint inventory procurement policy. Stevenson, representing M. & S., did not oppose it. For their part, and after reviewing the policy, the auditors of the company expressed no reservations.

31 The first actual criticisms were made by certain suppliers who said they were worried. They saw in the new system an attempt to burden Peoples Inc. with debt to the benefit of Wise. They all continued to do business with the group however, and several of them decided to make their invoices in the name of both companies.

32 At the same time, around the end of January 1994, the sales volume of Peoples Inc. fell below forecasts by a margin of about $32 million. It was therefore a company that was incapable of meeting the anticipated reduction in the borrowing limits imposed by M. & S. at the time of the sale. Wise asked that this limit be increased to $12 million, to which M. & S. agreed in exchange for a substantial reduction in the term of the debt, which would change from 72 to 26 monthly payments beginning July 24, 1994. In this manner, M. & S. was in the process of meeting its objective of being paid the sale price quickly.

33 In the interim, the market in which Wise and Peoples Inc. operated was hit by an earthquake resulting from the arrival of the American chain Wal-Mart. The presence of this gigantic new competitor brought about a ferocious price war.

34 In June, 1994, the financial results of the group indicated Wise was indebted to Peoples Inc. for $18,664,000. Ralph Wise, replacing his brother Lionel, who had suffered a heart attack, was worried about it and discussed the situation with Clément. The latter informed him that the debt resulted for the most part ($14 million) from an accounting error relating to the actual state of inventory in each of the companies. The error, Clément pointed out, would be the subject of an appropriate correction in the near future.

35 At the same time, M. & S. was informed of the existence of this debt between the related companies and of the implementation in February 1994 of the new joint inventory procurement policy. To say the reaction of M. & S. was negative is an understatement. The representatives of M. & S. were outraged. The news put in question the recently negotiated agreement respecting the debt ceiling of Peoples Inc. Negotiations, which could be qualified as very difficult, resulted in a new agreement under which:

- M. & S. authorized an increase of $15 million in Peoples Inc. borrowing limits;
- It also agreed to an extension of the term allowing the spreading of the payment of the balance of sale over 36 monthly instalments beginning in July 1995;
- M. & S. accepted as well the temporary continuation, until the end of January 1995, of the joint inventory procurement policy for the two companies with an inter-company debt limit of $3 million;
- The Brothers gave a personal guarantee of $1.5 million in favour of M. & S.

36 In September 1994, the internal financial statements showed that the inter-company debt had been reduced to $3,786,000 following the correction of an accounting error. However, Peoples Inc. still showed a decrease of more than $7 million in its sales volume as well as a loss of $700,000.

37 Management had not seen the end of its difficulties since the group was also experiencing difficulty obtaining the necessary financing from the TD Bank, which announced its intention of ceasing to do business with the group by the end of December 1994. Reluctantly and after much dickering, the Brothers agreed, under certain conditions, to provide another personal guarantee of $1.5 million. This undertaking never materialized but, in the interim, the group obtained an extension of financial backing from the TD Bank until July 1995.

38 For September, October and November 1994, the financial results were disappointing once again; they anticipated for Peoples Inc. a decrease of $7,104,000 in sales volume and of $4 million for Wise. The operating loss of the group was broken down as follows: 60% for Peoples Inc. and 40% for Wise.

39 In December 1994, the Brothers consulted insolvency specialists. At the same time, M. & S. reacted very badly when the Brothers presented to it the third quarter financial results at a meeting set up for this purpose. Three days later M. & S. had the Superior Court appoint an interim receiver under section 47 of the BIA. The group responded the same day by filing a notice of intention to make a proposal. All these goings-on proved fatal to the two companies, which declared bankruptcy in January 1995.

40 The assets of Wise and Peoples Inc. brought respectively $31,447,922 and $37,025,372. The receipts allowed payment in full of the TD Bank ($28,609,465 for Wise and $9,183,773 for Peoples Inc.), the balance of sale owed to M. & S. ($12,761,000) and almost all the claims of landlords under letters of guarantees agreed to at the time of the sale to Wise ($4,952,392 leaving a balance of $300,000).

41 However, at the time of bankruptcy, and according to the valuation used by the trial judge, the debt of Wise to Peoples Inc. since the setting up of the joint procurement policy in February 1994 amounted, after adjustments, to $4,437,115. This was the figure used by the judge to establish the extent of the liability of the directors of Peoples Inc.

THE JUDGEMENT IN APPEAL

42 It is by applying section 122(1) CBCA that, in the opinion of the trial judge, the Brothers are liable to the Trustee in bankruptcy of Peoples Inc. in their capacity as former directors. According to him, they breached their fiduciary duty and their duty of care by adopting the domestic inventory procurement policy. They failed to foresee the harmful financial consequences for Peoples Inc. of implementing the new system. Their negligence continued up to the end because they never controlled the degree of indebtedness resulting from Peoples Inc. henceforth assuming the cost of most of the buying of Wise.

43 According to the trial judge, the perverse effect of the domestic inventory procurement policy was essentially the result of the precarious financial situation of Wise, an established fact well known to the Brothers. At the time the new policy was set up, the parent company was reportedly unable to pay for its purchases in the normal course of business. Here are several excerpts which illustrate his view of things:

> The new domestic inventory procurement policy was a major and drastic departure from the prior policy, with potentially disastrous financial consequences for Peoples.
>
> {…}
>
> In fact, the 3 Individual Respondents, when consulting with each other and considering the new domestic inventory procurement policy proposed by Mr. Clément, at no time directed their minds to the creditworthiness or lack thereof of Wise Stores, or what the financial consequences would be for Peoples. There was also no real, effective consultation with their professional advisors.
>
> Clearly, a reasonably prudent and diligent person would have realised that the new process would strip hard assets (inventory) away from Peoples and it would receive in return an account receivable from Wise Stores which likely would not be collected and would be uncollectible, seeing Wise Stores' cash flow problems as alleged in paragraphs 67 and 68 of the Plea of the Individual Respondents and as well the fact that Wise Stores was seriously under-capitalized.
>
> {…}
>
> To conclude on this issue, 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.
>
> [Reference omitted]

44 Thus the debt between the related companies was, in the opinion of the trial judge, the main cause of the demise of Peoples Inc.:

> On the basis of all the evidence, we find that it was that interco, almost totally the result of the new domestic inventory procurement policy, which caused the demise of Peoples.

45 One thing that should be emphasized is that the entire debt of Wise to Peoples Inc. at the time of bankruptcy stemmed from purchases made in anticipation of sales during the Christmas season, namely those made after the month of September 1994. Although he takes note of them, the judge sets aside the explanations provided by the directors. They maintained that once the purchases were made, it was essential for Peoples Inc. to transfer to Wise the goods it needed for normal operations during the Christmas period. Otherwise Wise would not have had sufficient inventory to meet demand while Peoples Inc. would have been left with an impossible surplus to dispose of. The judge explained himself as follows:

> That explanation is seductive at first blush, but does not resist analysis. It is correct to argue that, once Peoples had purchased more than it needed for itself, it had no choice but to make the transfers to Wise Stores. However, the flaw in the «logic» is that Peoples should never have purchased for Wise Stores in the first place. Therein lies the fault and negligence of the Wise Brothers.

46 In short, by not taking into consideration the negative consequences to the financial health of Peoples Inc. of the setting up of the new policy and by not consulting their legal advisors before its was implemented, the directors protected the interests of Wise rather than those of Peoples Inc. Their reckless disregard towards the latter allegedly also caused prejudice to the various creditors of Peoples Inc. In the opinion of the judge, the latter are «stakeholders» of the company or, in other words, persons affected by the decisions of the directors. This explains why the directors have towards them duties which, when breached, result in personal liability.

47 In this context, the judge cites several judgements of the United Kingdom, Australia and New Zealand to hold that, in his opinion, Canadian company law should evolve in the direction that these authorities recommend.

48 The judge rejects finally the defence based on subsection 44(2) CBCA, considering that an action is not necessarily carried out with skill and diligence because it is authorized in theory by law. This subsection, in force at the relevant time[3], provided specifically that a wholly owned subsidiary could give financial assistance to its parent company. In the case at bar, although they did not receive any direct personal benefit, the Brothers would have, according to the trial judge, indirectly benefited in their capacity as shareholders of Wise.

49 Finally, the judge expressed his view that when the interests of a subsidiary are in direct conflict with those of the parent company, the directors must give priority to the interests of the subsidiary.

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[3] Section 44 CBCA was repealed by the *Act to Amend the Canada Business Corporations Act and the Canada Cooperatives Act and to amend other Acts*, S.C. 2001, c. 14, s. 26.

50 Aware of the innovative nature of his pronouncements in company law, and accordingly of their relative fragility, the judge considered it useful to study the claim of the Trustee from the point of view of the BIA.

51 According to him, subsections 100(1) and 100(2) BIA give the judge a double discretionary power. The first relates to the power to uphold the application of the Trustee for an inquiry under subsection 100(1) and the second, under the authority of subsection 100(2) BIA, to maintain the conclusions sought against any person sued who the evidence shows was «privy to the transaction» which is the basis of an application for review. Respecting these conclusions, the judge relies on the decision of the Ontario Court of Appeal in *Standard Trust Co. Ltd. v. Standard Trust Company*[4].

52 In applying himself to exercise this double discretionary power, the judge affirms from the beginning that the reviewable transaction, in this case the domestic inventory procurement policy, occurred within the 12 months preceding the bankruptcy, i.e. within the period covered by section 100 BIA. He goes back here to February 1, 1994, the date the new policy was implemented. In his opinion, the mere notations «accounts payable» and «accounts receivable» in the books of each company do not constitute consideration given or received within the meaning of section 100 BIA, especially since Wise never paid Peoples Inc. for merchandise that the latter bought for it. Hence his conclusion that there was in this case consideration that was «conspicuously less» than the fair market value of the goods involved in the transaction. Peoples Inc. suffered a prejudice that the trial judge ascribes to the Brothers, as persons being privy for the purposes of the application of subsection 100(2) BIA. Using the discretionary power conferred on him by this provision, he believes that there are grounds for finding in favour of the Trustee.

53 With respect to the establishment of the amount due, the trial judge bases his calculation in large part on the report of the accountant Philip Friedman, an expert heard on behalf of the Trustee. He estimates at $16,210,661 the extent of Wise's debt to Peoples Inc. on the date of bankruptcy.

54 The judge is however of the opinion that there are grounds for making a number of adjustments to this estimate to determine in a more precise manner the actual state of Wise's debt to Peoples Inc. Almost all of these adjustments reduce the amount of the debt based on the contributions of Wise to Peoples Inc. during the 12 months preceding the bankruptcy. In this respect, we find on page 126 of the judgement in first instance a spreadsheet of the elements the trial judge took into account to arrive at the amount of $4,437,115. Here is what it shows:

	Debit	Credit	Balance
Mr. Friedman's balance owing to Peoples by Wise Stores as at December 9, 1994			$16,210,661
Deduction of opening balance as at January 29, 1994	$1,354,818		$14,855,843

[4] (1995), 36 C.B.R. (3d) 1, at pp. 24 and 25 (Ont. C.A.).

Adjustment based on conversion ration of 51.7% instead of 55.5%	$4,323,979		$10,531,864
Deduction based on Mr. Frank Di Palma's lump sum adjustment re imports	$2,754,035		$7,777,829
Re-allocation of general and administrative expenses for the period of 12 months preceding the bankruptcy	$3,873,858		$3,903,971
Adjustment re volume incentive rebates and advertising allowances for the period from February 1, 1994 to the end of November 1994		$370,144	$4,274,115
Interest paid by Peoples to T.D. on behalf of Wise Stores		$163,000[5]	$4,437,115

55 The final amount of Wise's debt to Peoples Inc. on the date of the bankruptcy is used as a yardstick by the trial judge to measure the liability of the Brothers. Their reckless disregard and failure to fulfil their fiduciary duty to Peoples Inc. was the source of this debt, the same source that, according to him, was the primary cause of the bankruptcy of Peoples Inc.

56 All parties appealed.

57 In file 500-09-007536-980, the Brothers sought the setting aside of the judgement in first instance, alleging that the judge erred in holding them liable.

58 For his part, while applauding the merits of the judgment in first instance the Trustee instituted a cross appeal and sought an increase in the damages. Like the trial judge, the Trustee recommended that adjustments be made to the estimate by the accountant Friedman but the ones they identify are all increases and have the effect of raising the amount of the debt to $27,967,995 an amount to which interest and the additional indemnity should be added.

59 Moreover, in a related file No. 500-09-007557-986, Chubb Insurance Company of Canada, the insurer of the Brothers, pleads the absence of coverage respecting any award based on section 100 BIA. It maintains that the wrongful acts, if any, were committed by the Brothers as shareholders and not as directors. Thus, according to the definition in the policy, coverage under the policy only extends only to actions taken by the latter.

ANALYSIS

60 The judgment rendered is clearly the result of serious thought and considerable and careful work. I point this out at the outset because, as one may note in the pages that follow, my

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[5] In the trial decision, a glitch made the sum of $163,000 appear in error in the debit column.

opinion on several questions raised by the appeal differs from that expressed by the trial judge and I would not wish in any way that a disrespectful criticism be read into them.

61 That being said and before undertaking a complete analysis of the two aspects of this matter, I feel it necessary to emphasize that the Superior Court, as well as the Trustee, recognized the good faith of the Brothers in adopting and implementing the new joint inventory procurement policy. The trial judge expressed himself as follows:

> We hasten to add that in the present case, the Wise Brothers derived no direct personal benefit from the new domestic inventory procurement policy, albeit that, as the controlling shareholders of Wise Stores, there was an indirect benefit to them. Moreover, as was conceded by the other parties herein, in deciding to implement the new domestic inventory procurement policy, there was no dishonesty or fraud on their part.

62 This good faith, which marks the transaction being challenged, has in this case great importance with respect to the conclusions I propose.

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

63 An examination of this matter calls for a review of certain basic principles of company law.

64 On the constitutional level, depending on the subject matter, the federal and provincial governments have jurisdiction to legislate in company law matters[6].

65 Companies incorporated under federal law, as in this case, are certainly subject to federal law, but also to provincial laws of general application[7]. In addition, in Quebec, the Civil Code plays a supplementary role respecting the operation of corporations created under federal law[8].

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

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6 M. and P. Martel, *La compagnie au Québec – Les aspects juridiques*, Montréal, Wilson et Lafleur Martel, 2002 at p. 3-1 and ff.

7 *Upper Churchill Water Rights Reversion Act*, [1984] 1 S.C.R. 297; *Multiple Access Ltd.* vs. *McCutcheon*, [1982] 2 S.C.R. 161; *Canadian Indemnity Co.* vs. *A.G. of British Columbia*, [1977] 2 S.C.R. 504.

8 Art. 300 C.C.Q.; *Nadeau* vs. *Nadeau,* [1988] R.J.Q. 2058 (C.A.) at p. 2065; *Westburne inc.* vs. *American Home Assurance Co.*, [2000] R.R.A. 380 (S.C.) at p. 386 and 387; G. Bertrand, "La responsabilité des administrateurs", in *Congrès annuel du Barreau du Québec (1994)*, Montréal, Service de la formation permanente, Barreau du Québec, at p. 901 to 903; C. Pratte, «Essai sur le rapport entre la société par actions et ses dirigeants dans le cadre du *Code civil du Québec*», (1994) 39 *R.D. McGill* 1 at p. 20 to 22.

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/RM, 1991 at p. 509 and ff.

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 subsection122(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.

67 This section sets forth the obligation of directors to act in the best interest of the corporation[10]. In the absence of a more precise definition of what is meant by «interests of the corporation», the carrying out of the objects for which the company was formed best describes this idea. In a general manner, the interests of the corporation overlap those of all the shareholders because carrying out the objects of the company constitutes in theory the reason for the joint investing of monies.

68 Assuming that the shareholders wish the objects of the corporation to be carried out, we can say that the wishes of the shareholders and the interests of the corporation normally coincide.

69 As a general rule, it is therefore not a mistake to draw a parallel between the wishes of all the shareholders and the interests of the corporation. Therefore, when the company avails itself of subsection 122(1) CBCA to challenge actions taken by former or present directors, the goal is usually the protection of the legitimate interests of all the shareholders with the purpose of carrying out the objects of the company.

70 There are two types of general duties set out in subsection 122(1): a fiduciary duty (paragraph a) and a duty of care (paragraph b).

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.

72 The «fiduciary duty» or «*devoir de loyauté*» does not relate to the quality of the directors' management but rather, to their personal behaviour. 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

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[10] *Cogeco câble inc.* vs. *C.F.C.F. inc.*, [1996] R.J.Q. 1360 (S.C.) at p. 1378, appeal dismissed upon motion (C.A.M. 500-09-002619-963); P. Martel, «Le fonctionnement interne d'une compagnie ou d'une société», in Collection de droit 2001-09, École du Barreau du Québec, vol. 9, *Droit des affaires, faillite et insolvabilité*, Cowansville, Yvon Blais, at p. 208 to 211; J. A. VanDuzer, *The Law of Partnerships and Corporations*, Toronto, Irwin Law, 1997 at p. 217.

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.

73 Paragraph 122(1) (b) defines the liability of directors in light of the quality of their decisions. Authors and the case law often refer to the obligation that the legislator has imposed by the term «duty of care» or «*devoir de gestion compétente*».

74 In applying the rules which result therefrom, the courts have traditionally recognized the difficulties of analysing *a posteriori* decisions made by directors in the heat of the moment. Their right to make mistakes has thus been recognized. Gonthier, J., when he was with the Superior Court, summarized the state of jurisprudence under the regime of the *Canada Corporations Act*[11], the statute which preceded the CBCA, as follows[12]:

> [Translation] It is useless to recall the restrictive liability that the courts have held directors to. They are not personally liable for the acts of the company unless they commit gross fault. It is accepted that directors must bring a fair and reasonable duty of care to management of the company and act honestly and no more, and it was decided that they need not have special knowledge.

75 In the wake of recommendations of the task force directed by Mr. Robert W.V. Dickerson, the federal government adopted the *Canada Business Corporations Act*[13] which a short time later became the CBCA. In its report, the Commission had recommended the tightening of directors' liability to avoid them being able to escape easily from any liability by the application of purely subjective criteria of the type set out in the British decision *In Re: City Equitable Fire Insurance Company Ltd*[14]. Therefore, with regard to the duty of care, the Commission had proposed the adoption of a text which reads as follows[15]:

> Art. 9.19(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall
>
> […]
>
> (b) exercise the care, diligence and skill of a reasonably prudent person.

76 The legislature did not use the recommendation of the Dickerson report in its entirety. It acted in a somewhat more timid fashion by adopting the following text:

> 117.1(1) [now 122(1)] Every director and officer of a corporation in exercising his powers and discharging his duties shall

[11] R.S. 1970, c. C-32.
[12] *Crevier* vs. *Paquin*, [1975] S.C. 260 at p. 265.
[13] S.C. 1974-75-76, c. 33.
[14] [1925] 1 Ch. 407.
[15] R.W.V. Dickerson, J. L. Howard and L. Getz, *Proposals for a New Business Corporations Law for Canada*, vol. II, Ottawa, Information Canada, 1971 at p. 74.

> […]
>
> (b) exercise the care, diligence and skill that reasonably prudent person would exercise in comparable circumstances.

77 Commenting on the text adopted by the legislator, one of the commissioners, John L. Howard, wrote in 1975[16]:

> The Courts have therefore been understandably reluctant to adjudge in retrospect that a policy error, even if it turned out to be an egregious blunder, entitled the affected corporation or its shareholders to seek compensation for the resulting financial loss. By indirection the CBCA continues this policy, expressly declaring duty of care standards but at the same time preserving the common law defences and setting out a number of provisions that go far to relieve directors and officers of the intolerable burden of being accountable for honest errors of business judgment.
>
> [emphasis added]

78 In short, in his view, the new law did not really change the extent of the duty of care of directors. This was also the opinion expressed by Robertson, J. of the Federal Court of Appeal in *Soper v. Canada*[17]. The following extract of his reasons respecting the scope of a provision of the *Income Tax Act* which is almost identical to paragraph 122(1)(b) CBCA, namely subsection 227.1(3) of the *Income Tax Act*, seems to me to perfectly set out the limits of the duty of care[18]:

> The standard of care set out in subsection 227.1(3) of the Act is, therefore, not purely objective. Nor is it purely subjective. It is not enough for a director to say he or she did his or her best, for that is an invocation of the purely subjective standard. Equally clear is that honesty is not enough. However, the standard is not a professional one. Nor is it the negligence law standard that governs these cases. Rather, the Act contains both objective elements – embodied in the reasonable person language – and subjective elements – inherent in individual considerations like «skill» and the idea of «comparable circumstances». Accordingly, the standard can be properly described as «objective subjective».

79 This then is the general liability that the CBCA imposes personally on directors.

80. It does not follow absolutely that the act makes the directors personally liable only towards the company. The law in fact does make them liable for ensuring that the company performs certain categories of obligations. This is the case in particular for the wages owed to

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[16] John L. Howard, «Directors and Officers in the context of the Canada Business Corporations Act», in *Meredith Memorial Lectures, Canada Business Corporations Act*, Toronto, Richard De Boo, 1975, p. 282 to 303.
[17] 149 D.L.R. (4th) 297 (F.C.A.).
[18] 149 D.L.R. (4th) 297 at p. 317 and 318 (F.C.A.).

employees[19] and for taxes owed to the state[20]. In addition, in Quebec, the Civil Code makes directors personally and generally liable towards third parties in four types of situations that professor Martel has well described in an article which appeared in the *Revue du Barreau*[21].

His words are cited with approval by our colleague Forget in *Lanoue* vs. *Brasserie Labatt Ltée*[22]:

> [Translation] The personal liability of an individual who is the majority shareholder and director of a company may be maintained in the following circumstances:
>
> - He has guaranteed a contractual obligation of the company;
>
> - He has himself committed a fault giving rise to his extracontractual liability, for example by making false representations or filing false documents;
>
> - He actively participated in an extracontractual fault of the company (this is assumed if he is the sole director);
>
> - He used the company which he controls as a screen, as a foil to try to camouflage the fact that he committed fraud or an abuse of right or he contravened a rule of public order; in other words, the apparently legitimate action of the company is, because he is the one who controls it and benefits from such act, fraudulent, abusive or contrary to public order.

81 In the case at bar, however, to hold that the Brothers are liable, the trial judge did not invoke any of these situations or the existence of any personal obligation resulting from a specific text of the CBCA He relied rather on the general «duty of loyalty» and «duty of care» and took it for granted that the Trustee was entitled to claim under those provisions. He thereby accepted the premise of the Trustee who alleges that the rights set out in subsection 122(1) CBCA belong to the company and that, accordingly, it, the Trustee, is successor to these rights as of the pronouncement of the receiving order.

82 For purposes of the discussion I wish to recognize the Trustee as successor to the rights in question.

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

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19 CBCA, s. 119.

20 *Income Tax Act*, R.S.C. 1985 (5th supp.), c. 1, par. 227(1).

21 P. Martel, «Le «voile corporatif» – l'attitude des tribunaux face à l'article 317 du Code civil du Québec», (1998) 58 *R. du B.* 95 at pp. 135 and 136.

22 (April 13, 1999), C.A. 500-09-001693-951 and 500-09-001739-952, J.E. 99-857 at p. 9.

liability under paragraph 122(1) (b) and that the adoption of the new joint inventory procurement system constitutes at most an «honest error of business judgment»[23].

84 With regard to the fiduciary duty, I would point out that the Brothers were only motivated by a desire to solve the problem of inventory management which affected the operations of both Peoples Inc. and Wise. This is therefore a motivation falling within the pursuit of the interests of the company within the meaning of paragraph 122(1)(a) CBCA and which does not lend itself to any justified reproach.

85 With respect to the duty of care, and with the greatest respect, the *a posteriori* analysis which gave rise to the liability which the trial judge and the Trustee imputed to them does not take account of the factual context in which the new policy was adopted. This analysis in particular overlooks the real difficulties faced by the two companies, the relatively pressing need to find a solution, the apparent logic of the one chosen, the fact that it was proposed by a person whose qualifications and abilities were already proven and the fact that its implementation received a positive reception from the buyers, i.e. the staff members most affected by the problem which had to be resolved.

86 In my opinion, assuming for the purposes of discussion that an *a posteriori* examination demonstrated that this new policy did not constitute a valid solution to the difficulties experienced, I believe that its adoption at the time satisfied the objective and subjective standards of care as defined in the *Soper*[24] decision.

87 I believe the Brothers acted in what they in good faith believed followed the corporate objects and they did not show negligent incompetence for which they could be held liable.

88 Furthermore, I believe that they could legally rely upon the defence prescribed by paragraph 123(4) (b) CBCA:

> 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.

89 The Brothers had in fact taken advice from Clément, their trusted man. He conceived the policy and recommended its adoption. In my opinion, the evidence supports without qualification the conclusion that the Brothers were in good faith in relying on the report of

[23] 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.
[24] *Soper* vs. *Canada*, 149 D.L.R. (4th) 297 (F.C.A.).

Clément, whose commerce degree and experience in the field of administration and finance for almost 15 years gave credibility to his statements.

90 Continuing in the traditional perspective, one can overlook with difficulty the fact that the sole shareholder, Wise, never considered that there might have been a failure in the duty that subsection 122(1) CBCA imposes on directors. The premise of the Trustee actually takes for granted the existence of an exceptional situation, because the company which relies on subsection 122(1) CBCA was not doing so to protect the legitimate interests of its sole shareholder with a view to achieving the objects of the company. Here, in the words of the Trustee, the company was doing so essentially to protect the interests of its creditors to whom, for the purposes of this case, the trial judge attributes the quality of stakeholder in the management of the company. This proposition may be articulated as follows: *constrained by the duties imposed on them by subsection 122(1)CBCA, the Brothers did not act in the best interest of the creditors of Peoples Inc., which was equivalent to not acting in the best interest of Peoples Inc*.

91 According to the trial judge, Canadian company law should evolve in that direction, which had already happened in several countries as the following opinion of judge Cooke of the New Zealand Court of Appeal[25] attests:

> The duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors. For instance creditors are entitled to consideration, in my opinion, if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.

92 It is useful firstly to note that the opinion in question constitutes an *obiter* in which his two colleagues on the bench did not concur.

93 Secondly, and with respect, I believe that in advocating the adoption of this theory under Canadian law, the trial judge encroached upon the powers of the legislator in that he established a general regime of liability of directors for the benefit of third parties who would be harmed by management decisions of directors. I am not inclined to follow him in this step.

94 In 1978, the Canadian statute underwent a complete reform without the legislator explicitly accepting the principle of general liability of directors toward third parties. I say apparently because such a change of direction when compared to traditional thinking would, in my opinion, require a clear and explicit text. One finds nothing of the sort in the statute which was adopted by Parliament[26].

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

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[25] *Nicholson* vs. *Permakraft (N.Z.) Ltd.*, [1985] 1 N.Z.L.R. 242 at p. 249 (N.Z.C.A.).
[26] *An Act to amend the Canada Business Corporations Act*, S.C. 1978-1979, c. 9.

Canadian Charter of Rights and Freedoms. It is worth remembering, however, that it is only by exception that courts are called upon to modulate the rules of law, or even to create them, since their fundamental role consists rather in applying them and sanctioning the intent 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.

97 Before our court, the Trustee made a slightly less restrictive argument by relying upon the impending bankruptcy to justify the creation of an interest of the creditors in the management of the company. At this stage I believe it useful to reproduce the excerpt of a judgment of the United Kingdom invoked by the trial judge and on which this thesis rests[27]:

> But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.

98 I have great reluctance in associating the rights of creditors with those of shareholders, even when bankruptcy is imminent. I note in passing that the assets of the company are not those of the shareholders, even on a practical level, and I find it difficult to understand why they would later become more so those of the creditors simply because of the possibility of bankruptcy. The pronouncement contained in this excerpt therefore appears to me at first sight to have an excessive reach in Canadian law, although I can conceive that the interests of creditors in the manner in which directors manage the company may grow with the imminency of bankruptcy.

99 The words of Major, J., speaking on behalf of a unanimous Supreme Court in *373409 Alberta Ltd. (Receiver of)* v. *Bank of Montreal*[28], does not seem to me to leave much room for the establishment in Canadian law of the thesis of the interests of creditors in the management of a company. In that case, the sole director and shareholder of a company, a Mr. Lakusta, had diverted funds intended for his company for the benefit of another, called Legacy. At issue was whether the legitimacy of his act with regard to the participation of the bank constituted fraud in the opinion of the receiver. Mr. Justice Major[29]:

> In this appeal, Lakusta's diversion of money from 373409 to Legacy may very well have been wrongful *vis-à-vis* the corporation's creditors. However, Lakusta's action was not in fraud of the corporation itself. Since Lakusta directed the funds into Legacy's account with the full authorization of 373409's sole shareholder and director, being himself, that action was not fraud in respect of 373409.

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[27] *Liquidator of West Mercia Safetywear Ltd.* vs. *Dodd & Anor*, (1988) 4 B.C.C. 30 at p. 33 (C.A.).
[28] 2002 SCC 81.
[29] *373409 Alberta Ltd. (Receiver of)* vs. *Bank of Montréal*, 2002 SCC 81, p. 22.

100 As is the case here for the Trustee, the receiver was trying to assert rights belonging to the company. The Supreme Court held that, even in the presence of an apparently fraudulent act against the creditors, the company could not blame its director for anything because there was no fraud with respect to the sole shareholder. The receiver's claim was dismissed accordingly.

101 I believe that an identical solution is warranted in this case.

102 To attack the action taken by the Brothers, the Trustee had at its disposal the specific remedies granted to it under the BIA, in particular those prescribed by section 100 BIA.

103 In basing itself on a remedy under subsection 122(1) CBCA, the Trustee chose to exercise a recourse belonging to the bankrupt, i.e. Peoples Inc. itself. This latter could not, in my opinion, repudiate the adoption of the joint inventory procurement policy after having accepted it in full knowledge. Such an acceptance is inferred from the behaviour of Wise, the holder of all the shares of Peoples Inc.

104 In addition to these considerations, the theoretical nature of the argument of the Trustee convinced me to set it aside in the case before us. The actions which were said to be detrimental to the creditors in fact consisted in the adoption and implementation of the joint inventory procurement policy. It was adopted in November 1993 and implemented in February 1994, two periods during which the prospect of bankruptcy was not foreseen by anyone. In short, the theory of transferring the interest of shareholders to the creditors because of an impending bankruptcy finds no real reflection in the facts which gave rise to the dispute which must be decided.

105 In conclusion, I cannot subscribe to the general thesis proposed in the judgment of the Superior Court and I reject that put forward by the Trustee because it is not relevant to the facts in this case.

106 Having come to the conclusion that the Trustee erred in relying upon the rights set out in subsection 122(1) CBCA, I do not, strictly speaking, have to address the analysis that the trial judge made of the extent of the obligations of directors towards Peoples Inc., as he saw it as a legal entity. However, I must express significant reservations arising out of certain inferences he draws from the authorities cited in support of his finding which tend, generally speaking, to disassociate the interests of the company from those of the shareholders taken as a whole and in the context of achieving the goals of the company.

107 Certain of these reservations relate to the interest that the trial judge recognizes for creditors in the conduct of the business of companies, a subject I have just discussed.

108 Others flow from what the trial judge seemed to me to have minimized, or even set aside—the fact that all the shares of Peoples Inc. were held by Wise. Such a context eliminates the possibility of dissenting voices among the shareholders. Accordingly, all the authorities dealing with the role of directors in not closely-held companies are from the outset not applicable

in this case to the extent that they emphasize the failure of the duty of directors to take into account the interests of all the shareholders or groups of shareholders.

109 Finally, along the same lines, I note that the judgment in first instance tends to assimilate the remedy arising out of subsection 122(1) CBCA to that contemplated by section 241 CBCA, better known as the oppression remedy. The trial judge made this comparison as part of his comments on *Westfair Foods Ltd.* vs. *Watt*[30]. With respect, I consider that the comparison is inappropriate, the oppression remedy being one which calls upon the notion of equity, which covers a much broader range of situations than the notions of fiduciary duty and duty of care dealt with by subsection 122(1) CBCA

110 Lastly, I note that the trial judge set aside the reservation which, at the relevant time, the CBCA specifically provided to legitimize the financial aid which a wholly-owned subsidiary could give to its parent company:

> 44.(1) Subject to subsection (2), a corporation or any corporation with which it is affiliated shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise
>
> […]
>
> (2) A corporation may give financial assistance by means of a loan, guarantee or otherwise
>
> […]
>
> (c) to a holding body corporate if the corporation is a wholly-owned subsidiary of the holding body corporate;
>
> […]

111 To do this he relies on the judgment rendered in *Primex Investments Ltd.* vs. *Northwest Sports Enterprises Ltd.*[31], in which Tysoe, J. wrote[32]:

> The fact that the transaction complied with Policy Statement 9.1 of the Ontario Securities Commission is of little moment. The Policy Statement is directed at matters of securities law, not transfers of assets by a company. Compliance by the directors with securities law does not necessarily mean that they have complied with all of their duties.

112 The judge extrapolates in these words:

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[30] (1990) 73 Alta. L.R. (2d) 326 (Q.B.).
[31] (1995) 13 C.B.L.R. (3d) 300 (S.C.)
[32] (1995) 13 C.B.L.R. (3d) 300 at p. 323 (S.C.)

> We can easily substitute «Section 44(2)(c) CBCA» for «Policy Statement 9.1 of the Ontario Securities Commission». Hence, compliance by the directors with Section 44(2)(c), or more correctly, acting as permitted therein, does not necessarily mean that they have complied with all their duties. Here they did not.

113 With the greatest respect for the contrary opinion, I believe that this extrapolation is unfounded. One can easily accept that the simple fact of satisfying the requirements of another statute than the CBCA, originating from another level of government, in this case the Ontario provincial legislator, does not necessarily mean that the directors have also met the general duties imposed on them by the CBCA. But, in this matter, it is the CBCA itself that legitimizes the financial assistance which Peoples Inc. gave Wise Stores, which assistance is precisely the object of the Trustee's criticism of the former directors.

114 In short, I believe that we must presume that the legislator is consistent when it enacts a statute such as the CBCA and that it does not consider having a company do something that it expressly authorizes to be a failure to meet the general duties it imposes on the directors. Even if we accept the premise that a financial benefit resulted from setting up the joint domestic inventory procurement policy, I believe that the Brothers did not fail in these duties when they had Peoples Inc. do this in good faith and without any dishonest or malicious intent.

115 On the whole, I am therefore of the opinion that the Superior Court erred in finding that the Brothers were liable towards the Trustee in bankruptcy of Peoples Inc. under subsection 122(1) CBCA. This conclusion thus leads me to examine the analysis carried out from the point of view of the BIA.

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

116 Are there grounds for finding against the Brothers personally under the *Bankruptcy and Insolvency Act*? This is the opinion of the trial judge who, subsidiarily, renders a decision on this issue.

117 From the outset, all the parties agreed that the Brothers, Wise and Peoples Inc. are not dealing at arm's length among themselves. In the middle of the controversy is the joint inventory procurement policy, of which the adoption implementation and application constitute, according to the Superior Court, a reviewable transaction within the meaning of subsections 3(1), 4(1) and 4(2) BIA. The trial judge writes:

> Hence, they are presumed not to be dealing among themselves at arm's length and, accordingly, the understanding to put into effect the new domestic inventory procurement policy as at the start of the January 1995 fiscal year and maintaining it in operation until the effective date of the bankruptcy of Peoples and Wise Stores is a reviewable transaction. Also, it all occurred within 12 months of the date of the bankruptcy of Peoples. That being the case, it follows that section 100 has its full application in the case at bar.

118 I would again point out that, throughout the entire process, the good faith of the Brothers was not questioned.

119 The outcome of the case depends on the application of subsections 100(1) and 100(2) BIA, which it would be useful to quote:

> 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.

120 For all the parties, the majority opinion of the Ontario Court of Appeal in *Standard Trust Co. Ltd*.[33] adequately summarizes the scope to be given to these provisions. It is clear that the judge who is asked to rule on the Trustee's claim has a double discretionary power. The first, under subsection 100(1), allows him to review the transactions made by the bankrupt within the 12 months before the date of his bankruptcy. The purpose of this inquiry is to determine whether the bankrupt, Peoples Inc. in this case, received fair market value for the property and services it sold to Wise.

121 The coming into play of the second discretionary power depends on the result of the inquiry conducted under subsection 100(1). When it appears that the value of the consideration given or received by the bankrupt is conspicuously greater or less than the fair market value, the court may, under subsection 100(2), give judgment against the other party to the transaction, or against any other person being privy to the transaction, to pay the Trustee the difference these two values.

122 I would say at this point, and with the greatest respect, that I do not agree with the manner in which the trial judge applied the law to the facts of the case. I believe that he artificially isolated certain elements of the transaction that he deemed reviewable, which had the result of falsifying the basis for his appreciation of the value of the consideration received by Peoples Inc.,

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[33] (1995) 36 C.B.R. (3d) 1 (Ont. C.A.).

and hence the actual difference between such consideration and the fair market value. In other words, the trial judge did not take into consideration all the transfers which Peoples Inc. and Wise had made in implementing the new joint inventory procurement policy. Wrongly, in my opinion, he only took into consideration purchases made in the fall of 1994 for which Peoples did not receive payment.

123 Finally, I believe, with all due respect for his opinion, that the judge did not properly interpret or apply subsection 100(2) when the time came to decide whether there should be a judgment against «any other person being privy to the transaction with the bankrupt».

(a) Identification of the considerations given under the new joint inventory procurement policy

124 As rightly noted by Appellant Chubb, the policy in and of itself did not result in disbursements or the providing of a service. It only served as a framework for other transactions which themselves gave rise to an obligation to supply, on the one hand, and to pay, on the other. In addition, it occurred in a context of the integration of the operations of the parent company and its subsidiary, when real problems had to be solved and Wise provided Peoples Inc. with all administrative and management services. Essentially, the policy provided:

- that as of February 1994 and for both companies, Peoples Inc. would do all the so-called domestic purchasing;

- that Wise would do that same with respect to purchasing on the so-called foreign markets;

- that each company would reimburse at cost the purchases that the other company made for it.

125 Since it only generated obligations to do which were met by both parties, Chubb suggests that this agreement should not be reviewable. I do not share this opinion and prefer that expressed by the attorney for the Brothers according to which, since all the transfers governed by the policy took place within the framework of the ongoing operations, the consideration received should be appreciated as a whole. This is why, among other things, the trial judge should not have concentrated all his attention on the transactions for which Peoples Inc. did not receive any consideration and forgotten about the entirety of the services provided on both sides. He writes on this point:

> The account receivable by Peoples from Wise Stores was neither collected nor collectible and it was the cumulative total of those receivables which comprised the interco and which constituted the prejudice suffered by Peoples as a direct consequence of the new domestic inventory procurement process.

126 Contrary to what one might understand from this excerpt, the trial judge does not in fact take account of the cumulative total of the accounts receivable and the consideration received. In fact, nowhere in the judgment in first instance is it stated that if, in applying the joint inventory

procurement policy, Peoples Inc. transferred property of a value of $71,543,059, it also received from Wise $59,499,749 in property or cash. Thus, when Wise stopped making payments, because it was bankrupt, it had already provided consideration representing more than 83% of the value of the property which Peoples Inc. had transferred to it. This is why the statement that the accounts receivable by Peoples Inc. from Wise «were neither collected nor collectible» is unfounded. From this point of view, the judgement rendered appears to me to be affected by a manifest and overriding error[34].

127 In fact, the entire balance of the debt of Wise towards Peoples Inc. is explained by the significant volume of purchases made after September 1994, leading up to the period of commercial effervescence culminated by the arrival of the Christmas and New Year's holidays. There is no doubt that these purchases were made with a view to the ongoing operations of both companies. It was the bankruptcy brought about by M. & S. which is the initial cause of the stopping of payments at a time when the high inventory acquired by Wise had not yet been sold or paid for.

128 To determine the actual difference between the consideration given by each side, one must refer to the adjustments which the trial judge carried out, which showed the existence of an unpaid balance of $4,437,115 owed by Wise.

129 A debt of this size between related companies justified the Superior Court's inquiry at the request of the Trustee in accordance with the powers given to it under subsection 100(1) BIA. I also believe that the trial judge was right to hold that Peoples Inc. had not received fair market value when the bankruptcy occurred.

130 I do not believe, however, that the facts in this case support the conclusion that Peoples Inc. did not receive any consideration and that, accordingly, *«the requirement of section 100 BIA that the consideration received by Peoples in the reviewable transaction be «conspicuously less» than the fair market value of the property and/or services concerned in the transaction, is more than met, [...]».* Once again, the evidence shows that Peoples Inc. received more than $59 million for sales totalling $71 million and that, after adjustments which take into account in particular the interest paid by Peoples Inc. on behalf of Wise, the debt was only $4.4 million at the time of bankruptcy.

131 Along the same lines, a difference of just over 6% between the fair market value and the consideration received does not appear to me to meet the definition of «conspicuously less» (*manifestement inférieure*) used by the legislator in subsection 100(2) BIA. On this point, I adopt the interpretation put forward by Jacques, J., then of the Superior Court, in *Re Pacific Mobile Corporation*[35]:

> [Translation] The word «conspicuously», or in French «*manifestement*», means in the context «striking» or «notable», or «de façon criante ou flagrante».

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[34] See *Housen* vs. *Nikolaisen*, 2002 SCR 33.
[35] *Re Pacific Mobile Corporation; Robitaille* vs. *Les Industries l'Islet inc. and Banque canadienne nationale,* (1980) 32 C.B.R. 209 at p. 235 (Que. S.C.).

132 Thus, in my opinion, the facts revealed by the evidence did not justify the Superior Court exercising the power conferred under subsection 100(2) BIA to give judgment to the Trustee for «the difference between the actual consideration given or received […] and the fair market value».

133 But, even supposing that the value of the consideration provided by Wise under the challenged transaction was conspicuously less than the fair market value, was that grounds for a personal judgment against the Brothers? With respect, I don't believe so either.

(b) Interpretation and enforcement of subsection 100(2) BIA

134 It is important to keep in mind that it was Wise that, as co-contracting party with Peoples Inc., would, to the first degree, be subject to a judgment against it under subsection 100(2) BIA. The personal liability of persons other than the co-contracting party, in this case the Brothers, depends on an additional analysis which, in my opinion, must allow us to give an affirmative answer to two questions:

- Did the persons other than the co-contracting party have an interest in the transaction?

- Is the rendering of a judgment ordering the reimbursement of the difference between the consideration received by the bankrupt and the fair market value of that provided by the bankrupt, justified in equity?

135 In the circumstances of this case, I believe that the answer to both of these questions must be in the negative.

136 Firstly, it is far from evident that the Brothers had an interest in the transaction within the meaning of subsection 100(2) BIA. The legislator seems to me to have wanted to cover the case where it is a person other than the co-contracting party with the bankrupt who in fact receives all or part of the benefit resulting from the lack of equivalency between the respective considerations. Such an interpretation is in keeping with that retained by the Nova Scotia Court of Appeal in *Clarkson Co. Ltd.* vs. *White*[36]. It is also in harmony with the opinions expressed by Doherty, J., dissident, but with respect to different issues, in *Standard Trust Co. Ltd.*[37]:

> […] it (s. 100 BIA] is designed to «balance the books» as between the bankrupt, who suffered the loss, and the other party or parties, who received the benefit.

137 The trial judge attributed to the same terms a broader meaning which encompasses any person having knowledge of the transaction or participating in it. In this he based himself on one of the meanings which may be derived from the English version of the text, which uses the words «*any other person being privy to the transaction with the bankrupt*».

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[36] (1979) 32 C.B.R. 25 (N.S.C.A.).
[37] (1995) 36 C.B.R.. (3d) 1 at p. 12 (Ont. C.A.).

138 The word «privy» can be given the meaning retained by the trial judge, but it can also mean «a person having a part or interest in any action, matter or thing»[38].

139 I believe that to harmonize the English and French versions, we must favour this latter meaning and therefore limit the scope of the provisions only to those people who derive a benefit from the challenged transaction.

140 In this case, the Brothers were not personally involved in the transaction and did not receive any direct benefit. The indirect benefit associated with their capacity as shareholders of Wise is clearly too far removed here to be taken into account.

141 It therefore seems to me that the Brothers did not meet the definition of person «privy to the transaction with the bankrupt» within the meaning of subsection 100(2) BIA. In all logic, such a finding shelters them from liability under this provision.

142 But, were things different, there would still be no reason to hold them liable, as a result of the simple exercise of the discretionary power given to the Court under the same subsection. Speaking on behalf of the majority about the conditions for the judicial exercise of the discretion in question, Weiler, J. of the Ontario Court of Appeal expressed an opinion in which I fully concur[39]:

> When a contextual approach is adopted it is apparent that although the conditions of the section have been satisfied the court is not obliged to grant judgment. The court has a residual discretion to exercise. <u>The contextual approach indicates that the good faith of the parties, the intention with which the transaction took place, and whether fair value was given and received in the transaction are important considerations as to whether that discretion should be exercised</u>.
>
> (Emphasis added)

143 To properly exercise the discretionary power contemplated by subsection 100(2) BIA, we must therefore place the challenged transaction in context, assess how it was carried out and carefully review the actions and intentions of the various participants in the matter.

144 In this case, the basis for the discretionary holding appears tenuous and certainly does not take into account all the factors developed by Weiler, J. in *Standard Trustco*[40]. The reasons of the trial judge are summarized in the following paragraphs:

> Taking into account, among the other considerations described in the Standard Trustco Case, that here there was no «fair value» given or received, we have determined that we should exercise our discretion, both under section 100(1) and section 100(2).

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[38] The *Concise Oxford Dictionary of Current English*, 9th ed., s.v. «privy».
[39] *Standard Trustco* vs. *Standard Trust Co.*, (1995) 36 C.B.R. (3D) 1 at p. 24 (Ont. C.A.).
[40] *Standard Trustco* vs. *Standard Trust Co.*, (1995) 36 C.B.R. (3D) 1 at p. 24 (Ont. C.A.).

> Again, the three Wise Brothers being the only directors of Peoples and having made the decision to institute as of February 1, 1994 and then to pursue and continue the new domestic inventory procurement policy right up to the day of the Bankruptcy of Peoples, renders each of them privy to the transaction.
>
> The Court, again taking into account those same considerations described in the Standard Trustco, has decided that it should exercise its discretion under section 100(2) BIA insofar as the individual Respondents, each of whom was privy to the transaction in question.

145 As we can see, the judge began by saying that there was no «fair value» received by Peoples Inc. He refers here to his previous finding of the total absence of consideration, about which I have already expressed the opinion that it was tainted by a clear and manifest error. The undisputed proof reveals that, for the inventory items it purchased on behalf of Wise from February to December 1994, Peoples Inc. received consideration, the total value of which approached the fair market value.

146 Secondly, the trial judge only reiterated that the Brothers adopted and kept in place up to the bankruptcy a policy which he already said was the primary cause of the bankruptcy:

> On the basis of all the evidence, we find that it was the interco, almost totally the result of the new domestic inventory procurement policy, which caused the demise of Peoples.

147 At this stage, we cannot fail to question the accuracy of this affirmation. Although it does not have a direct effect on the outcome of the case, at first glance, this perception of the fundamental cause of the bankruptcy of Peoples Inc., influenced , I believe, the entire process which led the trial judge to the decision of liability.

148 With all due respect, I believe that this perception does not agree with the truth as revealed by the evidence. The analysis which led the trial judge to attribute the cause of the bankruptcy to the implementation of the new policy in fact disregards several determinant factors, identified here and there in the judgement. The main ones are the following:

- Peoples Inc. is a company which, under the management of M. & S., had annual losses of $10 million;

- The purchaser, Wise, who henceforth would control the destiny of Peoples Inc., is an under-capitalized business;

- The sale contained very restrictive financial conditions for Wise's management. Intended to force Wise to call upon new sources of financing, they considerably limited the room to manoeuvre of both companies until the debt of M. & S. was paid;

- The integration of the operations of Peoples Inc. raised serious inventory management problems;

- Peoples Inc. continued to operate at a loss under Wise's management, the profits from the first year being completely artificial;

- At a particularly bad moment for them, Peoples Inc. and Wise were led kicking and screaming into a ferocious commercial war with the giant Wal-Mart;

- The sales figures of the two companies were constantly deteriorating.

149 The starting point presented in this case showed that, to avoid serious financial difficulties, Wise had to make the operations of Peoples Inc. go from showing a deficit to profitable within a very short time after the acquisition. In other words, Wise did not have the internal strength to support a lame duck such as Peoples Inc. for long. Annual deficits of such a size, $10 million, might be absorbed within the overall operations of M. & S., whose sales volume of $20 billion annually allowed it to absorb the impact without too much worry. Wise, with its proportionally modest sales volume of $100 million, its under-capitalization and its lack of liquidity, obviously did not have the same leeway.

150 Also, and I say this with all due respect, I do not see how the trial judge could say with accuracy that, given all the evidence, the inter-company debt was the fundamental cause of the bankruptcy.

151 On December 9, 1994, Wise only owed $4.4 million, according to the assessment of the trial judge, and this debt did not have any influence on the cash flow of Peoples Inc., since this latter still had time to pay the suppliers' accounts.

152 In addition, both Peoples Inc. and Wise operated at a loss and watched their sales volume plummet. In a context of a price war, in the short-term there was little hope that the situation would correct itself.

153 In reality, it was the presence of that financial climate which was particularly unfavourable to the two companies that led to their decline and it was M. & S. that, to protect its own interests, sounded the alarm in December, judging rightly or wrongly that the situation of Peoples Inc. would only get worse with time. It is crystal-clear that the bankruptcy occurred at the most favourable time for M. & S., when inventory was high and the suppliers unpaid. Furthermore, M. & S. recovered all of the balance owing on the sale price as well as almost all its other debts.

154 Such a conclusion as to the actual cause of the bankruptcy seems to me to be more supported by the evidence than that drawn by the Superior Court. It places in a different perspective the fault which the adoption of the new joint inventory procurement policy allegedly constitutes, for which policy the trial judge reproached the Brothers.

155 In exercising his discretionary power to find against them, the trial judge does not take account of the fact that the Brothers did not receive any direct benefit from the challenged transaction, that they were in good faith and that their true intention was to find a solution to the

serious inventory management problem facing each of the companies. Because of an error of appreciation, he also ignores the fact that Peoples Inc. received substantial consideration for the assets it delivered to Wise. Finally, I note that 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.

157 In view of the conclusions which I have reached, it is not necessary to discuss at greater length the issues involving the size of the adjustments which the trial judge made and which allowed him to determine the amount of the debt of Wise to Peoples Inc. on the date of the bankruptcy. I would simply indicate in this regard that the Trustee did not convince me of the presence of manifest and overriding errors by the trial judge which would have led me to review the conclusions drawn in this respect.

158 It is also unnecessary to review the grounds of appeal which are specific to Chubb.

159 In closing, I would like to point out the high quality of work of all the attorneys in the file. Their respective contributions proved to be up to the complexity of the case and of the carefully rendered decision of the Superior Court.

160 With respect to costs, the Appellants did not raise any ground which would lead me to disregard the rule in 197(3) BIA, especially since the proceedings were authorized by the inspectors and a judge considered them sufficiently serious to allow them. Under the circumstances, I consider that there is no reason to order the Trustee to pay the costs personally.

161 In conclusion, I propose that the appeal of the Brothers Lionel, Harold and Ralph Wise and that of Chubb Insurance Company of Canada be allowed, that the cross-appeals of Caron, Bélanger, Ernst & Young Inc. be dismissed, the whole with costs, that the decision in first instance be set aside and that the amended motion of the Trustee to recover funds of which the bankruptcy of Peoples Department Stores Inc. were allegedly deprived be dismissed.

(s) François Pelletier
FRANÇOIS PELLETIER, J.C.A.